

Joe Terranova's Market Review & Outlook
Call Conducted September 22, 2016
Transcript edited for clarity and brevity

The following transcript, edited for clarity, features insights from Joe Terranova, senior managing director and chief market strategist, discussed during a special market review and outlook call on September 22, 2016.

Paul Cahill: *Welcome everyone. My name is Paul Cahill, managing director of national sales at Virtus Investment Partners. It's my pleasure to serve as host for this afternoon's podcast. Joining me to share his thoughts, and help provide some perspective on the markets as we edge closer to the fourth quarter is Virtus' Chief Market Strategist Joe Terranova. No doubt many of you recognize Joe from his role as a member of the ensemble team of CNBC's "Halftime Report" program. At Virtus we're committed to driving better client outcomes. Joe, I always enjoy hosting these calls, listening to your take on the markets. Your role as chief strategist where you don't have any particular asset class or strategy you're looking to build a case for really allows us the freedom to focus on a broader set of themes, topics to help investors meet their real needs, and to drive those better outcomes we talk about. So with that as our backdrop, let me welcome Joe. First of all thanks for taking the time and again for sharing your perspective with us.*

Joe Terranova: My comments are intended to provide some economic evidence more than anything else. One of the things I like to do is have expectations but they have to be evidence based. I really don't want to have a narrative about forecasts and predictions. Those don't seem to work too well, and if you reflect back upon the beginning of the year, and you look at the various forecasts and predictions, many of them were incredibly wrong. In fact, you could make the argument that the consensus forecasts for 2016 were entirely wrong. Not very many expected the U.S. dollar to be sitting where it is currently, down on the year 3.5%. Not many expected the price of oil to be at \$46 [a barrel]. It was either going to be at \$25 or \$65. Think about where U.S. Treasury yields are sitting right now, at 1.65%. Again, consensus forecasts, consensus predictions were wrong. And I think it has created an environment that's incredibly difficult. And that's where I want to begin this afternoon's conversation.

I want to talk about the challenges right now. Back in July I said one of the difficult things for a money manager or for an advisor is that you can make a compelling argument for each and every asset class right now. You could also conversely make an argument not to be involved in a particular asset class. It's a difficult environment. A couple of weeks ago I enjoyed a wonderful day in New York City at CNBC's Delivering Alpha [conference]. I had the opportunity to speak to many – Jim Chanos, Paul Singer, and Carl Icahn were in attendance. Going home that night, I was struck by how overwhelmingly pessimistic everyone was towards multiple asset classes. That's why the environment is so difficult and so challenging.

Thinking about behavior first and foremost, I want you to understand the difficulties. Human nature does not properly align itself with a lot of what we do in the business in terms of proper and successful investing. We tend not to think in a parallel universe but in a linear universe. Let me give you an example of that in the market environment that we're in right now. We tend to inherently assume more risk when the potential loss is greater. That's historically what we do and that's the environment right now. Look at equity valuations. You could call them as Leon Cooperman did [on CNBC], 'fairly but fully valued.' You could look at Treasuries and where there's this forecast and prediction for the grand reallocation which we haven't seen. However, the economic evidence does suggest that Treasury yields may have seen at least a near-term or an intermediate-term low surrounding the events of Brexit. So in an environment where we tend not to think parallel and we think linear, we take on more risk when bigger loss potential is there. That's kind of the situation we're in right now.

Think back to the winter of 2009. Think about what the potential loss was for equities at that moment. You could say, "Hey, Joe, I thought the S&P 500[®] was going to go from 670 to 335. The economic evidence though, the fundamentals at that time, the earnings which matter most, didn't suggest that the market would continue to absorb that kind of loss. But ultimately it was the Federal Reserve that had to step in and assume the risk because no one would assume the risk when the perceived loss was smallest. Let me give you a small analogy on that. It's kind of like having to make a 10 a.m. flight at the airport. You get up in the morning. It's one of those days where everything's working against you. As you're approaching the airport, you hit the final light. You know the reward potential is, if you get through the light, you make your flight. That's where we are in the market right now. The light turns yellow and you really don't think about the potential loss going through that light. We don't think parallel. We think linear. We think about getting through the light. We think about the reward and getting where we need to be.

