Q3 2013 PLAYBOOK:
State of Confusion

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Q3 Playbook
Introduction

I am not a big fan of flying; who is, really? However, I had a surprisingly enjoyable return flight from a Chicago Virtus due diligence meeting in early June. The flight didn't have any television or Internet capabilities. My market reading was completed. I found myself with nothing to do except sit quietly, relax, and reflect.

As the plane flew comfortably to LaGuardia, I began to think, as I often do, about my childhood. With the end of the school year approaching for my kids, my mind drifted back to my memories of transitioning from the end of the school year to summer.

Always an introvert and a shy kid, the end of a school year was tough for me. I had spent the majority of the prior eight months getting comfortable with my surroundings and building confidence. The arrival of summer meant the abrupt end of my brimming confidence and eight weeks of confusion about what awaited me in September. In many respects, I suspect that is exactly how money managers and investors are feeling right now – confused about what awaits the markets by the end of Q3 in September.

Just as I had grown confident with my surroundings, classmates, curriculum, and teacher, investors maintained a high degree of confidence in the direction of monetary policy, growth expectations, and which assets to own during the first five months of 2013. However, in late May that all changed and, ever since, investors have been challenged and in a state of confusion.

I expect the entire month of July and possibly early August will be spent seeking clarity so that the markets can move past this state of confusion. However, before that occurs, three vital questions must be answered:

1. Is U.S. economic growth above or below trend?
2. Should, not will, the Federal Open Market Committee (FOMC) moderate its monthly asset purchase program?
3. Will cyclical assets or bond-like defensive assets outperform?

Q3 Playbook
Confusion or Clarity?

1. IS U.S. ECONOMIC GROWTH ABOVE OR BELOW TREND?

There have been seven confirmed U.S. recessions over the last 45 years, beginning with the fiscal tightening-triggered recession of December 1969 to November 1970 and ending with the June 2009 end of the "Great Recession." In that timeframe, there has never been a post-recession period when annual GDP did not rebound back above 2.5% – until now. In fact, in each of those previous recoveries, a 3.5% annual GDP print was achieved by at least the third post-recession year. The annual GDP of the three years subsequent to the "great recession" was 2.4% (2010), 1.8% (2011), and 2.2% (2012). This is by far the weakest recession recovery in the past 45 years.

In 2013, the U.S. economy has the tailwind of strong housing and services industries while manufacturing remains a headwind. The Institute of Supply Management (ISM) Manufacturing Survey May print of 49.0 was the weakest reading since June 2009. The unemployment rate has fallen from 8.2% last July to 7.6% now. However, much of that decline is related to a continuing contraction of the labor force participation rate which fell to 63.3% during Q2, nearly a 35-year low.

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Over the past three months, job gains have averaged 155,000 per month. Assume for a minute that the labor force participation rate downtrend remains intact. With that assumption and the current job gain pace, the FOMC's 6.5% outcome-based employment guidance would be attained one year from today.

Core inflation continues to trend lower, toward 1%, well below FOMC target levels. Let's not forget that over the past few years Federal Reserve Chairman Bernanke has expressed his desire to lift inflation rates and fight deflation. However, he is quickly dismissive of the historically low inflation, citing "transitory influences," and attributing "the effects of sequester and medical payments" as the cause during his June 20 post-FOMC meeting press conference.

FOMC member James Bullard dissented at the June 20 meeting specifically because of his concern about such a low inflation environment. In fact, the actual FOMC voting, where one "dove" dissented and one "hawk" dissented, underscores how confusing an environment the current growth trend is.

Given such a meager recovery and current 2013 GDP tracking at 2.0%, why does the Federal Reserve currently maintain such a positive expectation for U.S. economic growth?

> FOMC 2013 GDP projection of 2.3% to 2.6%
> FOMC 2013 unemployment rate projection of 7.2% to 7.3%
> FOMC 2013 core inflation projection of 1.2% to 1.3%

Evidence to support the optimistic FOMC outlook is just not present. Recent volatility and corrective activity within the markets is a vote of concern that the FOMC is about to make a significant policy mistake by tapering too quickly.

2. SHOULD, NOT WILL, THE FOMC MODERATE ITS MONTHLY ASSET PURCHASE PROGRAM?

During Q3 there will be two FOMC meetings, the first July 30-31 and the second September 17-18. According to a Bloomberg survey, 44 out of a possible 54 economists surveyed expect the monthly asset purchase program to start being reduced from $85 billion to $65 billion at the September meeting.

