“2016 Market Outlook” with Joe Terranova

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 January 20, 2016.

John McCormack: *Good afternoon everyone and thank you for dialing in for the Virtus 2016 Market Outlook call featuring Joe Terranova. My name is John McCormack, Divisional Sales Manager with Virtus. With me today is Joe Terranova, Virtus' Chief Market Strategist and ensemble member of CNBC's “Halftime Report.” Joe will give a brief recap of the 2015 market action then discuss some of the headwinds and tailwinds that he anticipates for 2016.*

If you're interested in hearing more of Joe's thoughts on the capital markets and the economy, Virtus produces a monthly podcast featuring Joe. In the December and January podcasts, Joe speaks about the need to be cautious and entering 2016 as an observer. It goes without saying that we have gotten off to brutal start to this here. U.S. equity markets have experienced the worst start to the year in their history. Today's market action was more of the same. Joe, we're all interested in hearing your observations.

Joe Terranova: Thank you, John, and good afternoon for everyone that dialed in. It’s very humbling that you all took time out of your busy schedules, in particular on a day where the markets are at such a precipitous decline and we're experiencing such volatility.

As John mentioned, what I would first like to do is walk back a little bit. I think we have to walk back to the fall of 2014 to gain an understanding of why there seems to be so many headwinds that have emerged early in 2016 for the capital markets. The capital markets in the fall of 2014 began to experience the conditions as they related to the Chinese economy, commodities, and global currencies – otherwise known as the “three Cs.” We are now in 2016 expanding upon that and identifying it as the “four Cs” – we're including credit into that conversation.

John mentioned when he began the call that I've been advising a very patient strategy. I want to be very clear on something. I'm not suggesting to anyone, nor have I suggested to anyone, to have a “sell” mentality to raise cash. What I have suggested is that people need to be patient and sometimes the best trade or the best investment is no trade or no investment. You actually have some time on your side to wait out and gain more information and more understanding on what's going on in the marketplace.

So this all began in 2014 in November when oil began to roll over. And it really is predicated on the fact of global currencies experiencing a game of what I call “hot potato” as it relates to deflation. I want you think back to 2009. I want you to think about the United States and what troubled us, and think about our central bank. What was the mission of the central bank?

Think simplistically, monetize the debt, export our way out of the crisis. [We were in the midst of a] massive debt cycle, we needed to fix it….to get deflationary pressures out of the United States and send it out to the rest of the world. And that's exactly what the U.S. did. We exported our way out of it, we exported our deflation, and what we're experiencing now is that other economies are at the breaking point where they need to export their deflation back to the U.S.

As it relates to the Chinese economy and the concerns that we have that GDP is 6.8% and the concerns about slowing Chinese economy. If you pull up a chart of Chinese GDP in the wake of the 2008 crisis, what you'll find is that Chinese GDP topped out in 2010 at 12.2%. The Chinese GDP deceleration has been ongoing now for the better part of three years, entering its fourth year. The reasoning behind it was the U.S., by the mechanism of cheapening their currency, exported the deflation overseas. Well, along the way what other global central banks have recognized is they have to take that policy and cheapen their currency. So, the Bank of Japan, in November of 2012, [began to deploy] Abenomics to weaken the yen as much as they possibly can. The European Central Bank introduced Mario Draghi, [seeking to] weaken the euro currency as much as they possibly can. Now markets fear right now that the Chinese are going to do a one-off depreciating their currency. In fact, I don't believe that ever would occur. Chinese policy makers would lose all credibility with markets if they ever did that. But walk back to November of 2014 when this cycle began as it relates to currencies, where the U.S. dollar became a high yielding currency. The problem with that is because of the monetary policies of the last three or four years, a tremendous amount of debt was issued globally in particular to the emerging markets, and it was dollar denominated.

Now if you tell me that you're going to take the value of your domestic currency, being the U.S. dollar, you're going to be in a process where the rest of the world had debt denominated in that dollar, you're going to create a short squeeze. You're also going to create a condition where those holding the debt are commodity producers reliant on significant commodity [demand]. Tying that together with the decision that OPEC made – and I think for everyone at OPEC right now, if they look back upon what they did, and decided to do, in November 2014 – this is not what they wanted, $26 oil, by no means. I think if [OPEC] could reverse that decision in November 2014, I think they clearly would. What has gone on here is that the dollar has risen, commodity prices have obviously cheapened, we've got concerns as it relates to the Chinese economy, and it created an entire year in 2015 where David Kostin at Goldman Sachs correctly identified markets as “flat being the new up.”' And that's your expectation. Your expectation in 2015 was flat is the new up. And think for a second what we're in the midst of right now.

