Q3 2016

Multi-Sector Core Plus Strategy

Newfleet ASSET MANAGEMENT
A Virtus Investment Partner

Key Takeaways

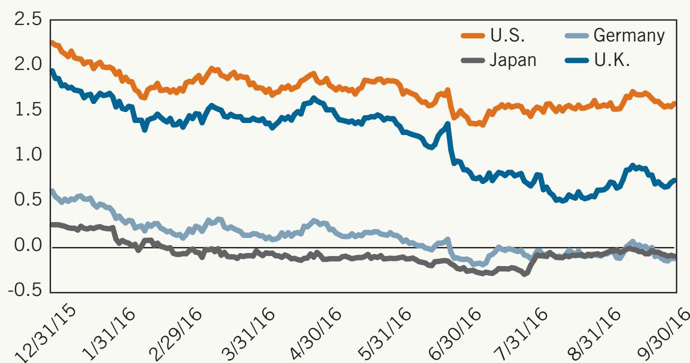
MARKET
The U.K.'s decision to leave the European Union (Brexit) shook markets early in the quarter, but then faded into the background for what would be a quiet summer. Concerns over global central bank policy brought some volatility back to the markets as the third quarter came to an end.

PERFORMANCE
The strategy's underweight to U.S. Treasuries added value in a period in which most spread sectors outperformed government securities. Exposure to the top-performing corporate high yield sector was a primary contributor as accommodative monetary policy and the global demand for yield lifted the sector.

OUTLOOK
With strong demand by investors and a supportive environment for fixed income, spread sectors continue to offer attractive opportunities to investors searching for total return and yield. Our emphasis continues to be on diversification, higher quality, and liquidity.

Important Developments this Quarter

Overview: The third quarter was unusually calm, though it began with fallout from the U.K.'s decision to leave the European Union (EU) and ended with a bout of volatility as investors questioned the efficacy of central bank policy.



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

Brexit: Bond yields in the U.S., Japan, and across Europe fell to historic lows in early July as investors fled to the safety of bonds based on global growth concerns fueled by the Brexit decision. On July 5, the yield on the U.S. 10-year Treasury closed at a record low of 1.37%.

Markets recovered rather quickly from the initial shock of the Brexit vote, though the British pound continued to slump. Versus the U.S. dollar, the pound fluctuated below 1.34 for the quarter, reaching a low of 1.29 in mid-August. Downward growth estimates led the Bank of England (BOE) to cut its key interest rate for the first time in seven years to a record-low level of 0.25%. The BOE also announced a stimulus program of gilts, corporate bonds, and a bank lending program. Despite encouraging economic releases in August, the U.K.'s future remains uncertain as the disentanglement process from the EU has yet to begin. Filling the political vacuum in Brexit's wake, Theresa May, the new Conservative party leader, will chart the course.

Global Central Banks: September brought heightened concerns about the ability and willingness of central banks to fight chronic low inflation and weak growth. The decision by the European Central Bank (ECB) to leave interest rates and its stimulus program unchanged was a precipitating factor in a widespread market sell-off, reinforced by fears that the Bank of Japan (BOJ) had run out of quantitative easing tools. Hawkish signals from the U.S. Federal Reserve added to the volatility. The BOJ subsequently decided not to change rates but to shift its focus to stabilizing the long end of the yield curve. This bolstered market sentiment, as did the Fed's eventual decision to stand pat. The VIX measure of volatility, which spiked on worries over the central banks, returned to its ultra-low levels of 11 to 14, from a high of 28 in February.

Federal Reserve: While the FOMC kept the benchmark rate at 0.25%-0.50% at its September meeting, three dissenters favored a hike. Chair Janet Yellen stated that the case for an increase had strengthened, but the policymaking body was willing "to wait for further evidence of continued progress toward its objectives." September saw a flattening of the dot plot of the Fed's medium- and longer-term expectations, which include a single quarter-point rate hike this year and two in 2017. Absent disappointing economic data or negative global developments, the probability of a December rate hike currently hovers around 57%.

U.S. Economy: The U.S. economy was reasonably sound during the third quarter. Gross domestic product (GDP) grew at a greater-than-expected annual rate of 1.4% in the second quarter. Despite stalling in August, consumer spending continues to be the primary driver of growth in the economy. The housing sector remains stable. Non-farm payroll numbers have been solid, though they were soft in August after two strong months. The unemployment rate at quarter-end was 4.9%. Inflation remains below target but has accelerated modestly over the past 12 months. Core PCE (personal consumption expenditures ex food and energy) stands at 1.6% versus the Fed's 2% goal.