We take more risk. We don't think that when we go through the yellow light, we could get in an accident. God forbid, we could kill someone else, we could injure or kill ourselves. We don't think in a parallel universe that we may get pulled over. In the delay in time for the paperwork of a ticket to be distributed, we would miss our flight.

So I wanted to begin today with getting an understanding of risk assumption because that's the most important thing when looking at any asset class right now – risk assumption. What's the risk assumption? What's the potential loss? Now you could say, "Well, Joe, that brings me to an environment where I want to be cautious. Yes, we want to be invested. I don't know if I necessarily want to use the word "cautious" though. What I do want is to provide evidence of the potential for the following: organic growth, dividend growth, and balance sheet flexibility where if you cannot have organic growth you can go out and buy it. Those are the things I think right now are important. Also aligning yourself to what the new economy is all about.

[You may be wondering what I think about the election.] What matters most about the election is this. The United States is a technology-oriented economy. Think of the reasons why Amazon is trading at \$805. Why? It delivers on two metrics that the consumer wants right now – time and convenience. We are an economy driven by technology. As Carl Icahn property stated, we can't just sit here and text each other back and forth. That's not what we can do. But as it relates to the election, neither candidate seems to have an emphasis on or an understanding of the new economy, and the new economy is technology.

And looking forward, that is a problem. You could bring forth all of the infrastructure spending that you possibly can imagine. Without a proper understanding, without a proper initiative to educate, without a proper initiative to expand the orientation of technology in this country, that's a problem looking forward.

We talk about building bridges and roads. I don't want to invest right now in farm equipment. I don't want to invest right now in hard capex (capital expenditure) projects. I want to invest in capex projects that are technology oriented. I want to invest in communications equipment. I want to invest in services equipment and software equipment. That's the capex that I want to focus on right now.

Think for a second globally. Number two in the world in terms of exportation of technology is Israel. Think about what a competitive advantage the U.S. has because of the distinction of its ability to produce the efficiency of technology. That's the new economy.

So as it relates to the election, the concern is that we have two candidates that don't understand the economy itself. In reality if you think back to the tests we used to take in

grammar school, that's what this election is all about. You had A, B, C, and D. And then you had E – “none of the above.” Well, if “none of the above” was on the ballot today, “none of the above” would win, and that's the problem.

The second problem we have is the Federal Reserve. The reason is not about when they're going to give us the 25 token basis point normalization [rate] hike. They gave us 25 basis points last December. Markets rolled over in January. Why? Credit concerns, Chinese economy concerns, commodity concerns, but really most importantly – and I talked about consensus expectations – concerns about the U.S. dollar restricting profit margins, which have continued to contract since November 2014. I'll talk about what an important indicator that is looking forward later in this conversation.

But it was the U.S. dollar that became that high yielding currency in that environment. That was the challenge. That was the difficulty. The Federal Reserve gave you a 25 basis points hike in December, and the market responded with a sell-off in February and reversed it once again. If the Federal Reserve would have given you 25 basis points yesterday or if it gives you 25 basis points in December, it doesn't matter to your portfolios. What matters is that the Federal Reserve has been telling all of us for the last three years that when the next recession comes – and I'm not making predictions or forecasts – we'll know unfortunately way too late. We don't know when the next recession is coming. But what's important is that when the next one comes, the Federal Reserve has told you the medicine in the cabinet cannot come from monetary policy. It has to come from fiscal policy.

And that's the important indicator for all of us. Will fiscal policy be readily available for the next recession? You're beginning to see global central banks which are absolutely coordinated. And at the G20 meeting back in February 2016, that was the singular reason in a globally coordinated effort why global markets lifted. We moved away from a competitive currency devaluation process. You've now begun to see and I think you saw it the other night in the Bank of Japan's actions.

