# Q4 2012 PLAYBOOK: Where's The Euphoria?

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*Whether a corporate CEO, professional sports coach, or even just a parent, much of the time spent in private reflection tends to focus on "what could go wrong" and identifying preventive measures. Investors are no different. In the past thirteen years, two historic market declines of greater than 45% blindsided investors. Investors are justified to consider whether a third secular decline is pending. Certainly much of the media coverage of the capital markets focuses on that scenario.*

*My third quarter playbook, "The Trend is Your Friend," focused on the potential upside for a market that was in the midst of an 11% correction from April into early June. This quarter's playbook identifies the conditions that suggest downside potential for the S&P 500® Index (SPX), which has appreciated 14% from its 1266.74 low on June 4, 2012.*

## Q4 Playbook

### Market Overview & Sentiment

The thesis for the third quarter playbook toward higher pricing was built upon the premise that markets had already priced in muted growth. In fact, I specifically stated that:

> *"Economic data consistent with 2% GDP growth will not foster enough selling pressure to breach the June 4 low as the market has already, during the second quarter, priced in 2% GDP growth. Furthermore, favorable consideration must be given to the sharp decline in oil prices, historically low private sector borrowing costs, and an uptick in housing data."*

Further favorable conditions presented themselves in the third quarter as the European Central Bank (ECB) emphatically alerted markets that it stands ready to be Europe's sovereign bond buyer of last resort. Corporate earnings were resilient, maintaining positive sales and EPS growth contrary to analysts' expectations for a slip into negative territory. Additionally, in September, the FOMC placed another "put" under risk assets with a third round of balance sheet expansion. The combination of it all equated to a 5.76% SPX gain in the third quarter.

However, what did not improve in the quarter was market sentiment. I would argue that, historically, a necessary component of any secular market top is alignment with very positive market sentiment, let's call it "euphoria." Euphoria generally equates to full participation by bullish forces. That cannot be said about the current market. Euphoria is missing and its absence is evidence that any near-term correction for the market should be shallow in nature as full bullish participation is achieved.

On March 24, 2000, the "irrational exuberance" secular top was traced out for the SPX at 1552.87. Fast forward to October 11, 2007 for another SPX secular top at 1576.09, this time fueled by the housing market euphoria. The SPX on September 29 closed out the quarter at 1440.67, just below its 2012 high established on September 14 at 1474.51. The type of euphoria that surrounded the two previous secular tops is absent.

So while prudent to ask "what could go wrong," the evidence does not suggest an imminent secular top. Perhaps as the calendar advances into 2013, a grand compromise regarding the U.S. fiscal cliff, oddly enough, will introduce euphoria and suggest a secular top.

For now, my focus is on any evidence that suggests a modest correction is unfolding in the fourth quarter. The upside potential isn't this quarter's concern; it's the downside.

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# Q4 Playbook

## Corrective Evidence

The highlight of the fourth quarter will be the November 6 U.S. presidential election. Bookending the election is the early October earnings season and the year-end holiday shopping season. Also, expect markets to look back over to Europe around Halloween, with a focus on Spain's funding needs and Greece's troika negotiations. I will be watching the following indicators for any evidence that a shallow market correction is unfolding.

### > SPX Technical Formation

I do not suggest relying on purely technical indicators for investment decisions. However, using technical formations along with a myriad of other market indicators can prove to be very beneficial.

This quarter, let's begin by looking at the SPX technical formation and then consider the fundamental indicators of corporate earnings, the U.S. presidential election, and the European equity and debt markets.

Year to date, the technical formation for the SPX has been pristine and highly useful. In fact, since the SPX elevated above its 200-day moving average on January 3, 2012, there have only been three days when the closing price for the SPX has been below the 200-day moving average. The 200-day moving average is now at 1359.03; an unlikely close below 1359.03 would signal a dramatic shift in the market and would warrant significant reductions in portfolio holdings.

