

Who's Going To Be The Hero?

In the NHL playoffs, when a game is tied and goes into overtime, a sudden death goal decides the winner. Before taking the ice, it's common for the captain to ask, "Who's going to be the hero?" a tradition they say got its start in the locker room of the New York Islanders in game 6 of the 1980 Stanley Cup when the Islanders went on to beat the Philadelphia Flyers, 5-4.

The hockey hero analogy is fitting for the waiting game playing out in the markets today. For much of the second quarter, we experienced a slowdown so eerily similar to last year's "baseball season of frustration" (to use another sports metaphor) that I've felt compelled to name this summer "the sequel."

To recap last summer's equity market, the S&P 500 hit a peak of 1219.80 on April 26, 2010, dropped precipitously in May and June, and bottomed out at 1010.91 on July 1, 2010. The market then moved sideways until Federal Reserve Chairman Bernanke announced at the Jackson Hole meeting in late August that a second round of quantitative easing (QE2) would soon be on its way. The market accelerated in response, aggressively rising from September 2010 through February 2011 without a corrective sell-off.

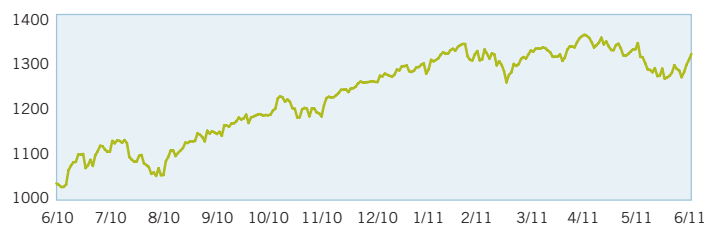
This year, global growth is moderating once again, similar to last year, and expectations are marked down. We are clearly in the

“We are clearly in the midst of a slowdown. The big question: Does it evolve into a meltdown, or is this simply a ‘pause that refreshes?’ Evidence suggests the latter.”

midst of a slowdown. The big question on everyone's mind: Does it evolve into a meltdown, or is this simply a "pause that refreshes?" Evidence suggests the latter. The difference this year is that we will need a new hero. Ben Bernanke and the FOMC cannot provide support for risky assets this time around.

By the way, for those who would judge QE2 a failure, I disagree. A tremendous wealth effect was created by QE2, which I believe was a main goal. When Mr. Bernanke gave his Jackson Hole speech on August 27, 2010, the S&P 500 was at 1039.70 and rose to 1320.64 by the time QE2 ended on June 30, 2011. In addition, if you look at Treasury yields, Mr. Bernanke was able to anchor private sector borrowing costs and keep them low, which Main Street really needed. From a market perspective, QE2 was a huge success. Getting back to the present, what could be the potential hero for the second half?

S&P 500® Index, June 30, 2010-June 30, 2011



Source: Standard & Poor's

Past performance is no guarantee of future results.

POTENTIAL HERO #1: MANUFACTURING

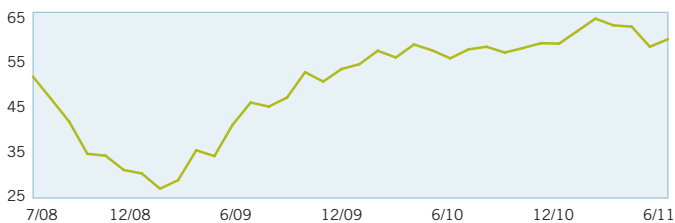
Going into the third quarter, there have been early signs of a recovery in the manufacturing sector. Manufacturing was a supportive force in the capital markets' recovery that started in March 2009 until growth began to slow in May 2011. The ISM Manufacturing Index declined and China PMI began to weaken as well, although those decreases may have had much to do with global supply disruptions in Japan resulting from the March earthquake, with the auto and technology industries being hit especially hard. Recent evidence suggests that is the case.

Now that Japan is back online, we have started to see improving manufacturing numbers late in the second quarter. Economic numbers released in late June support what Ben Bernanke had suggested earlier, that the earthquake's effects on the world's third largest economy would be transitory in nature. Japanese industrial production exceeded expectations, increasing 5.7% in May over April, and Japanese retail sales also came in better than expected, rising 2.4% for the same period.

On June 30, Chicago PMI, a key measure of manufacturing activity in the Chicago region, came in much better than expected. Chicago PMI jumped to 61.1 in June, from 56.6 in May, exceeding forecasts that it would drop to 54. One of the reasons for the rise, a surge in new car orders and production, further supports that the auto supply disruption from Japan is coming to an end.

