Q1 2017 Fixed Income Review & Outlook
Featuring Newfleet CIO Dave Albrycht, CFA
with Joe Terranova, Virtus' Chief Market Strategist
Interview conducted January 25, 2017
Transcript edited for clarity

Christine McQuillan: *Good afternoon and welcome to today's call. I'm Christine McQuillan, product specialist for the fixed income portfolios at Virtus Investment Partners. Joining me are Dave Albrycht from our affiliated manager, Newfleet Asset Management, and Joe Terranova, Virtus' Chief Market Strategist. As the global bond market evolves, understanding both opportunity and risk is essential to implementing a strong fixed income program. Newfleet can help investors leverage the opportunities in today's markets. Newfleet is a pioneer in multi-sector fixed income investing and looks for relative value across 14 sectors of the fixed income market. Their seasoned team of investment professionals is led by a core group that has worked together for an average of 20 years.*

Dave Albrycht is President and Chief Investment Officer of Newfleet and serves as portfolio manager on numerous strategies managed by Newfleet, including the flagship Virtus Multi-Sector Short Term Bond Fund. Virtus Investment Partners was named Barron's "Best Tactical Bond Fund Family" for 2012, an honor also received in 2010 due in large part to the expert management of the firm's multi-sector fixed income strategies managed by Dave and the Newfleet Team. Dave has over 30 years of investment experience and has successfully driven the firm's multi-sector approach since 1993. Joe, who many of you may recognize as an ensemble member of CNBC's Halftime and Squawk Box program, will be moderating today's discussion with Dave. It's my pleasure to turn the call over to Joe.

Joe Terranova: *Thank you and welcome to everyone who has taken time out of your busy schedules to join us. Here we are with the Dow at 20,000 and we get to hear from Dave and talk about 2016, the future, and Newfleet's strategies. Dave, think back one year ago when the yield on the U.S. 10-year Treasury was 2%, the price of crude oil was $29, and everyone was having a daily conversation about the concerns and perils related to energy debt and the impact it could have on the market. We also at the time were preparing for presidential nominations for both the Republican and Democratic parties and there was even a little conversation about Brexit. So walk us through what obviously was a year in which consensus expectations were completely wrong. Reflect back upon 2016 if you would for us.*

Dave Albrycht: I would characterize 2016 as a year of great volatility that translated into great returns. Most spread sectors outperformed during the year. The Fed took a dovish stance in mid-February which sparked a rally that really turned around extreme volatility that you just described; there were fresh concerns over China, plummeting oil prices, fears that the Fed had raised rates too soon, and the market plummeted in fixed income.

We stuck to our strategy and our disciplined approach. Opportunities were abundant and when others were running for the hill, we did what we do best; searched for relative value. At the end of the year our portfolio bets worked. Corporate high yield, the sector was down 5% on February 11, and returned 17%, so a 22-point swing. Loans, which were off 2% in February, returned 10%, so a 12-point swing. Emerging markets gave back – they were down almost 6%, and returned almost 10% – 9.88%. Select local currencies did double-digit returns. Corporate high quality, which is a long duration, low coupon asset class, was up as much as 10% before the Trump elections, gave back about 4%, but still ended the year up 6.11%.

Then we have those sectors that suffered from the possibility of tax reform and outflows. Investment grade munis were only up 0.25%, high yield was up right around 3%, and then some of the high quality liquid sectors that we use effectively and extensively, which are usually short in duration and higher quality, CMBS (commercial mortgage-backed securities) and asset-backed securities (ABS) were up 2 and 3.3% respectively.

Contrast that to the Bloomberg Barclays U.S. Aggregate Bond Index, which was only up 2.65% for the year and Treasuries up 1.4%, passive management and core suffered while active multi-sector dramatically outperformed.

Now other areas of volatility are the ones you mentioned; Brexit late in June, then the Trump election which awoke animal spirits in the market and we saw rates go up in a rally, and then the Fed moved one time in December, raising rates 25 basis points.

