Q1 24 MULTI-SECTOR FIXED INCOME

MARKET REVIEW AND OUTLOOK

Newfleet ASSET MANAGEMENT
A Virtus Investment Partner

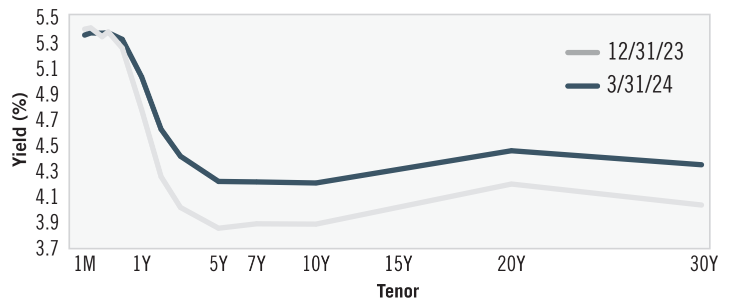
Confidence that the U.S. economy and much of the rest of the global economy had avoided central bank-induced pain remained high during the first quarter. Consensus among strategists and economists on Wall Street is that the Federal Reserve (Fed) has pulled off the elusive soft landing, with more than a few even suggesting there wasn't much of a landing at all. While economies slowed around the globe and geopolitical events remained top of mind, central bankers appeared close to declaring victory over the inflation that has ravaged the landscape since the pandemic. While more recent data suggests that the "last mile" of the inflation fight will be bumpy, the Fed continues to signal that cuts are coming later this year. Most risk markets have rejoiced at the Goldilocks environment of slowing inflation, low unemployment, resilient earnings, and economic growth that has outperformed expectations. We are optimistic that we have seen the peak in interest rates this cycle. However, we caution that monetary policy acts on the economy unpredictably and with variable lags, so we will pay close attention to the incoming data in the weeks and months ahead.

Few positive developments have occurred in the parts of the world that remain plagued by conflict. Though the financial markets have largely discounted day-to-day developments, they still bear monitoring as further escalation could disrupt the improving global inflation picture. Political activity will ramp up as we move through 2024, with research from Wall Street showing that the year will see the largest proportion of the world population in history head to the polls.

We have seen significant progress on headline inflation readings as supply chains healed, demand shifted from goods to services, and energy prices rebalanced. While still stubbornly above targets, core inflation readings are annualizing towards levels consistent with central bank goals. 2024 will likely deliver policymakers' first interest rate cuts across developed markets. However, they will be desynchronized. The above will likely create interesting opportunities for investors in the coming quarters.

With the positive economic tone, fixed income sectors turned in mixed total returns as interest rates increased. Spread sectors outperformed U.S. Treasuries, and spreads tightened. Within spread sectors, shorter duration and risk asset classes outperformed. The U.S. Treasury curve shifted higher and further inverted along most of the curve. The 2-year Treasury yield increased 37 basis points (bps), the 5-year Treasury yield increased by 37 bps, the 10-year Treasury yield increased by 32 bps, and the 30-year Treasury yield moved 32 bps higher.

U.S. TREASURY YIELD CURVE



Source: Bloomberg LP. As of March 31, 2024.

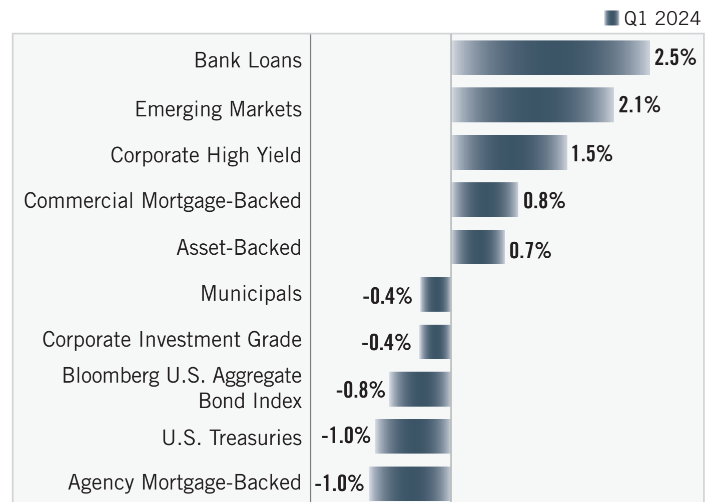
We continue to see value being restored across most of the fixed income sectors in which we invest. Yields remain elevated, and bond prices are broadly discounted. We expect the Fed to successfully return inflation to acceptable levels over time. We continue to watch data releases to inform our views on the global economic trajectory.

