



Riding the Tailwinds

MARKET OUTLOOK 2011

*Featuring the views of
Joe Terranova,
Chief Market Strategist,
Virtus Investment Partners*



ABOUT JOE TERRANOVA

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.



Where Will the Winds Blow in 2011?

When sailing, tacking into the headwinds and staying ahead of the tailwinds speeds you toward your destination. Similarly, investors who use the headwinds and tailwinds at work within the capital markets are better able to stay on course with their investment plan, even during periods of volatility.

Fast-forwarding to December 31, 2011, I expect the capital markets will be higher than they were on December 31, 2010. Historically, over the past 60 years, in the 12 months following mid-term elections, the S&P 500® Index produced average annual returns above 15%. For the nine-month post-election period, no return was negative. Obviously, past performance is no guarantee of future results, but based on the headwinds and tailwinds I see for 2011, I have reason to feel optimistic about the year ahead.

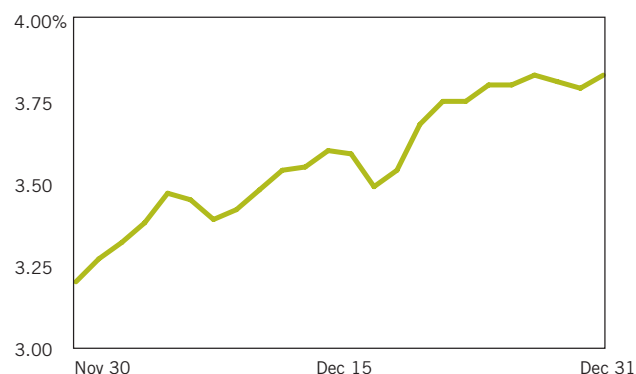
A Review of 2010 Headwinds

Over the course of 2010, the capital markets were driven by one major headwind per quarter. Those headwinds have since dissipated, but they are important to understand as they have turned into the tailwinds that represent opportunity for investors in 2011.

Q1 Fed Fence-Sitting

Will they, won't they? Going into 2010, the vast majority of market observers expected the Federal Reserve to raise interest rates and start to sell off earlier asset purchases to reduce the size of its balance sheet. In anticipation, the yield on the 10-year U.S. Treasury note rose significantly in December 2009.

10-Year U.S. Treasury Yield, month of December 2009



Source: FactSet

Past performance is no guarantee of future results.

In the end, persistent high unemployment forced the Fed to decide against removing any stimulus.

Unemployment Rate, January-April 2010

January	9.7%
February	9.7%
March	9.7%
April	9.9%

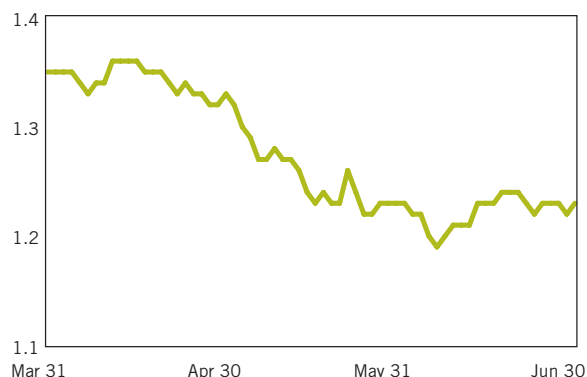
Source: U.S. Department of Labor, Bureau of Labor Statistics

Q2 European Sovereign Debt Crisis

By far, Europe's currency crisis was 2010's most threatening global headwind and the reason for the stall in the early-year equities rally.

Worries that Greece's liquidity crisis would evolve into a solvency crisis, then spread to Portugal and Ireland and require financial bailout from the EU and IMF, caused a significant sell-off in the euro.

Euro Spot Price, 3/31/10-6/30/10



Source: WM/Reuters, FactSet

euro per U.S. dollar

Past performance is no guarantee of future results.

Austerity measures, including bank stress tests and the establishment of a \$750 billion euro EU Stability Fund, prevented this global headwind from turning much worse.

A Review of 2010 Headwinds

Q3 “Double-Dip” Recession Fears

Manufacturing played a critical role in the 2009 economic recovery and this trend continued well into 2010. In August, however, negative news on U.S. manufacturing, private sector job growth, and China’s commodity imports triggered a “double dip” of pessimism among investors who feared a double-dip recession was imminent.

