

How Am I Doing?

The U.S. economy, the greatest economy in the world, is recovering. GDP continues to expand. We are seeing increased signs of confidence in the corporate and consumer worlds. Opportunity remains in the various tailwinds I identified earlier this year.

- > equities
- > emerging markets
- > corporate bonds
- > small caps

The first quarter had a strong finish, buoyed even further by positive employment news on April 1 showing private sector job growth on the rise. It was a great quarter for equities. The S&P gained 5.4% for the quarter, the DJIA rose 6.4% and the NASDAQ advanced 4.8%. The capital markets proved resilient in the face of multiple black swans, led by Japan's earthquake and social unrest in the Middle East and North Africa (MENA).

S&P 500, June 30, 2010-March 31, 2011



Source: Standard & Poor's

Past performance is no guarantee of future results.

My contention in January was that 2011 would be a catch-up year and that U.S. equities should perform well. This proved to be the case in the first quarter. But, investors need to analyze what's happening and challenge their expectations every quarter. Even though things seem to be working just fine, we must constantly reassess and ask, like former New York Mayor Koch, "How am I doing?"

So, how are we doing? Has anything changed over the past quarter? Yes, actually. The "overweight everything" trade is officially over. That easy trade to overweight all risky assets, which historically comes around every 5 to 10 years, ran its course. Look at the first-quarter performance of the S&P 500 and you'll see the market concluded "overweight everything" wasn't the trade anymore in late February when the market started to slip, well before the sell-off that followed Japan's earthquake on March 11.

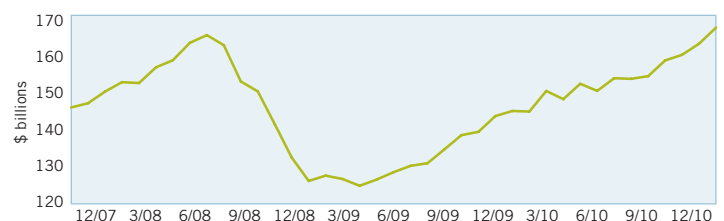
The winding down of QE2 is behind this shift. QE2 brought stability to the markets and made it possible for investors to overweight everything. When Fed Chairman Ben Bernanke began talking about a second round of quantitative easing measures last September, he essentially gave investors a free "put" underneath the stock market. Promising to buy \$600 billion in Treasuries was his way of reassuring investors not to worry about the negative economic data we saw last August or the possibility of a double-dip recession. He made sure the bond market would not riot and encouraged investors to trade their safe-haven fixed income assets for riskier assets.

QE2's success is proven by the explosive growth in U.S. exports since Bernanke first raised the subject. Last August, U.S. exports were at \$153 billion. By January, they had risen to \$167.7 billion, the highest month on record, exceeding the previous record of \$165 billion in July 2008.

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U.S. Exports, November 30, 2007-January 31, 2011



Source: U.S. Census Bureau

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In the wake of QE2, I still believe the equities markets end higher on the year, but I think it gets much harder from here. I believe QE2 ends on schedule in June as Bernanke planned. I also believe the market prices-in the fact that the Fed is no longer expanding its balance sheet,

amounting, in effect, to a 75 basis point tightening measure without the Fed actually raising interest rates. It will be interesting to see what comes out of the two FOMC meetings scheduled for the second quarter on April 27 and June 22, as well as Bernanke's remarks at his press conference following the April meeting.

Market confidence in the energy sector far surpassed any other sectors, reflected by significant outperformance. For the first quarter, the Energy Select Sector SPDR (XLE) was up 16.8% compared to 5.4% for the S&P 500 Index. The next best-performing sector was industrials, which also outperformed the S&P at 8.2%, but at a significant lag to energy.

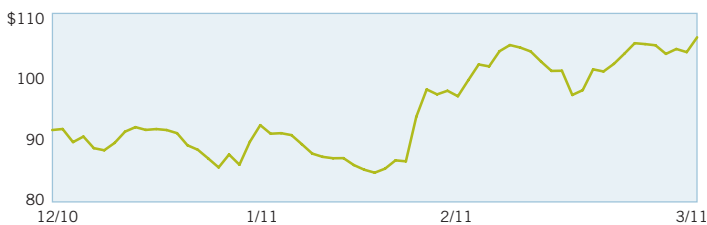
Right now, energy is the one sector I would continue to overweight, but that view could change. Heading into the second quarter, there are several reasons to overweight energy. The biggest reason: increased competition from emerging markets for dwindling global spare capacity. The U.S. is the world's largest user of oil, consuming more 19.5 million barrels a day, followed by China, at 10.4 million barrels, and Japan at around 4.5 million barrels. Demand from all three continues to rise, even in the wake of Japan's earthquake.

