Q1 2014 PLAYBOOK:
"THE SEARCH FOR ~~YIELD~~ GROWTH"

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Key Messages

1. During the six quarters from September 1, 2011 until March 31, 2013, the U.S. 10-year Treasury yield averaged 1.86%, creating clear justification for a search for yield strategy.

2. In the first quarter of 2014, growth replaces yield as the core investment driver, as the 10-year Treasury yield nears 3% and equity markets are at historical highs.

3. In setting strategy for the year ahead, investors should first focus on minimizing risk, and consider exposure to liquid alternatives.

4. For the current bull market to extend—which at 4.9 years already exceeds the average bull market duration of 3.8 years—U.S. corporate growth must continue in the form of stock buybacks and dividends, and an uptick in acquisitions.

5. The Fed's stimulus taper gets underway in January, marking a return to normalization—and to a healthier U.S. economy as housing, manufacturing, consumer spending, and more recently, labor, gain strength.

6. Continue to look to the U.S. for growth in 2014, specifically in technology and manufacturing equities, investment grade debt of financial institutions, REITs, collateralized mortgage-backed securities, as well as agricultural and energy plays within commodities.

7. Europe is investable once again, particularly Germany, the U.K., and Switzerland, while Spain and France are best to avoid. Japan remains critical to global risk asset performance, employing aggressive monetary and fiscal policy in the months ahead to ensure that the yen remains the funding currency for the global carry trade as it did in 2013.

8. Emerging markets likely remain the most challenged asset class for 2014, although select opportunities still exist. China has been undergoing a modest recovery, and while massive economic reforms that will soon be implemented are positive for the long term, they may likely impede near-term growth.

continued

Q1 Playbook

Manage the Risk

In 2013, the S&P 500® Index (SPX) generated a 29.6% return, putting it among the top ten yearly returns since 1970. Even better was the absence of extreme volatility. Last year was also the first time since 2006 that the SPX did not experience a sell-off of at least 10%. We witnessed similar scenarios from 1991 to 1996 and again from 2004 to 2006. So, history suggests that 2013 has the potential to be the start of a multi-year period without a sell-off of 10% or more. However, since history is not guaranteed to repeat itself, investors should focus on mitigating their potential risk in the event of a correction when setting strategy for 2014.

Two scenarios for investors to have on their "correction watch list" for 2014 are a technical breakdown in the SPX and elevated volatility.

- **Watch the Technical Formation**
  Investors should closely watch the market's technical formation to determine if a correction is unfolding. The pristine bullish chart formation for the SPX in 2013 showed a series of five "higher lows" and modest corrections, none of which was greater than 8%. A good near-term point of reference for investors is 1767.99, hit on December 18, 2013, the first day of trading following the initiation of the FOMC taper. As of year-end, the 200-day moving average of the SPX was 1682.06. A sustained sell-off below 1682.06 would negate the pristine chart formation of 2013.

S&P 500® Index (SPX) 2013 (through 1/6/14)

Source: Bloomberg.

- **Keep an Eye on Volatility**
  The CBOE Volatility Index® (VIX) averaged 14.84 in 2013, trading above 18.00 on only 16 days. The high for the year was 21.91 on June 24, making 2013 the first year since 2005 that it did not trade above 22.00. Over the past 24 months, the VIX has traced out a series of "lower highs." The last of these was early October's 21.34, which should serve as a key reference point for investors.

Q1 Playbook

Bull or Super Bull?

For the current bull market to extend—which, at 4.9 years, already exceeds the average bull market duration of 3.8 years—U.S. corporate growth must continue in the form of stock buybacks and dividends, and an uptick in acquisitions. Of the 15 bull markets since 1932, five were longer than the current rally, and three of these were super bulls: 1949-1956 (7.1 years), 1974-1980 (6.2 years), and 1990-2000 (9.5 years). The question we should now be asking: Is this a bull or a super bull?

Consensus estimates for 2014 SPX earnings are $122.60, while current 2013 SPX earnings are tracking near $111. 2013 was a year of multiple expansion, with the SPX P/E ratio expanding above 16 from 2012's 14.62, amid a continued sea of liquidity that kept the cost of capital at historically favorable levels for corporations. In fact, share buybacks of SPX-listed companies accelerated to above $430 billion in 2013, compared with nearly $400 billion in 2012, a figure only modestly lower than 2011's $405 billion.

