2024 Fixed Income Market Outlook

Newfleet ASSET MANAGEMENT
A Virtus Investment Partner

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Value has been restored to fixed income. In a year that saw interest rates rise across the curve, the Federal Reserve (Fed) continued its campaign of rate hikes to tame stubbornly high inflation, and U.S. Treasury yields rose to the highest levels post-Global Financial Crisis (GFC). This drove historically attractive yields in fixed income, boding well for future returns. Additionally, slowing growth and cooling inflation may finally bode well for bond market performance in 2024. Bonds have historically provided attractive risk-adjusted returns in a post-rate-peak environment, while equity performance has typically been more challenged. The traditional 60/40 portfolio, out of favor with many investors, may be poised to make a comeback as the negative correlation between bonds and equities reasserts itself—meaning that bonds tend to do better when equities struggle, and vice versa.

The year started with a strong market rebound following improving inflation reports, resilient economic data, and better-than-expected corporate profits that contributed to falling Treasury yields and renewed expectations that the Fed could pause following the March meeting amid declining near-term recession risks. However, macro data showing stickier inflation and a resilient labor market soon sparked commentary from the Fed suggesting it was not ready to stop hiking rates. Markets priced in additional Fed interest rate hikes and fueled concerns that the higher-than-expected interest rates could lead to a delayed hard landing. The banking crisis sparked hope for rate cuts and brought recession worries back to the forefront as investors became concerned that financial conditions would tighten as banks pulled back lending due to depositor outflows. This proved to be a short-term event and faded as the year progressed.

Stronger economic growth, a resilient jobs market, and relatively healthy fundamentals have supported market optimism for a soft-landing scenario and tight credit spreads. However, credit spreads are pricing in a lot of good news, and elevated inflation, tighter financial conditions, and higher-for-longer interest rates are significant risks and potential sources of spread volatility. Inflation has moved lower but remains above target. Though consumer spending has been supported by strong savings levels and a resilient labor market, caution is warranted as the Fed appears determined to bring inflation to target.

We begin the new year with an optimistic stance tempered by a fair dose of uncertainty around the global macroeconomic outlook. Yields are attractive, spreads are fair, inflation is cooling, and the economy has proven far more resilient than expected, but rates may remain elevated, with a greater risk of recession the longer the Fed waits to begin cutting rates. Geopolitical volatility in Russia/Ukraine and the Middle East poses potential risks to market performance as well.

Sectors we currently favor that we think will perform well in this environment include out-of-index/off-the-run asset-backed securities (ABS), non-agency residential mortgage-backed securities (RMBS), and investment grade corporate bonds. We also see value in higher-quality corporate high yield and bank loans. These are subject to change quickly with shifting fundamentals, technicals, and valuations.

FREQUENT CHANGES IN PERFORMANCE LEADERSHIP SUPPORTS THE BENEFIT OF DIVERSIFICATION

2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	YTD (9/2023)	12/13-9/23 Annualized
High Yield 7.44	Municipals 9.05	Municipals 3.30	High Yield 17.13	EM Debt 9.32	ABS 1.77	IG Corp 14.54	IG Corp 9.89	Bank Loans 5.40	Bank Loans -1.06	Bank Loans 9.91	Bank Loans 4.25
Bank Loans 6.15	IG Corp 7.46	MBS 1.51	EM Debt 10.19	High Yield 7.50	Municipals 1.28	EM Debt 14.42	Global Agg 9.20	High Yield 5.26	ABS -4.30	High Yield 5.87	High Yield 3.97
CMBS 0.23	MBS 6.08	ABS 1.25	Bank Loans 9.88	Global Agg 7.40	Bank Loans 1.14	High Yield 14.32	CMBS 8.11	Municipals 1.52	Municipals -8.53	ABS 1.99	Municipals 2.31
ABS -0.27	US Agg 5.97	EM Debt 1.23	IG Corp 6.11	IG Corp 6.42	MBS 0.99	US Agg 8.72	US Agg 7.51	ABS -0.34	CMBS -10.91	EM Debt 1.09	EM Debt 2.20
MBS -1.41	EM Debt 5.53	CMBS 0.97	CMBS 3.32	Municipals 5.45	CMBS 0.78	CMBS 8.29	High Yield 7.04	IG Corp -1.04	High Yield -11.18	CMBS 0.16	IG Corp 2.17
IG Corp -1.53	CMBS 3.86	US Agg 0.55	US Agg 2.65	Bank Loans 4.25	US Agg 0.01	Bank Loans 8.17	EM Debt 5.88	MBS -1.04	MBS -11.81	IG Corp 0.02	CMBS 1.58
US Agg -2.02	High Yield 2.46	Bank Loans -0.38	Global Agg 2.09	US Agg 3.54	Global Agg -1.20	Municipals 7.54	Municipals 5.21	CMBS -1.16	US Agg -13.01	US Agg -1.21	ABS 1.50
Municipals -2.55	Bank Loans 2.06	IG Corp -0.68	ABS 2.03	CMBS 3.35	High Yield -2.08	Global Agg 6.84	ABS 4.52	EM Debt -1.51	IG Corp -15.76	Municipals -1.38	US Agg 1.17
Global Agg -2.60	ABS 1.88	Global Agg -3.15	MBS 1.67	MBS 2.47	IG Corp -2.51	MBS 6.35	MBS 3.87	US Agg -1.54	Global Agg -16.25	Global Agg -2.21	MBS 0.67
EM Debt -6.58	Global Agg 0.59	High Yield -4.43	Municipals 0.25	ABS 1.55	EM Debt -4.61	ABS 4.53	Bank Loans 2.78	Global Agg -4.71	EM Debt -16.45	MBS -2.26	Global Agg -0.41

Returns in percent. As of 9/30/2023. **Past performance is not indicative of future results.** Performance of all cited indexes is calculated on a total return basis with dividends reinvested. The indexes are unmanaged, their returns do not reflect any fees, expenses, or sales charges, and they are not available for direct investment. For index definitions, please see page 12.

The exhibit below summarizes the potential impact of higher interest rates on various fixed income sectors, with higher rates more likely to impact U.S. Treasury, commercial mortgage-backed securities (CMBS), high yield, and collateralized loan obligation (CLO) markets, while residential mortgage-backed securities (RMBS), and investment grade are less likely to be impacted.

SUMMARY OF RATE LEVELS, ROLLOVER TIMELINE, AND HIGHER RATE BORROWER IMPACT

Market	Weighted Average Coupon (%)	% Floating	Re-Couponing, % Total		Rate Impact on Borrower	Behavior Shift with Higher Rates
			By End '24	By End '25		
U.S. Treasuries	2.1	22.6	17.1	30.0	High	Small
Residential MBS	3.6	5.8	2.0	3.0	Low	Small
CMBS	5.1	30.0	15.0	27.0	High	Large
Investment Grade	4.0	0.7	8.8	18.8	Low	Small
High Yield	6.0	25.0	30.0	40.0	Medium	Moderate
Loans / Private Debt	9.3 / 12.0	100.0	100.0	100.0	High	Large

Source: BofA Global Research. Note: U.S. Treasuries couponing data only applies to coupon securities; U.S. Treasury floating data includes bills and floating rate notes; investment grade data does not include commercial paper.

