

A “Baseball Season of Frustration” Is In Full Swing

Authored by Joe Terranova, Chief Market Strategist

The second quarter opened on a high note. Early economic numbers gave reason for investors to hope the economic recovery was in a desirable V-shape and not the U-shape prognosticators had predicted since late 2008. The S&P 500® charged ahead nearly 80% from its low on March 9, 2009 to a high of 1217 on April 23, 2010.

All that changed on April 16 when the SEC filed its fraud lawsuit against Goldman Sachs. Market confidence cracked, the tortoise rally since March 2009 ceased, and attention shifted to the gathering global economic headwinds. Toss in the May 6 “Flash Crash” and that was all the market needed for investor pessimism to quickly return.

Our challenge now is to determine if the capital markets are undergoing a natural correction or if we’ve hit a peak. By my count, this is the fifth correction since the S&P 500 hit its March 2009 low. A correction is considered a drop in the index of 5% to 20% from a peak. What is different about the current correction is its double-digit drop; the four earlier corrections ranged from 5% to 8%.

I disagree with analysts who suggest the recent sell-off is a return to the fall of 2008. No doubt this correction is deeper, more forceful, and more challenging for investors. Uncertainty prevails, especially in the euro zone where the risk is that the current liquidity crisis will evolve into a solvency crisis. Uncertainty also exists as to whether China’s economy is in a boom or bust pattern. Will China have a soft or hard landing? Will China’s policy makers step or slam on the brakes? Here in the U.S., second-quarter appreciation of the U.S. dollar has hindered the export recovery.

As I’ve said for months, I expect the capital markets will operate under a cloud of global uncertainty for most, if not all, of the U.S. major league baseball season. I don’t expect a precipitous decline during this “baseball season of frustration” as I like to call it. However, I do expect the length of this correction and the consolidation period that follows to be longer than we’ve seen in the last four corrections.

I believe the market will be searching for the next catalyst from July through September. There will be a period of fits and starts when it looks like bullish momentum will be reestablished; however, the lack of a clear fundamental catalyst will prevent significant gains, and the market could reject what should be viewed as a positive catalyst.

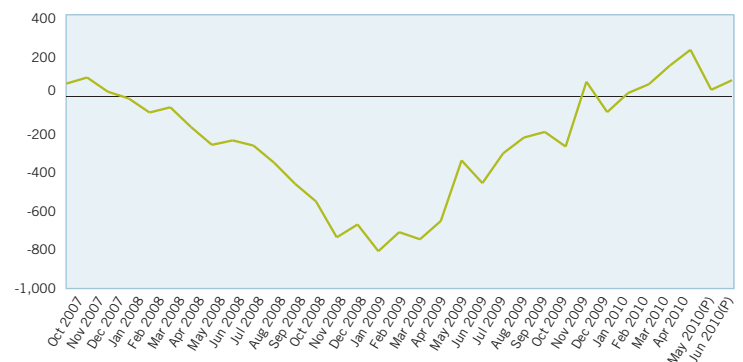
Look no further than China’s announcement on June 19 that it will gradually appreciate the value of its currency, the yuan, which initially pushed global stocks higher on the news but quickly reversed all of the gain. China’s willingness to revalue the yuan suggests that its economy is on solid footing and confidence exists in the role of the Chinese consumer on economic expansion. Realistically, I think we will see a gradual appreciation of the yuan to the U.S. dollar of 3% to 5% over the next year, which would be favorable for the capital markets.

China’s news came ahead of Toronto’s G20 summit in late June where pressure was on world leaders to reduce their nations’ deficits and remove the credit crisis stimulus. The U.S. resisted, highlighting deflationary pressures and the need to keep stimulus measures in place.

I agree with most analysts who suggest GDP will begin to moderate on an annualized basis in the second half. I expect the nearly 3% GDP growth in the first half-year to wane in the second half towards 2%.

What is the knock-off effect of weaker GDP? A weaker job market. Jobs track GDP, and the job market cannot undergo a V-shaped recovery if GDP growth moderates. There’s no foreseeable evidence of a V-shaped employment recovery. The unemployment figures released in June point to stagnation in private sector jobs, and that is of real concern.