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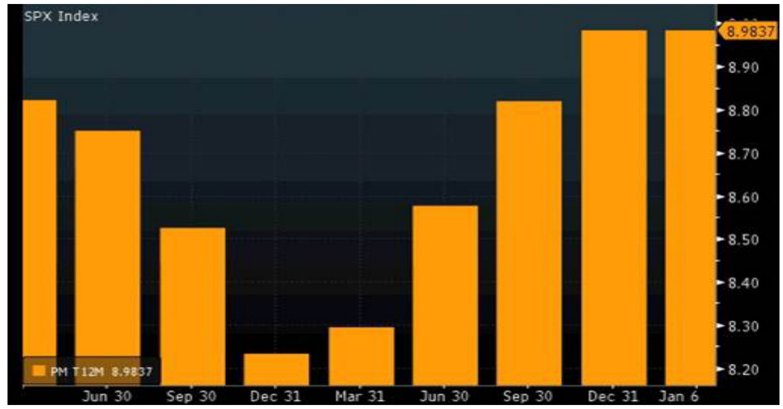
Q1 Playbook

Bull or Super Bull?
continued

In 2014, investors should expect continued strong buybacks, dividend distributions, and the emergence of acquisitions, along with continued corporate revenue growth. Expectations for 10% profit margins are not unrealistic. Although buybacks recovered in 2013, dividend growth and capital spending did not. I expect dividend growth to improve from 2013's rate of 12%, more toward 2012's 18%.

SPX Profit Margin Prior 18 Months (through 1/6/14)



Source: Bloomberg.

Capital spending will be incredibly important in 2014. After moderating in 2013 to less than 3%, I expect a robust rebound back toward 10% as corporations seeks growth via M&A, R&D, and other capital expenditures In fact, the level of corporate activities will help determine whether the current bull market, which hits five years in March, aligns with previous bull market periods, or if it is, in fact, the middle stage of a super bull market.

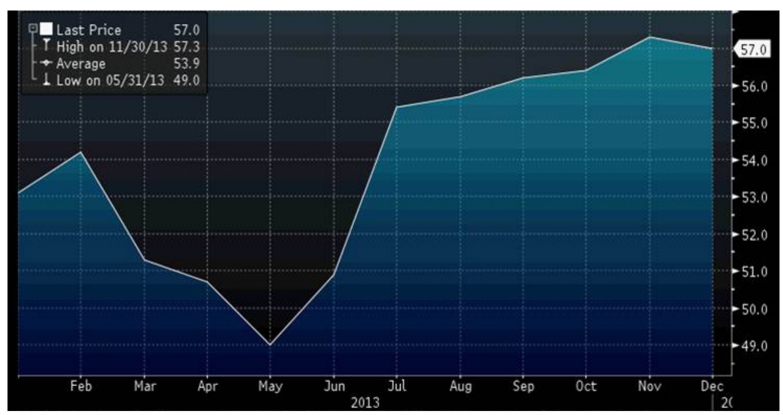
Q1 Playbook

U.S. Economy

Although it may not feel like we have seen 3% growth in the wake of the 2008 financial crisis, we have, in fact, with the posting of 3.3% GDP in Q1 2012 and 3.1% GDP in Q3 2012. Following that quarter, a dramatic deceleration in growth occurred as the anticipated fiscal drag from the pending 2013 sequester cuts took hold.

The contraction in manufacturing in the first and second quarters of last year, illustrated by the ISM figures in the chart, stands out as the most impacted area of the economy. However, late 2013 manufacturing figures suggest the effects were transitory and that a manufacturing recovery is underway. There is even encouraging end-of-year labor data that suggests a mild thaw in the structurally challenged U.S. labor market.

U.S. ISM Manufacturing Index 2013



Source: Bloomberg.

Continued strength in housing and autos, improving manufacturing, and a consumer that clearly was not impacted by higher income taxes, has created a foundation for growth acceleration in 2014. Consensus estimates are for this year's GDP to accelerate toward 3%, and I would argue that it could easily reach 3.5% if positive growth momentum is evident.