As this challenging stretch for bond markets comes (hopefully) to a close, we thank you for placing your trust in our team. We wish you and your families a happy holiday season and a wonderful new year.

Executive Summary

The outlook for fixed income is looking up now that we have some reason to believe overheated inflation may be largely behind us and yields in fixed income are near the highest levels in years. This year, the U.S. Aggregate Bond Index struggled as persistently high inflation prints and a stronger-than-expected economy led the Fed to hike rates up four times to a Fed Funds rate of 5.50%, and investors have increasingly become reconciled to the narrative that interest rates are likely to stay higher for longer. The regional banking failures in the spring and geopolitical volatility in Russia/Ukraine and the Middle East also contributed to some overall volatility for the asset class. However, we have reason to be cautiously optimistic as a stronger-than-expected economy and cooling inflation may fuel strong bond performance. A nimble, multi-sector strategy that can spot opportunities within the full credit universe is best positioned to take advantage of these opportunities while adapting to an unpredictable, challenging backdrop.

GLOBAL MACRO EXPECTATIONS FOR 2024

- Overall: Positive.
- 2024 is likely a year of moderation—both for inflation and growth.
- We expect global growth to slow further in 2024. Policy rates are high—broadly above neutral across the globe—which should continue to restrain economic activity.
- Growth slows…but does not stop. Our baseline expects that growth remains positive though below potential. The U.S. grows more rapidly than the Eurozone.
- Inflation around the world continues to move lower over 2024, though it remains above target at least through the first half. Inflation has already slowed as the lingering effects of COVID-related supply chain snarls and demand shifts have faded. Those continue, with slow growth adding additional impetus to that inflation moderation.
- The fallout from the problems in China's property sector continues, depressing growth in China and flowing through into reduced exports into China.
- If inflation cooperates, we could see developed market central banks start to reverse tighter policy toward the end of 2024. Earlier and sharper rate cuts would likely require recessionary conditions.
- Emerging markets (EM) should continue to lead along the path toward lower policy rates in 2024. EM central banks were, given their histories, more aggressive in their hiking cycles and consequently have also been ahead of developed markets (DMs) in rate cuts.
- Elevated geopolitical risk appears to be a feature of the world going forward. The U.S. and China relationship likely stays adversarial, with broad economic impacts as policy in both countries pushes toward less economic integration. The Russia/Ukraine war looks unlikely to see a quick conclusion, which will continue to significantly impact European economies and global commodity markets.

KEY RISKS

- Recession risks remain live as central banks might have miscalibrated tightening.
- A persistently higher interest rate environment, with neutral rates above 4%—substantially higher than the last two decades.
- China's economy tips into an idiosyncratic recession as the housing issues metastasize.
- The U.S. presidential election proves disruptive, injecting volatility.
- Many geopolitical risks remain. Among others, we highlight:
  1) A broadening of the Middle East conflict and associated commodity price shocks
  2) China invades Taiwan
  3) Increased fears of disintegration of the NATO alliance.

ELEMENTS OF OUR BROAD VIEW AS WE ENTER 2024

- Within investment grade corporates, we favor both BBB-rated bonds and the financial sector, which is still at historical wides in spreads compared with industrials. In our view, investment grade corporates are well-positioned to adapt to rising rates.
- We continue to remain underweight on EM debt, though we are now selectively adding back exposure on dips. We see more value in EM high yield than EM investment grade.
- Though there are indications that the labor market has cooled, unemployment is still at a strong 3.9%. Consumer debt delinquencies are on the rise as rising interest rates begin to flow through the economy and weigh on borrowers, though they're coming off of all-time lows. ABS credit spreads have widened, creating opportunities to invest in high-quality assets at attractive yields.
- We continue to see value in non-agency RMBS based on attractive valuations, strong mortgage credit, and a lack of housing supply.
- We also see value in high-quality bank loans and corporate high yield.
- In our view, our multi-sector approach to fixed income investing is suited for the current uncertain environment and enables us to scan the broader bond market for the most attractive investment opportunities..

—as of December 6, 2023

For the reader who would like more details on our sector outlooks, the following section provides in-depth views by Newfleet's sector specialists on their respective areas of expertise.

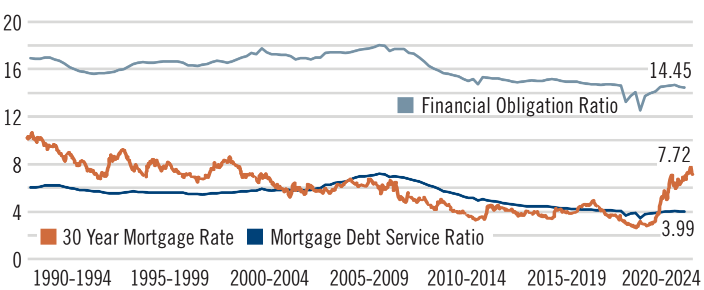
ASSET-BACKED SECURITIES (ABS)

By Nick Rinaldi and Zachary Szyndlar, CFA

The move higher in interest rates experienced in 2022 continued during 2023, albeit on a lesser scale. As of this writing, short duration assets, specifically ABS, performed extremely well on a total return basis versus their long-duration and investment grade corporate counterparts. In last year's outlook, we commented on higher yields and wider spreads, which made this asset class a very attractive investment. We also noted that we were increasing our allocation to the subordinate/junior tranches of the asset class. Thus far, on a year-to-date basis, investors have been rewarded as spreads have tightened for subordinate/junior tranches within the capital stack of ABS deals. However, even with the rally, ABS spreads are still wide to historical averages. Attractive relative and absolute valuations, coupled with resilient consumer fundamentals, has made ABS one our largest allocations within our short duration portfolios.

Heading into year-end, U.S. consumer fundamentals still look strong but there are signs of weakness going forward. The job market remains constructive, with 8.7 million job openings—roughly 1.34 openings per unemployed. The unemployment rate has ticked higher to 3.9% from a historical low of 3.5% at the start of the year. Bank of America Institute points to the fact that monthly median household savings and checking balances by income sit at higher levels today than pre-COVID. In addition, U.S. consumers have dry powder in the form of available credit card balances. Although credit card utilization rates have risen, they remain below pre-pandemic levels. Strong wage growth, especially for lower-quintile earners, has been a positive offset to higher inflation. The financial obligation ratio (see below), which measures how much household income is being spent on repaying debts and other financial obligations, remains lower than historical averages. Mortgage rates have spiked, but most homeowners were able to lock in at low rates offered over the past few years, and U.S. consumer mortgage debt service is at over 30-year lows.

