Second Half Portfolio Playbook
Joe Terranova's Market Review & Outlook
Call Conducted July 10, 2017
Transcript edited for clarity and brevity

Paul Cahill: *My name is Paul Cahill. I'm the Managing Director of National Sales at Virtus Investment Partners. It is my pleasure to host this call today. Joining me to share his insights and perspectives on today's global markets is Joe Terranova. Joe is Virtus' Chief Market Strategist. He's also a regular contributor on CNBC's "Halftime Report." I'm sure many of you are familiar with him from his role there as well as his occasional appearance on CNBC's "Squawk Box" in the morning. Joe has caught a touch of bronchitis so he's struggling to keep his voice. Thanks for keeping the call and for this chance to speak with you. There is no shortage of topics to discuss. Why don't we dive right in? I know you had some opening comments you wanted to make and we can begin there. Thanks, Joe.*

Joe Terranova: Thank you Paul. The third quarter is upon us as fast as 2017 seems to be moving. It's a great time for all of us to catch up and see where we're at in terms of a playbook and a strategy because I think that's the most important thing for everyone to be developing at this point in the year.

Here we are on July 10th…I think the most important question looking forward to Q3 is, which asset class should you not have in the portfolio? For the second half of the year, based on expectations, what asset class would we like to remove?

I think it's very important for investors to understand what's going on in the capital markets right now—and when I say investors, I mean your clients and those that I have the privilege to talk with at CNBC, those in the C suites, and a lot of hedge fund managers. I think the important dynamic right now is an overall sentiment of disbelief and almost fear of returning to an environment like in 2008, and trying to predict when we're going to see a peak in the market cycle that we're experiencing right now.

When I asked which asset class do you not want to own, the other side of that question is, what asset class do you want to own? Look at the landscape for a moment. The S&P 500® is up 8.5% year to date, and on a total return basis, it's up about 9.5-9.7%. The NASDAQ is outperforming, up 14%, with strong early performance in particular from the growth strategy. The Russell 2000® is down 4%, the Nikkei is up 5%, the U.S. 10-year Treasury is trading at 2.37%, the MSCI Emerging Markets Index is surprisingly up 17%--not many had that consensus expectation coming in at the beginning of the year. REITs are down 1%, and MLPs are down 6%, even with oil down 17%.

In the taxable fixed income space, high yield is up 4%, investment grade is up 3%, and municipal bonds are up 3% so year to date you're not seeing corrections but more of a rotation.

The rotations are coming because the speculative community—the hedge fund community that is trying to create a little more alpha than the retail investor in their portfolio by rotating continually, trying to find the particular strategy or asset class to own.

Think back to 2007… There's a distinction between where we are and where we were in 2008, a year preceded by a year with a heavy emphasis on commodities exposure, with oil prices at $147 a barrel.

Here's the difference between then and now. You don't have overexposure to a particular strategy or asset class. We did see a little bit of this with the exposure to technology, but what we're seeing right now is more of a rotation into other asset classes. You're not seeing money come out of technology and foster a decline in multiple asset pricing. You're seeing money come out of technology and try to find value, whether in financials or in healthcare on a sector basis.

That's important to understand with earnings coming upon us. When you look at the fundamental metrics of the technology sector, you can check all the boxes for what we're looking for in terms of a company's ability to grow revenue, have productivity, and geographic exposure that's necessary in this new economy. We've seen a bit of a rotation away from technology, but I'd be looking closely at technology earnings in the coming weeks because I think technology in Q3 could provide a significant source of opportunity.

As we're strategizing and coming up with a playbook for Q3, the theme remains that you could make a compelling case for each and every asset class. Why is that? Here are the metrics that are important to understand. You have low inflation, first and foremost. You have gradual global rate normalization, not just in the United States but globally, and you're seeing EPS growth. Those are three very important dynamics: low inflation, gradual global rate normalization, and global EPS growth. So what does that mean?

