

Expectations Outperform Forecasts

2011 will be a catch-up year for developed nations, and for investors, says Joe Terranova, Chief Market Strategist. It is time to focus on the tailwinds and take action.

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

Trading volumes have a tendency to slow down at the end of the year as risk is taken off the table. In the fourth quarter of 2010, the market began to de-risk shortly after the mid-term elections. Riskier assets were sold off in several difficult trading sessions that happened to fall on Tuesdays. For investors, 2010 seemed like it ended a lot sooner than December 31.

When year-end volumes decline, Wall Street tries to shift the focus back on the market with forecasts for the coming year. Personally, I'm uncomfortable delivering forecasts. When I think forecasts, I think weather. Forecasts are generally outrageous by nature and most are inaccurate. Looking back a year ago, forecasts for 2010 called for a rapid rise in 10-year U.S. Treasury yields to above 5%, a double-dip recession, and federal taxation changes that would trigger a year-end market sell-off. In reality, the headwinds behind these forecasts dissipated and they were proven wrong.

I prefer to think of 2011 in terms of expectations. Expectations are a show of confidence. When you have confidence in your investment strategy, you are better able to stay the course, navigate through headwinds that arise, and assume overweight positions as favorable tailwinds appear.

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Overweight positions are important for delivering extra return – what we call alpha in the industry. When I look ahead to 2011, my expectations center around four potential alpha-drivers: the U.S. consumer, corporate balance sheets, emerging markets, and Germany. I believe each of these offers opportunity to investors and will serve as tailwinds in 2011 capable of driving the tape higher.

Underscoring all of these tailwinds is the biggest tailwind of all for 2011: how time heals. When I appeared on CNBC in the wake of the 2008 credit crisis, I repeatedly said the market needed time to heal. I believe the healing that has occurred since then will be the catalyst to higher pricing in multiple asset classes for 2011.

My primary expectation for 2011 is that the market will end higher on December 31, 2011 than it did on December 31, 2010. That's not to say there won't be moments of vulnerability in the marketplace along the way. But, not much is likely to change from what we've seen over the last 20 months. I expect any correction will be shallow and a source of opportunity for those seeking to acquire assets.

Unlike tailwinds, I prefer to focus on one headwind at a time. My one headwind going into 2011 relates to something Fed Chairman Ben Bernanke said in his *60 Minutes* interview on March 15, 2009 – that we don't have the political will to do what is necessary to sustain the economic recovery. In my opinion, the lack of political will is a headwind with global implications.

I expect this headwind creates market vulnerability at some point in 2011. Here in the U.S., several potential triggers come to mind: the late January release of the Treasury Department's reform report on the GSEs (government-sponsored enterprises), a contentious subject of debate for both political parties; mounting pressure from the Tea Party that forces Republicans to address the federal deficit; and the January appointment of Republican Congressman Ron Paul, a vocal critic of the Federal Reserve, as leader of the Federal oversight panel itself.

This question of political will also extends to the European Union. Right now, the EU relies on the strength of Germany, its #1 economy and one of my tailwinds for 2011. Does the European Central Bank have the political will to sustain recovery of the 16-nation eurozone, or are stimulus measures removed too soon? I would also ask a similar question of China: Do Chinese leaders

have the political will to allow the yuan currency to appreciate enough? On a global scale, competitive currency devaluation is problematic but a lower dollar or lower euro would be good, either way. A lower dollar helps the U.S. export economy. A lower euro helps the German export economy.

2011 will be a year of global catch-up. From the second half of 2009 through 2010, global GDP was clearly driven by emerging markets, China in particular. In 2011, we won't need to rely on China or the BRIC nations to drive global GDP higher. All those countries need to do is "hold serve." For China, this means a GDP contribution of 9.5% to 10%, and for the BRIC nations, about 8.5% overall.

I expect that U.S. consumer spending continues to surprise, making it another tailwind for the markets in 2011. The U.S. and developed world are healed to the point where they should be able to resume making balanced contributions to global GDP. I expect accelerated GDP growth from Japan, the eurozone, and U.S. over the next six to 10 quarters. U.S. GDP could move from 2.5% to an annual pace of 4% over that period. I think that acceleration comes from continued low interest rates (short- and long-term), low inflation, and earnings-per-share growth and dividend growth both above 10% on average.