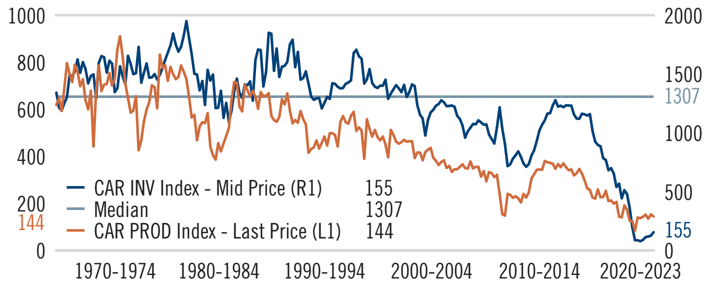
FINANCIAL OBLIGATION RATIO, MORTGAGE DEBT SERVICE RATIO, AND 30-YEAR MORTGAGE RATE



Source: Bloomberg LP. Financial Obligation Ratio data as of June 30, 2023. Mortgage Debt Service Ratio as of June 30, 2023. 30-Year Mortgage Rate Data as of November 23, 2023.

On the consumer debt side, delinquency rates rose for both prime and non-prime borrowers in 2023, with delinquency rates for non-prime borrowers exceeding pre-pandemic levels. Within the subprime auto space of the ABS markets, several smaller originators filed for bankruptcy and deep subprime borrowers continue to underperform. On a positive note, auto inventory levels are below production levels (see below). Inventory levels remaining below production output bodes well for vehicle recovery values on defaulted loans.

AUTO INVENTORIES VS. PRODUCTION



Source: Bloomberg LP. Data as of June 30, 2023.

Looking at the technical picture, ABS issuance is currently running slightly ahead of 2022 levels. Auto issuance historically comprises 50% of all ABS issuance and for 2023, the continued rebound in automobile sales was a large contributor to overall ABS issuance. For the better part of 2023, demand has been robust for ABS, especially as the benchmark two-year eclipsed north of a 5% yield. Looking ahead, unless there is a pullback in the economy, 2024 issuance is projected to exceed 2023 totals by a manageable 8-10%.

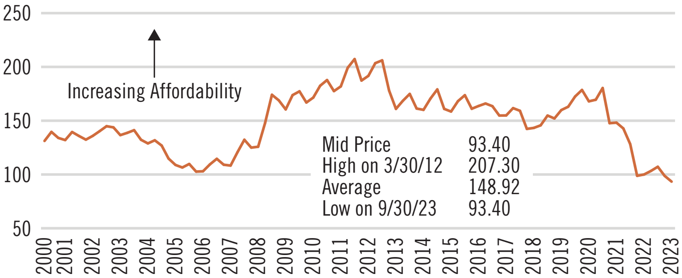
With spreads marginally wider on senior tranches and marginally tighter on junior tranches on a year-to-date basis, we still believe there is compelling value for short duration consumer ABS. As of this writing, we're investing in high-quality ABS securities with attractive yields in the 6.25% to 7.50% range. The narrative of a soft landing continues to play out; however, even if we head into a mild recession, the short duration de-leveraging nature of these assets coupled with current valuations make them very attractive. We will echo our 2023 ABS outlook of last year for this coming year: "If the U.S. Treasury curve stays rangebound in 2024 and the U.S. does not enter a deep recession, look for the ABS sector to produce a mid- to high-single-digit positive return".

NON-AGENCY RESIDENTIAL MORTGAGE-BACKED SECURITIES (RMBS)

By Andrew Szabo, CFA and Zachary Szyndlar, CFA

The magnitude of rising rates, while less than 2022, still commanded the mortgage market's attention this year. 30-year fixed mortgage rates touched 8% during the year, reaching a 20+ year high. What was more remarkable about 2023 was the resiliency of housing values in the face of record high mortgage rates. Most housing prognosticators had forecasts of 0%-10% price declines, but instead we saw housing values increase 6% year-to-date to new all-time highs. Limited supply of housing and tight inventories were the primary drivers of the higher-than-expected values, as a byproduct of high prices and high mortgage rates is poor affordability.

HOUSING AFFORDABILITY INDEX



Source: Bloomberg LP; National Association of Realtors. Data as of September 30, 2023.

Despite poor affordability, the lack of housing activity, coupled with a strong national economy, led to solid returns from our non-agency RMBS portfolio. Heading into 2024, housing values are not expected to fall on a national level. With a limited supply of new and existing homes available for sale, we expect non-agency RMSB issuance to remain very manageable. RMBS supply was down 50% this year, leading to a positive technical, and we expect similar issuance in 2024. With mortgage credit still being prudently offered, the setup for non-agency RMBS in 2024 is very positive. With spreads for most RMBS securities at competitive levels compared against agency MBS and corporate bonds of comparable maturity, we expect demand for RMBS to remain supportive. As we look ahead, valuations will always begin on broader macro trends. The robust fundamentals, structures, and broad opportunity set available in the non-agency market may ultimately provide attractive investment opportunities again in 2024.

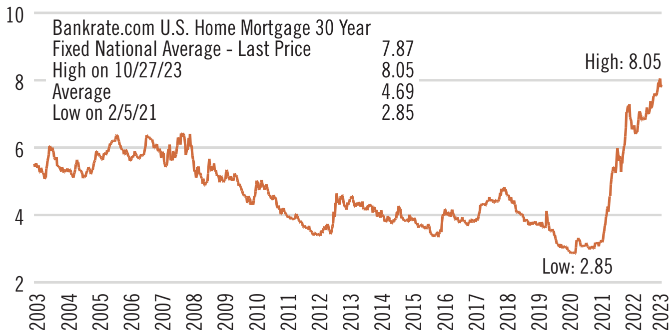
AGENCY MORTGAGE-BACKED SECURITIES (MBS)

By Andrew Szabo, CFA and Zachary Szyndlar, CFA

Agency MBS had another eventful year, but not for the reasons MBS investors had hoped for at the start of 2023. We noted last year that valuations were at their cheapest levels in a long time. That cheapness continued in 2023 as interest rate volatility overwhelmed any positives for the sector. Also, the banking stresses marked by the collapse of Silicon Valley Bank in March weighed particularly heavily on agency MBS, as banks are very important constituents of the MBS market. As a reminder, agency MBS carry no credit risk; however, investors bear prepayment risk, which is influenced by changes in interest rates. Ongoing rate volatility, coupled with banks stepping away, at a time when the Fed is allowing its balance sheet to run off, all pressured MBS spreads.

With mortgage rates spending most of the year above 7% and briefly above 8% in October, a lock-in and lock-out effect took hold of the housing market in 2023. Homeowners, the vast majority of which were able to secure mortgages around 3%, have found themselves locked-in to their mortgage, unwilling or unable to move with rates that have more than doubled. At the same time, limited inventory, record prices, and the highest mortgage rates in the last 20 years have locked-out many would-be homebuyers. This lock-in/lock-out effect is expected to remain until mortgage rates come down and supply picks up.