ISM Manufacturing Index, January-September 2010

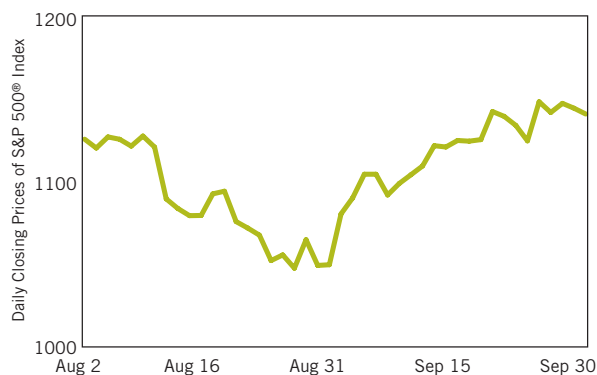
January	54.9	June	59.7
February	58.4	July	56.2
March	56.5	August	55.5
April	59.6	September	56.3
May	60.4		

Source: Institute for Supply Management

The ISM Manufacturing Index is a monthly measure of the health of U.S. manufacturing, based on an in-depth survey of 300 manufacturing firms. An index value above 50 indicates growth, below 50 contraction. Chart reflects release dates for previous month’s data.

The storm abated one month later on September 1 when the negative trend reversed itself. As a result, the S&P 500 had one of its best Septembers in over 60 years.

S&P 500® Index, 8/2/10-9/30/10

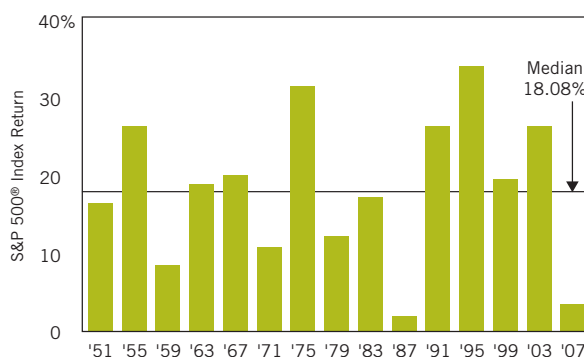


Source: Standard & Poor’s. *Past performance is no guarantee of future results.* The S&P 500® Index is a free-float market capitalization-weighted index of 500 of the largest U.S. companies. The index is calculated on a total return basis with dividends reinvested. The index is unmanaged and not available for direct investment.

Q4 Tax Sell-Off Worries

For much of 2010, the market anticipated a year-end sell-off, if the Bush-era tax cuts were allowed to expire. This worry began to subside in the wake of U.S. mid-term election results that gave Republicans control over the House and created a bipartisan “check and balance” system.

Return of The S&P 500® Index in First Year Following Mid-Term Elections, 1951-2007



Source: FactSet

Past performance is no guarantee of future results.

Congressional approval on December 16 of stimulative tax legislation for 2011, including temporary extensions of the tax cuts and unemployment benefits, put an end to this worry for now.

2011 Tailwinds Offer Growth Potential

I foresee five dominant tailwinds for 2011, creating a broad range of opportunities for investors.

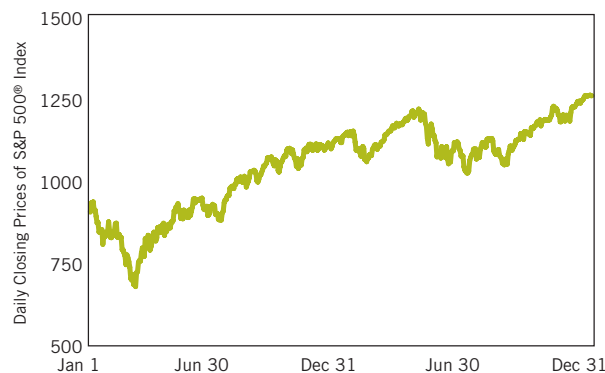
1 Time Heals

At the onset of the 2008-2009 global financial meltdown, I stated that the U.S. economy and capital markets needed time to heal and repair themselves.

Over two years later, consumer and corporate balance sheets are recovering, thanks to the combined stimulative efforts of the Federal Reserve, U.S. Treasury, and global central banks.

