Virtus Vital Signs, September 2016
Market Insights from Joe Terranova, Chief Market Strategist
Interview conducted on September 1, 2016
Transcript edited for clarity

Brian Portnoy: *Welcome to Virtus Vital Signs for the month of September 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. Hi Joe.*

Joe Terranova: Good morning Brian. I'm a little sad that summer has come to an end but excited about the end of the year. I hope you and everyone who listens enjoyed a great summer and shares my excitement as we finish out the year.

BP: *Summer was great but it's good to be in the back-to-school moment and think about the homestretch for 2016. It's actually been a good year for risk assets, both stocks and bonds. As you look out to the balance of the year – and even next year – what's your assessment of the markets right now broadly speaking?*

JT: I think the most important thing is that the Federal Reserve could give investors a vote of confidence by giving them another 25 bps [interest rate hike] either in September or December. I'm not necessarily sure unless this Friday we see a blockbuster jobs number that would be north of 225,000 (last month's was 217,000, this month we are looking at 180,000), but the Fed needs to give investors the vote of confidence that there's been healing both in the domestic economy and the global economy. By raising rates I think that will allow them to alleviate the concerns that many have had that the next recession is coming. If there's no [rate] hike in September or December, then you and I will be having a conversation in early in 2017 about whether there's a recession looming on the horizon. The economic evidence both domestically and globally that I see does not suggest that, but I want the Fed to give the investor the vote of confidence.

BP: *Right, you want the Fed to validate what appears, at least on the margins, some improvement, but what do you think would be on their minds if you didn't see the rate hike in the next few weeks or towards the end of year? What big data points will the Fed pay attention to, perhaps in order to continue to pump the brakes?*

JT: I think the Fed has done a poor job in its messaging to the market. It seems the conditions have changed over the last few years, and the metrics of what they might be looking at continue to change. If they don't go [with a rate hike], what will they point towards? It probably would be inflation expectations not being where they want it to be, the trajectory of a recovery, and inflation not where they want it to be. [But markets] don't move straight from a deflationary environment into an inflationary environment. You have to come out of the deflationary environment, and look at an economy that was 1-1.5% on growth that possibly now could go 2-2.5%. That's the best you could look for, and I think that's what's important.

Globally, you're seeing healing in the Chinese economy. China PMI last night reported at 50.4, taking it back north of 50. It was 49.9 previously. We haven't seen a 50.4 since October 2014, so that indicates a little bit of healing in the manufacturing sector. Some of the domestic figures here in the U.S. have been strong. We came through earnings relatively well. Finally, we broke the streak of six consecutive down quarters for S&P 500® profit margins – [it was] not very dramatic – a modest rise – but we didn't see the contractions. I think the Fed at this point will be seeking out that one metric that doesn't look so good, but if it is inflation, deflation straight into inflation isn't going to happen.

BP: *Turning to valuations, as I mentioned at the outset, equity markets have done relatively well this year in the U.S. and some emerging markets. There's certainly a lot written these days* *that despite the fact that markets have done well but valuations continue to get stretched, perhaps foreign returns won't be as attractive. When you look out the three-to-six-to-nine-month window we normally talk about, what do you think about the valuation perspective on equities?*

JT: I look at equities and echo what Lee Cooperman said yesterday on CNBC: "fairly valued but fully valued." What that means to me, in an environment of incredibly low volatility, is yes, the market is vulnerable for a garden-variety type of correction. Unfortunately September into October historically presents the opportunity for that. I have no problem with investors raising a little capital, maybe along the lines of 5-10%, raising the weighting more towards a cash orientation. I don't see that as a problem; I think a correction could come. The evidence isn't there to suggest a very deep correction similar to where we started the year, unless we see a return to concerns related to the price of oil, the high yield market, and the Chinese economy. But I do think a modest correction is coming.

When I look at equities, I'd be looking for a little bit of a sector rotation. The market right now seems to want to gravitate. Cyclicals have outperformed defensive over the last 45 days by nearly 500 bps. The market seems to want to be technology, and to go towards financials, and probably a little bit away from the defensive areas. Telecoms and utilities are both down about 5% in the last month. Oil is in a little bit of a risky place the way I see it, back below $45 [a barrel]. So the easier opportunity that you had in the second quarter might have passed. When you look globally, obviously you had a recovery post-Brexit in Europe. I would say go back and focus on a U.S.-orientation specifically, as I see the U.S. dollar having bottomed out on the correction that it had.

In the taxable fixed-income space, if the Fed is going to go [with a rate hike], if you look at non-agency mortgage-backed securities – and agency mortgage-backed securities (MBS) more importantly – you want to have the orientation toward non-agency (with the Fed supporting the agency). The commercial mortgage-backed securities (CMBS) market is also getting a little fully valued right now; I'd be looking at reducing weightings there.

BP: As always, a great overview. Have a great month of September and we'll connect again in October.

JT: Thanks.