U.S. HOME MORTGAGE 30-YEAR FIXED NATIONAL AVERAGE – LAST PRICE



Source: Bloomberg LP, Bankrate.com. Data as of November 11, 2023.

The rapid rise in rates over the last two years has created an MBS market with a broad array of coupons that will behave quite differently depending on interest rate moves. There are large discount, low-coupon, and long duration securities. On the other end of the coupon stack, there are coupons of 7.5%, at a premium with shorter durations. All MBS investors would benefit from a normalization of interest rate volatility, and the array of coupons provide options for investors going forward. Lower rates would greatly benefit the large discount, lower-coupon securities, while larger-coupon securities would outperform if rates continued to rise.

In 2023, we maintained an underweight to the agency MBS market while keeping exposure to the U.S. residential market via non-agency mortgages. This allocation served us well, as non-agency mortgages offer more spread and are less interest-rate-sensitive—a good combination for 2023. Agency MBS came into the year cheap and ended the year cheaper, with plenty of volatility along the way. We expect to remain overweight non-agency MBS; however, we appreciate the benefits agency MBS can provide in a portfolio. Should opportunities present themselves, we're in a good position to add agency MBS in 2024.

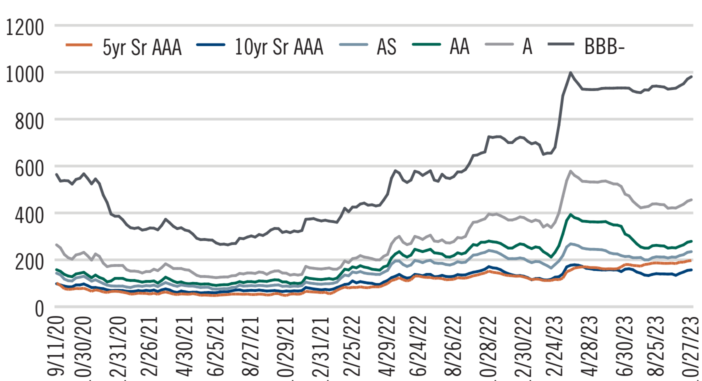
COMMERCIAL MORTGAGE-BACKED SECURITIES (CMBS)

By Roger Lavan, CFA and Angela Sheen

The one-two punch of the pandemic's allowance for many employees to work from home and the Fed's 2022-23 campaign to raise interest rates has staggered the commercial real estate (CRE) market this past year. Unlike residential mortgages, which are amortizing and have a 30-year tenure, most CRE loans are interest-only, and their much shorter 10-year terms make CRE loans significantly more susceptible to refinancing risk when rates rise. Many CRE loans that are coming due over the next few years have coupons of 3%-5%, while current lending rates are 7.5% or even higher. This rate shock has caused transaction volumes to decline markedly in 2023 as property owners are unwilling to sell at the lower valuations and appear hesitant to inject more equity that is needed to refinance maturing loans. Without transactions, it is difficult for lenders to value properties, and lending has thus dried up in many sectors of the CRE market.

While the multifamily and industrial sectors of the CRE have held up well, CMBS new issue volumes are down 65% this year and 2024 issuance is not expected to be much different. This lack of volume has been a favorable technical that has helped keep new issue triple-A CMBS spreads around 150 basis points (bps) above the 10-year Treasury and approximately 27 basis points wider on the year. However, further down the capital stack, the more credit-sensitive bonds (single-A and below) have had a tougher time as investors looking to reduce exposure to conduit CMBS with large office exposure have been selling into a very illiquid market with multiple point bid /ask spreads. As seen below, triple-B conduit spreads are 261 bps wider year-to-date to 981 bps.

CMBS 2.0 SPREADS VS. U.S. TREASURIES



Source: J.P. Morgan. Data as of October 27, 2023.

In 2023, we fortunately kept a lower weighting to the CMBS sector, with roughly 80% of that exposure in the single-asset single-borrower (SASB) space. Within that, most of our SASB exposure was invested in floating rate loans, which performed well as the coupon reset higher as the Fed lifted interest rates. SASB loans are typically structured so that the issuer can exercise three one-year maturity extensions. As higher rates make refinancing difficult or unattractive for many borrowers, we expect SASB borrowers to continue to exercise these extensions in 2024.

When SASB and conduit loans reach their maturity, the borrowers must either put cash into the property to refinance, default, or work out a loan modification with the special servicer. Currently, the CRE loan origination market is somewhat frozen, so many borrowers have asked for and received maturity extensions and, in return, have contributed some equity to the deal. This type of loan modification is often referred to as "extend and pretend." Going forward, the CMBS sector is going to see a lot of these modification as borrowers and lenders try and bridge the gap to late 2024 and 2025 when rates are expected to be lower.

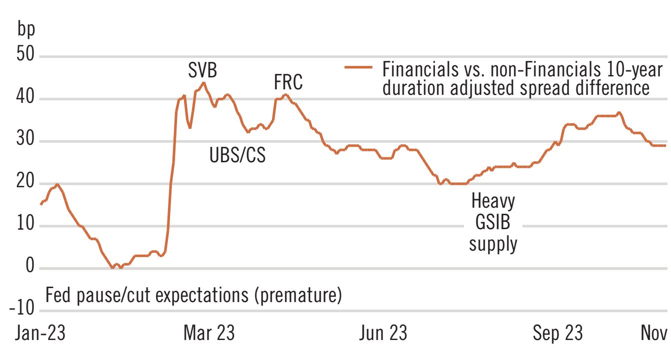
Lower rates will help the CMBS sector, but for the market to clear, CRE prices likely need to decline further in 2024, as interest rates are likely not going to fully retrace. Until CRE prices reset lower, we will remain defensive in our positioning while looking for opportunities to add bonds that are backed by high-quality loans.

CORPORATE INVESTMENT GRADE

By Ryan Jungk, CFA and David Torchia

It's complicated. Yields are close to decade highs. Fundamentals are solid. Spreads are about average. Our supply forecast is benign, and we expect demand to outpace it. The problem is that the demand is not focused where the supply is. This is leading to intra-market dislocations that we will seek to monetize in 2024. Both the financials-industrials relationship and the spread curve are at historical levels (wide and flat, respectively). While the forces driving these dislocations are still in place, we believe that relative value will have its day in the sun, and that this will provide a tailwind to excess returns in the year to come. With a starting yield of 6%, 500 bps of rate hikes behind us, and a net favorable outlook on spreads, we anticipate a high single-digit total return in 2024 with a low single-digit excess return.

FINANCIAL BONDS ARE TRADING 48 BPS WIDE TO NON-FINANCIALS, NEAR THE PEAK REACHED IN 1Q



Source: J.P. Morgan. Data as of November 24, 2023.

