STRONGER YEN STYMIEING BANK OF JAPAN'S EFFORTS TO BOOST GROWTH

AVIVA INVESTORS

May 2016

Key points

- Bank of Japan's efforts to reflate the economy are being foiled by stronger yen
- Spurring wage growth will be tricky when inflation expectations and union wage demands are falling
- Negative rates are punitive for banks; other measures will likely be required to weaken the yen
- A dovish Federal Reserve and pick-up in global sentiment may do more to stimulate sufficient inflation and growth than BoJ monetary policy

Mary Nicola

Senior Economist, Singapore*

Mary is responsible for our economic research and analysis of Asian markets, working with our Strategy Team.

Prior to joining Aviva Investors in May 2013, Mary was an FX strategist at BNP Paribas in New York covering the G10 markets. She has also worked with Standard Chartered Bank in Dubai and SCB Hong Kong, having joined the investment industry in 2007.

*Investment professionals listed are members of AIA's participating affiliate, Aviva Investors Global Services ("AIGSL").

The recent sharp rise in the value of the yen is complicating the task of the Bank of Japan as it looks to fight deflation and revive economic growth, argues Mary Nicola.

The Bank of Japan (BoJ) has showed its ability to surprise. In January 2016, just a month after it unexpectedly decided to increase the maturity of the government bonds it buys, its board voted by the slimmest of margins to take the significant step of introducing a negative deposit rate for the first time in its history. Then, on April 28, hopes it would expand its balance sheet further were dashed when the BoJ decided against it.

Working out what the BoJ is going to do next is getting difficult. But what is not in doubt is that the way in which the yen has been responding to these surprises is making the BoJ's task ever harder.

The yen has had its best start to a year in more than two decades, surging to an 18-month high against the US Dollar. The currency's 12 percent gain in the first four months of the year is casting doubt on the BoJ's ability to lift inflation.[1] And perhaps more worrying still, the perverse way in which financial markets reacted to January 2016's surprise rate cut has raised fears that monetary policy is becoming ineffective, partly because it may be having unintended consequences.

While the reasons for the yen's strength can be debated, with much of it no doubt the result of its perceived "safe-haven" status, the bottom line is that the appreciation is stymieing the BoJ's efforts to reflate the economy. That is because one of the ways looser monetary policy is supposed to boost economic growth is by improving a country's trade balance via a weaker exchange rate. A stronger yen is liable to have the opposite effect.

BoJ Governor Haruhiko Kuroda continues to talk up the bank's ability to achieve its inflation mandate by easing policy further. But recent history suggests he is going to be fighting an uphill battle. As the chart below shows, despite persistent efforts the central bank has failed miserably in its efforts to stoke inflation.

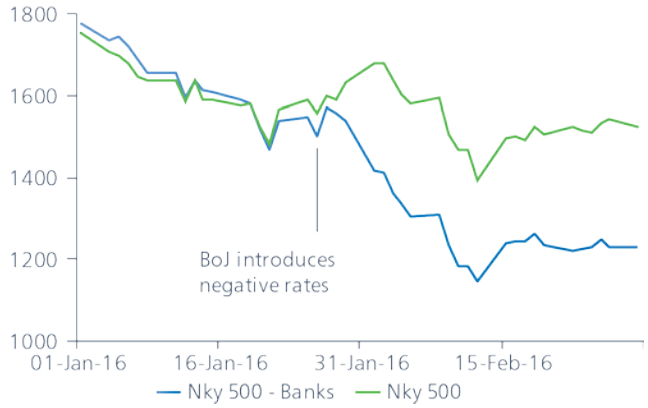
Inflation expectations have been declining

Source: Macrobond, March 2016 CPI – Consumer Price Index, TW JPY – Trade-weighted value of the yen.
Past performance is no guarantee of future results.

[1] Source: Bloomberg, as of 4/30/2016

Another unwanted side effect of negative policy rates is the detrimental impact on banks' profitability. As the chart below shows, these concerns have been weighing on Japanese banks' share prices.

Negative rates may be punitive for banks



Source: Macrobond, March 2016 Nikkei 500 Bank Index, Nikkei 500 Index
Past performance is no guarantee of future results.

While the BoJ has tried to mitigate this by introducing a tiered set of policy rates, there are concerns that a decline in banking sector profitability will adversely affect the availability of credit. But having opened the door to more negative rates, it may be that the BoJ thinks the negative impact on the banking system is outweighed by the added encouragement to domestic investors to rebalance portfolios towards riskier assets.

