Q4 2016

Newfleet
ASSET MANAGEMENT
A Virtus Investment Partner

Emerging Markets Debt Strategy

Sector Assessment

FUNDAMENTALS
have shown signs of bottoming out. However, recent geopolitical events have reintroduced downside risks. Ongoing drivers of sector performance include the U.S. rate path, Chinese economic data, commodity prices, and U.S. dollar movements.

TECHNICAL FACTORS
have weakened as outflows returned to the asset class in the fourth quarter and issuance is expected to increase in early 2017.

VALUATIONS
are generally fair even after solid performance in 2016. Credit selection remains critical.

Important Developments this Quarter

Overview: The unexpected victory of Donald Trump in the U.S. presidential election was a pivotal event in markets as well as geopolitics. Expectations of faster growth and rising inflation through infrastructure spending, tax cuts, and a loosening of regulations sent U.S. Treasury yields surging in the fourth quarter. The U.S. dollar rose in their wake. Politically, the Trump win was the U.S. equivalent of Brexit and another stake in the ground for global anti-establishment movements.

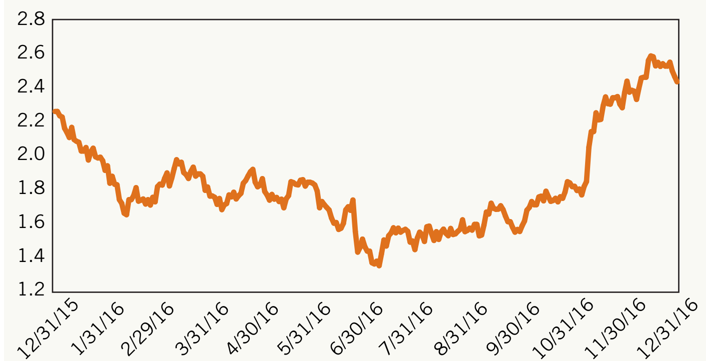
Treasuries: The yield on the U.S. 10-year Treasury accelerated in the immediate aftermath of the November 8 election. The benchmark yield ended the quarter at 2.45%, up from 1.60% at the end of the third quarter. The bond selloff went beyond the U.S., with rising yields reducing the outstanding amount of global negative-yielding debt from a high of $12.9 trillion in July 2016 to $8.6 trillion in early January 2017, according to J.P. Morgan. U.S. bonds remain attractive relative to their counterparts in Japan and Europe as the latter continue to rely on easy monetary policies and bond purchase programs to tackle chronic slow growth and low inflation. Key elections across Europe in 2017 raise fresh concerns about the Continent's growth prospects. As a precursor, a "no" vote on the December 4 Italian referendum to change the constitution gave that country's populist party an opportunity to advance its agenda.

U.S. TREASURY YIELDS

	12/31/14	12/31/15	12/31/16
2 year	0.67%	1.05%	1.19%
5 year	1.65%	1.76%	1.93%
10 year	2.17%	2.27%	2.45%
30 year	2.75%	3.02%	3.07%

Source: Bloomberg L.P.

10-YEAR U.S. TREASURY YIELDS (%)



Source: Bloomberg, L.P.
Performance data shown represents past results.

Federal Reserve: At its last meeting of the year, the FOMC raised the benchmark federal funds rate by 0.25% to a range of 0.5% to 0.75%. The decision to hike, the first since liftoff in December 2015, reflected improvements in labor market conditions and a considerable increase in market-based inflation expectations. The revised dot plot shows the policymaking body now expects three hikes in 2017, a more hawkish stance than the market had anticipated. While the December decision was widely expected, investor focus now turns to the potential impact of Trump's policies on future Fed actions.

U.S. Economy: By most measures, the new president will inherit a relatively sound U.S. economy. The labor market has shown solid jobs growth, with unemployment at 4.6% at year-end. Inflation expectations have increased since the election – a continuation of the longer-term trend, but also reflecting the inflationary impact of Trump's yet-unspecified spending plans. Core PCE (personal consumption expenditures ex food and energy), at 1.7%, is trending higher and slowly approaching the Fed's 2% goal. Consumer confidence and the housing sector

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both are supportive. Gross domestic product (GDP) grew at an annual rate of 3.5% in the third quarter, a sharp acceleration from sluggish growth in the first half of the year.

U.S. Dollar: As bond yields surged, the U.S. dollar followed suit as overseas investors sought to benefit from expectations of further Fed tightening and expansionary fiscal policy. The Bloomberg Dollar Index, a basket of 10 leading currencies against the U.S. dollar, closed the year at 1267.38, after touching a low of 1156.29 on May 2 and trading in a narrow and subdued range for much of the second and third quarters. The euro slid against the dollar during the fourth quarter, ending at 1.0517 and suggesting that the euro will reach parity with the greenback in 2017.