As the markets digest economic and geopolitical developments, we continue to believe active sector and issuer selection is critical to take advantage of market volatility as it arises. Our approach to fixed income—the approach we have implemented for over three decades—enables us to scan the bond market for the most attractive investment opportunities and is, in our view, ideally suited for the current environment.

FIXED INCOME SECTOR PERFORMANCE

Spread sectors posted mixed total returns during the period.

FIXED INCOME SECTOR PERFORMANCE



Past performance is no guarantee of future results. Performance as of March 31, 2024. Sources: J.P. Morgan: Emerging Markets (EMBI Global); Bloomberg U.S. High Yield 2% Index: Corporate High Yield; Credit Suisse: Bank Loans; Bloomberg Municipal Bond Index: Municipals; Bloomberg U.S. Aggregate Bond Index: All other sectors.

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The following sections reflect the views of the individual sector specialists.

TAX-EXEMPT MUNICIPAL BONDS

Following the move higher in rates in 1Q, municipals finished with a negative return but dramatically outperformed Treasuries. With this move, municipal/Treasury ratios were marginally higher in the 2-, 5-, and 10-year spots, though slightly lower for the 30-year, making munis generally more attractive versus Treasuries on a quarter-over-quarter basis.

The broader municipal bond market, as represented by the Bloomberg Municipal Bond Index, returned -0.39% for the quarter. The 1-year performed the best, followed by the 15-year. The worst-performing part of the curve was the long bond, followed by the 10-year. Yields were significantly higher by quarter end, increasing more in the short end and resulting in a flatter yield curve.

We ended the quarter at $102 billion in issuance—the highest level since 2007. In January, volumes rose by 49% year-over-year to $32 billion. In February, volumes rose by 57% to $32 billion, and in March, volumes rose by 17% to $38 billion. According to Lipper, mutual funds saw $6.3 billion in inflows, while ETFs saw $100 million in outflows. This has helped the market digest a significant amount of supply without causing underperformance.

Reversing the prior quarter's trend, credit spreads tightened in 1Q. The yield differential between the BBB Municipal Index and the AAA Municipal Index went from 124 bps at the end of December to 96 bps at the end of March. The spread between high yield and investment grade munis was also tighter, with the differential at 201 bps at the end of March, down from 235 bps at the end of December.

Outlook: Overall, the municipal bond sector remains well-positioned as we enter the second quarter. Credit quality remains high, and yields remain above their five-year average levels. Munis are highly defensive in a recession scenario and should maintain high credit quality given the strong positioning of many credits.