The July 1 ISM Manufacturing Index release also surprised, coming in at 55.3 for June, up from 53.5 in May, versus consensus estimates of 52. ISM Manufacturing paints a more complete picture of U.S. manufacturing and was a leading indicator of growth in the spring of 2009 and fall of 2010. ISM Manufacturing had been moderating during the final eight weeks of the second quarter, and the surprise increase in the July 1 report further supports my expectations that moderating growth will transition to accelerating growth in the second half of the year.

ISM Manufacturing Employment Index, July 2008-June 2011

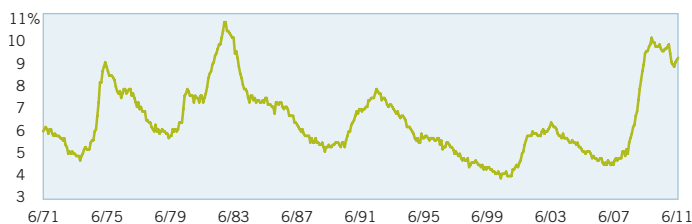


Source: Institute for Supply Management

Past performance is no guarantee of future results.

Of concern are recent inconsistencies in the June employment data released in both ISM reports (Manufacturing and Non-Manufacturing) showing job growth, compared with a disappointing U.S. Labor Department report showing job losses. Specifically, the employment component of ISM Manufacturing rose slightly from May to June, from 58.2 to 59.9, and that of ISM Non-Manufacturing rose 54 to 54.1, while at the same time the national unemployment rate climbed to 9.2%.

U.S. Unemployment, 1971-2011



Source: Bureau of Labor Statistics

Past performance is no guarantee of future results.

Until we get a better sense of what the labor numbers really are, we'll need to resume close monitoring of weekly initial jobless claims reported on Thursday mornings. In general, I believe a structural change has occurred in the U.S. labor market. Since September 2008, the unemployment rate has averaged 9.0%, compared to 6.4% for the 40-year average.

POTENTIAL HERO #2: CORPORATE EARNINGS

A second potential hero for the second half is corporate earnings, which have been phenomenal for several quarters. I will be looking at earnings to once again tell the story and potentially have a stimulative effect on the market.

The world is no longer U.S.-centric, and foreign sales are a major contributing factor to strong corporate growth, with 25% of profits coming from outside the U.S. The weaker dollar helps this trend. Non-financial companies have been the greatest beneficiaries to this point, with profit margins rising to 13% in the first quarter, the highest level since 2007, based on Commerce Department data.

“The world is no longer U.S.-centric, and foreign sales are a major contributing factor to strong corporate growth, with 25% of profits coming from outside the U.S.”

In June, Nike (NKE) reported a decrease in gross margins for its most recent quarter due to rising labor and material costs, but also reported a 22% surge in North American sales for the period, proof that U.S. consumers are still spending. In addition, equity valuations of many consumer discretionary companies hit new 52-week highs as of July 1, among them Fossil (FOSL), Tiffany & Co. (TIF), Starbucks (SBUX), and McDonald's (MCD). That tells us a lot about what's going on with consumer spending.

Within the technology sector, a future earnings contributor is expected to be increased spending on information technology (IT) among U.S. corporations and government entities. According to a June survey by International Data Corp., total enterprise IT spending is forecast to grow by 5.6% through the end of 2011, nearly twice the rate of GDP growth currently forecast at 2.5% to 2.9% for the year.

Apple (AAPL) is a prime example of the potential that exists in IT enterprise sales. People have speculated what Apple's next catalyst will be to follow the iPhone and iPad, which have driven sales for the last 18 months. Recent data shows Apple quietly gaining market share in the enterprise space. As corporate executives are becoming more comfortable with the Apple ecosystem, we are seeing increased purchases of Macs, iPhones, and iPods for use in the business environment.

In terms of the financial sector, bank stocks continue to languish. At June 30, 2011, bank ETF KBE closed at \$23.99, down from its \$24.21 close on October 15, 2009. People keep waiting for a turnaround in the sector, but that is not likely until mortgage lending picks up. Banks are not seeing the loan growth they need as the divide continues to widen between potential customers with favorable credit quality and those without. Equifax recently reported the average credit score is 696, the highest in four years. The pool of

potential loan customers keeps shrinking because of unemployment and a weak housing market, which continues to wade along the bottom of the bathtub. I see no end to that any time soon.

There is a bright spot in the sector, however. Corporate balance sheets of financial companies remain strong, and I continue to believe owning corporate debt of financials is a much more favorable strategy than investing in the stocks.

