Virtus Vital Signs, August 2016
Market Insights from Joe Terranova, Chief Market Strategist
Interview conducted on August 2, 2016
Transcript edited for clarity

Brian Portnoy: *Welcome to Virtus Vital Signs for the month of August 2016. I'm Brian Portnoy, Director of Investment Education for Virtus. As always, I have my friend and colleague with me, Joe Terranova, Senior Managing Director and Chief Market Strategist. Happy August, Joe.*

Joe Terranova: We hope it's "Happy August" and not something similar to August 2015, Brian. But good morning, and thank you for inviting me once again on the call.

Brian Portnoy: *Yes, thank you for starting on that negative note. We would all like to forget about August 2015. We will keep our fingers crossed. It is remarkable when you look at the stock market, the global stock market in 2016 so far. There seem to be so many worries on people's minds, whether it be anemic growth, low to even negative bond yields, Brexit, the uncertainties surrounding the U.S. presidential election. There's the old saying that markets climb a wall of worry. The S&P 500® is up about 7.5% this year. The main emerging markets ETF is up 13% this year, with the news from Brazil, and China, and so forth. Before looking forward, let us take a quick look backwards. Why do you think that the market has in fact climbed the wall of worry?*

Joe Terranova: I think there are two themes, Brian. First of all, central banks continue to be highly accommodative. Multiple central banks this year have expanded their programs and that has lent support to global asset pricing first and foremost.

Secondarily, I would highlight under-investment. I think that is very significant for 2016. Brian, you talked about the concerns coming into the year. If you think about it, they were energy, they were the credit markets, they were currencies as it relates to what the Chinese economy was going to do (would it significantly depreciate the value of their currency?). Those were the chief global concerns. Coming in positioning wise, there was a lot of negative sentiment surrounding global asset prices. The same thing occurred surrounding Brexit once again. I think the allocations towards equities on a global basis have certainly been underweight throughout the course of the year. What we're witnessing is moments where the market recovers and global managers are going in and raising allocations back towards benchmark weighting. I think that's been a large contributor to where we are in the global markets right now.

Additionally, you've seen healing in the credit markets. You've seen healing in the currency markets on a global coordination that clearly occurred at the G20 meeting in February, and then was rubber stamped once again at the end of July. You've seen healing in the energy market. If there is a chief concern for the markets right now, it's a pullback in oil. We will discuss that as we get a little further into this dialogue though.

Brian Portnoy: *Okay. Great, so we've had a great run. It's hard to say that folks are complacent precisely for the concerns that we talked about. But entering the home stretch of 2016 after the dog days of summer, where should folks be most vigilant? Because the returns have been very good. It is hard to say people were sitting on their hands. What would be top of your list for risks to keep an eye on?*

Joe Terranova: Well, I think first of all, the investor is highly suspicious of multiple asset classes. Instinctively, when constructing your portfolio sitting at historic highs in the equity markets and watching bond yields trade at historic lows, I think the important thing is to focus on diversification and risk mitigation. Those are the two conditions that I think are most important right now.

Nothing stands out as overwhelmingly compelling in terms of an investment for a particular asset class. But yet, each asset class at this moment in the cycle, you need to make a compelling argument why it belongs in a portfolio. Right now, having that diversification of owning multiple asset classes, I think is the right strategy.

Let me give you an example. Someone came to me and said in my portfolio right now, I only hold 10 to 15 equities. My response to that would be, well, your correlation to an equity selloff has just increased. You want to try and increase the number of equities that you're holding so your correlation will be reduced if in fact there is a pullback in the equities market. I think that works in an overall portfolio in terms of multiple asset classes. Let's identify and be in all the asset classes right now to try and get as much diversification as we possibly can, staying invested but also focusing on the potential for risk mitigation, which I think at this point in the cycle is the proper thing to do.

Secondarily, what are the chief concerns? Brian, the chief concerns are always the concerns at the beginning of the year that they resurrect themselves once again. I think energy would be at the top of the list right now. Earnings were just reported. They were good enough as it related to technology, consumer discretionary, and healthcare for us to kind of get by.

I'll use the analogy of Super Bowl XXV when the Giants were playing the Bills. All you wanted Jeff Hostetler to do was just not lose the game for you as quarterback, and let O.J. Anderson run his way to the Super Bowl, and that's what happened. Earnings, that was the condition; just kind of don't mess with the rally. Earnings were not great, but they were good enough not to send us into that correction I talked about.

But I return to – you have to focus on oil because oil continues to pull back. You have to have a little bit of an observation as far as what is going on with the Chinese economy. Generally, the concerns at the beginning of the year, if they resurrect themselves once again later in the year, that's when I think you'll see the correction in the marketplace.

Brian Portnoy: *Okay, got it. Are there any other particular sectors that you would ask long-term investors to keep an eye on in terms of either risk or opportunity?*

Joe Terranova: Well, I think right now the importance of technology can't be highlighted enough. You're seeing M&A, which is rare right now in 2016, because of the multiple elections that we're seeing, in particular the U.S. presidential election. You've seen a little bit of pullback in capital spending. Technology is the one sector that actually is spending a little bit.

One of the things I want to watch for Brian is the second quarter buybacks are down. The last couple of years, this has been a buyback equities market domestically here in the United States. We have a distinct focus globally on owning U.S. equities – and that's the right strategy. I believe in that strategy: U.S. equities above all other equities globally. But we need a return of buybacks. For the second part of 2016, in particular the fourth quarter, we want to see the resurgence in buybacks once again, we want to watch that. Secondarily, dividends, the dividend strategy, I don't know if the yield strategy as we close towards the end of 2016 is going to be enough. That's not going to be enough. That takes you to consumer staples, utilities, and then just the pure dividend plays. You want to have a strategy of growth combined with dividends. So who's going to grow their dividend? That goes back to technology itself. That is the sector that will grow the dividends. I want to focus on the performance of technology.

Keep in mind, a lot of the appreciation in the marketplace here over the last eight weeks, the catalyst has been technology itself. Let's make sure technology stays in the proper place as a key contributor to this equity market rally. That is the one sector that is really important right now.

Brian Portnoy: *Okay. Great. Well, as always, good stuff, Joe. Enjoy the month of August. I hope we don't have any surprises. We'll talk to you in about a month or so.*

Joe Terranova: Brian, I'll talk to you around Labor Day. Thank you very much.