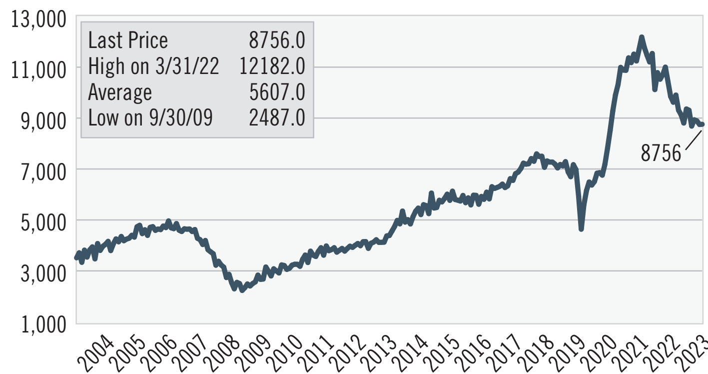
SECURITIZED PRODUCT

We witnessed tremendous demand for securitized risk assets as investors chased yield during the quarter. Even the much-maligned commercial mortgage-backed securities (CMBS) sector, whose valuations lagged behind its corporate counterparts last year, saw increased investor interest. Asset-backed (ABS), CMBS, and residential mortgage-backed (RMBS) securities spreads rallied dramatically amid the growing prospect of a soft landing, more than offsetting the rise in interest rates to produce positive total returns of 0.49% for ABS and 0.91% for CMBS. Within these sectors, deeper credit risk and non-mainstream assets produced returns that outperformed the Bloomberg Agg. On the other hand, MBS's negative performance of -1.04% was driven by interest rate volatility and the lack of new buyers.

From a technical perspective, new issue supply was strong across the board for ABS, CMBS, and RMBS during the quarter. ABS supply was up 45%, CMBS supply was up 164%, and RMBS supply was up 50% ahead of last year's pace. The dramatic CMBS supply increase builds off last year's paltry issuance of $7.3 billion for private label CMBS. However, the dramatic increase in ABS and RMBS did not deter investor appetite for structured products.

Though the trend of consumer fundamentals has been weakening, unemployment (3.9%) remains near all-time lows, job openings data is strong (see below), employment wage growth (4.2%) is nearly double the pre-pandemic growth rate, housing data remains robust, and the stock market is at all-time highs. The offset to this has been stubborn inflation data and delinquencies/defaults running near all-time highs for lower-scoring FICO borrowers. However, lending standards significantly tightened for lower-scoring FICO borrowers in 2023, which should translate into better fundamental performance in 2024.

U.S. JOB OPENINGS

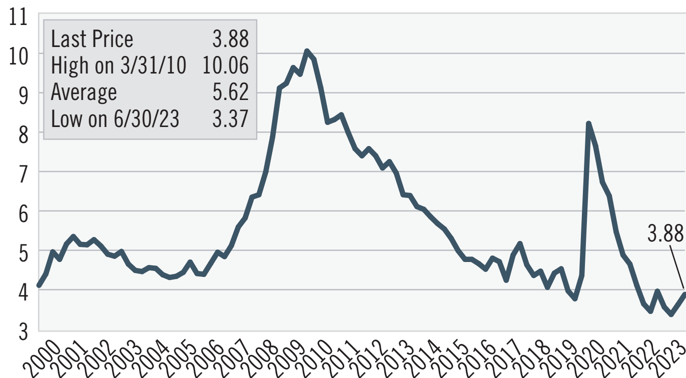


Source: Bloomberg LP. Data through February 29, 2024.

Mortgage credit fundamentals are still very solid as the housing sector continues to perform despite affordability headwinds from higher rates. Within the residential housing market, national HPA projections for 2024 are still projected to be flat to positive, and only 2% of mortgaged properties have negative equity. The monthly supply of existing homes is also historically low, creating a floor for potential price declines as mortgage delinquency rates remain near all-time lows. The first quarter was negative from an agency MBS

index price level, while non-agency RMBS continues to produce positive returns. High levels of homeowner equity and stringent underwriting continue to support the asset class's credit performance.

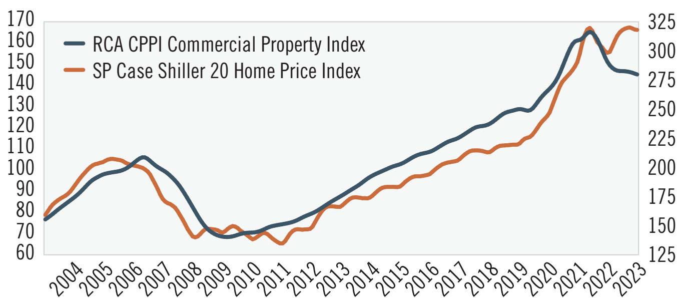
MORTGAGE BANKERS ASSOCIATION NATIONAL DELINQUENCY SURVEY



Source: Bloomberg LP. Data through December 31, 2023.