POTENTIAL HERO #3: U.S. FISCAL POLICY

Fiscal policy is also a potential hero. A recent example of fiscal policy was the June 23 decision by the International Energy Agency to release 60 million barrels of oil (half of that coming from U.S. reserves) in an effort to lower oil prices. While I disagree with this action (more on that later), it does illustrate how fiscal policy may begin to be used more frequently as a stimulative measure in the post QE2-era.

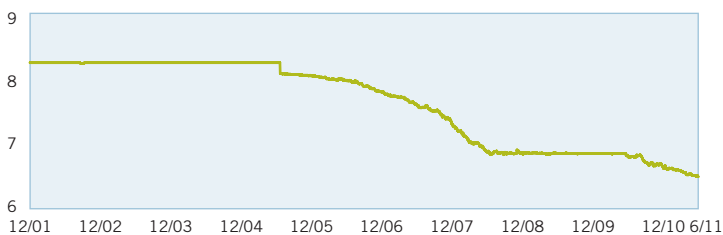
A fiscal policy hero could come in any form, whether an extension to the employee payroll tax cut or an employer-side payroll tax cut; a “repatriation holiday” giving U.S. companies (mostly tech) a tax break on profits held overseas; or a deficit-reduction agreement from Capitol Hill. I am not suggesting that any of these materialize, but I think there is growing potential for U.S. policy makers to use some form of fiscal policy to aid the capital markets in the second half.

POTENTIAL HERO #4: CHINA

The People’s Bank of China has continued to tighten its monetary policy since October 2010, raising benchmark interest rates five times and the bank-required reserve ratios nine times. Inflation remains high, food prices especially, which are up 14% year on year. For the second half of 2011, I expect no further rate hikes, continued modest appreciation of the yuan, and a reacceleration of China’s contribution to global growth in the fall. The evidence continues to suggest no hard economic landing for China.

In June, China’s currency, the yuan, appreciated to its highest level against the U.S. dollar since 1994. Further yuan appreciation would be an extremely favorable condition that could return global capital markets higher, although the pace of that appreciation may ease in the second quarter given recent data that shows China’s export growth slowing and trade surplus increasing.

Chinese Yuan Spot Price, January 2002-June 2011



Source: FactSet

Past performance is no guarantee of future results.

China has also been aggressively working to strengthen relationships with European countries, in particular Germany. During the last week of June, while Greece’s finance ministers met on its austerity budget, China’s Premier was meeting with Germany’s Chancellor to develop economic and trade ties.

Potential heroes aside, let’s look at some other important global indicators and trends I see happening, as well some areas of opportunity for investors in the second half of 2011.

CURRENCIES, THE U.S. DOLLAR, PRECIOUS METALS

Turning to the European debt crisis, I believe the EU will ultimately devise a way for debt-laden sovereigns like Greece and Portugal either to enact strict fiscal austerity measures or go off on their own. Greece needs to be isolated and have a time out. The best thing Greece could do is return to the drachma, monetize its debt, and devalue the currency. Over the next 12 to 24 months, I expect participants in the euro will not necessarily be what they are now.

The euro has remained strong for two reasons: the resiliency of the German economy, as well as France, and the euro’s increased participation in the currency reserves of central banks. The IMF recently reported global currency reserves at well over \$10 trillion, of which about \$6 trillion is in U.S. dollars, which represents a decrease of 10% over the last 10 years. This is not due to central banks selling away from the U.S. but rather an increased emphasis on diversification. The euro (aka “anti-dollar”) has been a beneficiary of this reallocation, as have the Swiss franc and commodity currencies (Canada, New Zealand, and Australian dollars).

The People’s Bank of China, in particular, has begun to diversify its foreign reserves holdings away from U.S. dollar assets, buying more European government debt and gold bullion. Gold continues to be the ultimate buy and hold asset (the exception to the rule), and I expect gold to remain strong in the second half as the marginal demand for gold continues to be India and China. Currently, China’s gold reserves are estimated at 3% to 5%, well below historical central bank gold ownership standards.

The European Central Bank (ECB) continues to normalize interest rates, raising its benchmark rate a quarter-point in early July, to 1.5%. The developed economies of Canada and Australia are also well ahead of the curve in terms of raising rates and enjoy a much better trade balance and employment condition than the U.S. A rate hike is not in the near future for the U.S., however, as the world’s economic superpower remains stuck with subpar growth. I believe the FOMC will not even consider raising the federal funds rate until 2012.

The U.S. dollar remains under pressure. I see weakness going forward following the recent disappointing jobs number (June data) and the unresolved federal debt ceiling deadline looming for August 2. The U.S. dollar index, which measures the dollar against

six other currencies, hit a 40-year low of \$70.69 on March 17, 2008, the day of former investment bank Bear Stearns' collapse. The question on everyone's mind: Will the dollar dip below that level in the second half, or will it stabilize above it? I'm not sure, and while I expect dollar weakness to continue, I do believe we are in the late innings of dollar depreciation.