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There has been an overall perceived concern that the impending moderation of FOMC asset purchases beginning in January will present a secular peak for risk assets. Candidly, a secular peak is always possible for risk assets. When evaluating FOMC tapering and its effect on yields, I expect the capital markets will understand it is nothing more than a return to normalization, and tapering not tightening.

Another misplaced investor fear is the impact of the federal debt ceiling deadline, which can be dismissed as a near-term headline. The real deadline is likely to be in late March or early April. When policy makers in D.C. ended the October government shutdown, they very quietly inserted the "extraordinary measures" option, which will allow the U.S. Treasury access to an emergency fund of roughly $200 billion to extend the debt ceiling beyond the original early February deadline.

Investment Themes – U.S.

IT'S NOW GOODS OVER SERVICES

- Since early 2012, the services side of the U.S. economy has outperformed the goods component. I believe we have reached an inflection point. While services are not to be ignored, investors should focus first on the apparent goods recovery that is underway.

OVERWEIGHT INVESTMENT GRADE FINANCIAL INSTITUTIONS

- Moody's completed a review of the eight systemically important financial institutions in November, and downgraded the debt of four, thus removing the "too big to fail" presumption. Investors should now focus on the continued balance sheet improvement of financial institutions as they respond to new regulations lifting capital requirements. The debt issued by financial institutions stands apart from other industries.

OVERWEIGHT TECHNOLOGY

- The greatest disparity between growth and value among the nine SPX sectors is in technology. On a return basis, value tech stocks significantly outperformed growth tech stocks in 2013 by nearly 2,000 basis points. I expect a mean reversion for this growth-heavy sector.
- SPX-listed tech companies hold over $400 billion in cash ready to deploy, on M&A, buybacks, and dividends. The end-of-year comeback for Apple (AAPL) shares should carry a positive tone into 2014 for both AAPL and the overall sector.

ADD TO U.S. REIT EXPOSURE ON Q1 WEAKNESS

- Once markets digest the velocity of the Treasury yield advance, I expect U.S. REIT market fundamentals will once again stand out. Solid earnings, rental inflation, and cash generation growth support the thesis to add exposure on any further Q1 rate-driven weakness. Opportunities exist in both the equity and credit markets for U.S. REITs.

YES TO CMBS, NO TO MBS

- The fundamentals of the commercial mortgage-backed securities (CMBS) market stand to benefit from favorable tailwinds, allowing for further spread narrowing. Both commercial real estate rents and pricing remain strong.
- 2014 FOMC tapering will challenge the demand for mortgage-backed securities (MBS) as the Fed is currently the majority purchaser of new issues. The most recent FOMC minutes surprised the Street with language to suggest that Committee members favored an even tapering process between MBS and Treasuries.

KEEP AN EYE ON COMMODITIES

- I suspect consensus estimates and sentiment for commodities have become too bearish. If growth accelerates, that should lend support for the commodity complex.
- This is not a call to overweight commodities, but rather a notice to seek out opportunities in equity names that produce or provide service to the agriculture and energy industries. Any Q1 weakness in either industry may provide opportunity when measured on the balance of 2014. Investors may wish to consider using further gold price weakness in Q1 to raise weightings to 4% from the 3% maximum that I suggested throughout 2013.

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Wasn't the Cyprus banking crisis at the beginning of last year supposed to be the catalyst for a lousy year for risk assets? In reality, 2013 was an excellent year for Europe which underwent dramatic healing from the deep recession.

Europe remains investable for Q1 2014; however, opportunities may be restricted to risk assets of Germany, Switzerland, and the United Kingdom. Unlike the U.S., there will not be a shift in monetary policy from the ECB, which will remain highly accommodative during the quarter.