Fundamentally, a higher-for-longer interest rate environment is "least bad" for investment grade corporates as compared to all other sectors. With an average maturity of 10.6 years, interest costs rise very slowly for high-quality issuers. This grants an ability to readjust the capital structure to a new optimal weighted average cost of capital over time, and this is already playing out. Shareholder returns are down 5% for industrial issuers and down 13% when excluding the energy sector. The proportion of acquisitions funded with cash/debt fell from 70% in 2021-2022 down to 30% by late 2023. Issuance from BBB-rated credits has fallen from 49% of the total (2017-2021 average) to 40% in both 2022 and 2023. The percentage of low BBB-rated credits has fallen from a high of 14.5% in early 2022 to 12% currently despite the largest rising star year on record ($120 billion) pushing names into that category (Ford, Occidental, Netflix, Las Vegas Sands, and Western Midstream collectively comprise 1.15%). Looking forward to 2024, we expect far fewer rising stars, but more importantly, see limited scope for significant fallen angels as well. In aggregate, corporate behavior has been restrained after the rise in rates and we believe there are ample incentives for this to continue.

Technicals are imbalanced. There is significant demand from yield buyers who are eager to lock in the highest yields the asset class has offered in a decade. These buyers are often matching their assets against long-dated liabilities and so are most active on the long end of the curve. Issuers, meanwhile, are not keen to lock in these rates. The average tenor of issuance in 2023 is set to be below 10 years for the first time since 2011. The result is two-fold. First, the 10s/30s spread curve is now inverted, which is a phenomenon we have not seen on a sustained basis since 2009. Second, the relationship between financials and industrials is at historically wide levels. While it is not the sole reason for this relationship expanding, the average maturity of a financial issuer is seven years versus 12 for the average industrial borrower and nearly 14 for the average utility borrower. Demand focused on the long end also means demand focused on industrial credits. Looking ahead to 2024, we anticipate a modest reduction in net supply, consistent with our view that corporate behavior will be restrained, limiting shareholder returns and debt-fueled M&A.

The result of this imbalance is a bifurcated market. Financials are trading in the third quartile (post-GFC time frame) while industrial spreads are in their first quartile. Banks have underperformed for three years running while energy, telecom, and transportation have outperformed over the same period. In aggregate, spreads are hovering around +120 currently, which is in line with the 5-and-10-year averages. For spreads to compress, financials need to outperform. We believe the fundamental case for this is easier to make than the technical. Large banks have de-risked their balance sheets over the past decade and regulations continue to crimp risk-taking activities. The regional bank crisis of 2023 looks well-contained at this stage, though longer-term concerns on commercial real estate exposure remain. Whether yield buyers relent and buy the higher-yielding financial securities, even with less duration, is admittedly difficult to forecast. While we are comfortable with an overweight to said securities, we are not sure those buyers can shift their demand. However, with the financials-industrials relationship already at historical wides, we believe the upside/downside from this overweight skews favorably.

TAX-EXEMPT MUNICIPAL BONDS

By Phillip Hooks, CFA, and Dusty Self

The municipal market saw a volatile year in 2023. Yields increased as the Fed continued to raise rates and reached decade-long highs across the curve. With these higher rates, supply fell below expectations as issuers were hesitant to lock in a higher cost of debt, and taxable refundings became unfeasible. Volatility and negative returns for much of the year led to persistent outflows in long-term funds, while ETFs saw inflows. As we enter 2024, yields remain at historically attractive levels. Tax equivalent yields approaching 10% and muni/Treasury ratios above the one- and three-year averages create an attractive entry point for investors.

Supply projections for 2024 forecast an increase in supply year-over-year, but at levels below historical averages. Current estimates range from $330 billion to $400 billion in supply for the year. Higher rates should continue to depress supply, while new money issuance increases year-over-year. New money issuance is likely to increase, both because it is less rate-sensitive and also because it will be critical to fund a growing backlog of projects delayed during the pandemic. Combined reinvestment projections are $405 billion for 2024. While this is lower than 2023's $417 billion, it should be solidly above the level of supply, creating a favorable supply/demand imbalance that should boost performance for the year.

Taxable muni issuance should remain relatively flat as advance refundings with taxable debt do not work at these yield levels. Following this, we expect taxable supply to be significantly beneath investor demand, as we have seen for much of 2023. This is likely to fuel the outperformance of taxable munis versus corporates, making them an attractive alternative.

Credit quality remains high as many issuers continue to benefit from solid reserves fueled by 2023's strong revenue collections and stockpiled pandemic aid funds. General obligation (GO) credits are well positioned, though we have begun to see signs of weakness in sales tax collections. As revenue growth slows, several states face budgetary deficits that have resulted in expense reductions or the use of one-time revenue sources. Should a recession occur in 2024, these pressures would likely accelerate, impacting a larger share of state and local issuers.

Transportation credits continue to perform well as economic activity and consumer travel held strong. Airports and toll roads performed strongly during 2023, and we expect further credit improvement in 2024. Conversely, the hospital and education sectors have seen margins pressured by wage inflation and revenue slowdowns. As a result, we remain cautious on both sectors. Municipal default rates remain low and concentrated in below-investment-grade credits in the healthcare and project finance sectors. Should economic pressures grow, the number of defaults would increase but would likely remain constrained to similar sectors.

The pressures seen in the GO, hospital, and education sectors highlight the importance of strong fundamental credit research and security selection. We continue to rely on our detailed bottom-up fundamental credit analysis, combined with our top-down analysis of sector trends. In concert, this has allowed us to opportunistically invest in pressured sectors where we feel strong issuers may have been unfairly penalized, and avoid credits that experience significant deterioration. To that end, we currently prefer higher-quality credits with strong revenue streams that are less economically sensitive.

In general, credit spreads are tight from historic levels, though the end of 2023 did see some widening. Performance for 2024 will largely be driven by the potential of a recession or a change in investors' perception of risk. Should a recession occur, credit spreads are likely to move wider as investors seek higher-quality investments. We remain positioned with a higher-quality bias and would be opportunistic in selectively adding credit if this occurred. As an asset class, municipal bonds remain well-positioned for a strong year. Investors are well-served to retain an allocation to the sector as it provides important diversification with high-quality credits, a compelling tax-free income stream, and a low correlation to other asset classes.

CORPORATE HIGH YIELD

By Eric Hess, CFA and Matthew Kearns, CFA

High yield is on pace for a strong year in 2023 despite the move higher in risk-free rates as recession fears proved unfounded and corporate profits came in better than expected. However, results have varied widely among industries. Destocking continues across many industries as companies respond to reduced demand and a healthier supply chain. Resilient consumer spending is supporting the rebound in industries that were most affected by prior supply chain issues, such as autos, as well as those that were most affected by the pandemic, such as travel and leisure. Additionally, housing has begun to recover from its downcycle last year when it was still too early to feel the impact of higher interest rates. It is now benefitting as those higher rates limit the supply of existing homes, making new homes more attractive. Corporate balance sheets are healthy, with leverage at pre-pandemic levels and high cash balances; however, financial conditions have tightened considerably and point to slower growth and deteriorating credit metrics ahead. Interest coverage is trending lower from record highs as companies refinance with higher rates and floating rate debt increases interest expense.