On the other hand, the CMBS sector is still facing challenging headwinds, with Real Capital Analytics reporting that commercial real estate (CRE) has depreciated 12% from its peak in June of 2022. (Note: Data points provided by Real Capital Analytics are based on repeat sales). The primary drivers for the revaluations include a supply/demand imbalance for apartments, the work-from-home phenomenon, slowed consumer spending, and the 10-year Treasury rate rising almost 300 bps since 2021. Due to the lack of CRE turnover, there has been less asset price transparency. However, during the first quarter, we did see the CRE market thawing as several properties changed hands, albeit at significant discounts. We believe equity sponsors' stage of grief is reaching the fifth stage —acceptance. As a result, we should see more CRE transactions in 2024 versus 2023. The CMBS market is forward-looking, and the significant rally in credit spreads this month indicates that losses within CRE will not be as high as the market expected in 2023. That said, valuations are contingent on the cost of capital and, therefore, cooling inflation, so the prospect of lower rates should benefit CRE in the long run.

REAL ESTATE PRICES



Source: Bloomberg LP, Real Capital Analytics National All Property Index. Data as of March 31, 2024.

Outlook: The yield opportunities we discussed last quarter still exist today, though credit spreads versus risk-free assets have compressed. In addition, the credit curve continues to collapse. In other words, the additional spread awarded to investors to take additional credit risk has shrunk. In ABS, investors were comfortable putting on levered consumer risk during the quarter, as indicated by the level of interest in new issue transactions. Non-agency RMBS and its diverse opportunity set still appear undervalued, given its risk-return profile and favorable technical setup. Agency MBS offers average entry points versus investment grade corporate debt. Within the CRE market, the mezzanine tranches tightened materially during the quarter as investor sentiment around CRE turned positive. With the dramatic collapse of the credit curve, our investments have moved up the ratings scale, as we believe any exogenous event will negatively impact subordinate bonds. This positioning will allow us to take advantage of credit spread dislocations in the future.

INVESTMENT GRADE CORPORATES

Spreads ground tighter to one-year lows in the first quarter while rates moved yields upwards to 5.30%. Total returns were negative, though excess returns were positive. Valuations are difficult, and compression trades are becoming harder to find. Overweights to BBBs and financials have worked and continue to be among our favorite trades, but the scope for outperformance is becoming more limited. While aggregate spreads remain wide of the June 2021 tights, industrials, long bonds, and AAA/AA bonds are tighter. While spreads are arriving at historically uncomfortable levels, absent a shock, it is hard to identify what knocks the current trajectory off-course.

Technicals were in the driver's seat for much of the quarter, with robust demand throughout (20-week inflow streak—strongest since 2021) and bouts of overwhelming supply. Supply of $537 billion set a quarterly record and was the second-heaviest supply month of all time (2Q20). We believe issuers have front-loaded their issuance needs this year given the impending election, with some lingering, though fading, uncertainty around the impacts of the Fed hiking cycle. Capital has been readily available, and borrowers have elected to take it. We believe the supply in the latter three quarters of the year will be below normal and supportive of a tighter spread environment. Demand has shown no signs of abating, and with yields remaining north of 5%, lenders are still putting money to work enthusiastically.