Month-over-Month Employment Change in Thousands
(October 2007 – June 2010)



Source: Bureau of Labor Statistics Employment, Hours, and Earnings Report
“Total Private Employment” 1-month net change

I believe the catalyst behind the recovery in 2009 will be the catalyst in 2010. What was the 2009 catalyst? There were several components: extremely low interest rates; ample liquidity; a favorable yield curve; the buoyancy of the Chinese economy as a global growth engine; and likewise, the contribution of the BRIC countries to GDP itself.

I believe these market drivers will spur further growth in the latter half of 2010. I still believe the equities market will be higher on December 31 than it was on January 1. Unfortunately, investors will be greatly tempted to deviate from their initial strategic plans because it will require them to endure the long baseball season of frustration into the fall.

I expect that U.S. Treasury yields will remain low throughout 2010. The 10-year Treasury yield has failed to break-out above 4%, as anticipated, and I expect it will trade in a range vacillating around 3.5% through year-end. The housing recovery ground to a halt after the federal tax credit stimulus ended in April. Private sector borrowing costs need to remain low. The unemployment rate will remain sticky, between 9% and 10.5%, over the next 12 months. The Federal Reserve understands correctly that we're in a fight against deflation. We're seeing deflationary pressures building inside the system, evident by monthly CPI and PPI data. It's clear the Fed will need to keep interest rates low for an extended period of time.

10-Year Treasury Yields (January 1, 2009 - June 30, 2010)



Source: FactSet

Past performance is not indicative of future results.

Underlying fundamentals continue to suggest that corporations went into the credit crisis with balance sheets in excellent shape. Corporations did a phenomenal job of reducing their bottom lines in late 2008 and early 2009, and the capital markets saw the benefit of that in the second half of 2009. I think they will continue to see added benefit in the second half of 2010.

Corporations, excluding financial institutions, have around \$900 billion on their balance sheets, and the cash cannot sit there. Cash is the ever-depreciating asset. Look at a company like Dell, flush with cash, which has not used it properly. In late March and early April, corporations began to move cash off their balance sheets by increasing M&A activity, dividends, and share buybacks. So, it's clear the cash fire power is there; we just need to navigate through the summer headwinds first. Once business confidence is restored, I expect corporations will once again deploy cash and that will be a significant driver of higher stock valuations, longer term.

The strength of corporate balance sheets is a key reason the trajectory of the capital markets remains upward. It's just a question of when the upside resumes and investor optimism returns. The global macro view is bearish as countries are challenged with incredible budget deficits as a percentage of GDP. Fiscal health will need to be achieved with austerity measures, including budget cuts and increased taxes.

In the currency market, deficits and their impact on currencies was a critical theme at the end of the second quarter. Clearly, the issue of contagion in the euro zone had an extremely bearish impact on the value of the euro. The offset was significant appreciation of the U.S. dollar. The euro region actually needs a weaker euro to stimulate exports and its underlying economies. In Germany alone, exports in May surged 14% on the cheapening euro.

Here in the U.S., we need exports to remain strong, now that the housing stimulus is over, inventory restocking is past peak, and employment is rather anemic. Without exports, you could almost take 2% GDP growth off the table. The only way President Obama will reach his goal of doubling exports in five years is to cheapen the U.S. currency. I don't believe the U.S. dollar will continue to appreciate much more in the second half of 2010. Rather, I expect the dollar will decelerate, consolidate, and resume its downward trend from September through November, historically the lowest valuation period for the dollar. A weaker dollar will have a positive effect on exports and, in turn, drive the valuation of commodities, gold, and U.S. equities higher.

The Canadian and Australian dollars have benefited from the euro zone sell-off. The Australian dollar, the most favored commodity currency in 2009, is now second to the Canadian dollar because its performance is tethered to China's uncertain economy. The Canadian dollar is more of a play than the Australian dollar and, given what's going on in the Gulf of Mexico, offers a touch of oil, which I think all investors need to flavor their portfolios.

In this current baseball season of frustration, investors need to put their money on the team with the deepest bullpen – the team with the best odds to still be standing in playoff season. Relative to the capital markets, the deepest bullpen will be determined by who has the best balance sheet.

