

Crisis of Confidence Returns

On July 15, 1979, President Jimmy Carter delivered what became known as his “malaise speech” from the Oval Office, in which he proclaimed that Americans were suffering from a “crisis of confidence” that threatened the economic stability of the nation. Thirty-two years later, our country seems to be in that exact place.

In my new book, *Buy High, Sell Higher*, coming out in January, one of the themes I emphasize is the importance of confidence to investing success. The market events of the third quarter clearly illustrate what happens when investors lose confidence. The S&P 500® dropped 14% for the quarter and 10% year to date, making it the worst quarter the equities markets has seen since the financial crisis peaked in late 2008.

Since the slowdown began in early May, I have continued to ask, when will this “pause” refresh and the markets begin to appreciate again? In early July, I suggested four potential “heroes” that might come to the rescue of the markets in the second half of 2011 – a global manufacturing rebound; resurgence in consumer demand from China once its monetary tightening had ended; stimulative U.S. fiscal policy; and continued robust corporate earnings.

At this point, my view of these potential heroes has shifted somewhat, and my expectations for fiscal policy have diminished. However, China appears to have unofficially ended its monetary policy tightening cycle, which would be stimulative to global growth. I also am looking for corporate earnings to remain strong. Finally, it may also still be possible for manufacturing to come through, to a lesser extent.

POLICY MAKERS TO BLAME

During the quarter, a “push-pull” dynamic of opposing forces conspired to work against a market recovery. Robust corporate earnings and resiliency in enterprise IT spending were offset by weak employment and manufacturing data, the S&P downgrade of U.S. credit, the absence of fiscal policy resolutions, and the escalating European debt crisis.

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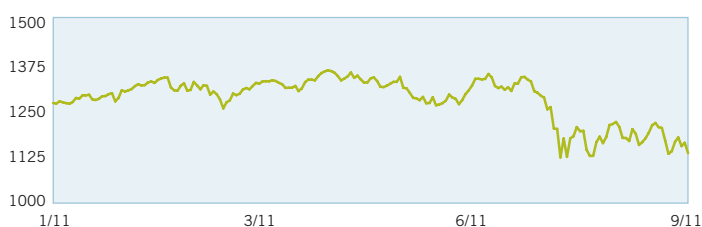
U.S. and European policy makers have been the biggest adversaries of the market. Negativity surrounded third quarter policy decisions from the European Central Bank, the European Union, U.S. Congress and the Obama administration. They were the real villains in a market that I expect would be substantively higher if confidence were restored once again on both Main Street and Wall Street.

While the Obama administration has been quick to blame Europe for what ails the U.S., I would submit that the real reason for the loss of investor confidence was the

highly contentious federal debt ceiling debate on Capital Hill in late July. In fact, the decline in the S&P 500 in the quarter didn’t begin until around July 26, when partisan bickering over the deficit was in full swing, and after most of the companies in the Index had reported earnings.

The S&P downturn was not the result of corporate earnings falling off; rather, it was the result of investors losing confidence in our policy makers. Republicans pushed forward an agenda focusing on a near-term deficit reduction, and now is not the right time for that conversation. You risk making a 1937-style policy mistake. On the other side of the aisle, the Democrats clearly have an anti-business agenda reliant on heavy taxation and regulation.

S&P 500® Index, January-September 2011



Source: FactSet

Past performance is no guarantee of future results.

Gridlock was certified at a moment when gridlock is not what the market needs. This summer, when the European debt crisis became headline news, as it did in the spring of 2010, we approached it differently, with far less confidence in our global policy makers and far more suspicion. The key difference last year was that we pinned our hopes on Chairman Bernanke's speech at Jackson Hole in August, knowing the Fed would be coming through with monetary stimulus in the form of \$600 billion in asset purchases. This year, the position we are in has defeated any hope for the successful implementation of monetary policy.

