Virtus Vital Signs, December 2016
Market Insights from Joe Terranova, Chief Market Strategist
Interview conducted on December 5, 2016
Transcript edited for clarity

Brian Portnoy: *Welcome to Virtus Vital Signs for the month of December 2016. I am Brian Portnoy, Director of Investment Education for Virtus Investment Partners and, as always, I have with me my friend and colleague, Joe Terranova, Senior Managing Director and Chief Market Strategist. Hi, Joe.*

Joe Terranova: Good morning Brian. How are you this morning?

Brian Portnoy: *I am fantastic. Can you believe we have another year on the books?*

Joe Terranova: Yes, but I think this year, certainly, feelings towards the upcoming year are much different than the feelings as we closed out 2015 and were rather negative looking towards 2016.

Brian Portnoy: *No doubt, but contrary to many expectations, this year in the market was quite good, especially U.S. equities. Small caps up 20%, the S&P 500® up 10%. A really nice year. What do you make big picture of the rally that many of us have just enjoyed?*

Joe Terranova: I think there are a couple of factors as it relates to 2016 that can benefit investors as they formulate their playbook for 2017. A year ago, you and I discussed the many indicators that we needed to watch. I don't think we made predictions or forecasts. We had a series of expectations and we tried to highlight what was important in terms of indicators. The prevailing wisdom on Wall Street was that the U.S. dollar would continue to aggressively appreciate in the first quarter, and energy would continue to be a problem, both on the credit and equity sides.

One of the things that we cautioned in our call in December 2015 was that we needed evidence to suggest further appreciation in the U.S. dollar. We never were presented with that evidence in the first quarter of 2016. The U.S. dollar actually declined in the first quarter and that was very beneficial looking forward, allowing energy and materials and, most importantly, the credit side of the capital market equation to improve and foster a nice recovery that was built upon a bit of an improvement in some of the indicators we were concerned about. But, more important was sentiment. Sentiment was so negative and you had this massive swing where performance began to accelerate and sentiment needed to align with it.

Brian Portnoy: *Okay. So, what is your read on the sentiment right now?*

Joe Terranova: Well, I think the sentiment is very positive looking towards 2017. The question that has been asked multiple times: Is this the President-elect Trump rally or a different type of rally? I think it's two conditions. Let's use financials sector evidence for a second. The financials sector began to recover towards the end of the summer heading into September. There were expectations that in December you would see a further 25 basis points normalization in rates. We had key metrics of the economy, like ISM manufacturing, which has now improved three months in a row. Labor continued to heal. I think the dynamic, very quietly in the marketplace, was that the economy was improving already. Now, you have optimism surrounding President-elect Trump's election, and the expectation from the capital markets that we're going to tackle healthcare, immigration, regulation, and tax reform. Many of these things could be beneficial to asset pricing and the potential for there to be consumer-driven spending and on the corporate side a lot of money going into R&D and possible M&A. These are all good things. We need evidence for them.

The biggest risk that we might have in 2017 is if the incoming administration attempts to tackle it all at once. If we look at immigration, healthcare, tax reform, regulation all at once, I think that's systemically a problem. My reason and expectation, as I just highlighted to you, is that the economy is already recovering significantly. So, you want to try and have the stimulative fiscal policies enacted when the economy needs it. I don't know if we need it so much right now. So, let's be methodical, slow, deliberate, and patient about what we enact in terms of fiscal policy replacing monetary policy, which is an important condition. But, for 2017, I think that's incredibly important to understand. It's something that we have to watch and it does create a degree of uncertainty for the capital markets.

Brian Portnoy: *Okay, so, is it your sense that some of the rally that we have seen over the course of 2016 reflects the fact that when we look at the high-level statistics, whether it be unemployment south of 5%, a bit of an uptick in wages and so forth, that the market has begun to appreciate that there was underlying improvement going on already?*

Joe Terranova: Well, we had the removal of the recession, not as much here in the United States, but in Europe and in Asia. Really, that was the conversation in the early part of 2016 and at the end of 2015 — is the world trending towards dipping back into recession once again? We've had the removal of those conditions. I would offer to investors that I expect in 2017, the same economic presence for the United States. I always like to say, first in, first out. The U.S. was clearly first in to the Great Recession. The U.S. was clearly first out of the Great Recession. The economic evidence firmly suggests that. And, in 2017, investors should expect that the recovery for the U.S. out of the Great Recession will accelerate.

Brian Portnoy: *We're going to have lots of opportunities in 2017 to discuss trends, opportunities, and risks, but by way of wrapping up today and 2016, what are some of your key contrarian thinking about how investors should put together their playbook for the year ahead?*

Joe Terranova: I hear much conversation regarding an acceleration in inflation. Yes, we are seeing a much needed steady improvement for both core CPI and overall CPI. We are seeing that. It's steady; it's what we need; it's what the Federal Reserve has talked about for many years. I don't know, necessarily, that the evidence suggests that we are seeing a rapid acceleration in inflation as many have suggested. I mentioned before that too many policy initiatives being enacted at once could lead to an aggressive acceleration in inflation, but I don't think right now that investors should look to 2017 and begin the conversation of their playbook with, "We are going to be in an inflationary environment." We're not in that condition just yet. We are recovering from a global malaise that inflation brought on by technology and the efficiencies of it and the advancement of it. Let's see some evidence before we take our portfolios and overweight them towards inflationary pressures. Good to have things like senior floating rate notes; I am okay with some TIPS in the portfolio, even a very incremental amount of precious metals, but I don't want to go overweight the inflation thesis, which, right now, seems to be prevailing on Wall Street.

Brian Portnoy: *Okay. That is interesting. Let's wrap it up there and let me wish you and your family a happy and healthy holiday season and New Year. It has been a lot of fun this year. Thank you for everything, Joe.*

Joe Terranova: Brian, thank you very much. Health and happiness to all our listeners. I thank them for listening with us each month and I hope they will continue to do so in 2017.