By [the Bank of Japan] targeting the yield curve, they were acknowledging they know they can no longer look away from the negative impact of banks and financial institutions having an absence of earnings growth. They are specifically acknowledging and understanding that banks and financial institutions need to have a favorable yield curve, need to be part of this process, just in case the next recession comes around. It can't come from just monetary policy. It has to come from fiscal policy.

Those are the concerns looking forward – Federal Reserve, Presidential election. Two things to keep in mind: What do we do with technology? What do we do the next time the recession comes around? What does this mean for your portfolio? Right now, I believe there is nothing wrong with raising cash, having some flexibility in a portfolio. When I say “raise cash,” I'm talking somewhere along the lines of 10%, maybe 15%. I personally have 68% allocated towards taxable fixed income and equity combined, both global and domestic equities. Then you want to have some [exposure] in hedge funds, ETFs, precious metals, [areas] that can be classified as alternative investments. It's the right environment for that right now.

I think in looking at portfolios right now, and as I mentioned, I believe the low on yields was placed, and it's time to move away from safety type holdings. Everyone always likes to find a bubble. If there is a bubble, there might be a bubble in safety. I think the opportunity now is to look past some of those safety, bond-like types of assets and holdings.

I said it before, there's a need, there's a compelling argument that could be made for each and every asset class. In taxable income, increasing exposure right now to MBS (mortgage-

backed securities) might be something that's favorable. High yield has performed incredibly well in 2016, despite consensus expectations. One of the reasons why is because energy has healed itself [in the credit space]; you have not seen the wave of debt maturity in 2016 that you're going to see, not in 2017 – so you still have a little bit more on the runway – but that you're going to see in 2018.

As it relates to the price of oil – which I believe is in more of a W-shape than anything else – next week you want to make sure you're paying attention to the [OPEC] meeting in Algiers where they're going to talk about an oil production freeze. What you really need is language that would suggest that at the meeting to follow, they'll take that oil production freeze potentially to an oil production cut. It also has to be coordinated along the lines that it was back in February with the G20 meeting as it relates to currencies. We need coordination for an OPEC cut as it relates to the Russians, OPEC members, and non-OPEC members.

In that environment, that will take you back in that environment that you get a production cut to wanting to look at the energy space as an overweight. Currently where the energy price sits right now, vacillating on either side of \$45 [a barrel], ownership of energy is warranted but it's warranted when looking at who has proven global reserves, who domestically in the United States can be shale survivors. I spoke before about technology. Please understand that nobody including myself predicted the dramatic increase in production that we saw domestically here from shale in the last five years. It was all because of the horizontal drilling and the efficiencies of technology. So I want to keep my eye on what happens [at the OPEC meeting] next week.

I also want to keep my eye on what happens with the U.S. dollar. The dollar is one of the more important indicators and really is behind the 8% rise we're seeing year to date in the S&P 500, and more importantly nearly doubling that in the MSCI Emerging Markets index up nearly 16%. The U.S. dollar has acted in a benign capacity, and I want to make sure it doesn't appreciate significantly. Why is that? Well I mentioned profit margins have been contracting since November of 2014. Finally, in the last quarter, last earnings season, we at least saw the rate of decline in profit margins moderate, become stabilized. Now I want to see those profit margins actually lift. That would be important. Let's get out of the earnings recession that we've been in for the last few quarters. An important component of doing that is the value of the U.S. dollar.

I talked about alternative investments. Gold and silver have worked incredibly well so far year to date. If you look at flat pricing of gold and silver, silver's up nearly 40%. Gold's up close to 25%. I like to always say ownership of metals, precious metals, in a portfolio is somewhere around 3% to 7%, [the jersey numbers of] Yankee legends. You could take it to the "Joe DiMaggio" [level], around 5% if you wanted to, utilizing it in a diversification process right now.

