

## Guilty Until Proven Innocent

The crisis of confidence within the global capital markets that began last summer grew in intensity over the second half of 2011, forcing money managers to favor defensive positioning. Going into 2012, political gridlock, fiscal constraints, and monetary missteps remain strong headwinds. Student council-like decisions from policymakers on both sides of the Atlantic continue to frustrate investors, and I expect risk assets will continue to be viewed as “guilty until proven innocent” for the time being.

I see no reason to switch gears from a defensive strategy in the first quarter. A year ago, I was excited about the opportunities presented by the first and second quarters; this year, I fear the greatest risk for a capital markets decline will be in the first quarter. “Risk off” remains the trade (possibly for the first half), based on my expectations for further volatility surrounding both the European debt crisis and lead-up to the U.S. presidential election.

Sometime in the second half, if not sooner, I expect China’s monetary easing tailwind to hit stride; Europe’s debt situation to start to sort itself out (perhaps with the help of an ECB-led large-scale sovereign bond purchase), and the outcome of the U.S. election to be priced into the market. As market sentiment improves, I expect a historic reallocation trade out of safe-haven Treasuries into risk assets. I also expect equity markets to end the year higher in 2012 than they started.

### GLOBAL SLOWDOWN, GLOBAL HEADWINDS

I typically prefer to focus on one headwind at a time when setting investment strategy. However, for 2012, there are multiple unavoidable headwinds: U.S. politicians whose beliefs have evolved from ideology to religion and European policymakers who cannot understand the concept of “all for one, one for all.”

The world economy slowed in 2011 to 3.8% global GDP, down from 5% in 2010. Further moderation is expected in 2012, to around 3.5%. I expect relatively strong growth from the U.S., around 2.5%, while the eurozone slides under 1% (and back into recession) and China slips below 9% for the first time since 2001.

The U.S. economy, while still sluggish, is showing positive signs of a comeback: a growing labor market, lower inflation, and increased consumer spending. If these trends can be sustained, the U.S. could surprise to the upside by the end of 2012.

While the Chinese economy has stalled, monetary easing initiatives begun in November should start to take effect in the second half, and rising demand from the Chinese consumer should turn into a tailwind. I expect other emerging markets will follow China’s lead and begin easing initiatives that will further contribute to the global growth story later in the year.

### CORPORATE EARNINGS TAILWIND?

I am concerned that the clock may be running out on the corporate earnings tailwind we have had for the last two years. Earnings of S&P 500® companies grew 47% in 2010, and are expected to increase 15% in 2011. There is a low probability for earnings growth to reach double digits in 2012. More likely, earnings growth will mirror the moderation in global GDP growth.

In light of consensus estimates that EPS growth begins to moderate, I want to hear the earnings stories before I make any reallocation decisions. I also want to hear from more CFOs (not just CEOs) for their insights into a company’s fundamentals, and to learn what the capital allocation strategy is, including share buyback plans. Much of the S&P 500’s improvement over the last few years has been on year-over-year share buyback growth (100% in 2010; 50% in 2011). I don’t expect to come close to that in 2012, but 10% to 20% would be favorable.

### THE GREAT TREASURY UNWIND – #1 “RISK ON” INDICATOR

For 2011, the #1 trade on most forecasts called for a sharp rise in 10-year Treasury yields, in some cases to 5% to 5.5%. Throughout 2011, the trade I most frequently heard offered on CNBC was to short Treasuries – “The trade of a lifetime” many called it.

In this new climate of European debt concerns, I haven’t heard anyone suggest shorting Treasuries. We have accepted that it’s okay to own Treasuries – and when you accept the condition of

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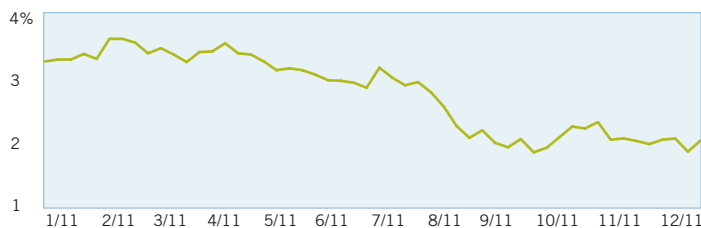
an asset class at such depressed valuations, it usually marks the end of a cycle. (A year from now, financial institutions may be in a similar cyclical position.)

In 2012, the 10-year Treasury note takes over as my single-greatest indicator, replacing the U.S. dollar, which normally holds this spot. (The U.S. dollar has become a less reliable indicator due to its unusual counter-trend appreciation in the fourth quarter.)