CASH REGISTER MENTALITY

Leading indicators are not consistent with an impending recession. Corporate earnings remain strong, enterprise IT spending is resilient, and while manufacturing has corrected and slowed somewhat, it does not suggest an impending recession. Market consequences, however, are what matter most, and the consequences are plain and simple. The world

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at large is suffering from a crisis of confidence right now. Global markets have a cash register mentality and risk assets are being sold to raise cash. One critical observation – the market would be much higher if it were not for a pullback in spending among affluent consumers. High-end consumers are highly sensitive to equity market declines. The affluent consumer doesn't look at economic numbers, but they do care about the “wealth effect” and how their personal wealth is impacted.

When asset values depreciate, the affluent consumer retrenches their spending habits. We got a hint of that in August when retail sales were disappointingly flat. Adding to their worries, the affluent consumer is also troubled by regulatory measures and a potential tax increase. In order for the economic recovery to be sustained, the affluent consumer must continue to spend. This will be a key indicator to watch in the months ahead.

MAINTAIN A DEFENSIVE PORTFOLIO

Despite my favorable expectations for China and corporate earnings, right now investors need to focus on market consequences. The optimal investment strategy is a defensive position, which I first suggested in the spring of this year and continue to uphold.

Given the riotous markets, I see no reason to move away from this position. In this type of environment, the simplest investment strategies are usually the best. Don't pretend to know more than everyone else. I know that I certainly do not. In fact, I fully expected by this point in the year to be suggesting allocations to riskier assets. Clearly I was wrong; the pause has not refreshed.

Since late 2008, there has been no other quarter where I would emphasize how important managing the downside is as it is right now. You need to be in the confidence business. This global storm will eventually pass. For now, investors should be focused on how to position themselves. There will be many places where confidence will return to the market in 2012 and I can't emphasize enough the importance of being prepared.

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I would suggest continued exposure to investment grade corporate bonds, which is the one asset class in which confidence is evident. In particular, I suggest owning the debt of U.S. financial institutions, not the equity. Municipal bonds also offer opportunity to investors.

As for equities, the strength of select corporate balance sheets will continue to attract asset inflows, including large consumer discretionary and technology names. I also continue to stress having exposure to basic consumer staples names that stand to benefit from the growing demand of emerging market consumers. Also along this theme, it's incredibly important right now for investors to be globally diversified to smooth out currency fluctuations. For instance, it makes sense to own multinational consumer companies such as a Unilever, which has 38% exposure to Asia, 30% to 35% exposure in the U.S., and 25% to 30% exposure to Europe.

Energy is also a place I want to be. Global spare capacity of oil remains challenged and is supportive of the sector, which I upgraded to overweight in mid-September. It seems that energy equities have priced in Brent crude oil at \$80 to \$85 a barrel, but I don't expect the price will fall much below \$100. Investors who want energy exposure should be looking at large integrated oil names with proven global reserves. High beta, highly sensitive energy plays are not necessarily the right strategy.

I would continue to overweight utilities. Utilities are an example of an investment where simplicity works best. What the Fed was really saying in August when they announced interest rates would be kept at historically low levels until mid-2013 is that

the search for yield had begun. Where do you typically find yield? Utilities. Earnings for utility companies have remained resilient. Despite natural gas prices being at depressed levels, utilities in general should continue to perform well.

Investors may ask, when should I get out of utilities? It's human nature to question success more than failure, but my advice is to stay with what works until it doesn't. The markets are liquid enough that you'll be able to shift your allocation when an investment no longer works. With correlations so high, being tactical is a defense mechanism.

Finally, a word about gold.... I have long maintained that the proper allocation to gold is between the uniform numbers of Yankee legends Joe DiMaggio and Mickey Mantle: 5% to 7%. Most non-professional investors cannot tolerate the volatility of an allocation above 7%. If the last quarter proved anything, it was exactly that, especially at the end of the quarter when gold and silver, which have bullish outlooks, fell victim to a cash register mentality of "sell first, focus on fundamentals later."