The emerging markets story is not over in 2011; it is evolving and remains a tailwind for 2011. Emerging market demand for natural resources and commodities continues to rise. And the emerging markets consumer continues to have tremendous impact on global spending. In fact, we could see 10% growth in collective consumer spending of the BRIC nations (Brazil, Russia, India, and China) in 2011.

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Cash asset ratios of S&P 500 companies are at all-time highs. The question now becomes, what happens with all that cash on balance sheets? In a catch-up year like 2011, especially for developed economies, companies will have to move cash off their balance sheets or risk falling behind.

M&A activity recovered on a global scale in 2010. In terms of stock buybacks, the third quarter of 2010 was the fifth quarter in a row that S&P 500 companies increased stock buyback activity. For the one-year period ended 9/30/10, S&P stock buybacks totaled \$260.28 billion compared with \$137.95 billion for the year-ago period ended 9/30/09 – an increase of 89%.

In 2011, I expect S&P 500 companies to achieve 10% dividend growth and to at least match the \$260.28 billion in stock buybacks realized last year. I also expect M&A activity in 2011 to be the strongest we've seen since 2007 as companies are forced to go out and buy the growth they can't get organically. In terms of S&P 500 earnings in 2011 and 2012, I expect there is the potential to hit triple digits. That will be welcome news to analysts who find it easier to calculate P/E when the market is trading at \$100.

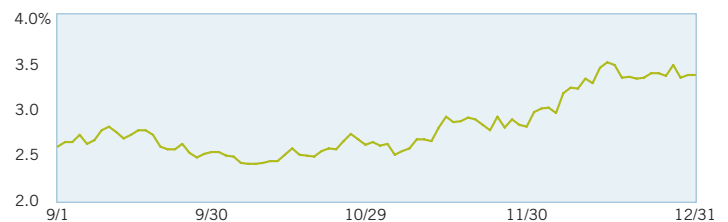
I expect the financial sector, which has lagged relative to the rest of the S&P 500, to have the opportunity to return to normalized earnings in 2011. While there were tremendous levels of M&A and stock buybacks in other sectors in 2010, financial institutions held tightly onto their cash. Financial balance sheets have healed enough to where this cash-hoarding mentality begins to loosen. I think there is real potential for large financial institutions such as JP Morgan to reintroduce their dividends in 2011.

During this catch-up phase, I expect hedge funds to assume more risk, which is favorable for the market. I also think that foreign investment capital could surprise to the upside, somewhere around \$100 billion-plus.

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I do not believe Treasuries are in a bubble. There has been an orderly reallocation trade out of bonds into equities since the fall of 2010. Rates are rising to more normal levels. The historical average yield for the 10-year U.S. Treasury is 4.33%. The 2010 closing yield of 3.29 is still well below that 10 year average.

10-Year Treasury Yields, September 1-December 31, 2010



Source: FactSet

Past performance is no guarantee of future results.

I do not expect yields to rise much above that in light of the FOMC's views that the recovery is not robust enough to improve labor conditions or the stagnant housing market. I think housing and unemployment are examples of best to expect nothing and maybe we're surprised with something.

I expect that productivity remains high in 2011 with continued room for margin expansion. Yes, we still have a problem with unemployment, but the four-week moving average for initial jobless claims began to come down in the second half of 2010. I don't expect the unemployment rate to come down. In order for that to happen, I think we need to see monthly gains of 150,000-200,000 in private sector jobs on average rather than the current 100,000.

Corporate bonds remain a desired asset class. Money is historically cheap, making it easy for companies to issue debt. Well over \$750 billion in corporate bonds were issued in 2010 with low yields and tight spreads. Companies are extending maturities at lower borrowing costs. BBB-rated bonds are yielding less than 6% for the first time in 45 years. This would be a good time to consider an allocation to high-yielding names with the potential to move up to investment grade over the next two to three years.