We nevertheless expect the BoJ will need to look at other policy options in addition to more negative rates, including possibly larger purchases of equities through exchange-traded funds. Given the detrimental moves in both the yen and domestic share prices, the challenge for the BoJ seems daunting

Weak wage growth casts further doubt on inflation target being met

The result of the first round of the "shunto" spring wage negotiations was disappointing to policymakers hoping to see faster earnings growth. The major car makers and electronics firms agreed to smaller hikes in base pay than in 2015. The annual increase fell to 2.08 percent from 2.43 percent the previous year.[2] Although companies were more generous with bonus payments and in terms of pay raises to temporary workers, if other firms follow suit, as seems likely, the BoJ will be faced with another headwind in its efforts to lift inflation.

China's renewed focus on growth and signs that output may be picking up in other large trading nations is good news for the BoJ. We believe a gradual recovery in global risk sentiment and economic growth should enable both inflation and wages to recover. But this is likely to happen only very gradually. And the central bank will have to repeatedly push back the date when it forecasts inflation returning to target as it did at the March 2016 meeting.

As for the yen, a stabilization in commodity prices and delay in US interest rate hikes could revive demand for emerging market assets funded by negative-yielding currencies such as the yen, or the "carry trade." This may do more to weaken the yen and help the BoJ achieve its reflation objectives than further aggressive easing of monetary policy.

[2] Source: HSBC Global Research, as of 3/21/2016

STRONGER YEN STYMIEING BANK OF JAPAN'S EFFORTS TO BOOST GROWTH

AVIVA INVESTORS
May 2016

Important Information

Unless stated otherwise, any sources and opinions expressed are those of Aviva Investors Global Services Limited (Aviva Investors) as of March 31, 2016. Opinions, estimates, forecasts, and statements of financial market trends that are based on current market conditions constitute our judgment and are subject to change without notice. Information contained herein has been obtained from sources believed to be reliable, but has not been independently verified by Aviva Investors and is not guaranteed to be accurate. References to specific securities, asset classes and financial markets are for illustrative purposes only and are not intended to be, and should not be interpreted as, recommendations. Past performance is no guarantee of future results.

The name "Aviva Investors" as used in this presentation refers to the global organization of affiliated asset management businesses operating under the Aviva Investors name. Each Aviva Investors' affiliate is a subsidiary of Aviva plc, a publicly- traded multi-national financial services company headquartered in the United Kingdom.

Aviva Investors Americas LLC (AIA) is the named subadviser to the Virtus Multi-Strategy Target Return Fund and utilizes the services of Aviva Investors Global Services Limited (AIGSL) and its other affiliates (collectively, Aviva Investors) to manage the Fund. These affiliates are Participating Affiliates as that term is used in relief granted by the SEC. The listed investment professionals are associated with AIGSL.

IMPORTANT RISK CONSIDERATIONS

Equity Securities: The market price of equity securities may be adversely affected by financial market, industry, or issuer-specific events. Focus on a particular style or on small or medium-sized companies may enhance that risk. **Foreign & Emerging Markets:** Investing internationally, especially in emerging markets, involves additional risks such as currency, political, accounting, economic, and market risk. **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. **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. **Derivatives:** Investments in derivatives such as futures, options, forwards, and swaps may increase volatility or cause a loss greater than the principal investment. **Leverage:** When a fund leverages its portfolio, the value of its shares may be more volatile and all other risks may be compounded. **Counterparties:** There is risk that a party upon whom the fund relies to complete a transaction will default. **Portfolio Turnover:** The fund's principal investment strategies will result in a consistently high portfolio turnover rate. A higher portfolio turnover rate may indicate higher transaction costs and may result in higher taxes when fund shares are held in a taxable account. **Prospectus:** For additional information on risks, please see the fund's prospectus.

Investors should carefully consider the investment objectives, risks, charges, and expenses of any Virtus Mutual Fund before investing. The prospectus and summary prospectus contain this and other information about the fund. Please contact your financial representative, call 1-800-243-4361, or visit www.virtus.com to obtain a current prospectus and/or summary prospectus. You should read the prospectus and/or summary prospectus carefully before you invest or send money.

Not all products or marketing materials are available at all firms.
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.