

## Third Time's The Charm?

In 2010 and 2011, the equity markets came out of the gates relatively strong, only to pause in the second quarter. In both years, the S&P 500® Index hit a peak in the second quarter – April 26 in 2010 and May 2 in 2011 – and the pause in appreciation that followed didn't refresh until November in the case of 2010, and never refreshed at all in 2011.

As the second quarter of 2012 gets underway, the question on everyone's mind is – Can we get through the quarter without a pause in market appreciation? Will the third time be the charm? The equity markets got off to a strong start this year, and as of Thursday, April 5 (before the Good Friday holiday and the release of the disappointing March U.S. labor report), the S&P 500 had risen 11.4% for the year, the NASDAQ was up 18.6%, and the Russell 2000® returned 10.8%. The Dow Jones Industrial Average was up only 7.7%, with much of that lag due to the significant underperformance of energy heavyweights Chevron and Exxon.

In both 2010 and 2011, a second quarter change in marketplace fundamentals impacted price performance and led to what I term a long “baseball season of frustration.” In 2010, the onset of the euro debt crisis was the trigger. In 2011, a series of events were to blame – rising energy prices, the aftershock of Japan's earthquake, and a false start to what was believed to be a recovery in the U.S. labor market.

Several fundamental factors and conditions could initiate a similar pause in the second quarter of 2012 and jeopardize the “third time being the charm” for uninterrupted market appreciation the rest of this year.

### EUROPE

First, let me rule out Europe as the root cause of any slowdown we might see. A key reason the markets didn't refresh in 2011 was Europe's slow response in addressing rising bond yields. In fact, the European Central Bank made the mistake of raising interest rates in the spring under former president Jean-Claude Trichet. Once the ECB finally took much-needed easing action in late 2011 under the new leadership of Mario Draghi, the markets bounced back quickly. A key reason was the ECB's two rounds of long-term refinancing operations – LTRO 1 at the end of December and LTRO 2 in late February. Draghi has a much different mindset than his predecessor, leaning toward easier monetary policy. In fact, a third round of LTRO is likely and could be easily digested within the eurozone.

For this reason, I do not expect that rising Spanish bond yields, which recently got above 5.75% for the first time since early December, or the threat of contagion within the eurozone, are likely to initiate a pause in market momentum. Europe is early in its quantitative easing cycle and the ECB still has plenty of effective easing tools at its disposal, unlike the U.S., which began easing in the first quarter of 2009. Monetary policy effectiveness tends to wear off the further along a country is in its easing cycle. The capital markets understand this and recognize that the economies of Spain, Italy, and Portugal are recessionary and will contract in 2012.

More broadly, I'll be closely watching the German DAX. The DAX is up over 16% for the year and is one of the better performing global equity indices. As long as the DAX doesn't experience a significant correction, I think Europe will be okay. In fact, the German economy remains strong with unemployment at a 20-year low, benign inflation readings, and robust business confidence.

### AREAS OF FOCUS

More important than Europe, there are three potential concerns investors need to focus on in the second quarter:

- 1) A super spike in the price of oil
- 2) Another false start signal in the U.S. labor recovery, which is much further along than it was at this time last year, and therefore could be more damaging
- 3) A significant contraction in U.S. corporate earnings growth

As I wrote in a recent [blog](#), it is more important right now to look at market technicals and identify the S&P 500 price points that would signal a correction or a classic second quarter pause that could refresh later in the year. Last year's S&P 500 high of 1370.58 reached on May 2 transitioned from a position of resistance in 2011 to one of support when the Index finally broke above that high in February of this year.

We will want to see the S&P 500 sustain above 1370.58 in April. If it can't, more likely than not, we will spend the second quarter fighting off a deeper correction. If the S&P 500 is above 1370.58 after earnings season essentially ends on May 4 when most S&P 500 companies have reported, resilient earnings will once again support the market, and any second quarter pause we experience would be positioned to refresh in the third quarter.

### **RISK ON? RISK OFF?**

A binary view of the markets doesn't apply for the second quarter. A "risk on, risk off" strategy is best utilized when correlations are rising. For the first time in a long while, correlations between individual stocks and the S&P 500 are normalizing and returning to where they were before the 2008-2009 financial credit crisis. Many investors fail to understand that when we've had significant market appreciation, such as the 25% return we had over the last six months, at some point that will give into sideways movement. I believe that is the likeliest outcome this quarter.