The ultimate market sign that the “guilty” verdict on risk assets has been overturned will be when we see a massive reallocation trade out of Treasuries. The Treasury move will be a once-in-a-generation trade. It might be motivated by pent-up investor frustration with lack of yield, or it could be in anticipation of inflationary pressures that could reemerge in the second half, similar to what happened in the spring of 2011.

I expect this reallocation occurs in the second half as the global economy improves, Europe’s situation settles, and there is greater clarity surrounding the U.S. presidential election. When it happens, the trade will be massive. The tell-all sign that it’s time to get back into risk assets will be a sustained move in 10-year yields above 3%, last seen in July 2011 before the federal deficit fallout.

**10-Year U.S. Treasury Yield, January 1 – December 23, 2011**



Source: FactSet

Past performance is no guarantee of future results.

### FATE OF THE EUROZONE

What truly ails Europe can be found in the credit markets. Sovereign bond yields, whether on Spanish, Italian, or German paper, cannot continue to rise. Debt servicing costs must be capped, given the challenges to governmental balance sheets.

We are seeing the initial glimpse into a potential recession for Europe. The biggest challenge the eurozone faces is whether it can overcome its “all for one, one for one” attitude and lack of competitive equality among its members. Indebted nations like Portugal, Ireland, and Greece don’t have the economic wherewithal to compete with Germany. I believe the euro has not deteriorated towards parity with the U.S. dollar because investors have priced in the eventual outcome that Germany will remain one of the few sovereigns left standing in the eurozone.

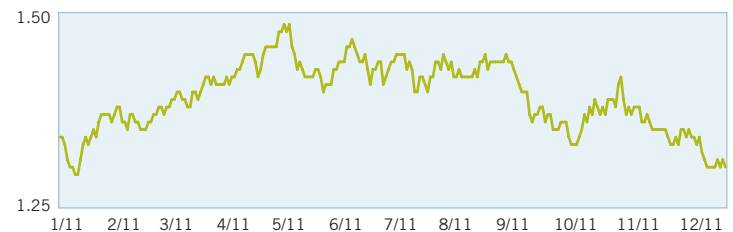
The ultimate path for these indebted sovereigns – even Italy, to a certain extent – is that they be allowed to leave the eurozone. When a country has significant debt and can’t

compete, the only mechanism to monetize the debt is currency depreciation. As long as these countries remain part of the unified euro currency, they don’t have the ability to do that. The market clearly understands the very high probability that the 17-member eurozone will be reduced in size in 2012.

The ECB is giving the market just enough to keep investors coming back but not enough to get them to stay. The market action that investors would respond to best would be the ECB’s large-scale purchase of sovereign bonds to lower yields, similar to the strong message sent by the Federal Reserve to the U.S. bond market in March 2009 when it announced its plan to purchase \$1.2 trillion in Treasury bonds and mortgage securities to anchor borrowing costs. That type of action by the ECB would send a clear message to Europe’s bond vigilantes that not only is there a buyer of last resort on the other side, but, just as we say, “you can’t fight the Fed,” Europe would have to follow the lead of its central bank.

The ECB need only look to at how the Swiss National Bank recently handled a similar situation by establishing a fixed ceiling for the Swiss franc. The bank announced that it was setting a maximum value of 1.20 francs per euro and would do everything in its power to defend that limit – which has meant purchasing foreign currencies until the limit is reached. Thus far, the strategy has succeeded in keeping the exchange rate consistently above 1.20 francs to the euro.

**Euro/U.S. Dollar Spot Price, January 1 – December 23, 2011**



Source: FactSet

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### U.S. ECONOMIC RECOVERY

If Europe were to go into recession, I don’t think the U.S. would follow. The world is coming to the realization that the Federal Reserve’s aggressive monetary efforts in 2008 and 2009 to fight what they viewed as Japanese-style deflation have resulted in the U.S. being much further along in the economic recovery process than Europe.

Because of the Fed’s easing efforts, the U.S. economy could very well be the economy that surprises to the upside in 2012. Recent signs of improvement in the U.S. labor market may evolve into a sustainable trend in 2012, which bodes well for the U.S. consumer. U.S. consumer spending fluctuated

between 2% and 2.5% in 2011; I don't expect that to change in 2012. In fact, I expect the U.S. consumer will be the leading world consumer in 2012.

### U.S. PRESIDENTIAL ELECTION

The 2012 election is going to be incredibly contentious and less about leadership change than a historic debate about income and equality, entitlements, and who should bear the tax burden – in essence, a rallying cry that it's time to reshape America.

In 1992, Bill Clinton defeated George H.W. Bush largely due to his strategic focus on the struggling economy, then in recession (remember the catchphrase, "It's the economy, stupid?"). While many today have suggested high unemployment could be the downfall for President Obama, I think that's unlikely, especially if the labor situation continues to improve.