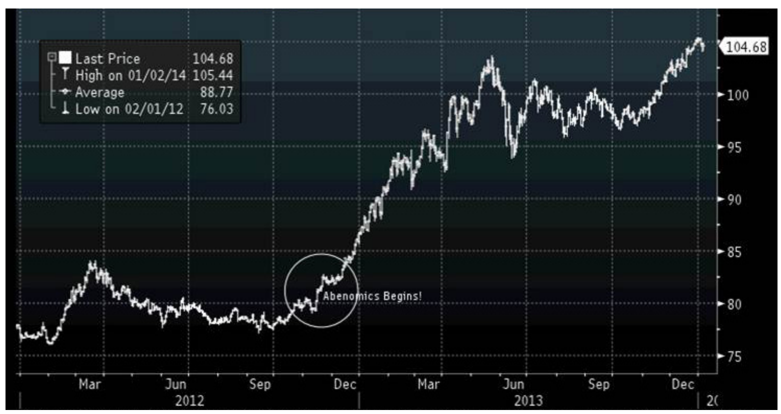
Spanish 10-Year Treasury Yield Prior 18 Months (through 1/6/14)

Source: Bloomberg.

Spain has enjoyed a modest recovery in recent months that I suspect has now run its course. The market's focus will now be on Spain's structural economic challenges which, more than likely, will impede any further asset recovery. France remains a "no touch" region as the dynamics of its economy suggest vulnerability to renewed economic contraction.

Investors will await the message from the Bank of Japan (BOJ) at its April 30 monetary policy meeting. That meeting will provide policy makers an opportunity to offset the April 1 enactment of a consumption tax rate hike from 5% to 8%. Given the determination of Prime Minister Shinzo Abe and BOJ Governor Haruhiko Kuroda, I do not expect investors to be disappointed.

Japanese Yen – Impact of "Abenomics," 2012-2013



Source: Bloomberg.

The aggressive fight against decades-old deflationary pressure will more than likely be expanded at that meeting which will support even more risk assets than announced in 2013. I expect that fiscal policy measures will also be introduced during the year, which may include a lower corporate tax rate, policies to increase nuclear power generation, and the completion of the Trans-Pacific Partnership trade pact.

Unlike other major developed economies, I do not expect Japan's GDP to accelerate in 2014, due largely to the consumption tax rate hike. Easing efforts therefore must intensify. That will foster an environment of continued weakness for the Japanese yen and its use as the funding currency for a favorable global carry trade. The structural challenges within the Japanese economy are many; however, I am focusing on the market consequence from policy makers' efforts to stimulate those depressed economic fundamentals. Japan is in a similar place to the U.S. during 2009/2010 in which "reflation" was the Federal Reserve's objective.

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Q1 Playbook

Developed Markets
continued

Where the yen trades in Q1 will be critical to risk asset performance, as it was in 2013. In May, the yen's decline stalled out and correlated with global risk assets trading unevenly over the coming months. Not surprisingly, resumption of the yen's downtrend in October has correlated with strong SPX performance.

Investment Themes – Developed Markets (Non-U.S.)

LONG GERMAN CONSUMER AND SHORT FRENCH CONSUMER

- For investors with a European equity focus, I expect long German consumer exposure versus short French consumer exposure will be the optimal opportunity in Q1. When measuring two developed economies with similar demographics, there is no greater disparity than between Germany and France.
- Unemployment in Germany hovers at a multi-decade low of 6.9%, while France's unemployment rate continues to rise, now above 11%. Disposable income effects, differing fiscal policies, and export ability all point toward the German consumer contributing to the earnings growth of companies that provide goods and services to that consumer.

JAPANESE REITS

- Japan's residential and commercial real estate markets have benefited from fiscal and monetary easing policies. I expect a reacceleration for the Japanese REIT market similar to the early months of 2013 as reflation efforts continue and long-term plans are unveiled ahead of the 2020 Tokyo Summer Olympics.
- Housing loans and housing starts have both been trending higher since late 2011. On the commercial real estate side, office vacancies have fallen from June 2012's 9.43% to a current 7.56%, and I would expect that rate to decline even further toward 5% in 2014.

Q1 Playbook

Emerging Markets

Along with precious metals, I expect that emerging markets assets will be in a vulnerable position again in Q1 and may be the most challenged of all global risk assets. Though they were afforded an opportunity to recover from a summer of elevated volatility and poor performance with the FOMC "no taper" announcement in September 2013, they will not be afforded the same opportunity again in Q1. Tapering in the U.S. has started, and the pace of asset purchases may moderate rather quickly with a complete ending by July 2014.