LOOKING AHEAD

While I expect equities will resume their appreciation, I caution investors against assuming too much risk in the fourth quarter. Be mindful of the potential downside. One of the most important things you can do in the final quarter of 2011 is to consult with your advisor and make sure your portfolio is positioned for where you want to be in 2012. The environment is not going to get easier. Political gridlock has been certified, and a historic presidential election is on the way.

If the Federal Reserve were to implement a third round of quantitative easing, it would be a bearish condition for risk assets, not bullish. QE3 would be a direct reaction by the Fed to try and return price stability to the markets and would likely mean we are in a recession and that the S&P 500 had broken and sustained a decline below its low of 1101.

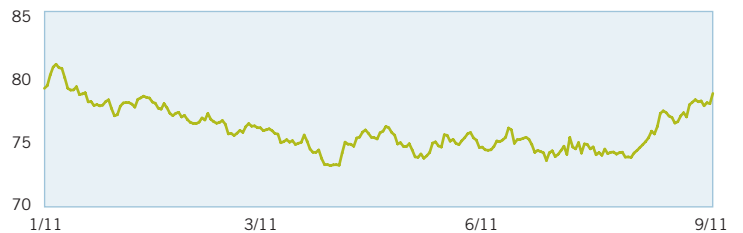
The S&P 500 declined to 1101 in early August and was trading at the end of the third quarter in the 1101 to 1225 range. Despite the decline, I continue to expect the equities markets will be higher on December 31, 2011 than they were on December 31, 2010. However, I also humbly suggest that if I am proven correct, the Index is not likely to end much higher. At best, I expect we might get back to even for the year, or perhaps slightly above.

In the fourth quarter, important indicators to watch will be unemployment data, manufacturing data, especially the ISM index (which reported a slight improvement in the early October release), and corporate earnings reporting in October and November.

We should also be looking for a willingness on the part of European leaders to recapitalize European banks at any cost. In this regard, it will be important to watch Italy to see if it is able to assuage the markets with the rapid implementation of austerity measures. Evidence to that effect will be important to demonstrate success on the part of the EU to stabilize its debt crisis and prevent contagion from spreading.

The most important fourth quarter indicator will be the value of the U.S. dollar, which we'd like to see resume its secular downtrend. I was wrong in my earlier belief that the dollar would continue its decline through the end of 2011. This has obviously not been the case as the dollar steadily appreciated in September. Further appreciation in the dollar restricts our ability to monetize our debt and boost exports, whereas a falling dollar boosts the ability of multinational corporations to sell their goods overseas and bolster their bottom lines.

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



Source: Barron's

Past performance is no guarantee of future results.

A FINAL WORD

Confidence will come back. Until it does, roll up your sleeves and consult with your advisor. I want investors to be in the market but to err on the side of caution. This is not the time to be in cash. This is a time to manage the downside, to focus on game plans and strategies. Clearly, the pause is not refreshing. Policy makers on both sides of the Atlantic continue to remove confidence from the markets by their failure to act in ways that reassure.

In the meantime, the markets will continue to experience an atmosphere of uncertainty leading up to the November 23 deadline for the congressional "super committee" to vote on a plan for reducing the U.S. deficit by \$1.5 trillion. Last year's Simpson-Bowles deficit-reduction plan would be a good foundation to the plan (it might even have a chance of being passed by both houses by the December 23rd deadline). No one knows with any degree of certainty what the outcome of the plan will be, or the market consequences, except that the weeks leading up to it will be filled with more political follies and discomfort.

I'll close by asking investors to keep two things in mind. First, a simple investment strategy works best in riotous markets; don't attempt complicated strategies or analyze beyond the obvious. Second, when you're tempted to panic, do the opposite of what feels easiest; doing what is hardest usually works best. In times like these, preparation is what matters most.

Restoring confidence to the markets will take time – but it will happen. Until it does, defensive strategies are best for now. I don't expect the next allocation move will be to cash. More likely, it will be the assumption of more risk (not in a gluttonous way), but before I can make that suggestion, I need to see evidence that confidence has been restored.

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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 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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