I expect the 2012 election could have a similar outcome to the 1936 election when Democrat Franklin D. Roosevelt beat Republican challenger Alf Landon in a surprise landslide victory, winning every state but Maine and Vermont. Everyone expected a close race, but FDR was carried to victory by an angry populace who blamed the GOP for the Great Depression, then in its eighth year. Average unemployment in 1936 was 16.9% (and on the downswing, from 20.1% in 1935). So even if unemployment remains high in November 2012, I don't think we can automatically assume a change is in store for the Oval Office.

Why do I suggest that a 1936-like outcome may be possible? It's simple. As we've seen with the "Occupy Wall Street" movement, middle class Americans are frustrated and angry with financial institutions (and the politicians perceived to be aligned with them) for taking away their piggy banks.

The risk for much of what's going on related to the election is that we digest it sooner than later in 2012. I expect the market will price in the election outcome well before November 6, including the agenda of the incoming administration.

### EMERGING MARKETS – CHINA, INDIA, RUSSIA

In 2012, not all emerging economies will be created equal. In terms of investing, we need to be selective about the countries we choose.

For instance, take Asia's rising giants, China and India. While both countries have comparable GDP growth rates (sub-9% in China, sub-7.5% in India), China is further along in the economic cycle and has the stronger consumer. India is running twin deficits (fiscal and current account); many government projects critical to stimulating its economy were delayed in 2011 (and are likely to be delayed again in 2012); and

when India's central bank begins monetary easing, its banking system's credit exposure will be 10% to 15%, compared to low-to-mid single digits for China.

What this illustrates is how countries that address their fiscal problems right away have an economic edge. Europe has been slow to deal with their debt problems; the U.S. was fast. China is further ahead in managing its economic landing relative to India and other emerging markets, and is somewhat less leveraged than India to European credit markets.

The Russian economy is another strong emerging market story for 2012. In 2009, Russia's budget deficit was around 6% of GDP. As a result of fiscal restraint and austerity measures enacted in 2010, Russia worked off its deficit, turning it into a modest surplus. How did Russia achieve that result? Its leaders dealt with the problem right away.

I expect Russia to become the dominant force in Europe's natural gas sector, which will be beneficial to its economy. I also expect Russia to benefit from oil's upward projection.

### DEVELOPED ECONOMIES – CANADA, AUSTRALIA

Even in the developed markets, not all countries are created equal. In the past I've recommended owning both Canadian and Australian dollar currencies. In 2012, I believe Canada will be in the more favorable economic position.

Australia's vulnerability in 2012 will be its exposure to the economic struggles of its largest trading partner China, especially in the first half. Canada, on the other hand, has no comparable weakness; it is somewhat removed from Europe's troubles and has limited exposure to the European banking system. In addition, Canada is blessed with natural resources, oil in particular, and its third quarter GDP surprised to the upside at 3.5%, well above U.S. GDP.

### EQUITIES – FOUR SECTORS TO FOCUS ON

When we get the reallocation trade out of Treasuries, even if inflationary pressures exist globally I think conditions will be favorable for equities. Four sectors offer attractive investment opportunities for 2012: consumer discretionary, consumer staples, energy, and technology.

Based on my expectations, the U.S. consumer will be a dominant tailwind in 2012, especially the high-end consumer, who has carried the economy for much of the last two years. Consumer discretionary names have been incredibly resilient, and I believe the sector will outperform the S&P 500 Index, as it has so far this year. Investment opportunity exists in dividend-paying consumer discretionary and consumer staples companies (both U.S. and international) whose

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revenues are derived from consumers in the U.S., followed by Latin American and Chinese consumers, particularly in the second half as China moves through its easing cycle. In light of Europe's slowing economy, I would not focus on companies that cater to the European consumer at this time.

Historically, there's a seasonal trade that works incredibly well, which I expect will work again in 2012 – a third and fourth quarter push in energy and technology. The energy sector outperformed the S&P 500 in 2011, and I expect it will continue to outperform. I maintain my bullish outlook on oil in terms of pricing, rising demand, and, most importantly, diminishing supply. Mid-continent refiners stand out as potential outperformers. I don't expect the infrastructure challenges in the oil supply hub of Cushing, Oklahoma will be alleviated with the reversal of the Seaway pipeline (allowing for the flow of oil from Cushing to the Gulf), and that this action will provide only temporary relief.

Finally, information technology remains the ultimate investment opportunity. A large percentage of S&P 500 companies quantified as growth are technology names. The sector also has Apple as a built-in tailwind, representing 16% of its market cap and 18% of its earnings. Investors in search of dividend growth should look to the tech sector, which has the greatest ability to deliver because balance sheets are so flush with cash.