I would just say, from a portfolio perspective, there was very strong performance across all of our fixed income products in 2016.I think one of the biggest drivers was overweighting spread sectors, underweighting Treasuries and agency MBS.

Another driver was adding at the right time, corporate high yield, emerging markets, and adding energy exposure when spreads got to what we considered back in February to be recessionary levels. Obviously, top performance drivers would be corporate high yield, emerging markets, non-dollar bonds, and bank loans.

We also had really great positioning within the securitized sectors. Asset-backed securities (ABS) – out-of-index bets in securities that tend to be what I would call less interest rate-sensitive like subprime auto, franchise receivables, timeshare receivables – there were really very few detractors. I think we timed it pretty well performance-wise, had a great year, and really delivered what clients expect.

Joe Terranova: *It sounds like you anticipated some of the tumultuous events in the marketplace and were able to play offense when they actually occurred. Would you agree that's a correct characterization when you reflect upon your portfolio management?*

Dave Albrycht: Yes, it's doing what we've done successfully for over 20 years, being opportunistic when the markets are the ugliest and going out there and finding value. I think we did a tremendous job.

Joe Terranova: *Okay, well here comes President Trump, 45th President of the United States. Since the election back in November, we've seen the largest advance in the equities market since 1900. Your twenty-first year managing the portfolio, what's your expectation looking forward? What's the impact you think that President Trump will have on the markets? And will it impact how you manage the portfolios looking forward?*

Dave Albrycht: Post elections, the markets were driven by a few things; hope, fear, enthusiasm, and then real action. The hope was that GDP would rise driven by tax cuts and fiscal stimulus. We saw a positive rise, as you mentioned, in stocks, risk assets, and credit – specifically leveraged finance. The fear was that we'd have rising inflation, rising deficit, rising debt burden, and possible trade wars. We saw that reflected in interest rates, Treasury rates. That really hurt core management style, it really hurt long duration. And munis obviously were affected by tax reform possibilities.

There's enthusiasm, and we've already seen some things getting done as executive orders are being passed. We also now have an alignment with the Senate and the House and the White House. Things should get done. But real action, probably you're talking 2018 – and for fiscal stimulus, it may be even out a little beyond that. Some of the companies are already acting "shovel-ready." So, that's something we have to take into consideration.

I would say that domestically, right now with trend growth at 2.2%, that's good. The yield curve was telling me in the last few weeks with the flattening that we saw that maybe 3 to 4% is a little ahead of ourselves for the next 12 months, maybe expect 2.5 to 3%, a little more within expectations, flattening of the curve that we saw.

The Fed is going to remain transparent and data dependent. The 25 basis points rate rise they did in December, right now they'd like to do a few more next year – and we can talk about that. Their balance sheet is still very significant at $4.5 trillion in size. They're still buying back $30 billion in agency mortgage-backed securities a month.

The housing market has stabilized. We love the non-agency mortgage market which is a lot less interest rate-sensitive and pre-payment sensitive than the agency mortgage market. And then, consumer fundamentals are still very, very stable. A big part of our short duration portfolios reside in asset-backed securities which are really consumer-driven products.

Joe Terranova: *I'm not going to have you give us a forecast on where you think the U.S. dollar is going. Obviously consensus thinks it's going to continue to move higher. Although this has a somewhat negative effect on the emerging markets, we're seeing one positive effect: the euro has fallen from 1.35 to 1.07 over the last two years and we're very quietly seeing a lift in the European manufacturing sector. I don't think many were prepared for the mild recovery that we're seeing globally right now. In fact the strategy of U.S.-centric sales is down 2.5% year-to-date, so I think that's caught folks a little bit offside here. Would you share your thoughts on the global markets, and expectations of what you foresee there? Also, we have a couple of elections coming up, could you walk us through those, and the impact they might have?*

Dave Albrycht: That's a very good point. Going back to last February, I think the dollar was priced to perfection, up almost 11%. We did some things there which we can discuss. But, like local currency investing in the foreign markets, things that we had come into the year at one of our lowest allocations in 22 years. But from a valuation perspective, things looked too beaten up and too great an opportunity to pass up. I would just say that we feel global growth is bottoming. Supportive policy is sort of the backdrop—helped by stronger oil in that comfort zone of where we are, in the mid to low $50s—the filter-through of accommodative central bank policy, not only in Japan but also the EU, and the U.S., and somewhat stability in China. And then stimulus efforts transitioning from monetary to fiscal, with the EU still doing $80 billion a month of buybacks, Japan's still doing $80 million a month in asset purchases.