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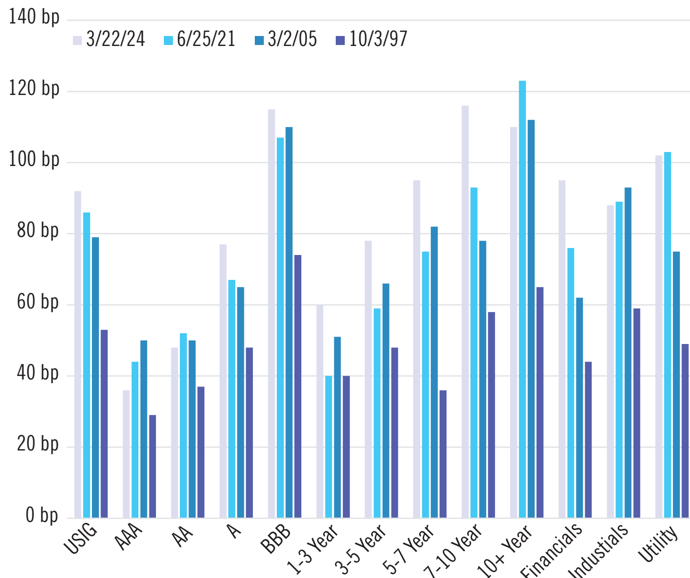
Outlook: Fundamentals are in the back seat and on continued good behavior. Fourth quarter earnings came in largely as expected, and the outlook is for progressively stronger growth as the year goes on. Credit metrics have generally been moving sideways and are healthy overall. After a record year for rising stars in 2023 (Ford, Occidental, Netflix), the ratings agencies have been quiet in 2024, though upgrades still outpace downgrades. The few troublesome areas in the first quarter were of the idiosyncratic variety: New York Community Bancorp, Boeing, and Paramount.

QUALITY/DURATION TRADING INSIDE RECENT TIGHTS



Source: CreditSights, FactSet, ICE Data Indices, LLC. Data as of March 28, 2024.

EUROPEAN CORPORATE HIGH YIELD

The European high yield market gained 1.03%, and spreads tightened by 40 bps in the first quarter due to supportive inflation data. Additionally, economic growth remained more resilient than feared, corporate earnings continued to surprise to the upside, and technicals were favorable. Despite the overall positive risk environment, several idiosyncratic developments in CCC credits caused lower-rated issues to underperform. For the quarter, BB, B, and CCC-rated credits returned 0.82%, 1.72%, and -0.76%, respectively. The index ended December with a spread of 321 bps and a yield of 7.34%.

By industry, home builders, energy, and food outperformed. Home builders and energy continued to benefit from a stronger economy and expectations for lower rates. Food outperformed due to strong earnings. Underperforming industries included technology, cable, and packaging. Technology underperformed after Apple canceled a major project with AMS-OSRAM. Cable and packaging underperformed after companies with near-term maturities indicated debt exchanges might be required to fix the capital structures.

New issue volumes jumped to €26.5 billion from €10.4 billion in the fourth quarter. While gross supply was healthy, most of the issuance was for refinancing, resulting in only €1.8 billion of new money. The strong markets enabled more lower-rated issues to come to market, and the share of BBs dropped from 68% to 54%. The market remains closed to CCC issuers, with the last CCC transaction pricing in April 2022. Floating rate notes accounted for 20% of supply, reflecting optimism around future rate cuts. Retail funds gained the most money since 2Q20, receiving €4.7 billion during the quarter. Over €1 billion entered funds each month of the quarter—the first time this has happened in a three-month period since 2015. €23.1 billion left the market, resulting in the market shrinking by over 2% and adding to the strong technical dynamics for the period.

Distress and default rates in Europe decreased as there were no defaults in the quarter. According to CreditSights, the 12-month par default rate declined to 2.2% from 2.5% in December, and the issuer default rate dropped from 3.4% to 2.5%. The distress ratio increased to 8.4% from 7%.