U.S. Dollar Index (DXY), January 2008-June 2011



Source: FactSet

Past performance is no guarantee of future results.

The weak dollar remains beneficial for U.S. corporations, as well as for ownership of precious metals. In fact, I think the third quarter

“The weak dollar remains beneficial for U.S. corporations, as well as for ownership of precious metals. In fact, the third quarter would be an opportune time to increase exposure to gold and silver in particular.”

would be an opportune time to increase exposure to precious metals, gold and silver in particular.

ENERGY AND OIL

In the first quarter, I suggested I would change my energy allocation from overweight to market weight in the second quarter, and that is exactly what I did on May 4. My next move will be to move energy back to overweight.

Global demand for oil continues to rise, with the Asia-Pacific region experiencing some of the fastest growth. Demand from China alone was up 10% in the most recent quarter. As demand rises and competition heats up for shrinking supplies, I don't see OPEC filling that need.

June's OPEC meeting was historic if only for the inability of member countries to agree on anything. Saudi Arabia walked away and upped production to 10 million barrels a day, which helped lower the price a bit. The IEA followed with its release of 60 million barrels on June 23. What does that tell us? It tells us so much about global supply and the competition for spare capacity. Here's how.

OPEC produces 40% of the world's oil supply, which means 60% comes from non-OPEC suppliers. If you need oil, why not go to non-OPEC suppliers like Norway, Russia, Mexico, Great Britain,

or Canada? We can't because these countries' infrastructures are antiquated, and they don't have the means to ramp up production. The only move the IEA had, which I think was wrong and done at the worst time, was to put barrels on the market and try to psychologically get energy costs down.

I'm not one who believes in “buy and hold,” but in this instance, it's important to look at the oil market from 30,000 feet. Instead of focusing on the spot price, the real focus needs to be on supply. It is more important to understand the widening price differential between domestic crude oil (WTI or West Texas Intermediate) and Brent crude oil out of the North Sea. Brent crude is trading at a \$15-20 premium due to growing demand from Asia and Europe amid Libyan output cuts, while demand for WTI has stalled and inventories have grown in Cushing, Oklahoma, waiting on new pipelines to export crude out of the region.

“I'm not one who believes in ‘buy and hold,’ but in this instance, it's important to look at the oil market from 30,000 feet. Instead of focusing on the spot price, the real focus needs to be on supply.”

The supply situation illustrates so well that before we can even begin to talk about a U.S. energy policy, we have to fix our energy infrastructure first. Although there may be, as President Obama has said, no “quick fixes” for the price of oil, many diversified utilities companies in the U.S. are working on energy solutions that represent tremendous potential for investors.

As energy demand rises, I see increased opportunity within the midstream energy space, particularly MLPs (master limited partnerships) focused on developing the U.S. pipeline infrastructure and the transportation of oil, and more importantly, liquefied natural gas, which I see as an up-and-coming area of tremendous growth potential.

SUMMARY

Second-quarter earnings will be critical to determining the prevailing market trend. If the current corrective decline proves to simply be a pause that refreshes, I would expect the following assets to outperform: technology, health care, investment grade corporate bonds with an emphasis on the financial and consumer discretionary sectors, and oil-related assets.

In addition, if resurgence in demand from China and other emerging markets materializes in the fall of 2011, opportunity will exist in the ownership of assets providing resources in support of that demand.

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 "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.

For more information, visit Virtus.com

This commentary is the opinion of Joe Terranova. Virtus Investment Partners provides this communication as a matter of general information. The opinions stated herein are those of the author and not necessarily the opinions of Virtus, its affiliates, or its subadvisers. Portfolio managers at Virtus make investment decisions in accordance with specific client guidelines and restrictions. As a result, client accounts may differ in strategy and composition from the information presented herein. Any facts and statistics quoted are from sources believed to be reliable, but they may be incomplete or condensed and we do not guarantee their accuracy. This communication is not an offer or solicitation to purchase or sell any security, and it is not a research report. Individuals should consult with a qualified financial professional before making any investment decisions.

There is no guarantee that a diversified portfolio will outperform a non-diversified portfolio, or that diversification among different asset classes will reduce risk. Asset allocation does not guarantee a profit or protect against loss in declining markets.

Not all products or marketing materials are available at all firms.

Mutual Funds distributed by VP Distributors, Inc., member FINRA and subsidiary of Virtus Investment Partners, Inc.

2011 7-11 © 2011 Virtus Investment Partners, Inc.