Though credit quality might have peaked in the first quarter, fundamentals remain strong, and companies entered the year with leverage below pre-pandemic levels and record interest coverage. Year-to-date, there have been more upgrades than downgrades, with the ratio by issuer at 1.03x and the ratio by par at 1.39x. Interest coverage remains topical given the new level of interest rates, but the fixed rate nature of high yield debt will give issuers time before the full impact runs through their financials. Additionally, most issuers took advantage of the low interest rates in 2020 and 2021 to refinance near-term debt. Though the default rate has climbed in 2023, it remains below the long-term average.

While we expect the default rate to increase going forward as companies face the full impacts of higher interest rates and a slower economy, we expect the rise to be muted by the improved credit quality of the asset class, a maturity wall skewed more towards BBs, and signs of easing financial conditions. Additionally, the energy sector has moved from downgrades and defaults to upgrades and rising stars.

Higher-quality credits continue to represent a larger portion of the market. CCC-rated issuance and LBO supply remain below historical levels. BBs remain at historically high levels near 50%, while CCCs remain at historically low levels near 10%. Since 2007, issues rated single B or lower have declined from 52% to 34%. Record secured debt issuance has increased secured debt to an all-time high percentage of the market. Almost 32% of high yield is now secured, including 44% of B-rated bonds.

The high yield market has declined in size by 16% from its June 2021 peak due to low issuance and over $200 billion of rising stars, though future expectations are more muted as the two main rising star candidates, Occidental Petroleum and Ford, have now both migrated to investment grade. While higher interest rates have triggered sizeable retail outflows, the higher yields have helped the market recover a portion of the flows as rates stabilize. New issuance in 2023 has jumped over 50% above the prior year's level and issuance is likely to continue to rebound in 2024. However, this is forecast to be only half of the issuance from 2020 and 2021, which benefited from significant refinancing activity due to the low interest rate environment. Companies have looked at several paths for addressing near-term maturities, including asset sales, sponsor equity contributions, private credit, and the public markets. The private credit market is an additional source of liquidity that has helped more troubled credits refinance debt and avoid default.

Areas of Concern – We expect to face similar growth and inflation concerns in 2024 as in 2023. We expect markets to continue to focus on the path of inflation, with sticky inflation data releases driving selloffs. Also, concerns remain around growth being too strong (leading to higher-for-longer concerns) and too weak (triggering fears of a hard landing). Risks include monetary policy, tighter lending conditions, availability of credit, and geopolitical events. Commodity prices, particularly oil and natural gas, remain topical for high yield despite the improved quality of energy-related borrowers as their credit spreads are now at meaningfully tighter levels. Higher interest rates and volatile markets increase the risk that the most troubled credits will be unable to refinance upcoming maturities. Additionally, the health of the consumer is a major focus as we continue to look for the delayed impact of higher interest rates on the labor market and consumer spending.

Valuation/Implementation – While spreads have recently moved back below 400 bps, yields of almost 9% are in the top 80-90th percentile of their historical levels and represent an attractive total return opportunity. Since we believe the markets will remain bumpy, we will continue to be opportunistic around reducing lower-rated debt—including unsecured LBO issues—into rallies and adding lower dollar bonds that become dislocated in selloffs. Attractive opportunities exist in senior secured bonds, shorter-maturity issues with liquidity or capital markets access, and wider-spread BB or crossover issues. We are also finding attractive opportunities with companies that have experienced elevated volume declines due to destocking that are positioned for improved earnings as volumes normalize to better reflect underlying demand. Overall, our goal remains the same: use fundamental analysis to find bonds with the best risk-adjusted returns.

BANK LOANS

By Frank Ossino

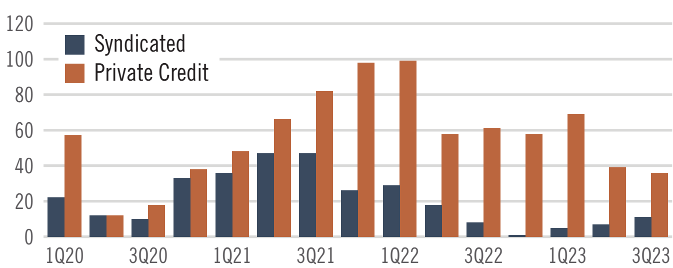
The steady increase in interest rates has resulted in a second straight year of outperformance for bank loans as other fixed rate asset classes were negatively impacted. Importantly, the rise in rates has led to a corresponding increase in the coupon, which provided a cushion against intermittent bouts of volatility during the year. Add to that a better-than-expected economy, and the backdrop for loans was optimal. Going into 2024, we believe that loans may be at an attractive "cruising altitude" due to their high current income, adequate cushion in the event of volatility, the reasonably supportive economy, and higher-for-longer rates. Loans are on track to return 12% in 2023, making it the best total return year since the GFC and in line with our initial forecast for historical equity-like returns this year.

However, as investors increasingly turn their focus towards the later stages of the cycle, the loan market will not be immune to macroeconomic concerns. So, despite a better-than-expected macro backdrop, positioning still points to playing slightly more defense than offense at this time, especially as data begins to indicate a slowdown in growth.

Fundamentally, one of the main stories of the year was the unexpected resiliency of the U.S. economy. A robust jobs market and better-than-expected savings allowed the consumer to continue to spend. Corporations worked through destocking and cost savings programs while finding that prices may be more inelastic than thought. The result was better-than-expected earnings and cash flow. The backdrop allowed risk metrics we watch—loans priced below 80 cents, and the downgrade/upgrade ratio—to both improve throughout the year.

Regarding the technical environment, the spring bank failures heightened concerns around broad capital markets access. Quarterly Senior Loan Officer Surveys throughout the year have shown tightening credit conditions. The high cost of capital also impaired new issuance, especially acquisition financing as it relates to private equity achieving return hurdles. Instead, we saw a material pickup in activity that pushed out near-term maturities via refinancing transactions. The technical story in 2023 also saw the proliferation of private credit—now $1.5 trillion in size—which, along with high yield and the broadly syndicated loan (BSL) market, became another capital market for non-investment grade borrowers to address financing needs. High yield market transactions also contributed to loan repayments. All told, the BSL market shrunk to $1.4 trillion. This occurred at a time when loan demand—retail funds/ETFs and CLO issuance—moderated but remained acceptable, thus acting as support for prices.