You mentioned the electoral calendar. We have the Dutch elections coming up, the French elections, the German elections. These are all very meaningful, especially with the nationalistic backdrop and trend in populism. We saw the resurgence of the Syriza in Greece, we saw Brexit in the U.K., both occurring for two different reasons. Syriza was more concerned with debt and deficits, Greece was a concern about immigration. We saw the U.S. elect Trump, and then in Italy there was the ousting of the prime minister. All of these have meaningful implications, obviously not only for the euro, but for the global economy.

Something else that we're still looking at very closely is China, its trade, its currency, its possible growth. And then the durability of the commodity price rebound. Will the OPEC production cuts hold? Will oil stay in this comfort zone of the mid-$50s? That's very important for the domestic high yield market, and I'll give you rationale on why oil at current levels is, I think, very important.

Back in 2009, the oil component of the energy market was about 3%. If you could extract, frack, and ship oil at $75 a barrel, Wall Street gave you money. When it got to $100 a barrel, they gave you more money and refinanced you. At the end of 2014 the energy component of the high yield market was 16%.Then on February 11, 2016, oil dropped to sub-$30 a barrel, which meant that every E&P deal that was done in the prior five, six years would default. Now that oil is back up in the comfort zone, in the mid-$50s, we've seen defaults peak, right now at around 5.6%. We think maybe that in another three to six months they'll peak around 6.3% and start trending down, which is very positive. So obviously oil prices in the comfort zone in the mid-$50s means that you start to see improved fundamentals in the energy space, especially in the high yield market.

I thought this was an interesting fact: if you take out energy, chemicals, metals and mining, which is 20% of the high yield market, the other 80% of the high yield market has defaults running at less than 0.5%. So obviously this has been the volatile component of the high yield market.

Joe Terranova: *You talk about rising oil prices. Do you have any concerns about inflation?*

Dave Albrycht: Inflation is what's now spooked the market and we've seen rates rise. Inflation always impacts total returns, especially in fixed income. I think that you have to look at the rate environment, maybe even the Fed. Our range on the 10-year Treasury is 2.25 to 2.75%. And right now the 10-year Treasury is sitting at 2.50%.

So, what's the Fed going to do? Based on their “dot plot,” it looks like they would like to raise rates three times, and based on Fed fund futures, it looks like they'd like to raise rates twice. I think the Fed does not want to get caught like they did last year. They waited and waited as the economy grew weaker. They came into the year saying they were going to do three to four rate increases, and those didn't occur, except one at year-end. I would say it’s probably unlikely the Fed will act at their January meeting. There’s probably a 50% chance they act in March barring any international developments or any market risk volatility. If markets stay in check, I think the Fed will raise rates.

As far as the 10-year Treasury, we expect 2.75% on the top unless we really see a breakthrough in growth and perfection in the implementation of what Trump would like to get through on the fiscal side, tax reform side, repatriation side.

Joe Terranova: *I want to go back to inflation because many on the Street have strongly urged investors, "This is the moment, make sure that you have exposure to things like TIPs (Treasury Inflation-Protected Securities), make sure you have exposure to inflationary products." Just for clarification purposes, are you thinking that way with your strategies?*

Dave Albrycht: I would say that the breakeven for TIPs we don't think is that compelling. TIPs ran quite a bit last year, mostly due to the fact that rates had dropped. They're long duration assets. We thought a much more compelling argument coming into the end of the year with our muni team was the crossover trade in municipal bonds. That was much more compelling at the levels in volatility we saw there.