A more likely near-term scenario would be a close below 1422.38, which was the intraday high achieved on April 2 of this year that provided significant resistance for the SPX throughout the second quarter. This occurrence would confirm a reduction in allocations from overweight back to market weight. Investors should also consider a close below 1422.38 as the initiation of a shallow, modest correction.

### > Corporate Earnings

Historically low private sector borrowing costs continue to benefit corporate profits. In fact, year to date, over 35% of the growth in corporate profits can be attributed to declining debt service costs. Given the recent FOMC QE3 announcement, that trend should continue.

Another theme for the upcoming reporting season will be the return of capital to shareholders. Historically, the fourth quarter tends to provide a surge in the return of capital to shareholders via special dividends. I expect the combination of that historical strength and concern over rising dividend taxation rates in 2013 will motivate cash-flush corporations to announce multiple and significant special dividends in the coming weeks.

In addition, the 2% decline in the U.S. dollar in the third quarter will provide a modest, unexpected currency tailwind.

Therefore, if there is a "red flag" for the upcoming earnings season, it is the presentation of disappointing negative EPS and sales growth. In the second earnings quarter, the technology, financials, and industrials sectors exhibited strong growth, while energy and materials posted negative growth. I expect that once again the leadership message, whether favorable or not, will come from technology.

### > Gridlock Wins on November 6th

On November 6, the U.S. electorate goes to the polls to vote. What many don't realize is that their vote, and the outcome of the election, will ultimately contribute to the arrival time of the next recession. In 2001, we were challenged with a corporate balance sheet recession; in 2008, a consumer balance sheet recession. The next recession, more than likely, will be a government balance sheet recession. A government balance sheet recession is the tipping point of many years of increasing debt that is no longer sustainable and must be de-levered. A vote that ensures continued Washington D.C. gridlock on November 6th expedites the arrival of a government balance sheet recession.



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## Q4 Playbook
### Corrective Evidence
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With a gross federal debt level above 90% for the past two years and current projections that suggest it will remain above 90% for another three years, much work needs to be done in Washington. Continued muted growth will be the expectation for the economy should we elect another cast of do-nothing politicians. A balance between abrupt austerity and continued liberal spending must be agreed upon. If there is a period of elevated concern during the fourth quarter, I suggest it will coincide with the election and the digestion of the winners with regard to their ability to strike a middle ground.

> **DAX Index & European Sovereign Debt Market**

In the third quarter, ECB President Mario Draghi provided necessary financial leadership in Europe for the first time since the beginning of the global credit crisis. His words had an extremely positive effect on both sovereign debt markets and the equity market that matters most to Europe, the German DAX.

Over the coming quarter I will be watching the German DAX closely to determine if a reversal of the third quarter's 12.48% gain unfolds. Since the European debt crisis began in 2010, the DAX has telegraphed the two significant market declines that occurred in the summer of 2011 and the second quarter of 2012.

Also, keep an eye on the yield for Spain's 5- and 10-year government bonds. On July 24, the yield for the 5-year was 7.50% and 7.57% for the 10-year. At the end of the quarter, the yield for the 5-year fell to 4.69% and 5.90% for the 10-year.

Spain faces redemptions of 20 billion euros this month and announced borrowing needs of 207 billion euros for next year. The ECB, through its language and eventually through the Outright Monetary Transactions (OMT) program, must keep the third quarter's stability in place, particularly for the Spanish government debt market.

## Q4 Playbook
### U.S. Economy

It must be tough to be an economist. Think about the third quarter for a minute as it relates to the economic data here in the United States. Manufacturing, which had been the bright spot for nearly three years, stalled out. In fact, the ISM Manufacturing Index for the last three months posted consecutive sub-50 readings (ranging between 49.6 and 49.8) for the first time since 2009. Private sector job growth has not printed above 200,000 since February. Inventories are building, and new export orders declining.

