GLOBAL HIGH YIELD: EUROPEAN BONDS IN POLE POSITION

AVIVA INVESTORS

May 2016

Key points

- While default rates are likely to rise in 2016, as more energy businesses default, they are unlikely to soar
- Some investment-grade energy issuers may be downgraded to high-yield status in coming months
- We believe global high-yield bonds will return between three percent and five percent in 2016. While this is lower than in recent years, returns still look decent compared with those likely from better quality bonds and shares
- The outlook looks most promising in Europe, especially given its lighter weighting to energy companies. Issuers in the financial and consumer discretionary sectors offer particular value

Kevin Mathews

Head of Global High Yield

Kevin is responsible for the global high-yield portfolio management team that manages global, US, and European portfolios. He joined Aviva Investors in 2014 from Scottish Widows Investment Partnership, where he headed US high yield. He has also worked at F&C Investments, ING Investments and Van Kampen Investments. Kevin joined the investment industry in 1982.

Despite the risks of slowing global growth and more falls in oil prices, prospects for European high-yield debt are particularly encouraging, says Kevin Mathews.

It has been a tough time for high-yield bond investors over the last eighteen months as slowing economic growth and a sharp slide in oil prices spooked financial markets; January 2016 saw the second worst start to a year since 2000.[1] However, bonds have rallied strongly since the middle of February, as fears over the economy ebbed and oil prices began to recover. By the end of April, high-yield bonds had returned 6.71 percent since the start of the year.[1] Can the rally continue given the risks facing the global economy and mounting corporate indebtedness?

Since Q3 2014, much of the movement in high-yield bond markets has been a consequence of energy businesses' debt, especially bonds issued by US energy companies. Demand for oil has slowed with prices more than halving since mid 2014, in turn reducing energy companies' profitability and increasing the risk of issuers defaulting.

Energy issuers face further falls in oil prices

The market has become more optimistic on the outlook for oil prices since February. In our view, it is now too optimistic. We doubt oil prices will hold above $50 a barrel, given current production levels and US inventories. In any case, fracking companies will struggle to make a profit even at the current oil price of $47.75.[2] Ultimately, some high-yield energy companies may be unable to meet their costs and could potentially go bust before the end of 2016. Furthermore, some better-quality, or investment-grade, energy issuers may be downgraded to high-yield status.

Despite recent concerns over global growth, a recession is unlikely in the short term. While we expect default rates to rise this year, primarily due to a surge in defaults by energy businesses, overall rates are unlikely to soar. Stripping out energy issuers, default rates for high-yield bonds globally should be close to their historical average with no clear trend in terms of which types of industries are likely to suffer most – which is a healthy sign. Default rates for non-energy companies may fall slightly in coming months.

The majority of high-yield debt is issued in the US, with energy businesses accounting for four-fifths of high-yield issuers in the country.[3] The European high-yield market is only around a third of the size of that in the US, though Europe's share of the global market was only a seventh a decade ago.[3] This is due to bank lending, especially to riskier companies, slowing since the financial crisis of 2008. More companies have been forced to turn to debt markets.

[1] Source: Barclays Global High Yield ex CMBS and EMG index unhedged, USD, 4/30/2016
[2] Source: Bloomberg, WTI Crude Oil, as of 5/16/2016
[3] Source: Barclays Global High Yield ex CMBS and EMG index unhedged, USD, based on data as 4/30/2016

GLOBAL HIGH YIELD: EUROPEAN BONDS IN POLE POSITION

AVIVA INVESTORS

May 2016

High-yield bonds issued by financial companies comprise a larger portion of the European market. It has been far more common for banks to raise capital in Europe through debt issuance than in the US. And, this trend is likely to persist as banks in Europe look to raise capital to meet tougher capital adequacy requirements.

Mind the gap

We expect the US Federal Reserve to hike interest rates once or twice in 2016, doing so for the first time in almost a decade in December 2015. Meanwhile, the European Central Bank (ECB) may take short rates deeper into negative territory. Against this widening gap between US and European interest rates, the former looks far closer to the peak of the "credit cycle" than Europe.

Furthermore, the ECB is planning to start buying higher-quality euro-zone corporate bonds as part of its asset purchases. This added demand for investment-grade bonds should boost prices and lower yields, adding to the appeal of high-yield bonds in its wake.

The persistence of negative interest rates in the euro zone is likely to hit banks' profitability. However, we believe European banks' balance sheets look reasonably healthy and high-yield bonds issued by these banks continue to offer value.

The average maturity for high-yield bonds is much shorter than for investment-grade bonds. In high yield there is far more opportunity to influence performance through portfolio positioning than by making calls on interest rates.

Pockets of value

In our view, the best value found among high-yield bonds at present is among the better quality debt, or those with credit ratings of double B or lower BB. We remain cautious on bonds issued by energy companies, which are likely to underperform given the market's optimistic expectations on oil prices, and our view on potential future energy price weakness.

We believe global high-yield bonds will return between three percent and five percent in 2016. While this is lower than in recent years, returns still look decent compared with those likely from better quality bonds and shares.

The outlook for the asset class looks most promising in Europe, especially given its lighter weighting to energy companies. Issuers in the financial and consumer discretionary sectors offer particular value, with companies in the latter group likely to profit from higher consumer spending spurred by increasing confidence and lower oil prices. While high-yield bonds in Europe yield roughly half of those in the US, the US market may struggle until there are signs that commodity-related defaults are close to peaking. Furthermore, the outlook for monetary policy is relatively favorable in Europe.

We expect high-yield bonds may struggle in the next few months. Stretches of volatility remain a risk for financial markets in coming months, possibly emanating from disappointing economic growth, a monetary policy shift or a surprise fall in commodity prices. While investing in high-yield bonds should be rewarding, it does contain more risk than higher quality asset classes.

GLOBAL HIGH YIELD: EUROPEAN BONDS IN POLE POSITION

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 May 6, 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. There can be no guarantee that the investment or risk objectives discussed will achieve their desired objectives.

High yield bonds involve a greater credit and liquidity risk than investment grade.

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.