It's important to be fully diversified right now. When I said that the potential for a bigger loss presents itself in all asset classes right now, you could also make a compelling argument for each asset class. So when you look at the U.S. dollar in a benign capacity, that lends itself well to precious metals itself.

Turning to the emerging markets, we often talk about the BRICs. Brazil has had a fantastic year. Do I believe that is a cyclical orientation or a secular orientation? Ask yourself that question if you are investing in that region. The answer based on the evidence that I see is it's more cyclical. It's a rebound of what was very horrible performance in 2015. The same can be said for Russian equities. When you look at the Chinese equities market, I view it as completely uninvestable at this point. You don't want to invest in Chinese equities. What you want to invest in is Chinese policy. Chinese policy is going through a restructuring

mechanism. It's done that significantly over the last couple of years. We've seen the moderation in GDP.

I've left out one component of BRIC – India, and I think that is where in the emerging market asset class there's the most opportunity on a longer-term secular basis. India enjoys the same demographic growth that you hear constantly talked about in China. Many global business leaders that I have the privilege of talking to on CNBC are turning their attention to India, visiting India, talking to the Modi government, and aligning with business investments there. So on a secular basis, when I'm thinking about the BRICs, India seems to be where the opportunity is.

Bringing it back to Europe before I return to the United States, as we play a game of spanning the globe, I don't believe the evidence suggests that although we've had a very nice recovery in asset pricing in Europe in the wake of Brexit, there are still complications. And once Article 50 is triggered – and when that will be we do not know -- but once it is triggered, I think you're going to have elevated volatility in the marketplace once again. It will be a reminder to all once again of the difficulties with the two-year window for the British to negotiate new trade agreements, both domestically in the euro region and globally.

I don't think the past couple of months provides insight on a secular basis of what could occur with European assets. In Europe itself, Germany has had an incredible recovery. Basically when you look at the DAX, it's unchanged year to date, up nearly 10% in the quarter. The only type of performance that's going to mirror that would be the emerging markets index [MSCI Emerging Markets].

But clearly you're seeing a shift going into Germany. I think there's good staying power with that because of the German consumer being strong. Keep in mind, the contentiousness of the elections that we're going through in the U.S. right now, Europe is going to experience next year, with Germany one of those places. I mentioned before quarter-to-date performance for the DAX and the emerging markets being real strong. That takes me to where I began, and that's the NASDAQ being up 10% in the quarter.

Looking back on technology, tremendous opportunity exists. Think back 15 years to 2001 when the bubble burst. Technology was the poster child of the recession that we experienced in 2001. In the years that followed -- 2003, 2004, 2005 – you couldn't make a compelling argument for ownership of technology names, either on the debt side or the equity side.

Well fast forward, and technology companies have done an incredible job rebuilding their balance sheets, focusing on productivity, focusing on having cash at hand. They reinvented themselves, and were able to withstand the 2008 crisis and come out of the crisis, which had such tepid growth, to position themselves favorably. So I want to ask myself in a lot of my [securities] ownership – whether it be on the taxable fixed income side of investment-grade type names or high yield names, or if it's on the pure equity side – what's the contribution from technology? What's the exposure to technology itself?

Everyone likes to talk about the health care sector. At CNBC I hear all the time conversations about Valeant Pharmaceuticals, Mylan Pharmaceuticals, and Sarepta. What I want to focus on are companies that are utilizing and enjoying technology – Thermo Fisher, Stryker, medical equipment, medical devices. Think about the improvements when you visit a medical facility, the technology right now. I want to focus on things like that, the technology contribution to a particular sector. In the retail space, I mentioned before Amazon – time and convenience. In the energy market, you want to look at the shale industry. Which shale players will be long-term survivors? The ones that properly have incorporated technology.