Oil: In another unanticipated outcome after months of false starts, Saudi Arabia-led OPEC and non-member major oil producers (notably Russia) reached a milestone agreement on November 30, 2016 to curb output and reverse the global supply glut. Brent crude, the international benchmark, ended the year at $55.89 per barrel after trading between $45 and $50 for much of the second and third quarters and reaching a low of $26.39 in January. Compliance with the agreement, which took effect on January 1, 2017, is a primary challenge to its success. An increase in U.S. shale production or slippage in demand as a result of a strengthening U.S. dollar could offset the impact of the curbs.

China: Relative calm persisted in China during the quarter amid some encouraging economic data. But storm clouds may be on the horizon. While the economy appears on track to maintain the government's annual growth target of 6.5% to 7.0%, the stimulus measures to support that growth may be unsustainable. Destabilizing factors include China's estimated debt load of 250% of GDP, as well as the potential for Trump's threat of a trade war to come to fruition. Further, China's currency began to slide following Trump's election, setting off a surge of capital outflows and a drain on foreign currency reserves to stem the losses.

Global Fixed Income Performance

The broader **fixed income** market as represented by the Bloomberg Barclays U.S. Aggregate Bond Index returned -3.0% for the fourth quarter. U.S. Treasuries tumbled with the backup in rates. Most spread sectors outperformed the benchmark as spreads tightened. The global demand for yield continued to boost returns.

High yield corporates was the quarter's best performing sector, offsetting the negative impact of rising rates with improving fundamentals and a positive economic outlook that led to spread compression. With the exception of healthcare, all of the industries within high yield had positive results for the quarter.

HOW THE STRATEGY PERFORMED

Contributors

- **Country Allocation:** Relative to the benchmark, the strategy's overweight exposures to Brazil, Russia, South Africa, and Venezuela helped performance, as did underweights in Panama, Poland, Malaysia, Uruguay, Dominican Republic, and Philippines. In Brazil, exposure to Petrobras and the outperformance of the corporate sector had a positive impact on performance. Venezuela/PDVSA and Russia both benefited from higher oil prices. PDVSA also successfully completed a debt exchange, which improved near-term liquidity. Russia enjoyed optimism regarding potentially better U.S. relations with the election of Donald Trump.
- **Sector Allocation:** The strategy's allocation to the corporate high yield sector provided the largest positive contribution to returns during the period, boosted by the recovery in asset prices of such companies as Enquest and Odebrecht Offshore Drilling. Enquest benefited from the rally in oil prices as well as the finalization of a restructuring agreement that boosted liquidity and thus ensured the completion of the company's Kraken project in the North Sea. Odebrecht was also helped by the improved energy market outlook, along with the settlement by a sister company with Brazilian regulators on corruption and bribery charges, and continued coupon and amortization payments.
- **Sovereign credits** of oil-exporting countries like Gabon, Ghana, Iraq, and Bahrain also outperformed. Gabonese Republic was one of the top contributors to performance over the quarter.

Detractors

- **Country Allocation:** The strategy's relative performance was hurt by overweight exposures to Mexico, Turkey, Argentina, and Indonesia. All of these countries experienced larger-than-benchmark losses due to increased uncertainty around rates and trade policy in the aftermath of the U.S. presidential election.
- **Security Selection:** The three largest detractors to performance were Republic of Uruguay, Pertamina Persero PT, and Argentine Republic. The selloff in long duration assets hurt Republic of Uruguay and Pertamina, while Argentine Republic fell on missed performance targets set by the government earlier in the year for growth, inflation, and fiscal balance.

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Metals & mining and energy were the top performers for the three-month period and the full year. On a quality basis, CCC-rated securities ably outperformed higher-rated credit tiers for the quarter and year.

Emerging Markets Debt Summary

Emerging markets debt, as measured by the J.P. Morgan Emerging Market Bond Index Global Diversified, returned -4.02% in the fourth quarter.

The poor performance of emerging markets in the quarter revealed their vulnerability to rising U.S. rates and a stronger U.S. dollar. Trump's espoused protectionist policies and their potential impact on trade and other economic lifelines were an additional factor driving the cautious sentiment toward these markets. The fourth quarter saw a surge in retail fund flows away from emerging markets.

In the aggregate, fundamentals have shown signs of stabilizing and economic growth appears to be bottoming out. Higher frequency economic indicators remain choppy and are country specific. Credit rating actions still have a downward bias, but may be improving.