You want to protect yourself when rates rise. Obviously you want to overweight spread sectors, those that tend to be less interest rate-sensitive, those that give you a pickup over Treasuries. Typically if you're in a rising rate environment with inflation and the economy's improving, spreads will compress quicker than rates will back up.

Some examples of that would be in the leveraged finance space – high yield and bank loans; in the mortgage space – non-agency mortgage-backed securities really lack the extension risk in a rising rate environment that you have with agency mortgage-backed securities – and then some of the out-of-index asset-backed securities which are short in duration, give you excess spread.

Then you also want to look at sectors that have low to negative correlations in rising rates, and a prime example of that is one that I mentioned up front which is senior floating rate. In the senior floating rate space, the biggest concern there was that we had floors in place and rates would rise; the Fed would raise rates in the U.S. and you wouldn't get a bump in your coupon to follow. The 3-month LIBOR is the pricing mechanism they use. They could use 1, 3, 6, or 9-months but the pricing mechanism of choice is the 3-month LIBOR.

The 3-month LIBOR breached 75 basis points in September last year. We pierced the 100 basis point floor – already we're at 104 today – so because of the direct correlation, any move by the Fed should translate into a slight lag but a bump in coupon in your senior floating rate assets. So it will do exactly what you want; protect you from rising rates, especially if the Fed begins to move on the front part of the yield curve.

Joe Terranova: *Well, let me ask you about the Fed, and tell me if I'm hearing you correctly because others have suggested to me that the marketplace is complacent about the potential for the Federal Reserve to step in here, and view some of President Trump's policies as stimulating the type of growth that could force the Federal Reserve to maybe move a little bit quicker. Also others have suggested to me, "Hey look, you need to be cognizant of the composition of the Federal Reserve itself and the possibility that it will have a new chair in 2018." I don't think I'm hearing you share those concerns, is that correct?*

Dave Albrycht: Well first of all, there are two seats to be filled on the Board of Governors by Trump; there are seven positions on the Board and five are filled. Janet Yellen's term as Fed chair ends I believe in February 2018. There are 12 voting members of the FOMC, if you include the Federal Reserve President of the Bank of New York and the other four Federal Reserve Bank Presidents that have a one-year rotating term with the other Federal Reserve Banks. So there is a lot of movement going on there but there could be as many as five positions filled out of the 12 in the next two years. I think that bodes a little uncertainty but I would say that it may be with Trump’s nominations getting in and getting his point of view across. I think he wanted higher rates because we were at emergency levels for so long.

But to get all those programs through, it seems sort of counterproductive to have them aggressively move on rates with everything he's trying to do. I think maybe he'll go back to being not as quick, being a little more transparent, and taking time to move gradually to get his programs implemented.

Joe Terranova: *I want to talk a little bit about the leveraged market, the foreign markets, high yield, and some of the securitized sectors where you might see the best value.*

Dave Albrycht: Well first of all, investment grade corporates is an area we can't forget. It was up 6% last year. One of the things there is that all of these sectors look like fair valuation but because we have $8 trillion of negative debt around the world, there's tremendous insatiable demand. In investment grade, we saw $1.4 trillion of gross issuance. We dipped down in capital structure and were a little more aggressive. For example, some of the banks—Goldman, Morgan Stanley, J.P. Morgan, Santander—that got involved in some of the oil companies that issued common stock—Hess, Exxon Mobil, Apache, Anadarko—all made sense.

One thing that I thought was interesting about this market, if you went back 4-1/2 years ago, the U.S. investment grade market yielded 3.20%, Europe yielded 3.20%, Asia yielded 2%. Jump forward 4-1/2 years, the U.S. is yielding 3.3%, Asia's yielding 1.06%, the EU's yielding 0.87%. So if I'm a bank, a pension fund, or an insurance company in Asia or Europe, and I'm going to get a comparably rated security in the U.S. at that much of a pickup, there's going to still be tremendous demand, and we're seeing that on the trading desk. So investment grade corporates is still an area that we like.