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Treasuries: The yield on the benchmark U.S. 10-year Treasury ended the quarter at 1.60%, up from 1.47% at the end of June. However, this is down from 2.27% at year-end 2015. Yields are lower across fixed income year-to-date as global central banks have maintained easy monetary policies. Relative yields in the U.S. are attractive, which has driven demand. Bloomberg reported that, as of September 30, negative-yielding bonds now account for almost $12 trillion. Japan represents roughly half of the total, with the bulk of the remainder from France, Germany, the Netherlands, Spain, and Italy.

U.S. TREASURY YIELDS

	12/31/14	12/31/15	9/30/16
2 year	0.67%	1.05%	0.76%
5 year	1.65%	1.76%	1.15%
10 year	2.17%	2.27%	1.60%
30 year	2.75%	3.02%	2.32%

Source: Bloomberg L.P.

Oil: Brent crude, the international benchmark, traded between $45 and $50 per barrel for much of the quarter before closing at $47.41. Off and on prospects of a production freeze by major producers and fears of a global supply glut drove volatility. In late September, OPEC leaders reached an agreement to curb output, but deferred finalization of the terms until their November 30 meeting. Regardless of the outcome, the International Energy Agency reported that the supply/demand imbalance will persist at least through the first half of 2017 given record levels of output by OPEC producers and slowing demand, particularly in China and India.

China: China remained out of the headlines for much of the quarter. Positive economic data releases in August, notably industrial production and retail sales, suggested that China may be on track to meet its full-year GDP growth target of 6.5% to 7.0%. As the quarter came to a close, the Chinese yuan was about to officially join the U.S. dollar, the euro, and the yen in the International Monetary Fund's basket of reserve currencies.

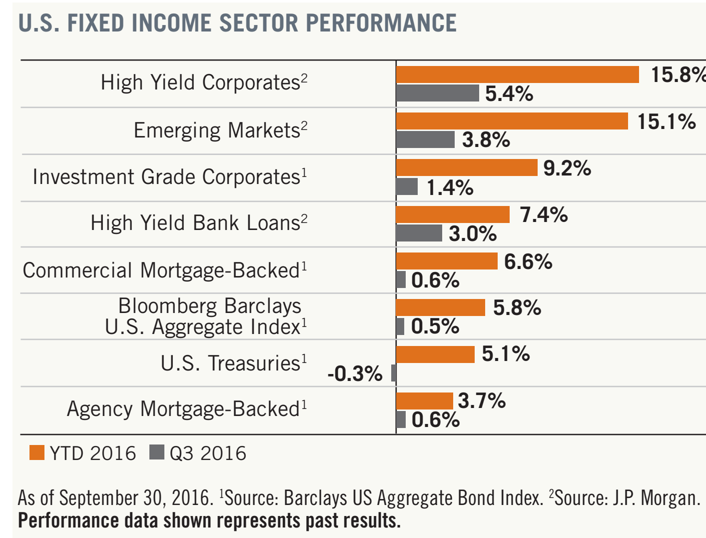
Global Fixed Income Performance

The broader **fixed income market,** as represented by the Bloomberg Barclays U.S. Aggregate Bond Index, returned 0.5% for the third quarter. Expectations of continued accommodative monetary policy and the global demand for yield resulted in strong performance for credit sectors. These sectors ably outperformed U.S. Treasuries as spreads tightened.

High yield corporates was the quarter's best performing sector, now posting eight consecutive monthly gains since the sharp sell-off in the early part of the year. All of the industries within high yield had positive results, led by metals & mining with a double-digit return. Telecommunications, chemicals, and energy also performed well; together with metals & mining, they are the sector leaders for the year to date. On a quality basis, CCC-rated securities continued to be the best performers. Fundamentals have weakened over the last year but are still sound, especially outside of energy and metals & mining. Leverage has increased, but interest coverage remains solid.

The **emerging markets** sector also delivered good performance.

U.S. FIXED INCOME SECTOR PERFORMANCE



As of September 30, 2016. [1]Source: Barclays US Aggregate Bond Index. [2]Source: J.P. Morgan.
Performance data shown represents past results.

HOW THE STRATEGY PERFORMED

Contributors

U.S. Treasuries and Agency Mortgage-Backed Securities: Our underweight benefited performance as most spread sectors outperformed the government sector.

Corporate High Yield: The sector was the primary positive contributor to performance during the quarter. As indicated above, the sector benefited from expectations of continued accommodative monetary policy and the global demand for yield. Technicals continue to be supportive, resulting from a net new supply shortfall and strong demand from overseas investors.

Corporate High Quality: Record supply year to date has been met with demand that has exceeded expectations, especially from foreign investors whose global investment grade alternatives offer much lower yields.

Detractors

Though exposure to the high yield sector contributed to the overall performance of the strategy, our higher quality bias detracted from returns during a period in which lower quality outperformed.

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In the aggregate, fundamentals have shown signs of stabilizing and economic growth appears to be bottoming out. That being said, emerging markets have benefited greatly from the favorable backdrop of a dovish Fed, easing policies of other central banks, the stabilization of commodity prices, fading concerns in China, and the global reach for yield.