I see the market as a large battleship turning away from the smaller cap stocks that rallied the market in the first quarter, now navigating towards quality, large-cap issues. Quality and balance sheet recognition will be critical to resuming the uptrend in the second half. Just look at the cash-rich technology sector and the potential for capital spending. Tech companies' cash levels are at historic highs, and I think a lot of that capital will be deployed into M&A activity and used for organic growth.

The key is to identify who's got the best balance sheet – on an individual sector basis and on a global scale. The U.S. has the best balance sheet in the world, thanks to a well-run 2009 capital assistance program, which allowed private banks to remain privately funded and not become nationalized.

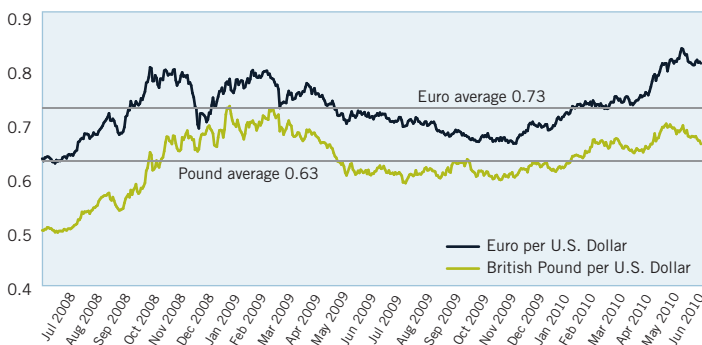
Europe failed in this regard and is paying the price. Euro zone countries were slow to enact quantitative easing and now have liquidity issues, but I don't think it will evolve into a solvency crisis that topples the European banking system. European banks, starting with Spain's, will undergo stress tests that will reveal how much private capital remains in place. The European Central Bank (ECB) has made funds available to banks in the euro zone. Yet, for example, the balance sheets of Spanish banks show only 2.5% of assets as ECB funds whereas in Greece it's around 13%. There's not as much of a run on capital as pessimism might suggest.

I don't view the outcome for the euro region as favorable, but I don't view it as Armageddon. We're in a multi-month stabilization period. I expect the euro/dollar to stabilize over the summer, which should benefit China's economy under the impact of the weakening euro. Chinese policy makers can then allow the yuan to appreciate, and that will have a positive effect in the second half of 2010 on risky assets, particularly U.S. risky assets.

In crisis, there is opportunity and right now, opportunity exists in Russia. Russia has been flying under the radar, but buy signs are strong. Capital is flowing into Russia properly, and Russia has the oil card, which is a critical growth element. I believe an allocation to Russia is warranted, which is why I have exposure in my personal portfolio.

I think the U.K. comes out of this crisis in much better shape than prevailing pessimism suggests. I think the British pound hit its trough point for the year in the second quarter. Deep fiscal cutbacks and the Bank of England's aggressive moves to fight inflation should be positive for the currency.

Currency Comparison (July 1, 2008 - June 30, 2010)



Source: FactSet

Past performance is not indicative of future results.

Corporate balance sheets remain strong, so corporate bonds are an obvious winner for 2010. Corporate bond flows remain at historic highs, with inflows in the first half at around \$75 billion, and I expect flows to remain strong. I expect default rates will continue to decline, however, as credit availability, credit restraint, and balance sheet repair become more critical this quarter; this might be a good time to move away from high yield and more towards investment grade bonds.

In the midst of a softening economy, balance sheet repair is important. Even more important is pricing power. That's why I think the allocation battleship is turning towards quality – where pricing power is.

Within equity sectors, basic materials, natural resources, and energy will retain pricing power because they're tethered to the growth of the emerging world. Technology enjoys pricing power for similar reasons. I think it's time to move away from the consumer discretionary sector, which was popular early this year, because I don't believe pricing power will be retained. I see healthcare retaining pricing power now that the sector's "abyss moment" is over in terms of U.S. regulatory reform; I think a market weight allocation to the sector is appropriate.

We can't speak to the second quarter without talking about the impact of the Gulf oil disaster. I think the eventual outcome is that oil prices move higher, global production is challenged, and demand begins to rise.