Global spare capacity comes primarily from MENA. With the ongoing social unrest in that region, global spare capacity is being significantly strangled and new investments to increase global spare capacity cannot happen. This confluence of events has created a perfect storm.

HEADWIND #1: OIL PRICES

This leads me to suggest that the greatest potential headwind for 2011, and biggest risk to the global economy, would be a super spike in the spot price of oil.

Oil Prices, December 31, 2010-March 31, 2011



Source: Bloomberg

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The way to protect your portfolio in that event is to overweight energy. Historically, the price of oil tends to rise in the second quarter. Five out of the last six years, the price of oil was positive in the second quarter except for last year when it was negative as a result of the Gulf of Mexico oil spill.

Given oil's incredibly bullish story, you may be wondering why I would consider moving energy from overweight to market weight. It will really come down to how the Fed's post-QE2, 75-basis

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point tightening mechanism plays out. Historically, the energy sector tends to lag the market when the rate cycle begins to anticipate any kind of tightening. That potential does exist, but the actual supply/demand dynamic currently at work keeps me in the overweight trade for now. I will be watching this situation closely and analyze whether it makes sense to continue to overweight energy.

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QUICK FIXES

Quick fixes in energy are the large integrated oil names with the biggest balance sheets, proven global reserves, and cash on hand to increase reserves. Pay attention to earnings coming out of this sector in April. Washington is unhappy over rising oil prices. The U.K. recently raised taxes on oil production profits, raising concerns that the same could happen here. Large integrated oil companies feel the need to assuage Washington and that’s likely to play out in significant dividend raises.

Meanwhile, the world looks elsewhere for energy. Russia and Canada are also quick fixes in the oil space, far away from the unrest in MENA. The Russian stock market is one of the better-performing equity indexes year-to-date off the oil trade, while the Canadian dollar is one of the better-performing currencies year-to-date. Coal has also been a beneficiary from the oil situation.

DIVERSIFICATION

Everyone always talks about diversification. Yes, we know it’s important. But, in the second quarter, diversification takes on even greater significance for investor portfolios. You’ll want to be as diversified as possible in the event one of two situations occurs. In the first, the market continues to melt and investors continue to throw money at everything because they lack confidence in where to be. In the second, the market begins to realize the Fed’s tightening mechanism that occurs when QE2 ends, and we start to see a reallocation trade. I don’t think the reallocation trade that’s come out of fixed income over the last few months goes back into fixed income; rather, I think it’s more of a rotational trade into sectors like financials, healthcare, consumer staples, and the utilities space.

PRIVATE SECTOR JOBS

I believe the Fed stands pat with QE2, doesn't end it early or extend it, and doesn't do a third round of quantitative easing. I believe this because we are beginning to see a recovery in the labor market, particularly in the private sector. Given our country's belt-tightening mode, I don't think we see further public sector job growth like we saw over the last six months. There are 29 new governors in office this year, finalizing their budgets and unlikely to hire.

It's time for the hand-off from the public sector to the private sector. The Labor Department's April unemployment report was favorable, with 230,000 private sector jobs added in March, on top of 240,000 in February. It was the first time private-sector hiring exceeded 200,000 jobs in consecutive months since 2006. In my opinion, that report was not a one-off and marks the start of something good.

HEADWIND #2: HOUSING DOUBLE-DIP

I also believe the Fed will operate as I've suggested because the housing market is likely to remain challenged for some time. Labor numbers are improving, but housing is teetering on the brink of a double-dip recession. For this reason, I see housing as the second headwind we face next quarter.

“The housing situation is one of the reasons I believe resistance is at 4.25% for the 10-year Treasury. 10-year yields should not be below 3% in an economy that is recovering. I expect yields continue to normalize and begin to rise as the marketplace anticipates growth. We are starting to see a growth trajectory that should put GDP somewhere around 4% later in the year.”

marketplace anticipates growth. We are starting to see a growth trajectory that should put GDP somewhere around 4% later in the year. That said, I think 10-year yields will fluctuate between 3.5% and 4% as private sector borrowing costs need to remain low as long as we have a housing market that remains challenged.

I'm very concerned that housing prices continue to deteriorate. Home prices dropped in nearly all major housing markets in January, according to price index numbers released in late March. We are entering the spring selling season, which will be the moment of truth for the housing market. If we are going to experience a double-dip, it will be confirmed in the second quarter.

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HEADWIND #3: REGULATORY REFORM MISTAKES

A headwind of lesser concern, but one I'll be watching out for, is a policy misstep in the commodities space. The deadline for enacting many of the financial regulatory reform measures under the Dodd-Frank Act, the sweeping legislation signed into law by President Obama last year, ends this July. Within that context, the Commodities Futures Trading Commission (CFTC) is feeling pressure to set position limits to curb excessive speculation in 28 commodities. My concern is that regulators make policy changes that are too stringent, resulting in adverse consequences for the commodities markets.