#### FIXED INCOME – CORPORATES AND MUNI BONDS

Credit fundamentals are the best they've been in decades. S&P 500 corporate operating margins are above 11%, a historical high, while interest expense and borrowing costs remain at historical lows. The

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fixed income outlook for 2012 is favorable, but I would tighten up on yield spreads due to the widening seen in the fall.

In 2012 to start, I would focus on investment grade corporate bonds of companies with strong balance sheets in very defensive sectors, including

consumer staples, technology, and energy. I would focus on short-dated bonds and avoid the long end of the curve. I'd also be looking to trade up to higher-yielding issues as market conditions become more favorable, likely in the second half.

Throughout 2011, I was overweight municipal bonds, much of that the result of the November 2010 default scare when investors fled the space, creating buying opportunities. I expect muni bonds will start out strong in 2012 but eventually fall victim in the second half when the reallocation out of Treasuries into risk assets occurs.

#### COMMODITIES – OIL AND PRECIOUS METALS

Oil is an unknown variable for 2012. It may be another year like 2011 when oil alternated between being a tailwind or a headwind. Global demand slowed significantly in 2011, fueled by a steep drop in Japan's demand following the earthquake. My position on oil went from overweight to market weight in the first half of the year, as the spot price rose at an uncomfortably fast pace, back to overweight by September (and holding) as prospects for oil brightened, in anticipation of modestly higher prices.

While I expect the price of oil to rise in 2012, I am hesitant to suggest just how much higher it might go. At some point, we have to recognize that the world's oil supply, in particular the non-OPEC supply, is not keeping up with demand. When global demand begins to normalize and rise, as I expect it will in the second half of 2012, we will be unprepared on the supply side, particularly in the developed world.

There are serious supply concerns ahead for 2012 that could impact oil prices. I am concerned about a potential supply disruption

from Saudi Arabia based on the instability posed by its aging royal family (complicated by the October death of the crown prince and heir to the throne), and the overall lack of a succession plan. Adding to that is growing social unrest in the Middle East, from which Saudi Arabia is not immune. Keep in mind that while the Saudi government is controlled by Sunni and the majority of its population is Sunni, the oil workers operating the production facilities are Shiite. If social unrest were to unfold, I fear that oil workers will strike and halt supply.

Clearly, U.S. capacity is constrained and somewhat limited to deal with rising demand. In June of last year, the Obama administration released 30 million barrels of oil from the Strategic Petroleum Reserve (SPR) to provide relief at the pump to American consumers before the busy driving season. How well did that affect pricing? Not!

Brent Crude Oil Spot Price, January 1 – December 23, 2011



Source: FactSet

Past performance is no guarantee of future results.

Ownership of precious metals is once again warranted in 2012. Select industrial metals, copper and aluminum in particular, will become a story, but not likely until the second half, when China's monetary easing tailwind hits stride.

#### **U.S. DOLLAR**

Another important indicator to watch is the U.S. dollar, which has given me pause for concern as it rose uncomfortably higher at the end of 2011, counter to the historical trend. I do not expect the U.S. dollar to continue to appreciate. When it does decline, that will be a tailwind for the materials and industrials sectors, which underperformed in the second half of 2011, and would support their return to positive performance. A weaker dollar is also necessary to achieve the Obama administration's goal of doubling exports over five years.

#### **PREPARE TO MANAGE YOUR RISK AND BE ACTIVE**

Historically, in the year of a presidential election, the equities markets have done well. In the election years between 1932 and 2008, the S&P 500 produced an 8% average return. That sounds promising for 2012 until you consider that the third year of the presidential election cycle has historically been the best – and that clearly was not the case for 2011.

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Investors today need to understand that we live in a different world. Statistics such as these have become meaningless. The markets and how we respond to them have changed dramatically. For example, one of the unintended consequences of Dodd-

Frank reforms in the financial industry is that fewer market participants are willing to physically occupy a trading desk. This has led to an increase in high frequency trading, where computers are significant contributors to daily transactional volume. Consider that in my early career in the oil trading pits, the Iraq invasion of Kuwait in August 1990 caused the price of oil to

rise \$7, from \$34 to \$41 – compared to the dramatic rise in oil prices in July 2008, when trades were mostly machine-led, and oil spiked to \$147 because there was no one to lay off the risk.

What will this mean for investors in 2012? Expect excessive volatility to continue and for the Dow to hit more triple-digit historic high days. Now is the time for all investors to approach the market like professionals, actively manage risk, and protect the downside first. If you are not comfortable in that role, seek out a financial advisor who can help you achieve your goals.

My New Year's wish for all of you – **Be Long Health and Happiness!**

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**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 the author of the book “*Buy High, Sell Higher*,” published by Business Plus. 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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