The S&P 500 has appreciated steadily since bottoming out in March 2009, yet many investors have avoided equities, waiting for a correction to get back in. I believe the pent-up demand for equities will grow and the interest in U.S. Treasuries begins to fade. Yes, housing and employment need more time to heal, but that's no reason to stay out of equities, not with valuations attractively low.

S&P 500® Index, 1/1/09-12/31/10



Source: Standard and Poor's

Past performance is no guarantee of future results.

Opportunities FOR 2011

- >> U.S. equities, including dividend-paying stocks for yield-seeking investors
 - >> Diversified ownership of equities across sectors
 - >> Emphasis on cyclicals, which tend to benefit most from economic upticks
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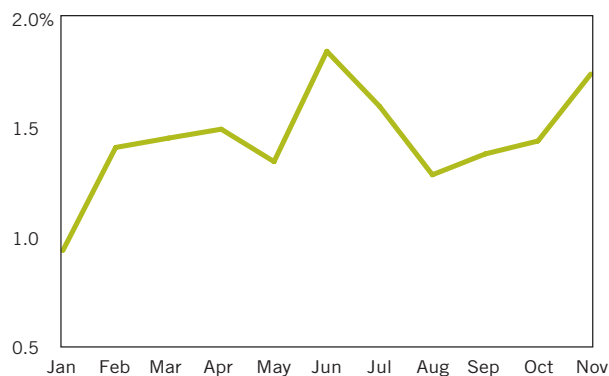
2011 Tailwinds Offer Growth Potential

2 Premium for Growth

In 2010, corporate earnings shone brightly. More than 70% of the companies in the S&P 500 experienced positive earnings surprises, and companies overall grew earnings above 40%, on average, with earnings per share for the Index at \$80 as of the end of the third quarter.

In 2011, I expect strong corporate growth to continue and that investors will be willing to pay a premium for that growth. Companies with strong balance sheets that can grow organically or buy growth stand to benefit tremendously. I expect \$400 billion to come off corporate balance sheets in the form of stock buybacks and M&A. Small-cap companies, in particular, have a lot to offer in 2011, buoyed by favorable tax legislation that encourages hiring and expansion.

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.

Historically, when real interest rates go above 2%, that indicates an acceleration point for equities. I believe we are seeing the start of an upward trend.

Opportunities FOR 2011

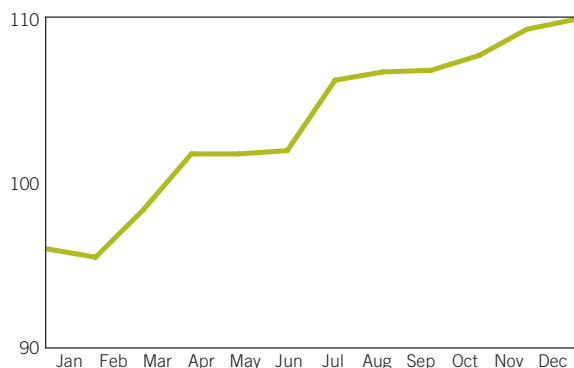
- >> Corporate bonds with stable credit quality
 - >> High-yield bonds expected to be investment grade in 2-3 years
 - >> Senior floating rate bank loans
 - >> Small-cap equities
-

2011 Tailwinds Offer Growth Potential

3 Germany's Strength

Opportunity exists in any crisis. The winner in the European sovereign debt crisis? Germany, which carried the European Union in 2010. As Europe's largest economy, Germany accounts for about 20% of Europe's GDP, and is the world's second-largest exporter after China. Germany has a leadership position across many industries, including automobiles and chemicals, and exports have been picking up with the global recovery. The prospects are bright for Europe's economic locomotive.

Ifo Business Climate Germany, December 2010



Source: Ifo Business Survey, Ifo Institute for Economic Research, Munich. The Ifo Business Climate is a widely observed early indicator for economic development in Germany. It is based on ca. 7,000 monthly survey responses of firms in manufacturing, construction, wholesaling and retailing. The firms are asked to give their assessments of the current business situation and their expectations for the next six months. The replies are weighted according to the importance of the industry and aggregated. The business climate is a mean of the balances of the business situation and the expectations.

4 Industrialization of Emerging Economies

Emerging markets, like China and Russia, have created a tremendous opportunity for investing in natural resources and commodities, such as copper, as global demand increases. Multi-national corporations that provide goods and services to emerging world households also stand to benefit from this growth trend. On the world stage, emerging markets are expected to be the largest contributors to global GDP growth in 2011, surpassing developed countries by far.