Investors would be wrong to interpret the July and August economic data releases as a debate about whether the FOMC "will" moderate its monthly asset purchases. Assume that they will. Rather, the confusion surrounds whether they "should" actually moderate at all. That's the investor focal point for July and August, as important economic reports such as ISM Manufacturing, U.S. labor, and inflation (CPI) are released. Hopefully those releases will transition confusion to clarity.

The optimistic FOMC economic projections are predicated on the belief that the impact from sequester is transitory and will abate after Q2. If they are correct, then first and foremost, a sharp snapback in U.S. manufacturing would be evident in both July and August.

Over the past few years, low private sector borrowing costs have enabled U.S. corporations to increase both dividends and buybacks. A sustained advance in U.S. Treasury yields will put that capital allocation strategy at risk. Additionally, favorable inflation readings have kept labor costs benign. However, as recent inflation figures tilt toward deflationary, pricing power for corporations disappears. On July 8, earnings season for results achieved during the second calendar quarter will start. I would pay particular attention to CEO and CFO commentary on conference calls. During the week of July 8, only seven S&P 500® Index (SPX) companies will report. However, in the weeks that follow, that number will increase significantly – the week of July 15 includes 85 companies, the week of July 22, 170 companies, and the week of July 29, 122 companies.

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Of the three "confusion or clarity" questions to be answered, it is the second one that I expect is currently having the most negative impact on the capital markets. Investors, as do I, fear a policy mistake is brewing. The battle lines have been drawn – the FOMC's above-trend view on growth versus the Street's continued below-trend expectation. Confusion will prevail unless July and August economic reports provide clarity.

3. WILL CYCLICAL ASSETS OR BOND-LIKE DEFENSIVE ASSETS OUTPERFORM?

My commentary surrounding questions one and two centered on the economy, monetary policy, and corporate actions. What I have not discussed yet are money flows. One of the problems for the markets is that confusion started at one of the worst possible times. After five strong, confident months in the market, there was reason for risk asset outflows in the last month of a calendar quarter. That timing could not have been worse. Historically, once "passive" money flows out from risk assets in the last month of a calendar quarter, it waits until a new calendar quarter to flow back in. In the final few weeks of June, that dynamic has created a classic "buyers' strike" environment.

After the surprisingly strong April labor report was released on Friday, May 3, money managers quickly rotated out of long held "bond-like" assets into cyclical assets. The valuation argument seemed to be the motivator. There are 294 companies in the SPX that can be identified as "cyclical;" the price-to-earnings ratio of the other 206 "defensive" companies trades at a 28% premium to cyclical SPX equities. Going one step further, the 89 SPX domestic cyclical companies with exposure to the continued U.S. housing recovery and strongest global consumer seemed to be preferred.

As 2013 progresses, I expect that an allocation adjustment is the correct action. Unfortunately, it has proven to be too early. The unwinding "carry trade" and continued below-trend Chinese economic growth figures have motivated the quick attraction to cyclical assets to neutralize just as fast. Either way, when confusion transitions to clarity regarding the cyclical or bond-like asset attraction, I expect the catalyst will come directly from corporate earnings.

Consensus estimates for SPX earnings per share (EPS) growth for the upcoming earnings season are +5% with SPX revenue growth of +3%. Cyclical assets will look rather compelling in the second half of 2013 if the earnings growth for the next quarter meets expectations. Current estimates for the quarter after the one to be reported in July stand at +17% EPS growth and +6% revenue growth.

However, a state of confusion remains about whether to allocate toward cyclical assets or bond-like assets. The evidence is not present at this time. The upcoming earnings season and guidance will be the most likely candidates to return recent money outflows.

Q3 Playbook
Investment Themes

Theme: "Search for Yield" – Confusion

Over the past year, a very popular, and profitable, investment theme was the "search for yield." Money manager confidence in allocating toward assets yielding more than U.S. Treasuries was very high. Central bank support for keeping rates historically low for an extended period of time was evident.

From May 1, 2012 until May 1, 2013, the 10-Year U.S. Treasury traded within a rather non-volatile range between 1.40% and 2.08%. The average yield during that period was 1.74%. On May 5, 2013, it closed at exactly 1.74%. Half the SPX, 250 stocks, offer a dividend yield greater than 1.74%.

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Almost six weeks later, the U.S. 10-Year yield rose above 2.50%, reducing the number of SPX companies trading above its yield to 159 companies. That figure will be reduced by nearly half to only 81 companies if the U.S. 10-Year yield trades at 3.25%.

