Virtus Vital Signs, June 2016
Market Insights from Joe Terranova, Chief Market Strategist
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Transcript edited for clarity

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

Joe Terranova: Good morning, Brian.

Brian: *So, I want to talk about the market at the big picture level this month. You made a quote on CNBC the other day along the lines of that the overwhelming pessimistic focus on market headwinds have created near-term tailwinds. In fact, there is a lot of pessimistic news out there, whether it be the duration of this bull market which is historically very long, some claiming that equities are not cheap, certainly political uncertainty figuring into that. You have made the claim in various ways that some of this pessimism actually creates tailwinds. So, the big question for today is, why has that happened and do you expect it to continue?*

Joe: I think it's a great question. First of all, I think it largely is attributed to consensus expectations coming into 2016 being incredibly wrong. If you reflect back to December and think about the concerns for the capital markets, it surrounded the [four] "C's: Commodity pricing, the Chinese economy and their currency, credit markets as it relates to high-yield energy, and again, going back to currencies, an environment where global central banks were involved in this war of devaluation.

In each one of those scenarios, we have seen a dramatic improvement in these conditions yet pessimism prevails. Think for a second about oil. Oil has risen from $27 and approached $50, which is exactly the type of fundamental scenario that we all desired back in December, but yet so many, as we approach $50, are arguing that the price should go back to $35. High-yield credit is approaching double-digit performance year to date. Where are the defaults that everyone talked about back in December? Chinese currency – if you go back to February, and you and I spoke about this – global central banks at the G20 meeting in February all got together and clearly behind the scenes adopted a policy where they were not going to go out and have this massive currency deflation devaluation war.

So, collectively bring it all back to the month of May. We've talked about "sell in May and go away." Well that obviously has not happened and it is continued negativity upon negativity, and now what you are faced with is very strong performance and it's not just in the S&P 500®. Let's talk about the investor, let's not worry about the short-term trader or the hedge fund. Let's talk about the investor. The fundamental conditions of the last six months have all improved and that does not warrant any dramatic changes to your portfolio. Last month you and I talked about "sell in May and go away." We wanted certain criteria to be met for that to happen. It has not happened. Sentiment remains as bearish right now as it was in December, and that is acting as a tailwind because now you are seeing money managers have to almost in a sense chase the performance and the performance is across multiple asset classes.

Brian: *Right. There is the old saying that bull markets climb a wall of worry and that seems to be what is going on right now. Does it flip around at all? Do we enter* *sort of a round world scenario where all of this good market performance in a relatively brief period of time might then spur some complacency, which in itself could be the source of some bad news down the road?*

Joe: That is a good question. I do not see the complacency though. I do not see complacency right now. Leon Cooperman rightfully said with us about a year ago on CNBC, bull markets don't die of old age. Bull markets generally die on extensive euphoria, and we are just not at that cycle right now. You are correct to ask the question and I'm not going to be one to time it, but I need economic evidence to suggest to me that the time to take the discretionary component of my portfolio and make significant changes to it, I need the evidence to prove itself and I don't see that right now.

Think for a second. We've had this longstanding debate by so many about whether we are in the midst of an economic recovery that is just fueled by central bank policy or whether it's real. Well, what we find is that as good economic data presents itself, we tend to dismiss it. Labor markets have healed but we dismiss the healing. Initial jobless claims – we tweeted this out last week from the Virtus Twitter feed – initial jobless claims are now below 300,000 for 64 consecutive weeks. That hasn't happened since 1973, and that's not the beginnings of a recessionary environment.

Brian: *Right, I guess the one thing that the bears would point out or those that are skeptical is that you might have decent job numbers but the wages are not there, the purchasing power is not there. Then again, there is some pretty decent news about consumer spending out there.*

Joe: We are talking this morning and consumer spending at the highest level in the last seven years was just reported this morning. Home prices, Case-Schiller up 5%. We are not talking about the go-go 90's economic environment, but all we are trying to highlight is that you had conditions in place at the beginning of the year that rightfully gave all investors and money managers concern going into the year. Markets sold off aggressively at the beginning of the year, down 11%. It looked like we were going down 20%, and what has happened is asset pricing has improved, fundamental conditions have improved, but yet the sentiment reflecting all of that has actually, I would argue, gotten worse.

Brian: *Let's wrap up on a bit of a speculative note. I don't think we've ever had one of these conversations where the Federal Reserve has not come up. Obviously, Chairwoman Yellen made some comments the other day backed up by some others that it is not unreasonable to think of a rate hike at some point later this year, whether it be in the summer or the fall. What's your insight into those comments, especially as it relates to these bigger picture ideas for investors?*

Joe: It's remarkable to me how expectations surrounding when we are going to get further normalization as it relates to the Federal Reserve is entirely up to the S&P 500 itself. The S&P 500 last year experienced a very weak period in August going into early September. Expectations for the Federal Reserve at that point were that they were going to normalize rates and give you 25 basis points. They did not. The economic evidence suggested they could [raise rates] but they did not because of asset pricing itself. If you think for a second, in December, [the

Fed] gave the 25 basis points normalization and some of the economic evidence had actually deteriorated but yet S&P 500 performance had recovered.

So, roll forward into March, normalization another 25 basis points….No, [the Fed] does not give it to you. Well, why not? We had a January and February where capital markets were under assault. We had extensive volatility in the capital markets globally. [The Fed] backed off. We're now in an environment where asset pricing has recovered significantly and it aligns itself with moderating good performance from the economic fundamentals. If now is not the time to further normalize the 25 basis points, then I am really not certain what conditions the Federal Reserve is looking for. I fully expect that they are going to further normalize 25 basis points. I think they are going to do it in June. There is a press conference associated with this meeting so that is a good thing; they get to have the transparency that they desire. They could wait until July but they certainly would telegraph in June that it is coming. I believe that [a rate hike] is coming in June. I think all the conditions point in that direction, and ultimately for investors, I do not think it means very much to your portfolio because on the other side of the Atlantic Ocean, you have central banks acting in complete contrast to what the U.S. is doing and that is going to keep yields in an environment where they're relatively anchored and we do not see a sharp spike in Treasury yields.

Brian: *Always a great perspective, Joe. Enjoy the month of June and about a month from now, we will do a mid-year review. Thank you as always.*

Joe: Perfect, thanks Brian.

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