If I were forced to take a "risk on, risk off" view, however, I would expect that small caps would be the immediate beneficiary in a "risk on" environment, just as they were in the first quarter. If the S&P 500 significantly deteriorated and the markets went to "risk off," a cash position would not be warranted. Rather than hide in cash, as is popular during such periods, I expect that high yield corporate bonds will be more attractive. In both the 2010 and 2011 corrections, high yield bonds outperformed the S&P 500 and were a better alternative to cash. I would also look to utilities in a "risk off" situation. Even though utilities have had a horrible year, favorable market sentiment and not fundamentals are to blame.

Based on my non-binary leanings this quarter, I would prefer to settle somewhere between "risk on" and "risk off" and adopt a quality strategy, focusing on taxable fixed income, select U.S.-centric consumer discretionary, and the technology space.

I expect there will be a natural correction, but one that evolves into sideways price action, leaving the possibility for a pause that refreshes. Investors should not take that as a signal to reallocate out of risk assets. For example, in an early February [blog](#) entry, I wrote about taking energy from overweight to market weight. That didn't mean that I no longer believed in energy; it simply meant that it was time to take that position down. Individual investors would be wise to follow the lead of good money managers who know that sometimes it's best to do nothing instead of something during sideways-trading ranges. Ultimately, I'd be more inclined to "sit on my hands" at such a time.

Economic data points will contribute to second quarter uncertainty. It started with the release of the disappointing U.S. Labor report on Good Friday, April 6, when markets were closed, which threw the markets into confusion when they reopened the next week. I would expect to see the markets continue to be challenged by further evidence of "weather payback" in upcoming second quarter labor reports. GDP has also been difficult to pinpoint and moved around last quarter, from below 2%, up to 2.5%, and is currently between 2% and 2.5%. Recent ISM Manufacturing figures have also indicated that the potential for a continued economic recovery is diminishing.

### **THE FED AND MONETARY POLICY**

Expectations for U.S. monetary policy are equally uncertain at this point. Much of the first quarter was spent speculating about whether Bernanke would lower the strike on the protective put he has, in essence, placed under the market over the last few years. At the slightest hint of a fallback in asset prices, the Federal Reserve has been there to pick us up.

Leading up to the end of "Operation Twist" in June, there will be much speculation as to Bernanke's next policy move. Improving first quarter economic data has placed the Fed in a box and thrown into question whether further quantitative easing is necessary and whether the outcome of rising inflation over the next 18 months is even appropriate.

The closer we get to the November election, any moves the Fed makes will be viewed as politically motivated. Any further easing will need to get done by the end of the second quarter. The June FOMC meeting will be especially important, as some asset purchase programs are also set to expire. If the Fed were to provide further asset price support, I expect it will be in the mortgage securities market. Given the lack of a housing recovery, this is one area where Bernanke could implement further easing without political implications.

The "Bernanke put" will always be present in the market, but the strike level has become much more of a moving target. Further FOMC participation in the capital markets in 2012 is not needed. In fact, it's much more favorable for the markets to have the ECB as the buyer of last resort, but not the Fed. For the Fed to do so would signal a structural challenge, not only to the U.S. economy but to the equities markets themselves.

### **U.S. ELECTION AND POLITICS**

Not long ago, I would have said it was too early to think about the U.S. election in November, but that is no longer the case. As a result of the latest labor and manufacturing data, the stakes for the U.S. presidential election have risen.

I had expected President Obama to be an easy favorite, based on the trajectory of the first quarter economic data, but I now believe the race will be much closer and the likely Republican candidate, Mitt Romney, will recover in the polls.

This will be a very divisive and contentious 1936-style election where the sitting president will be focused on pitting Mainstream America against the evils of Wall Street. In late June, the Supreme Court's expected ruling on Obamacare could spur further "DC follies" similar to last summer's debt ceiling debate and create a distraction in the markets.

### **EARNINGS**

Ironically enough, once again it will be up to Corporate America to save the day. First quarter earnings of U.S. corporations will be tremendously important. I'll be looking for incredibly modest EPS, somewhere around 5%. One thing that companies have working in their favor this quarter is the roughly 5% contraction in EPS consensus estimates made during the fourth quarter when the euro crisis was heating up.

### **EMPHASIS ON QUALITY**

In last quarter's commentary, I advocated a "defensive" approach to portfolio positioning when, in fact, I should have emphasized "quality." To that end, quality will remain an incredibly important theme for the second quarter. What do I mean by quality? Companies with pristine balance sheets, consistent sales growth and earnings, a reputation for management excellence, and a consistent capital allocation strategy, even in the wake of market turmoil.