As the yield on the 10-Year Treasury has normalized back toward its four-year average of 2.62%, allocating toward select risk assets based purely on a competitive rate comparison with Treasuries has ended. The confidence of the past year has transitioned to confusion as to where rates will once again trade in a non-volatile range. I expect that range will be at least 50 basis points above the low end of the May 2012 to May 2013 rate range.

Theme: "Abenomics" – Clarity

In October of 2012, it became clear that there was a global election that would actually impact the capital markets more than the presidential election in the United States. In Japan, Liberal Democratic Party candidate Shinzo Abe was to become the country's prime minister in December 2012. Coming into office, he introduced a massive reflation policy – Abenomics, a portmanteau of "Abe" and "economics" – and selected Haruhiko Kuroda to become Bank of Japan governor.

Mr. Kuroda has not disappointed money managers who have speculated since November 2012 that his policies would appreciate Japanese equities and allow them to consistently sell yen as the funding currency for the global carry trade.

However, late in May, the carry trade began to correct. The Japanese yen started 2013 trading at 86.75 before depreciating to a 103.74 low on May 22. By June 13, it had appreciated back to 93.79.

Along with the yen's unfavorable rally, the Nikkei 225 corrected from 15,942.60 on May 19 to 12,415.85 on June 13, reducing the year-to-date performance for the Nikkei from +50% to only +17%.

The question for all investors is whether or not the prevailing trends for Japanese equities and the yen will resume. If they in fact do, then investors should view the current confusing market environment as nothing more than a pause that refreshes, providing multiple investment opportunities at current valuations.

Let me be clear that I expect the prevailing trends for Japanese equities and that the yen will resume and once again be the number one tailwind for global markets. Nothing has fundamentally changed in Japan. Abenomics and the monetary policy efforts from the Bank of Japan are only just beginning. I would argue that Governor Kuroda's monetary policy initiatives are where Fed Chairman Bernanke was in the middle of 2009.

Additionally, Prime Minister Abe will be emboldened with a victory for his party in the July 21 upper house elections. Thereafter, expect significant favorable structural reforms to be added to the easy monetary policy and capital spending efforts already outlined.

I expect the tailwind from Japan will strengthen once again, with the potential power to reinvigorate the carry trade and lift global risk assets along with it.

Theme: "China and Emerging Markets" – Confusion

Financial conditions in the Chinese economy contracted during Q2. May export and import figures were relatively unchanged when reported in June. Between November 2009 and November 2011, the weakest monthly import growth figure was +19.5%; last month a contraction of -0.3% was recorded.

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Whether or not you believe in the theory of "decoupling," it is obvious that the U.S. equity and the corporate bond markets have been able to outperform over the past 18 months, despite the economic slowdown in China. Domestic equity indexes in China have not experienced that same good fortune; the Shanghai Composite currently trades near a four-year low.

What will matter most in Q3 is that investors understand the impact of a slowing Chinese economy on global risk assets. First, I expect that U.S. debt and equity markets can continue to reward investors, even with the Chinese economy muddling along. There will be sectors in the SPX that correlate with China and therefore underperform. The Australian dollar, down nearly 10% year to date, should continue to be used as a proxy for Chinese growth and allocated to at underweight. It is no coincidence that gold continues to decline as the marginal buyer that China once was in 2010 and 2011 now has other concerns and can no longer support gold as aggressively.

Emerging markets have significantly underperformed in 2013. As I highlighted in the Q2 Playbook, much of the underperformance relates a negative currency impact from a declining yen. The Indian rupee, South African rand, South Korean won, Brazilian real, and Mexican peso are down year to date. Strong currencies have been the hallmark for emerging market inflows over the past few years, somewhat aligned with the "search for yield" thesis.

There is a similar scenario, historically, to what the capital markets are currently experiencing. Back in 1994, the emerging market indexes peaked and actually traded lower over the next few years while the SPX appreciated significantly throughout the mid-1990s. It just so happens that this coincided with U.S. monetary tightening and a stronger U.S. dollar on above-trend growth. Sound familiar to what we have heard from the FOMC recently?

Theme: "U.S. Housing and Services" – Clarity

There is no better example of the long maintained economic theory of "first into a crisis equates to the first out of the crisis" than the U.S. housing and servicing industries. That is exactly what is occurring in 2013 and I expect that this tailwind will remain in place for Q3.

New home sales have increased 29% year to date to 476,000, a level not reported since Q2 2008. Year-to-date home prices, measured by the Federal Housing Finance Agency, are +7.4%. The most encouraging housing metric is the inventory of new homes for sale, which in Q2 fell to levels last reported in 2001, at only four months of inventory versus 11 months in 2009. The recent modest uptick in mortgage rates should have a positive contribution as "wait and see" buyers finally move from the sidelines.