It means that you're placing asset prices in the continued state of—and people years ago used the phrase Goldilocks but let's not. I prefer to use "confidence component" because we want to invest with confidence. I know that I am investing with confidence when I can see evidence of each of those three metrics. Why?

Number one, I know that global central banks are not going to get overwhelmingly hawkish with rate normalization and make a monetary policy mistake, and secondly, while they are modestly normalizing rates, you're seeing EPS growth both domestically and globally. Keep in mind, the consensus expectation coming into this year was not for the U.S. dollar to decline, and the U.S. dollar is down 6% year to date.

If you utilized a strategy where you are seeking and investing in companies that have sales internationally—or more specifically in the emerging markets—you're outperforming what was the consensus expectation that the optimal strategy was to have exposure specifically to the United States. When you have a declining dollar of 6%, it is benefiting both multinationals and global economies that are healing well beyond the expectations. There is a confluence of indicators coming together. Because of where we are in the market cycle, it's difficult and against human nature for us to accept these conditions and to understand that what is not ahead of us is a return to something that you saw in 2008.

One of the most important things to keep in mind for Q3 is what goes on with the yield curve. The yield curve has flattened. It has moved back down from around 125 basis points in the wake of President Trump's election, got down to about 80 basis points and is now trading around 95 to 98 basis points. That is a long way off from an inverted yield curve that would suggest an economic problem that would impact global equity pricing and global asset pricing.

Secondly, in the United States over the last three months, we are averaging 180,000 jobs a month. That is right in line with what we experienced in 2016 which was 187,000 jobs per month. By no means do these types of employment gains suggest we are in a go-go economy but they are the type of gains that will keep the Federal Reserve in a continuing state of not surprising capital markets with their intentions. Remember, it's the surprise that can be most detrimental to asset pricing. The Federal Reserve has done an excellent job over the last three years communicating with transparency exactly what their plan was going to be.

It's the surprise that would be the problem. When you see economic numbers like that, and when you add to them ISM manufacturing figures that two years ago were below 50 (around 47-48 in 2015) and now you're talking about ISM numbers, which have a high correlation to EPS growth, that are approaching 57-58. That is something to watch in Q3 and is suggestive of an economy that, as I said, is not a go-go economy, but an economy that's chugging along and doing just good enough.

Keep in mind, we have a seasonality effect in terms of the economy. GDP in the first quarter was basically down a tenth of a percent. GDP over the last 10 years, the average in the second quarter is up 2%. You could blame it on whatever condition we want to blame it on, weather, politics, whatever the case may be, but we are seeing a little bit of a snapback right now in the economy. It's a good enough economy that is not just domestically but we're also seeing some growth overseas in Europe and into the emerging markets.

We've gotten past critical elections. The next election, in Germany, looks like it's going to be okay in September. Italy's election in early 2018, that's a red flag. That could be a problem for markets, and create a little bit of a dislocation. In the fall, the Chinese government will have a bit of a change in political structure, but ahead of that they're taking necessary accommodative steps and measures to make sure that investors feel comfortable with the reform.

Collectively looking at all of this, the most difficult thing is dismissing this premise of what you're hearing consistently in the media about markets approaching a potential peak. Rather, if you have a broadly diversified strategy and a multi-asset approach, you understand that there's going to be these rolling rotations from time to time as the speculative community goes out and tries to find what the hot asset class is. If you have that general understanding and you have a broad diversified approach, then you're not setting yourself forth for an expectation or a prediction on where the S&P 500's going to be at the end of the year. That's not the right strategy.

I mentioned high yield bonds. The high yield sector is is up 4% year to date. The default rate has fallen from 4.7% a year ago down to 3%. What's your risk in high yield bonds? What's the thing that you want to look at? You have two risks. Your number one risk is that energy prices go below $40 and the debt maturity wall in the high yield energy market that we're going to see in 2018 resurrects itself as a problem once again. As of right now oil prices are at $44-45 at the lower end of the range. I do not have any degree of confidence that the price of oil is going to rebound significantly. The energy sector is about 6% of the overall S&P 500 and is less relevant in the conversation than it was years ago.