I also believe that growth over value is the way to go. In the first quarter, growth returned 14.7% while value returned 11.1%, as measured by the Russell 1000® Growth and Value Indices.

For me, the corporate bond space remains in the ultimate sweet spot. Companies have record levels of cash on their balance sheets and are implementing capital allocation strategies to return cash to shareholders through dividends and buybacks. Uncertainty surrounding the 2013 taxation policy may lend itself to corporations pulling forward capital returns into 2012. Historically low private sector borrowing costs are making it easy for corporations to borrow. I can't stress the opportunities in this space enough.

On a related note, and as I wrote about extensively in a late March [blog](#), an indicator of growing importance will be M&A activity. In the first quarter, global M&A activity had the lowest volume quarter since the third quarter of 2009, barely nudging above \$400 billion in volume. Will we start to see a rebound in deal activity in the second quarter?

### **TREASURY REALLOCATION ON HOLD**

Throughout much of the first quarter, I wrote about my expectations for a "massive" historic reallocation trade out of U.S. Treasuries into risk assets at some point this year. There is no doubt in my mind that this trade has been placed on hold. While the 10-year Treasury yield moved aggressively higher in mid-March, from about 1.9% to 2.4%, it is back below 2%. Given the latest U.S. labor and manufacturing data and European debt concerns, I still expect a reallocation out of U.S. Treasuries will occur at some point, but not in the second quarter.

To that point, according to Lipper, money market funds had net outflows of \$88 billion in the first quarter. Taxable bond inflows were \$47.5 billion for 15 consecutive weeks. Investors have read the investment landscape right and this flow of capital into fixed income is appropriate. Heading into earnings season, taxable fixed income remains an overweight for me.

Unfortunately, when it comes to equities, investors aren't getting it right. International equity inflows were \$5.6 billion in the first quarter, but U.S. equity funds saw \$1.6 billion in outflows. I don't know that I necessarily agree with that flow of capital. Even if the S&P 500 gets into a correction mindset and moves in a sideways pattern, I still believe that U.S. equities – growth equities in particular – remain a source of opportunity.

### **CHINA**

The main reason behind my U.S.-centric focus is my continued expectation that China will have a soft economic landing. Capital markets rose in the first quarter without the benefit of significant monetary easing from China.

China is still in the early stages of easing, and the latest data suggests that easing will continue throughout 2012. Premier Wen Jiabao recently reiterated China's central bank's commitment to reducing the bank reserve requirement and interest rates and to appreciating the yuan currency.

Aggressive easing from China will help to refresh any pause the markets might experience, but for now I view China as being in transition. Growth will continue, but in a more mature fashion.

### **OIL**

There is a significant divergence between the stock price of oil and energy equities. Year to date, the price of Brent crude is up about 15%, yet the Energy Select Sector SPDR ETF (XLE) is up only 1.9%, as of April 6.

A super spike in the price of oil related to a geopolitical shock would be problematic for the equity markets. Recent data is showing a much more benign balance between global supply and demand. For the first quarter, my expectations were that

global supplies would be challenged relative to rising demand. I'm actually beginning to see that as a result of the significant rise in energy prices, more global supply is coming online to meet the growing demand.

To those who would argue whether oil prices are going up on true fundamentals or geopolitical concerns, I would say that rising prices are more likely related to geopolitics than fundamental challenges in the oil market like we saw in the first quarter. I think the oil situation is transitory. As China continues to ease monetary policy, we could begin to see the fundamental balance shift back to rising oil prices that are driven by shrinking global supplies relative to demand.

#### IN SUMMARY

Unlike in the last few quarters, I can't emphasize enough that "risk on, risk off" should not drive investment decisions in the second quarter. The second quarter will be more about fundamental bottom-up analysis than top down, and I expect to see significant buying interest by investors on corrections.

Earnings will be the ultimate catalyst, and we need to look at where we are after earnings season ends. Once again, the onus is on Corporate America to pull the rabbit out of the hat. Corporations are in great shape, but it is highly unlikely they can continue to experience the same level of EPS growth as in the last few quarters.

My expectations for earnings are about the same as they are for Derek Jeter, the Yankees' Hall of Fame world champion short stop, now 38 years old. Sooner or later, there will be a slowdown – it's inevitable.

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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 the author of the book "*Buy High, Sell Higher*," published by Business Plus. 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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