

Fixed Income Market Commentary and Strategy Review

Third Quarter 2011



A Virtus Investment Partner

FIXED INCOME MARKET REVIEW

In the third quarter, a combination of global economic weakness, European sovereign credit anxiety, and an untimely S&P downgrade of the United States' credit rating threw world asset markets into a tailspin. Investors grew particularly glum after the Federal Reserve's seemingly aggressive "operation twist" security reinvestment program was met by selling in the equity, credit, and commodity markets. U.S. fixed income was the safe haven asset class during the quarter, as Treasury rates plummeted by 125 basis points [Figure 1] and the Barclays 10+ year Treasury index produced a remarkable 23% total return. High quality corporate and mortgage backed securities also managed to generate positive returns, but bonds with more credit exposure such as high yield corporates and emerging markets debt exhibited negative performance of -5% and -3.5% respectively.

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In our view, the risk selloff seemed excessive. U.S. High Grade Corporate spreads are now at Enron levels [Figure 2] and European bank spreads are 70 basis points short of their 2008/2009 peaks [Figure 3]. At plus 910 to Treasuries, High Yield bonds are back to where they were on the eve of the Lehman bankruptcy. Economic fundamentals are partially to blame, but investor's disdain for their political leadership has led to a crisis in

FIGURE 1. 10-YEAR TREASURY RATES

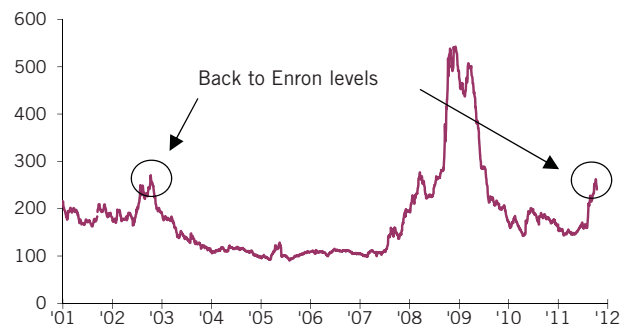
June 30, 2011 to September 30, 2011



Source: Bloomberg

FIGURE 2. U.S. CREDIT SPREADS

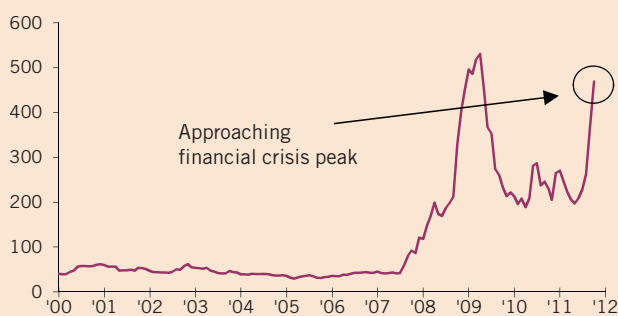
December 31, 2000 to September 30, 2011



Source: JP Morgan

FIGURE 3. EUROPEAN BANK SPREADS

December 31, 1999 to September 30, 2011



Source: Barclays Capital

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FIXED INCOME MARKET REVIEW (CONT.)

confidence [Figure 4], precipitating a wholesale exit from portfolio risk [Figure 5].

On the economic front, U.S. employment remained weak, though other economic data was more encouraging. Retail sales rebounded somewhat, as consumer retrenchment and the effects of the Japanese supply chain disruption appear to have bottomed. In the manufacturing sector, the Chicago purchasing managers survey and all-important national manufacturing ISM were impressive at 60.4 and 51.6 respectively. Globally, PMI's continued to hover around 50 (the boundary between growth and recession), with China teetering on the brink at 49.9. Europe's economy has been slowing however, with the sovereign debt crisis and incipient austerity diet sowing the seeds of recession.