Technology as a sector has the ability to go out and buy the growth when companies cannot get it organically. That is what is unique about it. And really the emphasis of this conversation today is about technology. We are a technology economy. It is what has kept us I believe from not falling back into a recessionary environment like some in the rest of the world have naturally done in the wake of the Great Recession. We've only had growth scares.

The continual advancement of technology in our economy is providing so many distinct opportunities, the challenge for all of us is in understanding the opportunities in an environment where you have political leaders who aren't even beginning the narrative and the conversation about what technology can do looking forward. They are utilizing it for social media purposes. We've changed the landscape completely, but if there's one thing I would emphasize first and foremost - it would be the impact of technology.

REITs have had a tremendous recovery since the middle of 2015. They've been stripped away from financials, and are now the 11th sector [in the S&P 500]. The REIT story is still a favorable story, both domestically and internationally, and one that I have been talking about quite a bit. From the month of August to the actual S&P 500 rebalance, not surprisingly the rebalance was the low. We're seeing an uptick once again. The economic evidence is there for me to believe that the REIT story is still a very good one.

Looking at some other asset classes, MLPs (master limited partnerships) have enjoyed a nice bounce. Again, a little bit of a W-shaped type of price movement looking forward. I think that's kind of where we are right now, in the middle of the W. If I can give you one outside-the-box thought in energy, it possibly could be natural gas, which very quietly over the last couple of years the investment community has kind of forgotten about once again.

Lastly, there is something that really needs to be stated and is most important when we talk about investments and threats. I'd like to end talking about the potential risk and threat to the financial services industry. I can't tell you important I thought the move by the Bank of Japan was the other night; hopefully regulators in the United States are recognizing and seeing that right now. You cannot grow your economy if you're going to punish your banking sector, and I'm not talking about what happened with Wells Fargo and the Congressional testimony.

You need to present a favorable yield curve so that banking and financial institutions have the ability to utilize cash on their balance sheets and not in such a punitive and restrictive way. They need to be able to build because as much liquidity as global central banks want to put out there, it becomes a trap on balance sheets and financial institutions are hoarding cash. I can't emphasize enough how important the Bank of Japan's action might be for recognition on the part of global central banks that this needs to be done.

Secondarily, I think what is very important in our industry is that we need to engage the younger generation in the financial services industry. If there is a threat, regulation is at the top of the list and right behind it is not engaging the younger generation in our industry because with innovation, efficiencies, and proper education, they will be able to take the success we've enjoyed in the last 25 years and advance this industry. Without that, we're going to have an industry that's going to look much different than any of us could have possibly imagined.

PC: *I'll just ask a follow-up from one of your last comments about the moves from the Bank of Japan and the modifications they made to their policy framework the other night. Would you*

like to see the Federal Reserve adopt similar changes? What would be necessary for you to come away with a positive feeling about interest rate policy here in the U.S.?

JT: I think the interesting thing as it relates to interest rate policy here in the U.S. is the communication mechanism has become complicated – there are too many speakers. I said at the beginning, I don't like forecasts. I don't like predictions. I like economic evidence. And I'd like to see the Fed focus more on the evidence they have at hand versus forecasts and predictions which are generally wrong. But more importantly – and I'm obviously part of it on a very close and daily basis – there are too many different messages. It's almost like there's too much transparency, and I think that's the problem. There are too many conflicting messages. I think it gets in the way of strategies for advisors and investment managers. I think it complicates things. It's almost the equivalent of over-trading a portfolio.

I think that's what the Federal Reserve is doing right now. So if you ask me what could they do, it would be to talk less, because I think the conversation is getting confusing. No one really knows what to look at right now. Conversely, on the other side, if we entered a recessionary environment, don't look for the breaking news on CNBC or Bloomberg, "Federal Reserve Enacts the Following..." It's got to come from fiscal policy this time.

PC: *That's helpful. Thanks*

JT: I want to thank everyone for listening. I wish all of you health and happiness, the two best positions in your portfolio.

PC: *Thanks. Joe, appreciate the time.*

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