Fixed Income Sector Review

As of April 30, 2017

MACRO ENVIRONMENT & MARKET CONDITIONS

- Risk markets moved cautiously higher in April as investors weighed healthy corporate earnings and the potential for corporate and individual tax cuts against looming Fed balance sheet normalization and slowing growth and inflation data.
- The U.S. economy added 211,000 jobs in April, above expectations for 190,000 jobs. The strong headline number can likely be partially explained as a bounce-back from the weak, weather-affected March report. The unemployment rate ticked down to 4.4%, but wage growth came in lower than expected at 2.5%, a deceleration from last month, and the participation rate declined to 62.9%. Wage growth continues to be benign despite an unemployment rate near the structural floor.
- Long-term inflation expectations eased over the last few months on hawkish Fed commentary and lowered expectations for inflationary fiscal stimulus. Realized inflation measures had been trending higher for 18 months, but core PCE (personal consumption expenditures ex-food and energy) decelerated to 1.6% in March, from 1.8% in February.
- The market is currently pricing in a 100% probability of an interest rate hike announcement at the June 2017 FOMC meeting, with roughly 60% odds of an additional hike by year-end.
- Q1 2017 GDP growth was 0.7% on the first reading, a slowdown the Fed dismissed as likely to be transitory.
- The housing sector is stable. We anticipate any further appreciation to be in line with overall wage growth.
- Economic data surprises, global developments, and the anticipated pace of rate hikes will drive further changes in the shape of the yield curve.

SECTOR ASSESSMENTS

Legend: Positive, Neutral, Negative

	Credit			Securitized Product				Non-U.S.			Municipals	
	IG CORP	HY CORP	BANK LOANS	ABS	MBS	RMBS	CMBS	EM HY	YANKEE GOV	NON-USD	TAX-EX	TAXABLE
Fundamentals	Neutral/Positive	Neutral/Positive	Positive	Positive	Neutral/Positive	Positive	Neutral/Positive	Neutral/Positive	Neutral/Positive	Neutral/Positive	Neutral/Positive	Neutral/Positive
Technicals	Positive	Neutral/Positive	Positive	Positive	Neutral/Positive	Positive	Positive	Positive	Positive	Positive	Neutral/Positive	Positive
Valuations	Neutral/Positive	Neutral	Neutral	Neutral/Positive	Neutral/Positive	Neutral/Positive	Neutral	Neutral	Neutral	Neutral	Neutral	Neutral

Newfleet's assessments of non-government spread sectors as of April 30, 2017. Assessments are determined by analyzing a sector's fundamental data, technical indicators, and relative valuations. Sectors (l to r): Credit: Investment Grade (IG) Corporate Bonds, High Yield (HY) Corporate Bonds, Bank Loans. Securitized Product: Asset-Backed Securities (ABS), Agency Mortgage-Backed Securities (MBS), Non-Agency Residential MBS (RMBS), Non-Agency Commercial MBS (CMBS). Non-U.S.: Emerging Markets HY, Yankee Government, Non-U.S. Dollar. Municipals: Tax-Exempt, Taxable.

Newfleet Asset Management's industry trends and observations are the result of research conducted by the portfolio management / research team. These observations reflect their industry expertise and have been prepared using sources of information generally believed to be reliable; however, their accuracy is not guaranteed. Opinions represented are subject to change and should not be considered investment advice.

SELECT SECTOR HIGHLIGHTS

Investment Grade Corporate Bonds	▶ Revenue and earnings growth are the strongest in two years. While fundamentals are improving, they are unlikely to get the near-term boost from fiscal stimulus that many investors were anticipating. ▶ Technical conditions are still strong. Net supply is slightly lagging 2016's pace, but demand is even higher. ▶ Spreads are on the rich side historically and versus securitized product, but remain cheap relative to higher beta sectors. Yields continue to remain attractive versus global alternatives.
High Yield Corporate Bonds	▶ Fundamentals appear adequate for the HY issuer universe. Although revenue growth has been elusive for many issuers, companies have implemented effective cost reductions as evidenced by more elevated EBITDA growth. April's issuer-weighted U.S. default rate fell to 4.5%, from 4.8% this time last year, and is expected to end 2017 at 3.0% and level off at 3.0% through April 2018 (well below the historical average). ▶ Issuance ($19B) was 41% below the 7-year average for April, historically a robust month for new deals. Refinancings continued to comprise the largest percentage for the use of proceeds at 66.2% YTD. ▶ Spreads are rich in a historical context. High yield might continue to grind even tighter based on the expectation of fewer defaults, accommodative global monetary policy should it persist, and the potential for stronger U.S. growth. The path of U.S. interest rates will be a key variable over the course of the year.
Bank Loans	▶ Credit pressures remain benign in a 2% U.S. GDP environment. With capital markets wide open, strong interest coverage (over 4x EBITDA/interest expense), and maturities extended (only 4.4% due in the next two years), the default cycle may have been pushed out. ▶ Retail fund flows ($2.4B in April), CLO creation ($10.2B in April), and domestic and foreign SMA mandates all continue to generate demand for loans at a time when new issue supply is constrained. We expect loan refinancings into lower spreads to continue, and may partially offset any benefit from rising LIBOR in the near-to-medium term. ▶ At month-end, 71% of the loan market was trading at par or higher, illustrating the limited price appreciation left in the market. Valuations nonetheless remain attractive on a risk-adjusted relative basis (especially compared to high yield) and warrant a strategic allocation, especially in a rising rate environment.
Securitized Product	▶ Low unemployment, strong consumer confidence, and a growing economy provide a positive backdrop to consumer credit, housing, and commercial real estate. We see these areas on solid footing as 2017 continues. ▶ Technicals are favorable in ABS, RMBS, and CMBS. Prudent levels of supply continue to be met by investors' need for yield. ▶ We do not expect credit spreads to rally much from here; however, we remain positive with respect to valuations. Lack of supply in most asset classes, coupled with stable underlying deal performance, still make these asset classes look attractive versus their U.S. Treasury counterparts.
Emerging Markets Debt	▶ Fundamental data points continue to favor the thesis that growth has bottomed, but this remains contingent on a supportive global backdrop. Ongoing drivers of sector performance include the U.S. rate path, Chinese economic data, commodity prices, and U.S. dollar movements. ▶ Technicals are sound, with the asset class the beneficiary of fund inflows and a heavy calendar of coupons and amortizations in the near term that will likely be reinvested. ▶ Valuations are generally fair but are now slightly through longer-term averages; credit selection remains critical.
Non-U.S. Dollar	▶ Currency and interest rate fundamentals and technicals remain mixed across both developed and emerging markets. Global markets remain volatile, sensitive to macroeconomic data (U.S., China, EU), U.S. monetary policy, and commodity prices. ▶ Valuations are mixed and heavily influenced by directional U.S. dollar views.
Municipal Bonds	▶ Fundamentals at the state level continue to be challenged by high fixed cost burdens, pension liabilities, and healthcare expenses. At the local level, fundamentals generally are solid due to rising property values and tax bases. ▶ Limited inflows and outflows in recent weeks reflect the hesitancy of the market in the current environment. High yield funds continue to garner flow as investors still look for yield. ▶ Municipal bonds remain stable despite unknown details on tax reform and Fed action.

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