Early estimates suggest a premium bump of \$8 to \$12 on the price of oil as production in the Gulf is reduced over the next three years. Based on the pre-disaster forecast of 1.5 million to 2 million barrels of oil coming from the Gulf over this period, I think the deepwater drilling moratorium will cut that number by about 40%. Prices could rise in the next three to six months, but more likely over the next year or so as the market begins to digest how extensive the reduction in production will be.

China, the second largest oil consumer, has seen about a 30% surge in oil imports year on year. China is also traveling further to get oil, with Angola now a bigger provider than Saudi Arabia. Global tanker rates are rising considerably and are at \$45,000 per day – well ahead of the \$25,000 to \$30,000 projected. It's not unthinkable rates that could rise to \$100,000 by the end of 2010.

Major oil players will have reduced incentive to operate in the Gulf and will need to weigh heavy regulations, taxation issues, and the spill risk. The drilling moratorium is not favorable for offshore drillers and will spill-over to oil service names as well. For the first time, money managers will be challenged on how to get exposure to energy equity names. The legacy names once part of the equation – British Petroleum, Anadarko, Halliburton, Cameron, and Transocean – are now called into question.

Inevitably, British Petroleum will need to divest some of its significant global assets. Not only will a potential buyer need the balance sheet to acquire the assets, but they must also be palatable to the Obama administration. That likely leaves out Petro China and the Russians. Instead, think larger names like Exxon Mobil, Occidental, Conoco Phillips, or even Royal Dutch Shell, which, although not American, would be acceptable to the administration.

Given the heavy weighting of energy names in the S&P 500, rising oil prices will provide underlying support to the index itself. Once the Gulf situation has stabilized, S&P 500 energy names should begin to move higher in late 2010.

Natural gas comes out a winner from the Gulf crisis. We've seen a run-up of about 25% in natural gas prices, going from \$4 to \$5 in the second quarter. We'll not likely see further appreciation in the flat price of natural gas unless a major hurricane hits the Gulf, but I think it's important for investors to get longer-term low-beta exposure to natural gas prices.

Looking at precious and base metals, there have been no major global discoveries of copper in years. China is funding copper mining joint ventures around the world. To me, copper is a classic risk asset that has softened in value, similar to the equities markets, but I don't see the deep dive or significant peak others have suggested. Rather, I see copper in a normalized correction that, as we get past this season, will resume its uptrend.

Let me touch on gold. Gold is a classic example of "buy high, sell higher." Right now, gold doesn't offer a reason to go to underweight. I'm actually not paying attention to gold prices and I don't want the investor to either. Current pricing suggests being overweight in gold but not all in. So, all I have to say about gold is, stick to your allocation, between 8% and 12%, for the diversification benefit. There's no reason to dive deeper.

U.S. regulatory headwinds are prevalent. Decisions coming from Capitol Hill may be unpopular on Wall Street and popular on Main Street, but I don't think market appreciation will be derailed. This summer, incumbents will be asking constituents for their votes this fall. The one claim they will all make – which I believe is completely unfounded – is that they contributed to the process that saved the U.S. from the second Great Depression, Armageddon, and the abyss. The truth is that the U.S. was in a natural economic cycle and the real heroes are the Fed and Ben Bernanke who did an unbelievable job supporting risky asset prices. No matter, incumbents will use this to their advantage, and the last thing they want to see on Election Day is a return to riotous capital markets like the fall of 2008.

Coming back to this quarter's theme, a baseball season of frustration is in full swing. We're in the fifth market correction since March 2009, which I believe will last longer than the previous four before the market resumes its bullish momentum. There's too much uncertainty and too many headwinds out there. Will China have a soft or hard landing? Will liquidity issues in the euro zone transform into a solvency crisis? How do we restart employment growth here in the U.S.? Will GDP growth moderate from its first-half levels? Will the housing market return to a period of stagnation?

These challenges ahead will delay the positive catalyst the markets need to restart momentum. Understand that this battleship is turning and that it takes time for battleships to turn. But when the battleship completes its turn, it will be towards the better balance sheet, towards the deepest bullpen, towards pricing power. That's where you want to place your investments and when you'll want to move from being underweight to market weight or from market weight to overweight.

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