2011 Global GDP Consensus Estimates

China	10.0%
Asia ex-Japan	8.5%
India	8.5%
Latin America	5.0%
U.S.	2.5%
Europe	2.0-2.5%
Japan	1.5-2.0%

Opportunities FOR 2011

- >> Natural resources and commodities – oil, copper, gold
- >> Multi-national companies, both Western and U.S.-based
- >> Consumer-focused emerging markets investments

2011 Tailwinds Offer Growth Potential

5 Resilient U.S. Consumer

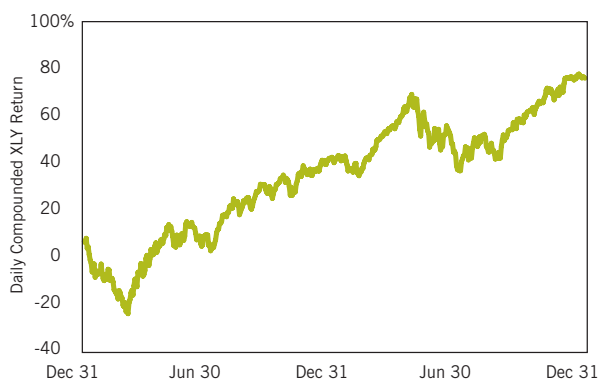
Retail sales surged in 2010 with consumer discretionary stocks leading the market. Growth came from luxury brands snapped up by affluent consumers, popularity of e-commerce and consumer gadgets like the iPhone, and a rebounding auto market with sales in November 2010 at their highest since October 2008, excluding August 2009 which was skewed by the “Cash for Clunkers” stimulus. Same-store sales rose over 14 consecutive months through October 2010, and the expectations for November and December 2010 are for the largest increases since 2006.

In 2011, look for consumer spending to continue contributing to the improving economy. I expect that consumer spending will challenge 3%. More important, however, is my expectation that residential investments, which for consumers contracted by 3.5% in 2010, will see a reversal of +2.5% to 3% in 2011.

Opportunities FOR 2011

>> Consumer discretionary stocks

Performance of the Consumer Discretionary Select Sector SPDR (XLY), 12/31/08-12/31/10



Source: Yahoo! Finance

Past performance is no guarantee of future results.

Adjust for the Winds and Stay the Course

The start of a new year is an ideal time to review your investment plan and make any needed adjustments to stay on track with your financial goals. Like sailing, investing requires a readiness to reset your sails in response to changing winds so you can stay on course.

My expectation for 2011 is that multiple tailwinds present themselves, signifying opportunity for investors. Tailwinds create investor confidence, particularly when the capital markets are in a “catch-up” phase, as I expect will occur over the coming year. The tailwinds I identified earlier suggest that investors can no longer remain frozen on the sidelines, disbelieving the recovery. Their catch-up strategy should focus on diversifying their portfolios to strengthen overall growth potential.

This could be a year where we make up for lost ground on many fronts. I expect American consumers to continue to surprise the market with their resiliency; cash-rich corporations must exhibit growth, either organically or through acquisition; and developed nations (not just emerging markets) will make meaningful contributions to global GDP.

Realistically, it will not be smooth sailing all the way. If there is vulnerability, it will likely occur in the first or second quarter, concurrent with China’s tightening of monetary policy. I also anticipate some form of political discourse in the U.S. or the eurozone to contribute to a shallow capital markets correction. However, any correction in 2011 will create an opportunity for asset acquirers.

My strategy? Find confidence in the tailwinds as they arise, take advantage of the opportunities they present, and stay the course. I repeat: I believe the markets are higher at the end of 2011. As the year unfolds, I believe balance will be restored, both globally and domestically. The greatest headwind for investors might just be a poorly defined investment plan and under-allocation. Investors who can overcome these challenges and keep on an even keel will be able to navigate whatever comes their way.



“Markets must navigate through headwinds. Having a strategy and expectations for where tailwinds can be found gives the investor confidence that the headwinds will dissipate.”

Joe Terranova, 2010



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Visit Virtus.com to read Joe Terranova's recent blog updates, quarterly market commentary, and monthly economic indicator calendar.

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