Another idea for consideration is how physical housing transacts. It is one of the few remaining asset classes that money managers can't trade by placing their fingers on a computer keyboard. I suspect that if you could have transacted the value of a house on a computer in 2008, home prices would have experienced quite a crash beyond what already felt pretty bad. The good thing is that you still can't transact home prices on a computer today. Rather, pure supply and demand rule, which equates to an economic tailwind.

Clearly, a wealth effect from a recovery in housing is evident. Domestic consumers are spending on big-ticket items such as autos and appliances. Shares of consumer finance companies are experiencing earnings growth as consumers spend. The ISM Non-Manufacturing Index, a measure of the U.S. services industry, has averaged 54.5 this year, well above the expansion/contraction level of 50.

Lastly, the positive trends for housing and services have remained in place, despite the expiration of the payroll tax and implementation of the Affordable Care Act tax. There is clarity on the condition of U.S. housing and services, a sustained tailwind.

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Q3 Playbook

Investment Themes
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Theme: Gold & Silver – Lesson Learned?

As we enter Q3, much commentary regarding gold and silver is being bandied about in the business media. The constant media dialogue and a year-to-date decline of nearly 30% is tempting investors to increase allocations to gold and silver.

If you currently do not have any precious metals exposure in your portfolio, you may consider using the price decline to take a maximum allocation of no more than 3%. However, before doing so, you need to understand that the allocation is an investment, not a position to be traded or actively managed. The past three years have provided multiple occurrences in which the temptation to significantly increase, and actively manage, precious metals allocations has proven false. In July 2010, spot gold prices were $1200, the same place they are today.

For those who desire a larger allocation, maybe 10%, as some in the media have suggested, why not use those funds to allocate toward real estate? Find a domestic or international REIT or invest in physical real estate. Institutional investors are selling gold and silver to buy real estate. They, and I, have confidence in the U.S. real estate recovery. In 2013, allocations to real estate offer all the perceived benefits of precious metals, plus the income.

Real interest rates have moved aggressively from negative territory at the beginning of Q2 into positive territory now, not a favorable condition for rising precious metals prices. Global central banks, in particular emerging market economies, have been the marginal buyers of gold the past few years. However, in 2013, as those economies battle capital outflows, weak equity and currency values, and slowing growth, their appetite to purchase has lessened.

Let the lesson of 2013 be learned: gold and silver allocations are warranted in a portfolio at small, single-digit exposure. Precious metals allocations are investments not to be actively managed or traded.

Q3 Playbook

Investment Ideas

1. Investors should continue to favor U.S. real estate, both the paper and physical assets, at the expense of gold and silver.
2. 2013's worst performing sector, materials, should continue to be held at underweight. Heavily impacted by China's GDP, which appears on target to soften below 7.5% in 2013 for the first time since 2008, there is no evidence to support the misguided "buy the laggard" thesis here.
3. The financial sector should continue to benefit from a domestic recovery in housing, autos, and labor. Insulated from the headwinds of Asia, a new tailwind of rising rates and a steepening yield curve should further support overweight allocations for both debt and equity financial holdings in Q3.
4. Overcapacity in the Chinese industrial sector, contracting domestic credit growth, and a looming inventory surplus have shifted the dynamic for copper. It must now be included with other materials at underweight.
5. At current levels, investors should seek opportunity in high yield bonds before investment grade.
6. U.S. home, auto, and life insurance companies will continue to experience expanding multiples and pricing power as solid domestic housing fundamentals and consumer auto demand accelerate earnings growth. Investors should seek opportunity both in the equity and debt markets.

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7. European manufacturing figures steadily improved throughout the second quarter. Additionally, European Central Bank President Mario Draghi has done an excellent job keeping the value of the eurocurrency anchored below 1.35 since February. That should support exports, in particular for Germany. Europe is becoming “investable” once again. The German equity index (DAX) has underperformed other developed economy indices in 2013. I expect that gap will narrow during the remainder of 2013.

8. I expect South Korean, Indian, and Mexican equity indexes to trough before those of other emerging markets.

9. Investors seeking opportunity in deep cyclical assets should consider energy assets first. Historically, energy performs better than other sectors in the months leading up to a shift in monetary policy. Also, unlike the Q2 corrections of the past three years, spot oil and natural gas prices have remained stable, leaving upside potential during Q3 for spot pricing and a positive contribution to energy earnings.

