VIRTUS FUNDS

Virtus Stone Harbor Emerging Markets Debt Income Fund

A: VSHCX (92828Y565) | I: SHMDX (92828Y557)

MARKET REVIEW

Sector Review "Broad Market"

In Q1, 2023, tighter financial conditions in the U.S. and Europe and fears of reduced credit availability amidst banking sector stress led to a reversal of earlier gains in developed country credit markets. By extension, returns on emerging markets (EM) bonds also turned down in March as spreads widened and portfolio outflows resumed. However, tracking indices for the three sectors of EM debt[1]—hard currency sovereign debt, local currency sovereign debt, and hard currency corporate debt—delivered positive total returns of 1.9%, 5.2%, and 2.2%, respectively. Global fixed-income benchmark returns, including EM, benefited from a decline in U.S. Treasury yields, which dropped in March, after increasing in February on strong U.S. economic data. U.S. high yield and investment grade corporate debt returned 3.7% and 3.5%, respectively, while 7-10 year U.S. Treasuries gained 3.0%. The USD depreciated as U.S. yields fell. EM currencies appreciated on average.

For more on our quarterly market review and outlook, **click here**.

Investment Grade

The EM investment grade (IG) sovereign benchmark posted a total return of 2.8% in Q1. All IG country bond markets delivered positive returns as falling U.S. Treasury yields enhanced performance. The largest contributors to index gains were Indonesia, China, and Qatar, with total returns of 3.06%, 2.89% and 2.28%, respectively. Investment grade sovereign spreads widened by 19 basis points on average, and widened in each country bond market except for China, Croatia, Kazakhstan, and Malaysia. Accordingly, excess returns relative to U.S. Treasuries were negative in 8 of the 19 benchmark countries. Romania, Mexico, Malaysia, China, and Hungary outperformed, generating excess returns over comparable maturity U.S. Treasuries of 1.7%, 1.5%, 1.3% 0.6%, and 0.5%, respectively. The Philippines, Panama, Uruguay, and Saudi Arabia posted the largest negative excess returns for the quarter, ranging between -1.3% (Philippines) to -2.2% (Saudi Arabia).

High Yield

Non-investment grade or "high yield (HY)" bonds delivered on average a total return of 0.9%, comprising a wide range of returns at the country level. The top ten highest total returns ranged from 4.4% (Brazil) to 24.1% (El Salvador). Two of these top performers—Lebanon (+11.4%) and Sri Lanka (+19.7%) are currently in default and negotiating with creditors on debt restructurings.

Venezuela's debt, which remains in default and has been excluded from benchmark return calculations since 2020, continued to post standout returns. The average return of debt of the Republic of Venezuela and Petroleos de Venezuela was +16.3% in Q1. The U.S. Department of Treasury's Office of Foreign Asset Control imposed sanctions on the bonds in 2019 in a push to restrict access of the Venezuela's government to U.S. capital markets. Bond prices moved higher amidst limited liquidity and from deeply distressed levels following reports of oil-focused sanctions relief. The U.S. government granted Chevron a license to expand production of oil in Venezuela and export to the U.S.

The largest detractors from returns were Ecuador and Egypt, which returned -25.7% and -9.8%, respectively. Political instability rather than weakness in macroeconomic factors, we believe, led to the downturn in Ecuador bonds, which sold off sharply after elections on 5 February. Ecuadorians rejected all of the government's consultation proposals and opposition candidates performed well in local elections, raising questions about governability under President Guillermo Lasso. Heavy investor positioning in Ecuador's bonds, reflecting the country's limited debt service over the next several years, and strong U.S. dollar revenue generation at current levels of oil prices, likely amplified the selloff, in our view. In Egypt, large external financing needs weighed on the macroeconomic outlook for the country. While Egypt secured a US$3 billion 48-month Extended Fund Facility with the IMF in December 2022, the need for extensive structural reforms, combined with restrained capital inflows, raised concerns about Egypt's external funding gap and dampened demand for Egyptian bonds. Nevertheless, in the final weeks of the quarter, Egypt secured additional funding from the World Bank (US$7 billion) and is likely to pass the first review of the IMF program early in Q2.

FUND PERFORMANCE REVIEW

The Fund (Class I) returned 2.41 % (net of fees) and 2.59% (gross of fees) in the first quarter versus the J.P. Morgan EMBI Global Diversified Index return of 1.86%.