Bank loans also performed well, though the sector lagged high yield as a result of its lower beta and lesser exposure to energy and metals & mining. Bank loans' inherently shorter duration compared to other sectors in the portfolio was also a dampening factor in an environment where longer duration assets outperformed.

Current Strategy Positioning

Reduced Exposures: We have reduced our weightings to corporate high yield, U.S. Treasuries, and emerging market securities. We redeployed the sale proceeds primarily to corporate high quality securities, asset-backed securities (ABS), and agency mortgage-backed securities.

Foreign Exposure: We maintained the strategy's overall foreign exposure over the quarter. Valuations in specific countries are attractive, and fundamentals seem to be turning as a result of the dovish Fed and other central banks easing higher commodity prices, fading concerns over China, and the improvement in global risk sentiment. We favor sovereigns in larger capital structures. Total foreign exposure remains relatively low compared to historical averages.

Higher Quality Focus: In addition to sector allocation changes, our relative value focus often includes repositioning within sectors. During 2015, we upgraded the overall credit quality of the strategy, which included staying underweight and reducing our exposure to energy-related credits. As credit spreads in sectors such as corporate high yield and corporate investment grade continued to widen during the first half of the first quarter of 2016, pricing in a high degree of negative news such as a potential U.S. recession, we added incremental credit risk to the strategy. We increased the strategy's positions in U.S. high yield, emerging markets, non-U.S. dollar bonds, and investment grade corporates. Although we have added to credit, we continue to emphasize higher quality companies, generally avoiding very low rated credits.

Overweights: We continue to overweight corporate high yield, high yield bank loans, residential mortgage-backed securities, and ABS (specifically out-of-index/non-traditional ABS).

Structured Finance: Our allocation to the structured finance sectors continues to play an important role in the strategy. Valuations remain attractive in the areas in which we invest, and this segment of the market offers diversification to sectors more sensitive to global macroeconomic concerns. They also offer diversification to the corporate credit allocation within the strategy.

- Commercial mortgage-backed securities have benefited from the strengthening U.S. economy and demand for U.S. real estate. Underlying commercial real estate fundamentals have softened but remain solid and, for the most part, are not hurt by low oil prices.
- Our consumer focus within the asset-backed sector has been helpful to performance as a result of the continuing ability of the U.S. consumer to lift the domestic economy.
- Non-agency residential mortgage-backed securities have benefited from the steady improvement in the housing market and demand for mortgage credit.

Looking Ahead

The U.S. economy appears to be on stable footing, with expectations that the second half of the year may be stronger than the first half. At quarter end, a number of forecasters upgraded their third-quarter annualized growth forecasts to 3% or better. All eyes will be on the Fed and its assessment of economic data, which will dictate whether a rate hike takes place before year-end.

As we enter the fourth quarter, there are a number of issues that could challenge the U.S. as well as the global economy. Concerns regarding the effectiveness of widespread unconventional central bank policies rocked markets in September and may re-emerge with more intensity. The Brexit process is likely to get underway and resurrect many of the uncertainties that surrounded the June 23 decision. In addition to fragile economic conditions across Europe, the Continent also faces the risk of political discord, including Italy's contentious December referendum to amend the constitution. Finally, the U.S. presidential election almost certainly will introduce some volatility.

As always, we believe it is important to stay diversified, have granular positions, and emphasize liquid investments. We continue to look for opportunities in all sectors of the bond market, striving to uncover any out-of-favor or undervalued sectors and securities. We are constructive on spread sectors based on still-sound fundamentals, strong technicals, accommodative central banks, and attractive valuations in certain areas of the fixed income markets. We continue to focus on higher quality credits within our below-investment-grade exposure, and are willing to give up some yield in order to avoid potential credit issues as we navigate the credit cycle.

With strong demand for fixed income by investors and a supportive environment, spread sectors continue to offer attractive investment opportunities to investors searching for total return and yield. Some of the specific sectors where we see value are out-of-index/off-the-run asset-backed securities, non-agency residential mortgage-backed securities, corporate high yield, high yield bank loans, corporate investment grade, and emerging markets.

The strategy maintains its higher quality focus and short duration to limit both spread and interest rate volatility.

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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 **Bloomberg Barclays 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 Barclays U.S. Corporate High-Yield Index** measures the USD-denominated, high-yield, fixed-rate corporate bond market.

The indexes are unmanaged, their returns do not reflect any fees, expenses, or sales charges, and are 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. **ABS/MBS:** Changes in interest rates can cause both extension and prepayment risks for asset - and mortgage-backed securities. These securities are also subject to risks associated with the repayment of underlying collateral. **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.

For more information on the Newfleet Fixed Income strategies, please contact:

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