U.S. CORPORATE HIGH YIELD

The high yield market returned 1.47% and spreads reached levels not seen since late 2021 before ending the quarter 24 bps tighter due to stronger-than-anticipated economic data and messaging from the Fed that a strong labor market would not necessarily prevent cooling inflation and rate cuts. Early in the quarter, better inflation data and solid economic growth contributed to the market sentiment that the Fed was likely to cut interest rates, with the market pricing in as many as seven rate cuts for 2024. As economic growth continued to beat consensus expectations, U.S. Treasury yields moved higher as Fed officials emphasized caution around inflation and rate cuts. This sparked a delay in market expectations for the Fed's first rate cut from March to May or June. However, as economic data began to ease inflationary concerns, markets returned to "Goldilocks" optimism, with expectations for near-term cuts and a strong labor market and economy. In addition to the positive macro data, earnings remained supportive of tighter spreads, and the positive technicals enabled companies to refinance near-term maturities. The favorable risk environment contributed to the outperformance of lower-rated issues. By industry, retailers and paper companies outperformed due to positive

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economic data, while life insurance outperformed due to lower U.S. Treasury yields. Distressed exchanges and challenging fundamentals caused cable & satellite, wirelines, and media to underperform.

Credit quality has been mixed as the higher interest rate environment has had different impacts across companies. Fundamentals have deteriorated more for both smaller and lower-rated companies. In March, more issuers were downgraded than upgraded for the fifth time in the last six months, though upgrades remained higher than downgrade volumes, indicating healthier credit among larger companies. However, lower-quality issuers are suffering more than higher-quality issuers, with the upgrade-to-downgrade ratio in the quarter for BB, B, and CCC-rated issuers at 1.08, 1.28, and 0.47, respectively. Gross leverage declined slightly after rising 1H23, although net leverage increased slightly. Interest coverage rose slightly after four straight quarters of decline as EBITDA increased and the interest expense growth rate decelerated. The default rate edged slightly higher on an issuer basis. Still, it declined on a par basis as larger companies have been better able to manage the higher interest rate environment due to better access to capital and a greater ability to cut costs and sell assets.

Technicals were strong as the positive risk environment triggered a significant demand for yield, with investors adding $6.8 billion to funds. The primary calendar was very active during the quarter as companies issued new debt to refinance near-term maturities. Although the $88 billion of new issuance was well above the $40 billion from 1Q23, excluding refinancings issuance, it was only $15 billion compared to $12 billion in 1Q23.

Outlook: More benign inflation and healthy labor markets sparked a return to a "Goldilocks" environment for spreads. However, the impact of inflation and rates on economic growth are still potential sources of credit volatility. As spreads have priced in a successful soft landing and multiple rate cuts in 2024, the market is more vulnerable to softer economic growth or sticky inflation. During the quarter, we increased our exposure to BBBs and crossover issues with attractive relative value versus BBs. We also continued to selectively add lower-rated issues with appropriate spread compensation and exited lower-quality cyclical bonds that benefitted from the market rally.

BANK LOANS

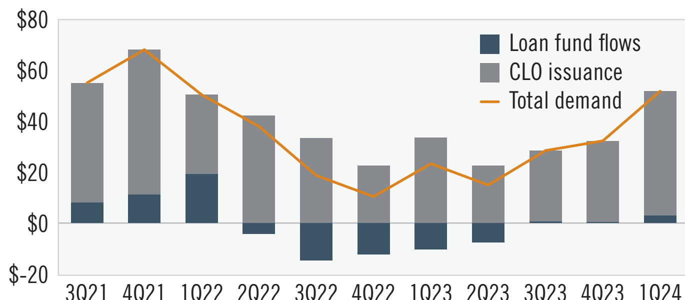
Bank loans returned 2.52% for 1Q—with almost all of it coupon-driven—as rate cuts failed to materialize in January or March after both CPI and economic data came in hotter than expected. With the Fed's interest rate path proving difficult to predict, the loan market's performance has exceeded expectations thus far. We think bank loans will return 7-8% this year.