Additionally, I am concerned that a late Q1 announcement for further fiscal and monetary easing from Japan will initiate a new leg lower for the Japanese yen. 2013 began with significant yen weakening on the initial monetary easing announcement, which became the catalyst for the cycle of emerging market currency weakness and eventually emerging market equity weakness. Emerging market economies need strong currencies to attract money flows. Unfortunately, 2013 was an environment of outflows for those emerging market economies.

Structural domestic reform is underway in China and should set the foundation for long-term sustainable growth. Early in November 2013, the third Plenary Session of the CPC Central Committee set forth significant economic reforms focusing on open, competitive markets, the environment, new child policies, and product safety and services. Since the announcement, Chinese equities appreciated to a new high for 2013.

However, China's near-term growth may be impeded, as it was earlier in 2013. I do not expect a Q1 reversal for the modest economic recovery seen over the past few months. Manufacturing indices have moved higher once again, inflation remains moderate, running at about 3%, and the value of China's currency recorded another new all-time high on October 24, 2013.

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Q1 Playbook

Emerging Markets
continued

For investors, China's Q4 2013 GDP is the one metric to focus on early in the upcoming quarter. Sustaining above a 7.5% print should be good enough to not disrupt global risk assets.

Investment Theme – Emerging Markets

ALLOCATE TO EMERGING MARKETS EXPOSED TO THE U.S. & CHINA

- Given the appearance of a modest growth rebound in China for Q1 2014, I have expanded my list of attractive emerging markets economies to include not only those with ties to the U.S., but also those with a high correlation to the Chinese economy. Taiwan and India screen well, with high correlations to both China and the U.S.
- I suggest investors allocate to these particular emerging markets –Taiwan, South Korea, Mexico, or India – by investing in select, domestic companies, rather than via a pure equity index play.

Q1 Playbook

Final Thoughts

Prudent portfolio decisions are made based on solid evidence, executed without emotion. While it is unlikely for markets to repeat the strong performance of 2012 and 2013, investors can feel confident in their approach to 2014 if they have proper diversification and risk management strategies in place.

Health & Happiness!

Joe

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Joe Terranova is chief market strategist for Virtus Investment Partners. He was elevated to that position in June 2009, having started with the company in the role of chief alternatives strategist.

In his current role, Mr. Terranova works with Virtus' regional sales teams and the financial advisors who sell the company's investment products, providing insight into the domestic and global investing landscape and has represented Virtus as a keynote speaker for several financial institutions. He is a member of the Virtus Investment Oversight Committee.

Prior to joining Virtus in 2008, Mr. Terranova spent 18 years at MBF Clearing Corp., rising to the position of director of trading for the company and its subsidiaries. In this capacity, he managed more than 300 traders and support staff for MBF, one of the New York Mercantile Exchange's largest firms. His work was highlighted as the feature story in the June 2004 issue of *Futures* magazine.

Mr. Terranova is perhaps best known for his risk management skills, honed while overseeing MBF's proprietary trading operations during some of the most calamitous times for the U.S. markets, including the first Gulf War, the 1998 Asian Crisis, 9/11, and the collapse of Amaranth Advisors. In 2003, he was one of the first Wall Street professionals to make an early call for higher energy, natural resources, and commodity prices. In June 2008, he cautioned investors to move to the sidelines in commodities and, in March 2009, he encouraged investors to ignore the global "embracement of pessimism" and overweight equities. Before joining MBF, Mr. Terranova held positions at both Swiss Banking Corp. and JP Morgan Securities.

Mr. Terranova has been an ensemble member of the CNBC *Fast Money* franchise since 2008. He also frequently contributes exclusively to CNBC's other business programs. He is the author of "*Buy High, Sell Higher*" (Business Plus, 2012), a book about the "new rules" of investing based on his years as a professional trader.

In 2007, Mr. Terranova and Hockey Hall of Fame player Mike Bossy established "Bossy's Bunch," a program that rewards excellence in the classroom for elementary school students.

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