Positive Contributors

- **Argentina:** An overweight and issue selection enhanced relative performance. Several developments supported prices of sovereign bonds: 1) the government implemented a sovereign bond buyback program, 2) the IMF disbursed US$6 billion following successful completion of its review of Argentina's Extended Fund Facility, 3) Argentina announced its expectations of a June completion of a gas project in Vaca Muerta, the second-largest shale gas formation in the world that will increase domestic gas production by 25%, and finally, 4) investors looked to the potential for a market-friendly change in the political regime in the upcoming October presidential elections.
- **Venezuela:** An overweight enhanced relative performance. Bond prices increased from low levels, reflecting market expectation of recovery in valuations if U.S. OFAC restrictions clear at some point in the future.
- **South Africa:** Issue selection enhance performance.

Performance Detractors

- **Ecuador:** An overweight detracted from relative returns. Political instability rather than weakness in macroeconomic factors led to the downturn in Ecuadorian bonds this quarter. Ecuador bonds sold off sharply after 5 February elections in which the population rejected all of the government's consultation proposals and opposition candidates performed well in local elections, raising questions about governability under President Guillermo Lasso. Heavy investor positioning in Ecuador's bonds, reflecting the country's limited debt service over the next several years, and strong U.S. dollar revenue generation at current levels of oil prices, likely amplified the selloff, in our view.

[1] J.P. Morgan EMBI Global Diversified, J.P. Morgan GBI-EM Global Diversified, and J.P. Morgan CEMBI Broad Diversified.

Effective January 30, 2023, this Fund's name has changed.

Continued on page 2

> **Tunisia:** An overweight detracted from relative returns. Tunisian sovereign bonds underperformed as continued political uncertainty delayed negotiations with the International Monetary Fund.

> **China:** An underweight in China detracted from relative performance. China's sub-index outperformed the broader market as the reopening positively impacted performance.

PERFORMANCE ATTRIBUTION BREAKDOWN as of 03/31/2023

Portfolio (gross basis – USD)	2.59
JPM EMBIG DIV	1.86
Difference	**0.73**
Breakdown	
Hard Currency Sovereign Allocation	**0.64**
Country Selection	0.12
Issue Selection	0.52
Local Currency Allocation	**0.03**
FX Exposure	0.03
Yield & Yield Change	0.00
Hard Currency Corporate Allocation	**0.02**
Country Selection	0.03
Issue Selection	-0.01
Treasury Attribution	**0.04**
Miscellaneous Difference	**0.00**

SECTOR DISTRIBUTION

	% Fund	Benchmark
Sovereign Hard Currency	74.60	100.00
Corporate Hard Currency	18.86	0.00
Sovereign Local Currency	1.41	0.00
Corporate Local Currency	0.00	0.00
Net Cash	5.13	0.00

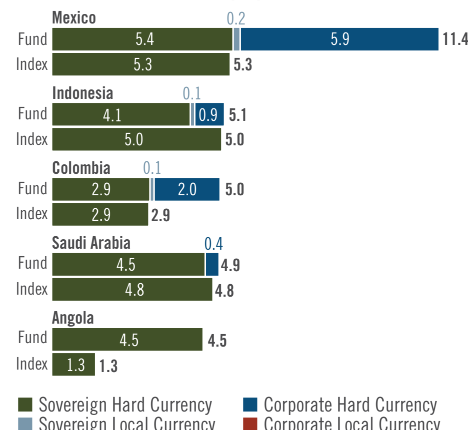
Sector weights are subject to change.

REGIONAL ALLOCATION

	% Fund	Benchmark
Africa	19.07	11.72
Asia	11.81	18.35
Europe	10.90	14.44
Latin America	36.73	33.09
Middle East	16.36	22.40
Net Cash	5.13	0.00

Weightings are subject to change. Weightings may not add up to 100% as a result of the use of certain financial instruments, including derivatives, which may be used to gain or reduce market exposure and/or for risk management purposes.