Everyone's talking about the precipitous decline of 2016. We're in the midst right now of a significant time correction. Yes, prices [have] declined significantly; so far year to date, the S&P 500 is down 10%. But understand this correction began in May of last year. So it’s a time correction more than anything else, than a price correction. Now, looking forward, understanding those conditions, you have to ask yourself, has anything changed? Or is there anything about those three C's, and the potential fourth C being credit, that has changed or will change looking forward?

Well, if you're in a cycle of deflation where everyone else is exporting their deflation back to the United States, you have to ask yourself the first question, can the U.S. economy withstand deflationary pressures coming onto its shores? It first shows up in corporate earnings. We're in the midst of a little bit of a corporate recession. Please don't get panicked. We're coming off historic highs as it relates to profit margins. So profit margins from 9.7% roughly are sinking below 9%. We'll characterize that as a corporate recession. Keep in mind though, not this earnings cycle but the next earnings cycle, the comps are going to look much more favorable for S&P 500 companies. There's a tailwind that's emerged. That's why I'm asking all of you to have time on your side. So in terms of the impact, it's first represented in terms of corporate earnings. That's the thing that we need to hear about. Secondarily, I know all of you have heard a tremendous amount of concern as it relates to the absence of [share] buybacks, and I think that's one of the reasons you've seen the volatility in the marketplace that we're having right now, is because you don't have the underpinning of corporate buybacks, which have been so largely significant in contributing to S&P 500 appreciation.

Seventy-five percent of S&P 500 companies will have reported by February 5. There's another tailwind that is going to emerge once again. But going back to the question, can the U.S. economy import the deflation, and can it withstand it? I believe the answer to that is yes it can, and the reasoning behind that is we are in the midst of manufacturing a natural resources contraction, but we are not in the midst of a housing contraction, and more importantly, we have a dynamic and a measure of the U.S. economy that's stealth – and that's technology itself. And if you think about it, everyone talks about the goods we're transporting, whether it be on rails or whether it i on trucks. We're not a bulk economy anymore. That's not what the United States does. The United States is a consumer software, technology services exporter. We export technology. We do it the best in the world. Only the Israelis come a close second to [the U.S.] in terms of exporting technology. So I believe if you look at… whether it be Amazon, whether you look at Microsoft, and look at some of their earnings, I think [technology] is more of a true representation of where the economy is.

So my expectation as it relates to the U.S. economy is by no means do I think we sink into a recession in 2016. I don't believe that at all. I think the corporate recession reverses itself, not in the upcoming earnings report, but in the following earnings report after that. I do believe that we are seeing conditions being imported to the United States globally that will take a very dovish Federal Reserve and put them on pause. The expectations for a 100 basis point rise as it relates to the fed funds rate I think is completely unrealistic and unhinged to what the dynamics are for the overall marketplace. So my expectation is that the U.S. economy will be able to digest and absorb the deflationary pressures. Now, what does that do? It's the same thing I'm asking all of you to do, have time on your side. And it allows the rest of the world time to heal once again. I will offer to you that the emerging markets are what are challenged right now.

If you ask me about Japanese equities, I'm as bullish on Japanese equities as any of the other major global equity indices. The Japanese yen is the ultimate “buy and hold” strategy as is the Nikkei…. Japanese yen…November 2012…75…Walk it forward four years…here we are at 117. I believe over the next three to five years you're looking at a move, a monetary policy from the Japanese that continues to weaken the yen to 150.

So it is not all global indices that are being challenged right now. Within the emerging markets, look at India. India presents the demographics of the Chinese society, but yet with more advancement, more friendly fiscal policies – more in terms of the pursuit of providing better technology and transportation and food and health care to its citizens. I offer India as an opportunity.

In looking at Europe, my expectation clearly for 2016 is that the ECB is going to need to do more. They’re going to have to do more in terms of monetary policy. Now I always ask to make the distinction between a social consequence and a market consequence. Social consequences, as we’ve seen with the policies of the Federal Reserve of the last five to six years, we may not like them. Look what we've created. We've created a global contagion as it relates to cheapening our currency and exporting deflation to other sovereigns. But from a market consequence, we all know what the reflation story is, and the reflation investment.