Valuations are generally fair even after solid 2016 performance. Credit selection remains critical.

Current Strategy Positioning

Country Exposures: Over the fourth quarter, we increased weightings to Brazil, Turkey, and Russia and decreased weightings to Mexico and China. The strategy's top country exposures as of December 31, 2016 were Brazil, Mexico, Turkey, Russia, and Indonesia.

We remain constructive on the Brazil and Argentina recovery stories, although the latter fell a bit short of expectations in 2016. Politics in Brazil are likely to heat up in late 2017 as we get closer to the 2018 presidential election. The reform process enacted by new President Michael Temer continues on track, however, and is still well supported by the majority of Brazilians.

We are somewhat cautious on Mexico, although valuations have re-priced cheaper and we believe we are being compensated for the increased uncertainty around trade policy and the overall U.S. relationship. We believe that negotiations will end with limited damage to Mexico's credit quality and that this is largely reflected in prices. That said, we do expect increased volatility over the next three to six months.

With regard to Russia, we believe it will be a beneficiary of an improved U.S. relationship with the potential for sanctions to be lifted. The supply technical picture remains very supportive and the economy should exit recession in 2017. We have increased Turkish risk exposure on the back of cheaper valuations. Although we have been early on our investment call, we believe lower debt levels and prudent fiscal management will ultimately support the credit. The main risks to our thesis are external account vulnerability and geopolitics.

Sectors: High yield exposure rose during the quarter from 46.4% at 9/30/16 to 50.6% at year-end, largely reflecting our increased weightings to Turkey and Brazil.

Key Risks: Factors that could affect emerging markets debt performance going forward include uncertainty around President Trump's economic, trade, and foreign policies; the health of the Chinese economy; the timing and pace of Fed rate hikes; and progress on Brexit. Lower growth, terms of trade adjustment, and fiscal adjustment remain key challenges for many sovereign debt issuers in this environment. Tighter credit and lower trading liquidity are additional issues within the corporate space.

Looking Ahead

We are entering 2017 with a fair amount of uncertainty, much of it related to whether and how the newly elected president's campaign rhetoric will materialize into well-defined policies. Other challenges from 2016 remain as the new year begins. These include the ramifications of divergent global monetary policy; the extent to which the U.S. dollar will appreciate as the Fed tightens; the path of commodity prices; Chinese economic activity and policy; and the ever present but unknown geopolitical risks. Politics has become a heightened dimension of uncertainty as important elections in Europe in 2017 will test the strength of political gains made by anti-establishment individuals and parties.

We also enter the new year with renewed optimism for U.S. economic growth, modestly improving credit fundamentals, and evidence of continued albeit slowly improving emerging markets fundamentals. All of these factors should be positive for spread sectors. Trump's proposed policies are growth-oriented, which implies rising inflation and interest rates. We believe, however, that the Fed will stay the course and let economic data drive monetary policy. While the exact pace and magnitude of future rate hikes is unknown, there is significant evidence to support a gradual rise in rates. This also creates a positive situation for spread sectors.

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The **J.P. Morgan Emerging Markets Bond Index Global Diversified (EMBI Global Diversified)** is a uniquely-weighted version of the J.P. Morgan EMBI Global Index. The index limits the weights of those countries with larger debt stock by only including specified portions of these countries' eligible current face amounts of debt outstanding. The countries covered in the EMBI Global Diversified Index are identical to those covered by the EMBI Global Index. The EMBI Global Index tracks total returns for U.S. dollar-denominated debt instruments issued by emerging market sovereign and quasi-sovereign entities: Brady bonds, loans, Eurobonds. The index is unmanaged, its returns do not reflect any fees, expenses, or sales charges, and is not available for direct investment.

The commentary is the opinion of the subadviser. This material has been prepared using sources of information generally believed to be reliable; however, its accuracy is not guaranteed. Opinions represented are subject to change and should not be considered investment advice or an offer of securities.

Risk Considerations

Credit & Interest: Debt securities are subject to various risks, the most prominent of which are credit and interest rate risk. The issuer of a debt security may fail to make interest and/or principal payments. Values of debt securities may rise or fall in response to changes in interest rates, and this risk may be enhanced with longer-term maturities. **Foreign & Emerging Markets:** Investing internationally, especially in emerging markets, involves additional risks such as currency, political, accounting, economic, and market risk. **High Yield-High Risk Fixed Income Securities:** There is a greater level of credit risk and price volatility involved with high yield securities than investment grade securities.

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