When you look at energy right now, oil is going through the same dynamic that natural gas went through years ago. Natural gas had a dramatic technology-driven supply shock increase with horizontal fracking and the ability to go sideways instead of straight down to produce more oil, creating a shale boom. I think we have to get comfortable with oil prices not being as relevant to impacting the S&P 500 with the high degree of correlation it did years ago.

That said, the risk in the high yield market is that we have a dislocation from energy. I don't see signs of that right now. As I mentioned, default rates are lower.

Additionally, in the high yield market, you have exposure to retail. Retail is struggling year to date as the overall retail space is being monopolized almost to a certain degree by Amazon. With around 7% or 8% exposure to high yield retail, the risk is if we were to see significant weakness in retail in the third quarter.

Other than that, high yield is fully warranted for being in the investor's portfolio as is investment grade. When you're looking at taxable fixed income, the only thing to keep in mind—and I think you'll get this announcement in September from the Federal Reserve—is that they're going to reduce the size of their balance sheet. That's going to impact MBS (mortgage-backed securities). Let's see how MBS reacts once the announcement is made. My suspicion is that it is already built into the marketplace, so let's keep our eye on that in the third quarter.

I mentioned MLPs earlier. Year to date, MLPs are down 6%, even with oil prices down 17%. Keep in mind two things. The asymmetric risk is to the upside in terms of fiscal policy for the Trump administration. We have now priced in that we're not getting tax reform. We have priced in that we're not getting an infrastructure plan. All of the things that November and December markets believed we were going to get quickly, the markets have priced in that we're not going to get them. So REITs and MLPs, with high distributions to shareholders and not paying corporate taxes because of that, will not be beneficiaries of any tax reform policy.

The marketplace knows that. REITs, which are up 1% year to date, even with a 50 basis point move lower in yields from the middle of December to the middle of June was somewhat disappointing. However, when I look at the other side of that, the housing market still remains incredibly strong. FICO scores continue to move higher; lending standards rather are still tight and you're beginning to see some renters qualify. So maybe while REITS right now are not giving you the performance that we would expect, I certainly would not look at the REIT market and say it is an asset class that I don't want in the portfolio.

Going back to MLPs, there is the same situation as it relates to the tax effects. They're not going to be the beneficiary that other sectors might be if we get corporate tax reform in this country. These are the distinct things we have to keep in mind for Q3 in understanding what should be included in the portfolio.

Healthcare is a sector that many suggested two to three years ago, because of the impact of the Affordable Care Act, that you shouldn't own, but as we've begun to talk about in the business media lately, the one thing that's so favorable about healthcare is services—not so much drug pricing—but the services that Amazon has not been able to disrupt. So with Amazon's inability to disrupt or deliver your healthcare services on its platform, you're continuing to see strong pricing power.

That gets me to the last part of this: pricing power for where we are in the cycle right now. We might be in the third or fourth quarter or, as some suggested to me last week on CNBC, we might be going into overtime or extra innings. Nobody really knows where we are in the cycle, but we know one thing. Pricing power at this point in the cycle is incredibly important.

You are now approaching in the next two weeks the test. You will see the test of whether companies are retaining pricing power or not, and that's reflected in earnings. That's reflected in profit margins that have bounced from 8% to 9%. That's reflected in EPS growth and revenue growth that last quarter was incredibly strong.

If we continue to see revenue growth near double digits and EPS growth north of double digits, let's not make a determination or form a referendum on where we believe the top is in a marketplace. Rather, let's understand that it's an environment that is unexpected to all. It's an environment that's optimal and we need to make sure we are invested on a multi-asset basis because that is your defense mechanism in case we see a significant correction in any particular asset class. Trying to determine the best asset class to own is not the right strategy. Trying to determine which asset class *not* to own is the better strategy, and based on all the evidence that I see in front of me right now on July 10th, not many of these asset classes fit the category of not wanting to include them in your portfolio