U.S. LEVERAGED LOAN ISSUERS–QUARTERLY EBITDA GROWTH

Source: PitchBook LCD. Data through December 31, 2023.

The resilient economy also bolstered borrowers' ability to pay down debts: EBITDA growth has ticked up, which means leverage has come down while interest coverage has improved. The downgrade-to-upgrade ratio is also at a five-month low. These strong fundamentals and an attractive coupon have stoked investor appetite for risk. With volumes at $48.8 billion for 1Q, collateralized loan obligation issuance is now at the fastest pace since 4Q21 and marks the fastest start to a year since the Global Financial Crisis. On the retail side, loans recorded inflows for seven consecutive weeks through March 27—a run not seen since April/May 2022.

U.S. LEVERAGED LOAN MARKET–MEASURABLE INVESTOR DEMAND ($B)



Source: Pitchbook LCD; Morningstar Direct. Data through March 29, 2024.
Fund flows data includes monthly reporters.

The flip side of this is that supply has not kept up. While M&A activity picked up toward the tail end of the quarter, overall, leveraged buyouts stayed at low levels during the period. This resulted in prices going up as investors chased a smaller pool of assets. The quarter ended with 38% of the loan market priced at or over par, and borrowers were thus able to refinance and reprice—i.e., reduce interest expense—and push out loan maturities. About 10% of the market repriced at an

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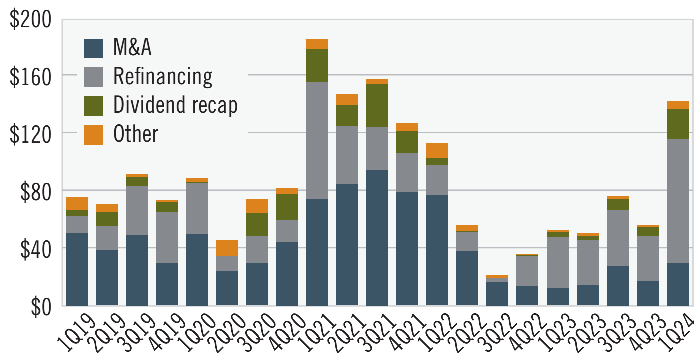
average savings of about 54 bps. These savings are material in a high interest rate environment where interest coverage, debt service, and interest expense remain a concern.

U.S. INSTITUTIONAL LOAN VOLUME ($B)



Source: PitchBook LCD. As of March 31, 2024.

As loan market investor sentiment improved, private credit deals took the opportunity to shake off higher-cost financing—about $10-11 billion came back into the broadly syndicated loan market to reduce interest expense. This contrasts with last year's trend when $16 billion left the broadly syndicated loan market to go to private credit due to a lack of investor appetite and prohibitively high new-issue spreads.

It's true that current loan market valuations look rich relative to historical levels. However, in an environment where the economy is in better-than-expected shape, rate cut forecasts keep being pushed further out, borrowers are able to take the right measures to manage the cost of borrowing, and the base rate remains attractive, we think there is a strong case to be made for long-term investors to own loans. Even in a scenario where the Fed cuts rates three times this year, the bank loans sector would still be yielding more than high yield because of its 100 bps in yield advantage.

Should investor demand stay healthy—particularly if the Fed skips rate cuts in May—capital markets might be open to riskier single-B borrowers, allowing them to reduce interest expense and, by extension, improve loan market fundamentals at the margins. This is significant, as the issuer quality of lower-rated borrowers poses one of the major potential risks within bank loans. These technical dynamics, refinancings, and borrowers' ability to manage through a higher-rate environment will inform our view on implementation and will be the main areas of focus for us moving forward.

Outlook: Though we're still underweight risk relative to the market, that gap has started to close over the last nine months as we began to adapt to the reality that the economy was more resilient than previously thought and as recession risk looked increasingly less likely. We're therefore looking to be fully invested while incrementally adding higher-quality risk. Though we're overweight single B-rated loans overall, it would be more accurate to say we're overweight higher-quality Bs and underweight lower-quality Bs. We will probably be keeping this bias in the near term.