U.S. DOLLAR

It's going to be worth watching what the U.S. dollar does in the second quarter. The dollar defied historical seasonality in the first quarter. Rather than appreciate in January and February as it usually does, the U.S. dollar traded below its 2010 low. I expect that the European Central Bank (ECB) begins to raise interest rates in the second quarter. That move will most dramatically impact the trajectory of the U.S. dollar and the euro. If the euro sees a rise, the U.S. dollar will be the counter trade to that. My real focus though is on where the dollar will be in the second half of the year, historically a period of dollar depreciation.

MUNICIPAL BONDS

Many concerns have been raised about the deteriorating fiscal health of U.S. states and the impact to the \$2.9 trillion muni bond market. While muni bond funds have been experiencing record outflows, some of that can be explained by the pursuit of higher yields. In my jobs discussion, I remarked on the 29 new governors settling into office. Muni issuance was not a priority for them. In fact, at \$45.5 billion in new issues, the first quarter was the slowest quarter for muni bonds since 2003. I expect issuance to climb above \$50 billion in the second quarter and to learn the market's appetite for munis.

STRONG TAILWINDS REMAIN

The first quarter saw an unusual confluence of natural disasters and geopolitical events around the world. The market quickly dismissed these concerns. At the end of the day, market consequences matter most.

Global crises make the U.S. that much more attractive. The U.S. economy, the greatest economy in the world, is recovering. GDP continues to expand. We are seeing increased signs of confidence in the corporate and consumer worlds.

Opportunity remains in the various tailwinds I identified earlier this year. My views have not changed other than a few updated observations here:

Resilient U.S. consumer – You have a U.S. consumer that is incredibly resilient in the face of rising food and energy costs.

Even with gas prices going up in the first quarter, retail sales numbers were robust, including motor vehicles and the consumer discretionary sector – very encouraging news.

Premium for growth – Corporate earnings remain incredibly strong. Margins, share buybacks, dividend raises, and M&A activity are on the rise. We’re seeing a lot of share buybacks and dividends funded by the debt market. Normally investors don’t like this type of leveraged play, but companies are raising capital while maintaining good credit quality.

Germany’s strength – Germany as an investment remains strong and continues to be my lead indicator in the euro zone. I expect the ECB will raise interest rates in the second quarter. Investors should look at that increase as confidence that the worst has passed.

Industrialization of emerging economies – I’ve said in my past commentaries and blog that all I need emerging markets to do is “hold serve,” and they’re doing exactly that. In the past, I’ve debated the potential for a hard versus soft economic landing for China.

I now believe we need to consider no landing. The numbers coming out of China, including PMI, oil demands, and import data, suggest that China’s economy is handling its central bank’s tightening measures remarkably well. Essentially, the training wheels are off the bicycle and we’re seeing just how well China can handle itself.

SUMMARY

Every quarter investors need to revisit their market expectations. What we expected last quarter may no longer apply. It’s important to ask, what could go wrong? I’ve given you a few ideas of what I’ll be watching out for.

Ben Bernanke’s QE2 easy-as-they-come, “everything overweight” trade has ended. It doesn’t mean that markets go lower. We should position ourselves not for significant price appreciation but for more of a mean reversion where the market appreciates in more historic fashion. Instead of riding the express elevator up, investors should expect to walk the winding stairs.



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Joe Terranova is Chief Market Strategist for Virtus Investment Partners and a member of its Investment Oversight Committee. Mr. Terranova is a regular contributor to CNBC, appearing as a full-time panelist on the highly-rated daytime program *Fast Money* and a frequent panelist on *Fast Money Halftime Report*. He is also in demand as a keynote speaker for the investment industry, known for his insightful viewpoint.

Prior to joining Virtus in 2008, Mr. Terranova spent 18 years at MBF Clearing Corp., one of the largest firms on the New York Mercantile Exchange, where his work as Director of Trading was the subject of a June 2004 feature in *Futures* magazine. Earlier in his career, he held positions at Swiss Banking Corp. and JP Morgan Securities.

Mr. Terranova is perhaps best known for his risk management skills, honed while overseeing MBF’s trading operations during the calamitous U.S. markets of the first Gulf War, 1998 Asian Crisis, 9/11, and 2006 collapse of Amaranth Advisors. In 2003, he was one of the first Wall Street professionals to make an early call for higher energy, natural resources and commodity prices. In 2008, he cautioned investors to move to the sidelines in commodities, and in 2009, encouraged them to ignore the global “embracement of pessimism” and overweight equities.

Mr. Terranova holds a bachelor’s degree in finance from the Peter J. Tobin College of Business at St. John’s University in New York.

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