Joe Terranova's Q2 Market Outlook

The following transcript, edited for clarity, features global market insights from Joe Terranova, senior managing director and chief market strategist, presented on a special outlook call held April 6, 2016.

Barry Mandinach: *Good afternoon everybody. I'm Barry Mandinach, Executive Vice President and Head of Distribution at Virtus Investment Partners. It's my pleasure to welcome you all to our call today. Joining me is my friend Joe Terranova. Joe, who many of you will recognize as an ensemble member of CNBC's Halftime program, is Virtus' Chief Market Strategist. At Virtus, we're committed to driving better client outcomes and recognize an insightful market perspective is always helpful to FAs stewarding client portfolios. Leveraging his expertise, which is extensive as an investor and as a market analyst, Joe will provide an update on the capital markets. It's my pleasure to turn the call over to Joe Terranova.*

Joe Terranova: Thank you Barry. For those of you who were on the [Q1 Market Outlook] call in January, I talked quite a bit about currencies and the impact they were having on global risk assets. I think we need to extend that conversation as we've now gone through a very, very volatile first quarter that was met with a January that we had many apocalyptic calls once we went down 10%, for a 20% forecast by many.

[We've seen a] significant recovery, one of the better recoveries that we've witnessed, and we come into April with a little bit of a change in the dynamic as it goes back to that narrative surrounding currencies. Let's first begin with that changing dynamic. I think the biggest singular change is the language, the rhetoric surrounding the Federal Reserve. Keep in mind, the expectations coming into this year was that the possibility was there for 100 basis points of additional tightening from the Federal Reserve -- normalization as we like to call it. Now it looks as though the expectations for the market right now are somewhere around 34 basis points. You're not going to get 34 basis points. You're going to get 25 or 50 bps at some point. The Fed has clearly gotten far more dovish. The reasoning and the consequences of that dovishness are the changing dynamic of what we need to understand.

Let me be clear. It directly relates to the emerging markets. It directly relates to the global growth concerns, and it directly relates to the Federal Reserve being a willing participant of the conversation about stimulating global growth through backing off on its monetary policy. So what you have right now is an easing in the valuation of the U.S. dollar. I would argue it's more of an arresting of the appreciation of the U.S. dollar than anything else.

The expectation should be that the U.S. dollar has not shifted from what was an uptrend since late 2013 into a now downtrend. Do not have that expectation walking forward, and I'll correlate it with risk assets what that meaning is. What we're witnessing right now is a result of FOMC language, FOMC dovishness, and a little bit of a correction in the U.S. dollar. As I've said before, I don't think it's a condition that's going to persist.

Let's give you some economic evidence to support why I don't think the continuation in the selloff in the U.S. dollar will be with us. Gold tends to forecast the direction of the U.S. dollar very well. Back on December 16, when the Federal Reserve gave us that first 25 basis point normalization [rate hike], gold bottomed. On March 10, gold actually, from the December 16 low, found its peak. If you have a dovish Federal Reserve, a U.S. dollar that's trending lower in the near term, and a rally in the emerging markets, gold should continue to rally. It is not. The reasoning behind that is the expectation that what we're witnessing right now is nothing more than a consolidation. A lot of the large contribution that you've gotten from arresting the decline in the value of the U.S. dollar is going to act as a tailwind over the next couple of weeks.

Here's your expectations as it relates to S&P 500 earnings. Many are asking: Is the rally in the S&P 500 that's taken us back to flat for the year now over? I don't expect that it is but that it continues. Keep in mind we're only 3% from the historical high. I wouldn't be surprised if we see us going there again. Earnings begin on April 11. EPS estimates for the upcoming quarter at the beginning of the year were flat. They're now down 9.4%.

Excluding energy, EPS estimates are down 4.7%. What we have done is lowered the bar. The expectations for the upcoming earnings report are significantly muted from what they were at the beginning of the year. We've also allowed those in the C suite to talk in commentary and forward guidance about having a little bit of a tailwind from the U.S. dollar correcting so far year to date as it has nearly 4.5% on the down side.

A lot of the commentary and guidance in previous quarters was all about a rising U.S. dollar. What did the rising U.S. dollar do? The most important thing when you look at S&P fundamentals and financial analysis is to look at profit margin – 9.62% on profit margins is where we went out in 2013; 9.25% is where we went out in profit margins in 2014; and 8.09%, that's a 116 basis point decline, in 2015. That's representative and evidence of flat being the new up as 2015 was, and that's evidence coming into this year why there was so much muted expectations for the S&P.