10. Since 2001, a seasonal allocation toward technology during the month of August rewarded investors by year-end in all years except 2008 and 2012. The credit crisis provided 2008’s headwind. Shares of heavily weighted Apple tumbled 22% in the fall of 2012, providing that year’s headwind.

I wish you all an abundance of life’s two greatest assets – ***Health & Happiness!***

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PERFORMANCE AS OF JUNE 30, 2013

Equity Indexes	Closing Price 6/30/13	Q2 2013	YTD 2013
S&P 500 Index (SPX)	1606.28	2.36%	12.63%
Dow Jones Industrials (INDU)	14909.60	2.27%	13.78%
Russell 2000® Index (RTY)	977.48	2.73%	15.09%
NASDAQ 100 Index (NDX)	2909.60	3.23%	9.35%
MSCI Emerging Markets Index (MXEF)	940.33	-9.14%	-10.89%
Deutsche Borse Ag German Stock Index (DAX)	7959.22	2.10%	4.56%
Currencies			
U.S. Dollar Index	83.14	0.17%	4.22%
Euro/U.S. Dollar	1.30	1.49%	-1.39%
Japanese Yen	99.14	-4.96%	-12.50%
Australian Dollar	0.91	-12.29%	-12.08%
Commodities			
WTI Oil	96.56	-0.69%	5.16%
Brent Crude Oil	102.16	-7.14%	-8.06%
Gold	1223.70	-23.39%	-27.25%
Copper	305.75	-11.09%	-16.92%
Natural Gas	3.56	-11.41%	6.39%
Silver	19.47	-31.54%	-35.88%
Corn	511	-5.11%	-14.80%
Soybeans	1252	0.04%	-3.90%
Wheat	671.50	-5.85%	-18.19%
Cotton	84.01	-3.85%	6.69%
Coffee	120.40	-15.45%	-21.02%
Sectors			
Technology (XLK)	30.59	1.04%	6.01%
Consumer Discretionary (XLY)	56.40	6.42%	18.89%
Financials (XLF)	19.45	6.79%	18.64%
Health Care (XLV)	47.61	3.48%	19.38%
Consumer Staples (XLP)	39.67	-0.25%	13.67%
Materials (XLB)	38.35	-2.13%	2.14%
Industrials (XLI)	42.64	2.11%	12.51%
Energy (XLE)	78.30	-1.27%	9.63%
Utilities (XLU)	37.63	-3.76%	7.76%
U.S. Treasuries	**6/30/13 Yield**	**3/31/13 Yield**	**12/31/12 Yield**
U.S. 2-Year Treasury	0.36%	0.24%	0.25%
U.S. 5-Year Treasury	1.39%	0.76%	0.72%
U.S. 10-Year Treasury	2.49%	1.85%	1.76%
U.S. 30-Year Treasury	3.50%	3.10%	2.95%

Past performance is not indicative of future results.

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JOSEPH M. TERRANOVA, *Chief Market Strategist, Virtus Investment Partners*

Joe Terranova is chief market strategist for Virtus Investment Partners. He was elevated to that position in June 2009, having started with the company in the role of chief alternatives strategist.

In his current role, Mr. Terranova works with Virtus' regional sales teams and the financial advisors who sell the company's investment products, providing insight into the domestic and global investing landscape and has represented Virtus as a keynote speaker for several financial institutions. He is a member of the Virtus Investment Oversight Committee.

Prior to joining Virtus in 2008, Mr. Terranova spent 18 years at MBF Clearing Corp., rising to the position of director of trading for the company and its subsidiaries. In this capacity, he managed more than 300 traders and support staff for MBF, one of the New York Mercantile Exchange's largest firms. His work was highlighted as the feature story in the June 2004 issue of *Futures* magazine.

Mr. Terranova is perhaps best known for his risk management skills, honed while overseeing MBF's proprietary trading operations during some of the most calamitous times for the U.S. markets, including the first Gulf War, the 1998 Asian Crisis, 9/11, and the 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 June 2008, he cautioned investors to move to the sidelines in commodities and, in March 2009, he encouraged investors to ignore the global "embracement of pessimism" and overweight equities. Before joining MBF, Mr. Terranova held positions at both Swiss Banking Corp. and JP Morgan Securities.

Mr. Terranova has been an ensemble member of the CNBC *Fast Money* franchise since 2008. He also frequently contributes exclusively to CNBC's other business programs. He is the author of "*Buy High, Sell Higher*" (Business Plus, 2012), a book about the "new rules" of investing based on his years as a professional trader.

In 2007, Mr. Terranova and Hockey Hall of Fame player Mike Bossy established "Bossy's Bunch," a program that rewards excellence in the classroom for elementary school students.

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