COUNT OF LEVERAGED BUYOUTS FINANCED IN BSL VS. PRIVATE CREDIT MARKETS



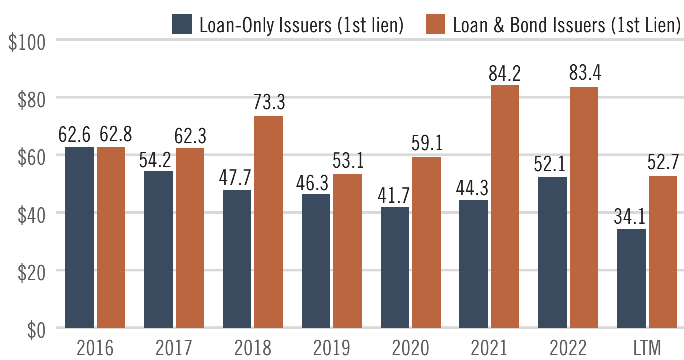
Source: PitchBook LCD. Data through September 30, 2023. Private credit count is based on transactions covered by LCD News.

Although the path was not a straight line, the better-than-expected appetite for credit and lack of duration risk in a rising rate environment resulted in loan spread tightening and outperformance relative to fixed rate asset classes and even equities.

We anticipate that retail fund flows may see another year of redemptions. On the supply side, a high cost of capital could result in another slow new issuance year. The wild card is the potential demand created via loan repayments with private credit and high yield bond take-outs. Additionally, with CLO structures accounting for roughly 69% of the primary investor market, a possible slowdown in CLO issuance is also worth monitoring.

Areas of Concern – A worse-than-expected economic slowdown tops our list of concerns going into 2024 and could impact our forecast. The Fed remains committed to fighting inflation at the expense of economic growth. With minimal/flat growth as the starting point and interest rates potentially being higher for longer—and the full impact of these rate increases becoming more apparent—the backdrop could be challenging for credit risk assets. In fact, we have seen a clear impact of interest rate coverage on borrowers. Nearly 20% of loan market borrowers now maintain interest coverage (EBITDA/Cash Interest) of less than 1.5x – up from 9% in mid-2021.

RECOVERY RATES FOR LOANS AND HIGH YIELD



Source: J.P. Morgan. Data as of November 11, 2023.

Lastly, the persistent degradation of credit quality created by a decades-long low-interest rate environment will put a premium on core fundamental analysis. We expect the loosening of credit documentation terms and conditions to reduce loan default recovery rates.

Outlook – Going into 2024, we believe that investors can be constructive on the loan market without being overly bullish on fundamentals, as the current yield profile provides a cushion against volatility. On top of that, the growing narrative supporting a soft landing, the high current coupon, and spreads wide of non-recession historical averages all make loan valuations still attractive. Even assuming a return to historical long-term default rates, lower-than-average principal recovery rates, and eventual rate cuts, the current jumping-off yield appears adequate to result in a net positive outcome over the next twelve months—this, while also maintaining the benefits of seniority in the capital structure as we head into a possible shift in the cycle.

LOANS AND HIGH YIELD VS. EQUITIES (1/1/92-9/30/23)

	Annualized Return	Standard Deviation	Return Per Unit of Risk	Rolling 3-Year Periods		
				Best	Worst	% Negative
Leveraged Loans	5.48%	5.37%	1.0	17.5%	-8.0%	3%
High Yield Bonds	7.09%	8.35%	0.8	26.1%	-7.6%	6%
Large Cap Equity	9.76%	14.76%	0.7	32.8%	-16.1%	17%
Small Cap Equity	8.79%	19.32%	0.5	29.6%	-17.8%	13%

Past performance is not indicative of future results. Source: Credit Suisse, Bloomberg LP, S&P, FTSE Russell. Data as of September 30, 2023. The Leveraged Loans, High Yield, Large Cap Equity, and Small Equity Markets are represented by the Credit Suisse Leveraged Loan Index, Bloomberg U.S. Corporate High Yield Index, S&P 500® Index, and the Russell 2000® Index, respectively. Returns were calculated using monthly data and begin with the inception of the Credit Suisse Leveraged Loan Index on January 1, 1992.

DEVELOPED MARKET GOVERNMENT BONDS

By Simon Lau, CFA and David Scott

After negative returns in 2022 and 2021, we may be posting positive U.S. dollar-hedged returns from global Treasuries in 2023. The outlook for the Fed, and by implication, the U.S. Treasury market, remains somewhat uncertain but appears increasingly positive. Markets currently price a Fed Funds rate of 4.48% by the end of 2024 with a 2-year yield of 4.36% and a 10-year yield of 4.59%. This implies some easing by the Fed, with a little more priced for 2025, and a gentle but noticeable steepening of the yield curve while long rates remain broadly unchanged. This seems consistent with a soft landing in which the yield curve normalizes. The challenges to this pricing are clear. Firstly, soft landings rarely happen but are often anticipated in the early stages of a slowdown that becomes a recession. If that were to happen, we would expect to see a broad-based rally and curve steepening beyond that which is currently priced. Alternatively, with inflation still too high and the economy perhaps more resilient than expected, the Fed may feel compelled to ensure a recession. This would imply further tightening and a rise in short-dated yields but might push longer-dated yields lower as the markets move to place a higher probability on eventual recession. The common theme across both these scenarios is lower, longer rates. High 10-year real yields offer valuation support to this analysis, leaving the U.S. more positive than we were at this time last year.

Having seen the European Central Bank (ECB) raise rates by some 200 bps over the course of 2023, the market now anticipates that tightening has finished, and by the middle of next year, moves will be taken to ease policy with a cumulative easing by year-end of 75 bps. As in the U.S., the forward pricing of the yield curve sees little change in 10-year yields, combined with a curve steepening which would see the 2/10s spread move from -35 bps to +32 bps. Current data readings suggest that the impact of past policy tightening is having a more rapid impact on economic activity in Europe, with growth near stagnation and the PMI readings suggesting further weakness ahead. With growth weak and inflation falling, it seems likely that the bias in yield moves will be to the lower side. Real yields are somewhat lower than in the U.S., and this suggests that, ultimately, better value will be found in the U.S. However, it is possible that early-year weakness in European activity may mean that that value is not realized until later in the year.

In the UK, monetary policy expectations oscillated throughout 2023. However, interest rate expectations for the Bank of England (BoE) were the most volatile among its developed market peers. At its peak, market participants expected the BoE to raise its policy rates by up to 1.25% to 6.25% amid stubborn inflation and a resilient labor market. The market has now recalibrated and anticipates that the BoE will maintain its policy rate at 5.25%. Market-based inflation expectations remain above 3% for the next two years, but there are potential signs of disinflation in the U.K. According to the October Recruitment & Employment Confederation (REC) report, progress is being made towards a better balance between staff demand and availability.