Right now profit margin is running around 8%, so the next couple of weeks look favorable. I think the markets could make a run. As I said, we're 3% off the highs. I think we can make a run towards it. I also believe that the unfortunate and very tired moniker of "sell in May and go away" is probably going to work. So, what I'd be doing with risk assets, if we get the lift that I expect through the remainder of April, is I'd be looking to pair back risk, neutralize risk for what could be a little bit of summer volatility.

Why do I expect a summer of volatility? Several conditions exist. Number one: June 23 Brexit. It's obviously something that's on everyone's calendar. The implications of what could happen if, in fact, [UK] voters vote with their heart. You can vote with your heart, or you can vote with your mind. I think right now a lot of the electorate would like to leave [the European Union], but I think the economic change they'd be making is a very difficult one. I think the reality is, as that June 23 vote occurs, I don't expect [the UK] to vote to leave the EU.

If they did, the biggest implication is that business activity in the UK would grind to a halt because a lot of negotiated treaties would begin a two-year window where there would have to be a renegotiation of the existing treaties that the UK has with its EU partners and its non-EU partners. During that time you can't expect a lot of capital spending plans to be enacted by businesses in the UK. A lot of volatility is going to lead up until that June 23 Brexit.

Additionally, June 7 is the last primary as it relates to the Republican candidate. It's been very contentious here in the United States. I think this is one of the first elections that really has mattered. I think it's going to continue to be a little bit of a headwind for global markets surrounding who the ultimate Republican candidate is going to be.

The other thing most people are not talking about is that June gives the Federal Reserve its last chance [to raise interest rates]. I said before that 34 basis points is what the market expects from the Federal Reserve in 2016. You're either going to get 25 or 50 bps. If you're going to get 50, you're going to get the first 25 in June. You could say, Joe, where are you coming up with getting this first 25 basis point hike in June when you've already told us that the Federal Reserve is so focused on stimulating global growth, and it's a reason why they came out so dovish with their language in March?

It's important to pay attention to the manufacturing figures. The manufacturing figures especially as it relates to China and the United States have improved. Let's give you the actual evidence on this. China PMI reports at 50.2. The last time that China's PMI was above 50 was in July of 2015. U.S. ISM manufacturing, which is basically the same thing as China PMI, reported just last week at 51.8. The last time we've seen that number before 50 was in September. The combination of a healing U.S. equities market and the signs that manufacturing, which has clearly been in a recession, is also healing itself could motivate the Federal Reserve to give the market that 25 basis point hike in June.

So I want everyone, as April progresses, to focus on what could be coming for the duration of the second quarter and understand that the risks may outweigh the opportunity and it's time to play a little bit of defense as it relates to the global risk markets. Let's talk a little bit more specific as it relates to particular risk assets themselves.

First and foremost, we have to talk about oil, which has lifted to $26, $27, $28 [a barrel]. OPEC, as they did back in February, is going to remind the world of the risk to reward of being short oil at $26, $27. Speculators are incredibly levered. A lot of the activity in oil futures is all speculation. If you're going to be short oil at $27, you better have a high degree of conviction it's going to $15 or $16. The world got reminded of that at $26, $27.

The other side of that is that the market has now gravitated in oil towards $40, I would not be looking at the upside projections for $50 to $60. Rather, my expectation would be, okay, the price of oil and the easy money as it lifted to $40, has already been made. Now let's look at what matters most, the impact on the high yield market. Let's turn our attention to the high yield energy market because I think that's one of the most important when you look at passive investing and true portfolio construction.

What's the impact on oil prices and the rebound and recovery if we sit towards $40? First of all, it was a very surprising quarter for high yield, up nearly 3.7%. One of the opportunities when you look at risk assets is investment grade companies that have actually fallen to high yield [status]. In the first quarter, you had $65 billion worth of debt downgraded from investment grade to high yield. The majority of it came from the commodity space – $39 billion in energy, $35 billion in mining and metals. The default rate currently fits, if you factor in energy, at 3.4% in high yield. However, if you strip out energy, which energy alone, by the way – energy, mining and metals collectively – the default rate's running somewhere near 16%. If you strip out that component, we're still at a historically low default rate for high yield at 1.5%. Over the last 12 months, 75% of the high yield default is coming from energy, metals and mining.