TOP 5 COUNTRIES (%)



CURRENT FUND STRATEGY

Positioning

> Overweight non-investment grade bonds vs investment grade debt

> Regional overweights in Latin America and Africa, underweights in Asia and Middle East, and neutral Europe

> Off-benchmark exposure in select local currency debt markets and U.S. dollar-denominated emerging market corporate debt, particularly in Colombia and Mexico

	YIELD (%)		RATING**		NOTABLE DEVIATIONS	
Strategy	**Portfolio**	**Relative***	**Portfolio**	**Benchmark**	**O/W**	**U/W**
Sovereign Hard Currency	10.59	2.25	BB	BBB-	Angola, Venezuela, Tunisia	China, Bahrain, Malaysia
Corporate Hard Currency	11.65	N/A	BB+	N/A	Mexico, Colombia, Kazakhstan	N/A†

*Relative to **JPMorgan EMBI Global Diversified Index**.
**Credit ratings issued by Nationally Recognized Statistical Rating Organizations assess the credit worthiness of the issuers of the underlying securities and not to the Fund or its shares. Ratings are measured using a scale that ranges from AAA (highest) to NR (not rated). Not rated securities do not necessarily indicate low quality. The security's credit rating does not eliminate risk and credit ratings are subject to change. Credit Quality reflects a weighted average composite of the ratings of Standard & Poor's Corporation, Fitch, Moody's Investors Service, Inc and DBRS. Ratings are then adjusted to the Standard & Poor's rating tiers shown. In the case where the composite is in between two ratings the rating will be rounded down. A composite will not be generated if the bond is only rated by one of the four rating agencies. Expected ratings and unsolicited ratings, designated by 'e' and 'u', are not included in calculating the composite.
†Not in the JPM CEMBI-Broad Diversified.
Benchmark: **JPMorgan EMBI Global Diversified Index.**

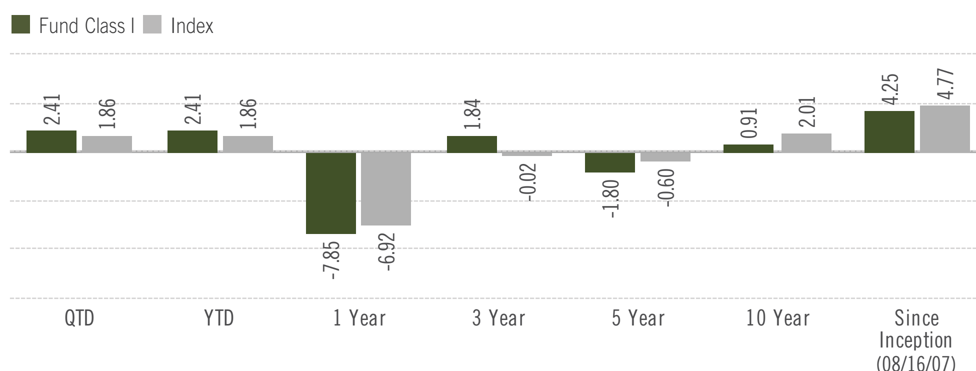
OUTLOOK & STRATEGY

Our base case macroeconomic scenario is a softish landing, with tighter financial conditions induced by higher Fed policy rates and a fading rebound from COVID-19, meaningfully slowing growth. Under this scenario, to which we assign a 50% probability, we assume that growth in emerging markets recovers as the impact of China's reopening offsets the drag from developed markets, while commodity exporters still benefit from strong terms of trade. U.S. growth remains positive but anemic, and Eurozone growth is close to zero. Alternative scenarios include a central bank-led global recession (30% probability), stubbornly sticky inflation (10% probability), and spiraling banking problems (10% probability).

The recent widening of credit spreads increases the expected returns for EM debt, in our view. Sub-investment grade credit spreads have returned to levels from early November before a rally that lasted through January of this year. Recent underperformance of some sovereign high yield markets in the latter part of March, particularly in sub-Saharan Africa, created better entry points, while outperformance of lower-yielding investment grade credits, particularly in the Gulf States, offered good opportunities to lighten exposures. Despite the decline in oil prices this quarter, several high yield oil exporters, including Angola, Ecuador and Iraq, maintain strong capacities and willingness to repay debt, and we believe still possess attractive valuations relative to similarly-rated peer countries.