The Europeans over the next 18 months will have that continued benefit. So when you look at European corporate credit and think to yourselves, what are the conditions? You're looking at low interest rates. You're looking at a cheap euro. You're looking at balance sheets that are being built once again. So while we're talking about corporate credit in the U.S. that has deteriorated, I see the opportunities in European credit looking at it right now. So I want to make this clear distinction for all of you in the expectations of 2016, all is not lost. We're just asking for time as the world can heal itself as the U.S. continues to absorb deflationary pressures, as the U.S. economy digests and works its way through the processes that we're seeing right now. Now I know that obviously when we look at -- and let me point one thing out as it relates to the Chinese economy. The Chinese economy has softened to 6.8%. There is not any expectation on my part that we are entering a hard [economic] landing. When you look at capital spending, when you look at leading economic indicators coming from Chinese statistics, all of those numbers are not suggestive of anything representing itself as a hard landing. What they are suggesting is a transformation in the marketplace, plain and simple.

Now, I'm asking for time because I'm still not sure that the volatility that we're experiencing right now with the absence of buybacks, with the increased amount of algorithmic trading factoring into our marketplace. I visited with multiple offices over the last four to six weeks which are electronic marketplaces. The predominance of activity on the algorithmic side continues to build. Think back to the selloff we had in August of 2015. August 24, that Monday, it was driven by algorithmic models that closed down on a Friday afternoon, woke up Monday morning, the machines turned on and everyone was looking at the same thing, a break of the 200-day moving average. So the market has become more technical in nature. And you know we could debate the reasons why, but the Dodd-Frank legislation is removing a lot of the arbitrage that was done; also the market makers and the investment banks. But you have to understand the dynamic that more algorithmic models are going to create more volatility. So my expectation for 2016 is yes, it is going to be a far more volatile type of capital markets, whether it be in fixed income, the equity side, or the credit side. Think for a second, the market's down today at 12:50, 550 points. It rallies all the way back at 3:30 to being down basically 110, and closes down 250 points. You can expect more days like that. What I'd like to do right now before I open up for some questions, I want to talk about particular asset classes and walk you through what some of the expectations are that I see for that. I mentioned the BOJ and the ECB – they're going to continue to be friendly to global capital markets, continuing to look on the side of easing. Don't look at the Chinese to make a big policy mistake. I do not believe that happens. The FOMC – four rate hikes I think is completely unrealistic given where we are in the marketplace. Muni bonds, the best performer in 2015 (I think up 3.3 %), are getting a little bit expensive when you look at where they are on a valuation basis right now. You're also going to have some supply concerns coming forward in the next couple of months. So I would take a look at municipal bonds.

MLPs – I don't view either upstream or downstream as being ready. Select midstreams, certainly, if you have a three to five year time horizon, but there is no one that could tell you that the volatility that's been experienced in the MLP and energy space is going to abate at any time soon without flipping a coin in the air, and that's not something I'm going to do. I don't make calls on where the S&P 500 is going to be at the end of the year. Nobody knows the answer to that. You don't know what the exogenous event is going to be. As it relates to crude oil itself, what is troubling crude right now is a lack of global leadership in the absence of OPEC and non-OPEC members being able to commit to the correct [production] policy. And additionally, a tremendous amount of oversupply – yes – but even more troublesome and more problematic is on the credit side as it relates to energy, the need for those that are buying the energy get at $0.60 at a dollar, at $0.50 at a dollar, at $0.45 at a dollar to use the future's market to hedge out, and also use energy equities to hedge out. That's this process that's going on right now. I think we're closer to a potential – what I would identify as – a tradable rebound in energy. Long-lasting by no means. I think energy is going through the transformation that technology went through after 2001. Think about the Cisco's and the Yahoo's in technology in 2003, 2004, 2005. You couldn't get anyone to buy those names, or even Apple for that matter. So I think in the wake of 2008, you had the same type of conditions for financial institutions. Natural gas, once it fell from $10, went through the same thing. Yes, you are going to get a tradable bounce at some point as it relates to oil, but I do think this time is different. I don't see a "V" [shaped] recovery. I think those looking for $60 to $70 oil at the end of the year, that's far more unrealistic. That does have a positive impact on the consumer. For those suggesting that it is not showing up, that is not true. It is showing up. It's just that the purchases being made are discretionarily much different than purchases witnessed in the past.

As it relates on the fixed income side, I think you continue to look at duration risk over spread risk. Continue to look at investment grade companies which are being pulled down into the high yield category right now by the contagion that's being witnessed right now in the energy and the natural resource space. No reason to bottom pick in any of those. Technology, the sector itself presents itself as incredibly interesting. One of the reasons why technology so far year to date has been sold so aggressively, in my opinion, is because the margin contraction. Technology was the last sector to really not experience margin contraction. And you're beginning to see that, but I think that's going to create a tremendous opportunity because I think when you look forward at the dynamics of the economy and where markets will pay a premium, they're going to continue to pay a premium for consumer-oriented types of assets. They're going to continue to pay a premium for technology-oriented types of assets. The premium that was paid for growth will continue to be paid. We're late cycle. If you could show me growth, then you will be rewarded for displaying that growth. But the strategies have to be simplistic, they have to be patient, they have to be understanding that we are late cycle in the marketplace right now. And there has to be too specific focuses when you look on the equity side: the strength of the balance sheet, and secondarily the exposure to international sales versus U.S. sales.