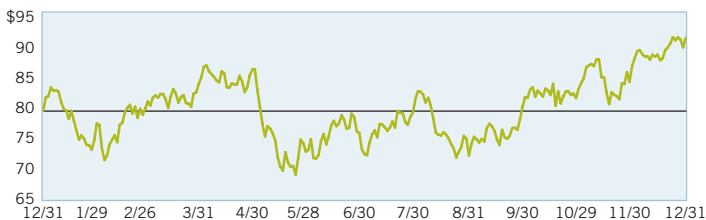
It's important to understand the role of volatility. Since 2008, volatility has run above 25% on average, as measured by the investor "fear gauge," the VIX® (CBOE Volatility Index®). This volatility measure is one of the biggest barometers for getting the retail investor back in the space. When the VIX reverts to a mean below 20%, that will be motivation for significant inflows to equity mutual funds.

In 2010, you needed to be a sniper in the equities space. In 2011, during this catch-up phase, you will need a shotgun. I view small caps in particular as a continued source of opportunity as investors are willing to pay a premium for growth. Diversification across sectors will be important. Capital flows coming into the market will seek opportunity across sectors. Sectors that have underperformed will be equally as favorable as those that have market-performed or outperformed their benchmarks.

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If there's a standout story for 2011, I think it's the energy sector. I am not suggesting exposure to the spot price of oil. I am talking about diversified exposure to the energy space through equity names, including, but not limited to, oil refineries, oil services, and large, multi-national integrated oil companies. Oil traded between \$65 and \$90 a barrel in 2010 with an average price of \$78-\$79. As long as the average price of oil remains at around \$80, an investment in energy is clearly favorable.

Price of Oil, January-December 2010



Source: FactSet Prices

Past performance is no guarantee of future results.

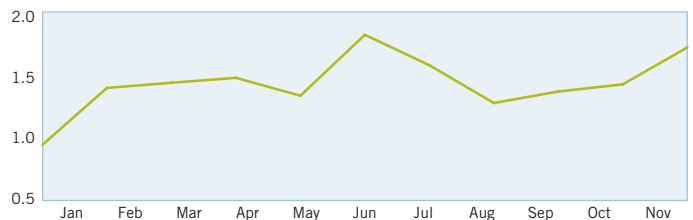
I don't expect a spike in energy prices, but I do expect continued recovery in the demand for oil. High oil inventories that built up during the recession are finally being worked off. I think the developed world catches up in demand in 2011. China's oil demand continues to surge, using one million-plus barrels a day in 2010 versus 2009.

Despite growing demand, the Gulf of Mexico continues to see a reversal in production, potentially losing as much as 80,000 barrels a day in 2011. The incentive to produce in the Gulf has diminished because of potential regulation in the wake of the BP spill. When Congress scrapped the previous \$75 billion liability cap, the operating risk for companies became unknown. Obviously, lost Gulf production is not favorable for supply. OPEC's spare capacity is down to about 2.5 million to 3.5 million barrels per day.

2010 was an excellent year for the utilities space, which offers an attractive dividend yield. Continued lower natural gas prices threaten to slow the potential earnings growth for the utilities space in 2011. Natural gas is a great investment but I don't think it is the investment now.

Real interest rates are determined by subtracting headline CPI from the 10-year U.S. Treasury yield. Historically, when real interest rates get above 2%, that's the acceleration point for equities to take off. I believe that's where the market is trending. It's also one of the reasons I think an allocation to gold or other precious metals should not exceed market weight right now.

Real Interest Rates, January-November 2010



Source: FactSet

Real Interest Rates: 10-year Treasury minus headline CPI.

Past performance is no guarantee of future results.

It's clear the FOMC's efforts to expand the size of its balance sheet are working. The evidence is in the \$1.5 trillion-plus in wealth creation from rising equity prices that was added to consumer balance sheets in the fall of 2010.

2011 will be a catch-up year for developed nations—and for investors as well. Through much of 2010, many investors have stayed out of the markets, sitting on the sidelines in disbelief. "Paralysis by analysis" is what happens when you focus on too many headwinds. You can't remain in that position any longer. Time has helped with the healing. It's time to take action. 2011 could be a year we make up for lost ground.

Happy New Year!



JOSEPH M. TERRANOVA, *Chief Market Strategist, Virtus Investment Partners*

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 "embrace 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.

For more information, visit Virtus.com

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