Paul Cahill: *You've had a recurring theme of being able to build a compelling argument for almost each and every asset class going back to the end of 2015. To hear that continues is certainly an interesting topic, but I'm also interested to know, what, if any, are the potential signs of deterioration? You mentioned the potential inversion of the yield curve. You talked about the price of oil dropping below $40 potentially being an issue, at least for the high yield sector, but what would lead in your mind to any deterioration in the economic conditions or warning signs for a fall in asset prices?*

Joe Terranova: The immediate answer to that would be a political one. The risk in the third quarter is that we have a flair-up of the rhetoric in Washington, D.C. whatever side of the aisle you're on, and they try to impeach President Trump and none of his policies are put forth, or geopolitically we have some form of a flare-up or a hot spot.

Unfortunately, though, that is the wrong way to think about investing. If, before we put our head on the pillow at night, we thought about all the perils that are out there, all of the obstructions and things that could be impediments to successful investing, you'd wake up in the morning with cash in your portfolio and that would be it.

And that's going back way before we were even involved in the marketplace. There's an expression that 'markets climb a wall of worry.' It seems as though they're always climbing above those things. For the third quarter, the most important and relevant things to consider are: Do companies lose their pricing power first and foremost? Is there a select asset class that we lose? Right now technology has pulled back; it's more of a rotation than anything else. Do we see fundamental change in the earnings power of technology companies and do we see significant performance deterioration from technology which has been such a strong performer? Do the emerging markets, which are up 17% year to date, pull back? Those are the type of things that I would be looking at.

The last thing I want to highlight is this. In preparation for "Squawk Box" one day, the CEO of an S&P 500 company was sitting with me in the green room talking about the economy. He made the statement that the growth of his company's corporate debt was actually outpacing the profit growth. He saw the quizzical look on my face and I said, so your debt growth is outpacing your profit growth? And he said yes. I asked how that could be a good thing. He said it's a good thing because it's a transitory condition and is based on the confidence that we have as a company in the economy and in our ability to retain pricing power and grow our earnings. And he said to me, if the economy was contracting, or there was no visibility on our ability to grow earnings, we wouldn't for a second overstep our bounds and grow our debt, but we're confident right now in growing the debt because of what we see right now.

So things like that I think are what really matter in determining if we are going to see this long-awaited deterioration in economic and earnings conditions that precipitate a significant decline in the marketplace. It can happen but give me the evidence. I need the evidence first and foremost.

Paul Cahill: *We spent a couple days in San Francisco together at the APEX conference about a month back, and there was nearly uniformity of thought around the fact that international equities were poised to outperform, or were in a better fundamental position than were domestic equities going forward. Does that uniformity of thought scare you off or give you confidence?*

Joe Terranova: Let's talk about why it occurred first of all. No one expected that. Everyone expected a higher dollar and everyone expected the U.S. would see the growth, and the rest of the world would not. There was concern about the French elections and Article 50 for Brexit and then everyone was concerned about President Trump's policy of protectionism relative to globalization. If you think back to November after his election, technology underperformed on the prospects for protectionism versus globalization; technology more than any sector would negatively be impacted by a protectionist policy versus globalization.

Being at that APEX conference and listening to everyone, no one expected what we actually witnessed, that the first thing that happened in 2017 was rising manufacturing figures out of Europe—who could imagine that Europe could grow and see strong manufacturing? But that was followed by emerging markets healing and rebounding and recovery and then when you put a lower dollar on the year inclusive in that, it leads to a global story.

I don't want to say everyone was underinvested, but no one was trying to create or seek alpha in Europe or the emerging markets. They were doing it domestically here in the U.S. I wouldn't do anything in the portfolio but I would keep a watchful eye on the emerging markets and any bounce in the U.S. dollar, then you may see a natural rotation—a modest rotation—away from some of the international asset classes that have outperformed so far year to date just based on the U.S. dollar alone. I think the U.S. dollar will be incredibly important to this story in the third quarter.

Paul Cahill: *Joe, we appreciate the time.*

Joe Terranova: Thank you.