In corporate debt, the market faces a manageable debt maturity wall over the next 12 months, and in most markets, local financing remains a viable option for high quality issuers. This technical tailwind, combined with lower defaults in 2023 than in 2022, we believe, will be supportive for the sector. Defaults in 2022 were the products of the onset of the Russian/Ukraine war and the sharp downturn in the Chinese homebuilding sector; markets have already discounted these impacts. While emerging market companies would not be immune from a slowdown in global growth should additional stresses in the U.S. and European banking sectors emerge, we believe most large emerging market banks remain well capitalized, systematically important, and beneficiaries of implicit government support.

AVERAGE ANNUAL TOTAL RETURNS (%) as of 03/31/23



Performance data quoted represents past performance. Past performance does not guarantee future results. Investment return and principal value will fluctuate so that shares, when redeemed, may be worth more or less than their original cost. Current performance may be lower or higher than the performance data quoted. Please visit virtus.com for performance data current to the most recent month end. This share class has no sales charges and is not available to all investors. Other share classes have sales charges. See virtus.com for details.

The fund class gross expense ratio is 0.80%. The net expense ratio is 0.73%, which reflects a contractual expense reimbursement in effect through 4/7/2024.

Average annual total return is the annual compound return for the indicated period and reflects the change in share price and the reinvestment of all dividends and capital gains. Returns for periods of one year or less are cumulative returns.

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

INVESTMENT ADVISER

Virtus Investment Advisers, Inc.

INVESTMENT SUBADVISER

Stone Harbor Investment Partners

PORTFOLIO MANAGERS

Peter J. Wilby, CFA
Industry start date: 1980
Start date as Fund Portfolio Manager: 2011

James E. Craige, CFA
Industry start date: 1988
Start date as Fund Portfolio Manager: 2011

Stuart Sclater-Booth
Industry start date: 1992
Start date as Fund Portfolio Manager: 2017

Kumaran Damodaran, Ph.D.
Industry start date: 2000
Start date as Fund Portfolio Manager: 2015

David A. Oliver, CFA
Industry start date: 1986
Start date as Fund Portfolio Manager: 2011

Notes on Risk: Emerging Markets Investing: Emerging markets securities may be more volatile, or more greatly affected by negative conditions, than those of their counterparts in more established foreign markets. **Foreign Investing:** Investing in foreign securities subjects the portfolio to additional risks such as increased volatility; currency fluctuations; less liquidity; less publicly available information about the foreign investment; and political, regulatory, economic, and market risk. **Credit & Interest:** Debt instruments are subject to various risks, including credit and interest rate risk. The issuer of a debt security may fail to make interest and/or principal payments. Values of debt instruments may rise or fall in response to changes in interest rates, and this risk may be enhanced with longer-term maturities. **Counterparties:** There is risk that a party upon whom the portfolio relies to complete a transaction will default. **Currency Rate:** Fluctuations in the exchange rates between the U.S. dollar and foreign currencies may negatively affect the value of the portfolio's shares. **Derivatives:** Derivatives may include, among other things, futures, options, forwards and swap agreements and may be used in order to hedge portfolio risks, create leverage, or attempt to increase returns. Investments in derivatives may result in increased volatility and the portfolio may incur a loss greater than its principal investment. **High Yield Fixed Income Securities:** There is a greater risk of issuer default, less liquidity, and increased price volatility related to high yield securities thaninvestment grade securities. **Liquidity:** Certain instruments may be difficult or impossible to sell at a time and price beneficial to the portfolio. **Income:** Income received from the portfolio may vary widely over the short- and long-term and/or be less than anticipated if the proceeds from maturing securities in the portfolio are reinvested in lower-yielding securities. **Market Volatility:** The value of the securities in the portfolio may go up or down in response to the prospects of individual companies and/or general economic conditions. Local, regional, or global events such as war, terrorism, pandemic, or recession could impact the portfolio, including hampering the ability of the portfolio's manager(s) to invest its assets as intended. **Prospectus:** For additional information on risks, please see the fund's prospectus.

Please consider a Fund's investment objectives, risks, charges, and expenses carefully before investing. For this and other information about any Virtus Fund, contact your financial professional, call 800-243-4361, or visit virtus.com for a prospectus or summary prospectus. Read it carefully before investing.

Not insured by FDIC/NCUSIF or any federal government agency. No bank guarantee. Not a deposit. May lose value.

Distributed by **VP Distributors, LLC**, member FINRA and subsidiary of Virtus Investment Partners, Inc.
9543 5-23 © 2023 Virtus Mutual Funds