EMERGING MARKETS DEBT

EM Sovereign Debt: EM debt returned 1.40% in the first quarter of 2024, led by high yield EM, which posted a strong 4.48% total return for the period. The investment grade EM sub-index posted a negative -0.76% return. The EMBIG index spread moved lower by 32 bps to finish the quarter at 285 bps—a level not seen since Feb 2020, just before the COVID pandemic, and a level seldom reached in the post-GFC period since September 2008.

The EM high yield index spread moved tighter by 81 bps to finish the quarter at 563 bps—a post-COVID low—while the EM investment grade index spread was flat at +114 bps. Meanwhile, the move higher in Treasury yields—the 10-year higher by 32 bps during the period—functioned as a brake on total returns, especially in the investment grade arena where there is less spread relative to high yield.

Country Highlights: The lowest-rated C/CCC tier of countries led returns, with that sub-index posting a positive +22.8% return in the period. Ecuador (+51% total return), Argentina (+26%), Egypt (+22%), Pakistan (+27%), Ukraine (+25%), Ghana, Sri Lanka, and Zambia all had positive news around reforms, increased IMF funds, multi-lateral engagement, or progress toward restructuring debt, in specific cases. We benefitted from Ecuador, Argentina, Egypt, Ukraine, and Ghana exposure. Negative contributions came from Venezuela (-4.7%), South Africa (-3.1%), and Colombia (-2.4%), where we held overweight positions.

EM Corporate Debt: EM corporate debt returns were strong in the quarter at +2.32% for the CEMBI-BD, led by the high yield sub-index, which was up +4.22% compared to the investment grade sub-index return of 1.04%. Like the sovereign story, the lower rungs of credit quality led the way. Spreads moved tighter, more than offsetting the move higher in rates. The overall index spread moved tighter by 50 bps to end the quarter at 231 bps, with the high yield sub-index spread moving lower by 87 bps to 423 bps.

EM Local Market Debt: Local market debt posted a negative -2.12% return for the period as broad dollar strength and higher yields were negative themes. The worst-performing markets were Chile (-11.7%), Turkey (-8.6%), and Hungary (-6.8%), while Mexico (+2.70%) and Colombia (+1.73%) contributed to positive performance.

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Authored by:

The Newfleet Multi-Sector Team

Newfleet leverages the knowledge and skill of a team of investment professionals with expertise in every sector of the bond market, including evolving, specialized, and out-of-favor sectors. The team employs active sector rotation and disciplined risk management to portfolio construction.

Bloomberg U.S. Aggregate Bond Index measures the U.S. investment grade fixed rate bond market. **Bloomberg Municipal Bond Index** is a market capitalization-weighted index that measures the long-term tax-exempt bond market. **J.P. Morgan GBI-EMGD** tracks total returns for local currency debt instruments issued by emerging markets sovereign and quasi-sovereign entities to which international investors can gain exposure. **J.P. Morgan CEMBI Index** tracks U.S. dollar-denominated debt issued by emerging market corporations. **J.P. Morgan EMBI Global Index** tracks the total return for the U.S. dollar-denominated emerging markets debt, including Brady bonds, Eurobonds, and loans. The **Credit Suisse Leveraged Loan Index** is a market-weighted index that tracks the investable universe of the U.S. dollar denominated leveraged loans. The **Bloomberg U.S. High-Yield 2% Issuer Capped Bond Index** is a market capitalization-weighted index that measures fixed rate non-investment grade debt securities of U.S. and non-U.S. corporations. No single issuer accounts for more than 2% of market cap. The indexes are calculated on a total return basis. The indexes are unmanaged, returns do not reflect any fees, expenses, or sales charges, and are not available for direct investment.

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