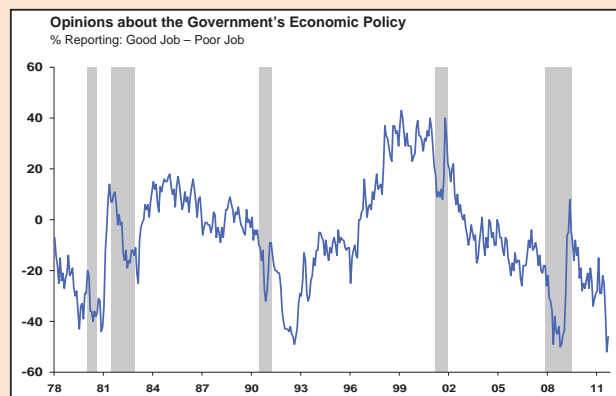
FIXED INCOME MARKET OUTLOOK

As dreary as things look in the rear view mirror, we are more optimistic about what lies ahead. We think that the U.S. economy has bottomed, that there is an achievable solution to the European debt crisis, and that China's cyclical landing will be soft.

First, Europe; we'll begin by asserting that Italy and Spain are solvent and that Greece, with large fiscal deficits and debt comprising 150% GDP, is beyond saving. Spain has relatively little debt (70% debt to GDP) and is firmly addressing its fiscal deficit, while Italy is more heavily indebted but actually enjoys a primary surplus. The risk for these two is not solvency but funding, as debt markets fear that contagion from an inevitable Greek default could spread to these two large economies. For now the ECB has stepped in to fill the financing gap, but a more solid fiscal solution must be arranged. This can only be accomplished by a joint effort between the fiscal authorities through an enlarged European Financial Stability Fund (EFSF), and the European Central Bank (ECB). To achieve stability Europe must do three things. First they must recapitalize their banks. Germany, France, and the major supranationals (IMF, ECB, and EU) are in agreement on this and we expect implementation to begin in November. Recapitalization will consist of both capital injections and balance sheet

FIGURE 4. INVESTOR CONFIDENCE IN GOVERNMENT AT ALL TIME LOW

1978 to 2011

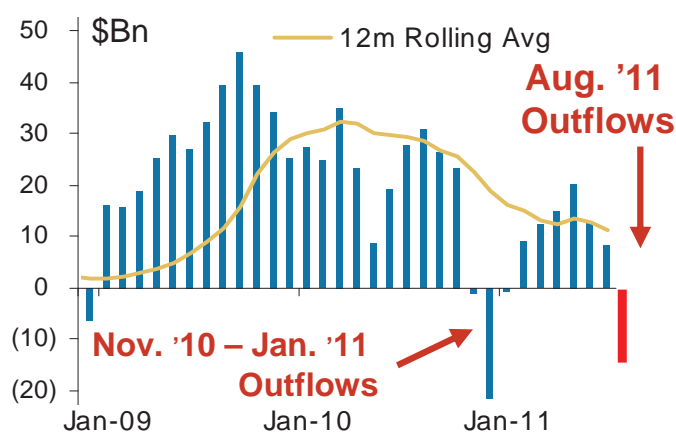


Shaded areas designate recession

Source: Thomson Reuters/University of Michigan Survey of Consumers

FIGURE 5. MONTHLY MUTUAL FUND FLOWS

2009 to 2011



Source: JP Morgan

deleveraging. The second imperative is the provision of long term funding. The ECB has already made substantial progress in this respect, and we expect the incremental contribution of the EFSF to fill in the remaining gaps. The final step is to prop up asset values by buying or guaranteeing the debt of the two large peripheral countries. Repellent as this is to Europe's solvent citizens, there is no other solution. To do otherwise would result in a chaotic series of peripheral defaults, accompanied by a steep global recession. ECB opposition to direct monetization means a creative solution must be

FIXED INCOME MARKET OUTLOOK (CONT.)

found to enable ECB/EFSF collaboration to pave the way to European financial normalization. This is not dissimilar to the challenge faced by U.S. policy makers in 2009. Despite statutory impediments, the Fed and Treasury creatively collaborated to find ways to shore up the financial markets. We expect that, of necessity, Europe will too.

Clarity on the European sovereign front will remove a major impediment to U.S. economic growth by eliminating concerns about contagion to the banking system. This should restore confidence in the overall financial system, encourage lending and support growth. Monetary policy will be supportive as well, as the Fed has vociferously asserted its resolve to fulfill its growth mandate through extraordinary measures. We believe that operation “twist,” the duration equivalent of another QE II, will provide a strong tailwind to the economy in the 4th quarter and early 2012. Should it fail, financial conditions are commensurate with those that precipitated QE II, [Figure 6] and we would anticipate a QE III if needed. For the U.S. economy overall, we are projecting modest (2%) U.S. GDP growth for the next several quarters and a concomitant boost in the market’s risk appetite, propelling credit markets higher, and putting a floor on long term interest rates.