High yield, as I mentioned, there is bifurcation in that market if you take out the big performers. In 2015 energy was down 23%, in 2016 energy was up 37%. Metals and mining in 2015 was down 23%, in 2016 it was up 45%. Chemicals was down 5% in 2015, and up 23% in 2016—that's a huge swing. That's why we saw the market down 5% in February of last year, and end the year up 17.1%. Issue selection there has never been more important. Now that we've seen a big swing in the high volatile component of the market, the other 80% of the market—which looks very favorable at 4 to 6% yields—provides stability. Names in the gaming space: Affinity Gaming, Boyd Gaming, IGT. Names in the homebuilders: Toll Brothers, TRI Point. Some of the

high quality oils: Continental, Parsley, Antero, some of the more aggressive: QEP, MEG. There's definitely value there, but it's a credit picker's market.

Lastly, in the bank loan space, which was up 10% last year, it's already up 0.50% this year. There's been thirty straight weeks of inflows. As I talked about, you're pulling forward the coupon now with where the 3-Month LIBOR is. There is not a lot of M&A going on, so there is a lack of issuance but very robust demand and again, you can benefit from that bump in coupon, but great names like Western Digital, T-Mobile, First Data, and Hilton Hotels, are a great way to diversify and to protect yourself during rising rates.

And then lastly there are the foreign markets. We decided in February last year that yes, the dollar looked really strong, and that strength may continue, but there were some other currencies that we thought looked really attractive, especially the large-cap currencies, Russia, Brazil, South Africa, Indonesia, were all up last year anywhere from 10 to 23%.

We thought that in the EM space selling Central Europe—Romania specifically—made sense, and to go out and buy some of the sovereigns—Turkey, Brazil, Mexico, Argentina. Buying some of the quasi-sovereigns—PKO Bank in Poland, Sberbank in Russia—and even buying some of the dollar-denominated Mexicans—Pemex, CEMEX, Televisa—and then in India there's ICICI Bank, Bharat, Vedanta all made sense.

Joe, you know how important country selection is in emerging markets, last year's best performer and worst performer at the sovereign level were separated by 90%. Belize was down 37%, Venezuela was up 53%. So security selection has never been more important.

Lastly, one other thing that we like is the structured market. Asset-backed securities—short duration, high quality ABS—haven't been more attractive, especially the one-off bets that we do, such as subprime auto like Santander. Almost two-thirds of our holdings have been upgraded over the last 12 months. Also franchise royalty receivable deals—you own a franchise, make a royalty payment to the parent company, they securitize it and sell it. We've done Taco Bell, we've done Wendy's, we've done Dunkin Donuts, Domino's Pizza -- all those have done extremely well with yields 2.50 to 4%. And then lastly some of the timeshare receivable deals: Hilton Hotels, Marriott, Wyndham Properties all have generated very nice returns for an investment grade asset in a relatively short three-year space. We think they're very attractive.

Joe Terranova: *You mentioned Pemex (Mexican stated-owned petroleum company). We've seen significant volatility in the Mexican peso with a lot of the things that President Trump has talked about. Has there been opportunity as it relates to Pemex debt?*

Dave Albrycht: Yes, number one, Pemex is a dollar-based commodity, plus a lot of their sales take place within the country. We've looked at it, we thought it made sense on a relative value basis, and it performed to our expectations. Even countries that have a lot of volatility—and I agree, the Mexican peso is obviously extremely volatile, down substantially last year, down another 2.50% this year, that's a concern—and Turkey has been another very volatile place to be—but on a valuation perspective, we think they make sense. Pemex, we looked at it. We saw it's pricing in a lot of bad news. We thought it made sense as a total return player and we bought it, and it performed to our expectations.