Right now S&P 500 companies with a U.S.-centric revenue exposure are outperforming those companies with global exposure by 530 basis points. So there is a clear distinction between those assets. Treat everything as guilty until proven innocent. Do not believe that this is a "sell all assets" 2008 style moment. Boring is going to work best. And what is boring is deliberate patience in this environment. I haven't even begun to mention a very significant and important election at the end of 2016. It's an economy that will accelerate when you look beyond 2016. The numbers are in place for that, the comparables will be in place for that, and potentially the fiscal policy will be in place for that. So I think that's enough of a summation of where we've been, where we are, and where I expect we can be.

John McCormack: Joe, I want to circle back to something as it relates to the price of oil. If I look at energy today or the price of oil today, what's the impact on that? We see obvious impact for energy companies, but as far as bankruptcies are concerned of an overall economy domestically here, and geopolitically what is the impact on the price of oil at $27 a barrel?

Joe Terranova: It's interesting because from the geopolitical standpoint, I think a lot of countries have boxed themselves in. You know, we speak about the loss of American excellence. And I'm not necessarily sure as it relates to the economy and the capital markets, that's true. If you think about American excellence, it's shown itself over the last five years in just how quickly we were able to advance the blessing of shale (I don't think anyone expected that with technology) and really it's technology itself. And that's why to me any dip in technology is an opportunity because technology continues to win out. Now, it may not be helping labor. It's reducing labor because of the efficiencies and productivity that it creates. But just think about the global impact that technology has and think about how it is helped as it relates to shale itself.

So I think that ultimately, a lot of nations have done themselves an injustice playing this game, and I think they've hurt themselves. So the question becomes - and this is what I think you're asking me, John – do you think they hurt others? Do you think there's a dynamic where the price gets so cheap that they lash out against others? No one knows the answer to that. But I think economically, they've kind of boxed themselves in. And the only solution is an economic solution. I think that's the only way out and the only reality. Now, what that specifically comes down to is that the Russians and Middle East oil producers need to come to some form of a resolution where both OPEC and non-OPEC production can begin to be significantly stated as going to be curtailed going forward. We haven't seen that so far yet to date. But I don't see the mischief that others have suggested. You know, if you think back to Russia and Ukraine, there were suggestions that that could happen at that time. You didn't see it happen at that time. So I don't know necessarily if I see that as occurring. Like I said before, the thing that concerns me going forward with oil is that I don't think the oil recovery is going to be the "V" [shape] that people expect. I think it's going to be more like a "U" and it could even be an "L" [shape].

John McCormack: All right, terrific. And just one other follow-up to that, if I could. If you look at the energy market and oil out there right now, there are people that perhaps may want to bottom-fish the market. How would you do that? Would you do it from an equity standpoint or would you do it from a debt standpoint. What do you think?

Joe Terranova: I'm very surprised that everyone who's so taken aback by what the markets did in 2015 with basically flat returns. Knowing what we knew going in 2015 as it related to the three Cs, I'm very surprised how people are taken aback by what's gone on in January. Everyone returned to work. If you think about it, in October we borrowed all the gains from November and December. There was no November and December rally. The U.S. 10-year Treasury fell back from 2005 in early November with the FOMC about to normalize rates, so to speak. So I think I'm kind of surprised. What I mean by that is things are playing out exactly as you would think they would play out. Now, that might be somewhat boring that that's the way it's playing out, but I think it's playing out exactly as people think. So if you look at the market right now, John, exactly what I said before. On the equity side, when you're talking about energy companies, year to date I'm just going to pull this up real quick….Exxon Mobil down 4%. Well who's got the biggest balance sheet on the energy side? Exxon Mobil, right? So that's something that I think the market tells you what to do. On the debt side, that's a very complicated strategy. And you better have one heck of a manager that's able to execute it for you because if you're wrong, I sure as heck don't want you managing the position like institutional speculators are right now, hedging in oil futures or having to short sell on the energy equity side.

John McCormack: *All right. Thank you very much, (Lena). Joe, thank you very much for your comments today. I found them insightful as I'm sure everyone else did.*

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