Japan looks likely to be the outlier in 2024. Having effectively ended yield curve control in the fourth quarter of 2023, we should see, economic data permitting, a continuation toward policy normalization in 2024. At its latest meeting, the Bank of Japan (BoJ) raised its inflation forecasts for this fiscal year and the next two. The key to policy normalization is likely to be found in how those inflation expectations evolve—this will be dependent on wage growth trends. According to UA Zensen, Japan's largest industrial union that represents approximately 1.8 million workers, it will seek a 6% total wage increase during upcoming negotiations. If wage growth materializes and translates into a durable inflationary impulse, the BoJ may be in a position where its policy diverges from other developed market central banks. If current projections are a fair representation of what to expect in 2024, the BoJ will begin tightening policy just as the Federal Open Market Committee, ECB and BoE prepare to ease. Against a backdrop of potential rises in policy rates, it is unlikely that Japanese government bonds will show the gains that we expect in other markets.

After pausing for several months, the Reserve Bank of Australia (RBA) raised its policy rate by another 25 bps to 4.35% amid upward revisions to its inflation expectations. The central bank now projects inflation to hit 3.50% by the end of 2024 before drifting down towards the upper end of its 2-3% target in 2025. The central bank also tweaked its language and said that further tightening would be contingent on the incoming data and the evolving assessment of risks. Although the RBA is one of the smaller central banks, the sequence of its rate hiking cycle—i.e., hike-pause-hike—serves as a reminder of central banks' resolve to tackle persistent inflation and their ability to respond to ensure inflation returns to target in a timely manner.

EMERGING MARKETS & NON-U.S. DOLLAR DENOMINATED BONDS

By Peter Lannigan, CFA, and Daniel Senecal, CFA

Following the broader bond market selloff from the prior three years, higher yields and average spreads leave us with a neutral view of the asset class. EM bonds cannot escape what is happening in the broader bond market, which had been declining for the past three years through October 2023. During such bouts of overall bond market pressure, EM bonds typically sell off more than comparably-rated U.S. credit sectors.

Total return %	YTD through 11/15/23	Average annual 5-year return
J.P. Morgan Emerging Markets Bond Index Global	1.9	0.4
Investment Grade Emerging Markets	-1.0	0.4
Investment Grade Emerging Markets less U.S. bps	-117	-81
High Yield Emerging Markets	6.1	0.2
High Yield Emerging Markets less U.S. bps	-106	-332

Past performance is not indicative of future results. Source: Bloomberg LP. Data as of November 15, 2023. Investment Grade EM represented by the J.P. Morgan Emerging Markets Bond Index Global – Investment Grade. Investment Grade U.S. Corporates represented by the Bloomberg U.S. Corporate Bond Index. High yield EM represented by the J.P. Morgan Emerging Markets Bond Index Global – High Yield. High yield U.S. Corporates represented by the Bloomberg U.S. Corporate High Yield Bond Index.

Our strategy has worked well. EM credit underperformed U.S. corporate credit in both the investment grade and high yield tiers of credit risk. As a result, we now see relative value differentials between EM and U.S. corporate credit as fair in investment grade, and we view select EM bonds as attractive in the high yield space.

From here, leading into 2024, we believe a sufficient level of value has been restored in EM bonds to induce us to add EM exposure on macro-driven dips. Since financial markets settled 14 years ago following the 2008 GFC, EM bonds have presented an attractive entry point when the all-in yield has approached 9.0%. It is currently 8.4%.

On the positive side, we think the Fed is done hiking, and, if not, it is very close. At the same time, we believe the Fed is still likely to continue to engage in quantitative tightening or simply not move back to quantitative easing. We've been light on EM exposure for the past five years to make room for U.S. credit. This worked as EM underperformed U.S. credit in both investment grade and high yield. The opposite happened during the great U.S. Treasury rally, which ended on August 4, 2020. EM outperforms when U.S. Treasury rates are declining more than when equities are rising. While this applies most of the time, relative performance is more mixed during bouts of risk-off.

To learn more about Newfleet Asset Management, please contact us at 212-548-1200 or visit newfleet.com. To learn more about Virtus's products, please contact us at 800-243-4361 or visit virtus.com.

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.

The **Bloomberg Emerging Markets Hard Currency Aggregate Index** is a hard currency emerging markets debt benchmark that includes USD-denominated debt from sovereign, quasi-sovereign, and corporate EM issuers. The **Bloomberg Global Aggregate Index** is a broad-based measure of global investment grade fixed-rate debt investments. The **Bloomberg Municipal Bond Index** is a market capitalization-weighted index that measures the long-term tax-exempt bond market. The **Bloomberg U.S. Aggregate Bond Index** is a broad-based benchmark that measures the investment grade, U.S. dollar-denominated, fixed-rate taxable bond market, including Treasuries, government-related and corporate securities, MBS (agency fixed-rate and hybrid ARM pass-throughs), ABS, and CMBS. The **Bloomberg U.S. Corporate Investment Grade Index** measures the performance of investment-grade corporate securities within the Bloomberg U.S. Aggregate Index The **Bloomberg U.S. MBS Index** covers agency mortgage-backed pass-through securities (both fixed-rate and hybrid ARM) issued by Ginnie Mae (GNMA), Fannie Mae (FNMA), and Freddie Mac (FHLMC). The **Bloomberg U.S. Asset Backed Securities (ABS) Index** measures ABS with the following collateral type: credit and charge card, auto, and utility loans. The **Bloomberg U.S. CMBS Index** measures the market of conduit and fusion CMBS deals with a minimum current deal size of $300M. The **Bloomberg U.S. Corporate High Yield Bond Index** measures fixed rate non-investment grade debt securities of U.S. corporations, calculated on a total return basis. 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 **Credit Suisse Leveraged Loan Index** tracks the investable market of the U.S. dollar denominated leveraged loan market. It consists of issues rated "5B" or lower, meaning that the highest rated issues included in this index are Moody's/S&P ratings of Baa1/BB+ or Ba1/BBB+. All loans are funded term loans with a tenor of at least one year and are made by issuers domiciled in developed countries. The **J.P. Morgan Emerging Markets Bond Index (EMBI) Global Diversified** is an unmanaged index of USD-denominated bonds with maturities of more than one year issued by emerging markets governments. The **Russell 2000® Growth Index** is a market capitalization-weighted index of growth-oriented stocks of the smallest 2,000 companies in the Russell Universe, which comprises the 3,000 largest U.S. companies. The index is calculated on a total return basis with dividends reinvested. The **S&P 500® Index** is a free-float market capitalization-weighted index of 500 of the largest U.S. companies. The index is calculated on a total return basis with dividends reinvested. The **Morningstar LSTA U.S. Leveraged Loan Index** is a daily total return index that uses LSTA/ LPC Mark-to-Market Pricing to calculate market value change. On a real-time basis, the index tracks the current outstanding balance and spread over LIBOR for fully funded term loans. The facilities included in the Index represent a broad cross section of leveraged loans syndicated in the United States, including dollar-denominated loans to overseas issuers. **LIBOR:** London Interbank Offered Rate. **SOFR:** The Secured Overnight Financing Rate.

The indexes are unmanaged, their returns do not reflect any fees, expenses, or sales charges, and they are not available for direct investment.

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