Lastly, something else I thought worth mentioning is the muni market which has been extremely volatile. Coming into the elections you had a nice total return. When Trump was elected, you saw huge givebacks, almost 6% in high yield, almost 3% on the investment grade side. People were worried about tax reform, outflows, the potential for more issuance. Obviously a lot of these municipalities are burdened with high fixed costs, heavy debt loads, and the threat of unfunded pension liabilities. There are only a few times in the muni market where you get a nice selloff and you get an opportunity to buy. Even with tax reform, we think it

will affect the corporate level much more than the individual. So, pension funds and insurance companies with big tax breaks may not be big buyers of munis, but I think the individual will always be a big buyer of municipal debt and always have a tax advantage on a taxable equivalent yield. There's always a place in a portfolio for it. So when you have the opportunity for selloffs, when you hear stuff about Chicago and unfunded pension liabilities, or even the oil belt states, we think it's a buying opportunity, and will do that as a crossover total return player.

Christine McQuillan: Thank you, Joe and Dave. At Virtus we are committed to driving better client outcomes and believe that insightful market perspective is key to helping investors meet their objectives. To learn more about our investment solutions, please call us at 1-800-243-4361 or visit us at Virtus.com.

Virtus Low Duration Income Fund (A: HIMZX, I: HIBIX)
Virtus Multi-Sector Intermediate Bond Fund (A: NAMFX, I: VMFIX)
Virtus Multi-Sector Short Term Bond Fund (A: NARAX, I: PIMSX)

Virtus Low Duration Income Fund

Top 10 Holdings As Of: December 30, 2016

Security	*% Total*
U.S. Treasury Note, 0.75% 12/31/2017	4.04
U.S. Treasury Note, 1.38% 04/30/2020	2.79
iShares iBoxx $ Investment Grade Corporate Bond ETF	1.90
FNMA, 2.5%	1.69
FNMA, 3%	1.40
FNMA, 2.5%	1.10
FNMA, 3%	0.79
UAL Pass-Through-Trust, 6.64% 07/02/2022	0.77
FNMA, 3.5%	0.70
Fannie Mae Pool, 3.50%	0.67
Total:	***15.85***

Virtus Multi-Sector Intermediate Bond Fund

Top 10 Holdings As Of: December 30, 2016

Security	*% Total*
Virtus Credit Opportunities Fund Class R6	3.03
Republic of Turkey, 4.88% 10/09/2026	0.74
CarFinance Capital Auto Trust, 3.58% 06/15/2021	0.71
FNMA, 3.5%	0.65
Towd Point Mortgage Trust, 3.25%	0.62
Sunoco Lp / Sunoco Finance Corp, 6.38% 04/01/2023	0.60
Argentine Republic, 8.28% 12/31/2033	0.55
FNMA, 3%	0.51
General Electric Co. Series D, 5.000%, 5% 12/29/2049	0.50
Alpek SA de C.V., 5.38% 08/08/2023	0.49
Total:	***8.42***

Virtus Multi-Sector Short Term Bond Fund

Top 10 Holdings As Of: December 30, 2016

Security	*% Total*
Virtus Credit Opportunities Fund Class R6	0.99
FNMA, 3%	0.73
America West Airlines Pass-Through-Trust, 7.1% 04/02/2021	0.56
FNMA, 2.5%	0.53
Wells Fargo (Wachovia Bank) Commercial Mortgage Trust, 5.59%	0.49
FNMA, 3%	0.49
U-Haul S Fleet LLC, 4.9% 10/25/2023	0.43
First Data Corp, 03/24/2021	0.38
Republic of Turkey, 6.25% 09/26/2022	0.38
OneMain Financial Issuance Trust, 3.19% 03/18/2026	0.38
Total:	***5.37***

Holdings are subject to change.

IMPORTANT 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 security may fail to make payments in a timely manner. Values of debt securities may rise and fall in response to changes in interest rates. This risk may be enhanced with longer-term maturities.

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.

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.

Bank Loans: There may be no ready market for loan participation interests. The fund may have to sell the interests at a substantial discount. Such interests are subject to the credit risk of the underlying corporate borrower.

Leverage: When a fund leverages its portfolio, the value of its shares may be more volatile and all other risks may be compounded.

Foreign & Emerging: Investing internationally, especially in emerging markets, involves additional risks such as currency, political, accounting, economic, and market risk.

Prospectus: For additional information on risks, please see the fund's prospectus.

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