We are less sanguine about emerging markets. Unlike the North American countries, the emerging world is heavily reliant on Europe for financing and trade. The retrenchment of the European banking system will reduce loans to marginal borrowers, directly constraining funding to emerging markets banks. On the trade front, emerging markets look to Europe for roughly 42% of their exports, and a Europe in recession will hit the emerging world hard.

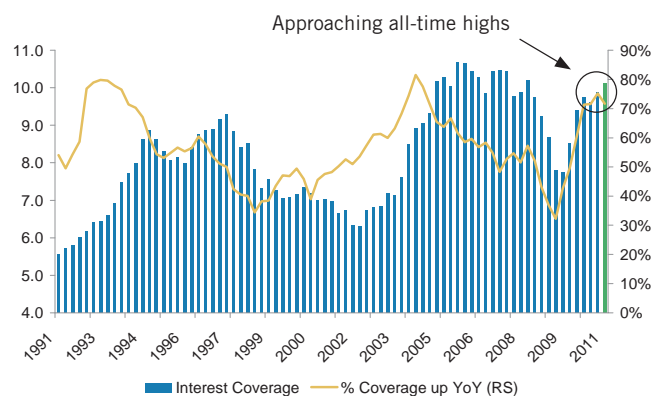
Economic improvement and European credit stability should have a salutary effect on credit markets, which have suffered excessively during the recent financial turmoil. High Grade corporate bonds are trading at recessionary levels; an outcome we do not anticipate. Their credit spreads imply five year default rates of 38%, higher than any five year period in modern history. Technical factors, have put additional pressure on Credit as well. Quarter end selling and Dodd-Frank regulation placed unusual pressure on the market, but should not

FIGURE 6. U.S. FINANCIAL CONDITIONS INDEX
June 2009 to September 2011



Morgan Stanley Financial Conditions Index
Source: Morgan Stanley Research

FIGURE 7. INTEREST COVERAGE
1991 to 2011



Source: Morgan Stanley, FactSet, Bloomberg

persist into the fourth quarter. Fundamentally, we expect corporate credit quality to remain superb for the foreseeable future, providing a strong impetus for performance. U.S. corporate borrowers have some of the lowest leverage and highest liquidity and interest coverage metrics in years [Figure 7]. This combination of strong fundamentals and depressed valuations has produced a tremendous opportunity in corporate credit.

FIXED INCOME MARKET OUTLOOK (CONT.)

On the other end of the risk spectrum, Treasuries appear overvalued. Throughout the third quarter's market chaos, panicky investors snapped up the riskless asset, driving yields below the rate of inflation. Besides their role as flight capital, Treasuries also served as the preferred policy vehicle for the Federal Reserve and the Peoples Bank of China. The Fed is now focused on buying MBS, and in our view risk aversion has peaked. As such, we would expect Treasury performance to lag in the fourth quarter.

INVESTMENT POSTURE

There will be clear winners and losers in the fourth quarter:

In the U.S., High Yield bonds and commercial mortgage backed securities should benefit most from the improvement in credit markets. The combination of strong credit fundamentals, economic improvement, and depressed valuations should be a potent combination, and we will maintain a strong overweight to the sector.

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In the Investment Grade arena, European stability should give a lift to banks and other financials on both sides of the Atlantic as contagion fears diminish. Our investment grade exposure will be ample, and weighted firmly toward financials. The glow of Treasuries should dim however, as negative real rates repel real money investors, leaving the category to central bankers and collateral managers.

We are currently underweight Agency mortgaged backed securities, but with the tailwind of the Fed reinvestment program, they should perform well. We will use them as a high quality replacement for Treasuries.

One other sector that underperformed late in the third quarter is Municipals. While general obligation bonds remain credit impaired, essential service revenue bonds, with their dedicated fee-based revenues, have maintained their credit quality. Along with corporate bonds, Munis have lagged Treasuries during the tension of the third quarter. We have begun to include high quality revenue bonds in the portfolios as another Treasury substitute.

Our exposure to the emerging markets will be limited to the top credits in countries that are not reliant on external funding.