Now you've got a price of oil that has now gravitated towards $40, that should be good enough to not create further contagion in the high yield market, and the beneficial capacity of that is to look at a lot of investment grade non-energy and view them as an opportunity. One area that I have to highlight because the spread between investment grade financials and investment grade non-financials is the widest it's been since 2013. To me, investment grade financials right now are the low-hanging fruit. To borrow Carl Icahn's phrase, they really are a no-brainer when you look at them on a three-year horizon.

The markets have given you the opportunity that it gave you back in 2013. One hundred percent, I'd be looking at investment grade financial opportunities. I don't think when you look at the treasury markets and you look at yields, you're going to see any of these yields really get away from you because the Federal Reserve is basically 25 to 50 [bps] at best with a put underneath the market where global growth doesn't stimulate itself, the Federal Reserve basically isn't going anywhere.

The impact on oil prices as it affects the high yield market leads you to the investment grade opportunity. In terms of the fixed income market, agencies right now is an area that I would favor. I’d also be looking at senior floating rate notes. I’d be looking at that to give your portfolio a little inflation protection. Just think for a second about the Federal Reserve and the things that the Federal Reserve has shared with all of us in their communications over the last couple of years.

The one thing they want to stimulate is inflation. They want to meet the inflation target. We all understand that inflation is nowhere to be found. This is a story about global deflation, right? But we’re finally getting a little bit of evidence of inflationary rift —1.7% up in February — and the Federal Reserve is suspicious of it. They have reason to be suspicious of it.

The Federal Reserve has been wrong in much of their economic forecasts and now finally they’re getting a little bit of a hint of inflation, they’re forecasting that inflation we shouldn’t believe it. To me that means you go out and you grab yourself a little bit of inflation protection in your portfolio, whether it’s TIPS, whether it’s senior floating notes, whether it’s REITS or some form of real estate investment, CMBS, whatever the case may be. Get a little bit of inflation protection within your portfolios.

By the way, the reasons why the Federal Reserve is suspicious of the inflation lift is there was a one-time Affordable Care Act price cut that’s now rolled off. So, 65 basis points of the rise that we’ve witnessed in inflation since July of 2015 is coming from healthcare, so the Federal Reserve wants a little bit more time to digest that information.

Lower oil prices, the effect on taxable fixed income, now let’s talk about the effect on China and what’s gone on there. It has been beneficial. It’s allowing for the currency, which was a huge concern in January, a very big concern for global capital markets. Where would the Chinese currency be fixed versus the U.S. dollar? We haven’t seen the significant depreciation. In fact, the Chinese currency has been pegged flat to slightly higher versus the U.S. dollar over the last six weeks.

That’s been positive in terms of capital outflows. We’re seeing a lift and a benefit on the manufacturing side of the equation. It’s allowing for a little bit of healing in China itself. The bleed-through effect on that is emerging market currencies were 3.6% on the quarter. Emerging market equities, when you look at the MXEF [EM ETF], had very strong performance relative to global markets, up nearly 3% year to date.

Specifically, when you look at emerging markets, look at country specifics. Here’s your opportunity to look at something like India, which is up 7% since last June. The strategy that I want to adopt in the emerging markets is a strategy of focusing not on EM currencies which are up 3.6%.To me, that’s something you want to take risk off there. You want to stay focused on EM technology. You want to stay focused on the EM consumer, and you want to have disdain for EM banks and EM materials. Why?

Because sustainability, in terms of the U.S. dollar downtrend, I don’t believe is going to be with us. Again we’re using opportunities in April to shed risks looking forward in the EM space. That’s going to present itself. Of all the appreciation that we’ve seen so far year to date, I think EM comes into focus as being the one that’s highly questionable whether it can act in continuance. There’s a right strategy there. It’s one that focuses on the consumer, focuses on technology itself.

Overall, the expectation for the year is that it’s a second half story. I think you have to look at where we were, not so much at where we’re going right now. What I mean by that is, think of the apocalyptic calls that we had back in January. In January, we talked about an equities market that many felt was going to go down 20%. Now we’re sitting 3% from the May of 2015 historic high.

That's a phenomenal recovery in the markets. I think it's important to highlight that. We need to see the lift in profit margins throughout the remainder of the year going into the second half of the year. The contraction in earnings that we had, we should come out of that in the fall quarter. The expectation is that the fall should be a much better time. It's going to be a patient story, a waiting story. I think it's one over the next six months or so you're going to have to focus more on what's your risk, what's your exposure versus what are the opportunities in the marketplace itself.

Barry Mandinach: *Thank you Joe and thank you everyone. I really appreciate your time.*