Given the collective body of muted evidence, economists were justified to expect sub-2% GDP growth. But, as I stated in my Q3 playbook, the SPX had already priced in sub-2% growth. It is a classic example of "tell me something that I don't already know." Well, what economists and money managers didn't know was that the composition of the U.S. economic contribution would change. A shift occurred in the third quarter. Services were favored over goods, both in the economic data and in portfolio strategies.

The ISM Non-Manufacturing (services) Index recorded two consecutive monthly increases, August 53.7 and July 52.6. Domestic auto sales continued to improve, having recorded a seasonally adjusted annual rate of 14.46 million for August, the highest reading since the "cash for clunkers" days of three years ago. The housing data for the third quarter continued its surprising recovery in terms of both prices and sales. The months of supply for existing homes is now at 6.1 months, below the 30-year historical average of 7.4 months. Retail sales improved, 0.9% in August and 0.6% in July, reversing the second quarter negative trend (June -0.7%, May -0.1%, and April -0.5%).

The collective body of evidence does not suggest a robust growth outlook for the economy. Clearly, the FOMC acknowledged that with a new round of asset purchases (QE3). Let me be the first to candidly offer how difficult it will be to forecast what the economy will look like on December 31. In fact, I will not even try. What will be important for the market is enough good evidence on the services side of the economy to offset the obvious weakness in labor and manufacturing. Although the social consequence of 2% GDP is lousy, the market consequence was already priced in back in the second quarter.



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## Q4 Playbook

### China

One of my expected tailwinds for 2012 has yet to emerge – resurgent Chinese demand. As the baseball season heads toward the post season, an analogy can be drawn. China in 2012 is the injured All-Star clean-up hitter who has yet to play but his team is still headed to the playoffs. What a bonus if the team gets him back for the playoffs! If Chinese demand and growth reaccelerates in the fourth quarter, than I suggest it will be rather difficult for the markets not to appreciate beyond SPX 1500.

Somewhat similar to the U.S., a soft landing in China has already been priced in to global equity prices. Pessimists might offer that what has not been priced in is a hard landing. I disagree. The evidence doesn't support a hard landing. The transition of power, which will begin to take shape with the November 8 Communist Party congress, has taken much of policy makers' attention away from aggressively stimulating growth through both fiscal and monetary easing. Additionally, the scandal surrounding former Politburo member Bo Xilai has also deflected the attention of Communist leaders away from growth stimulants.

China manufacturing is weak, with recent PMI readings at 49.2 and 50.1. Global markets have priced in 2012 China GDP at 7.5%. Industrial production in August rose 8.9% year on year, the weakest growth since the spring of 2009. Export growth was only 2.7% last month. But these are known conditions.

Lastly, the correlation between the Chinese currency (yuan) and global equity market performance remains highly efficient. Beginning in early May, the yuan reversed trend and began to depreciate into late July. Guess which direction global equity markets traded? Lower. Consistent with global equity market appreciation since late July, the yuan has appreciated to its highest level since 1993, as of September 28. Yuan appreciation is not consistent with a hard landing. Maybe the All-Star clean-up hitter might just take the field before 2012 closes out.

## Q4 Playbook

### Investment Themes

Bullish momentum has clearly been traced out over the past ten weeks, providing evidence that the path of least resistance is higher. Earlier I stated that the fourth quarter's focus should be on the downside potential, not the upside potential. Sounds confusing? Actually, it is rather simple. Historically, investors diminish their returns when they anticipate market reversals without the confirming evidence. In fact, the hardest investment discipline is to stay committed to the rising market. What is hardest to do is usually the correct choice.

For those concerned that a third secular top is pending, I see it as unlikely without the currently absent euphoria. More realistically, a modest correction could unfold in the fourth quarter, but it must be confirmed by the evidence. Utilize the four indicators outlined above. But until they are confirmed, stay committed and consider the following investment themes for the quarter.

1. **Investing in underperforming assets will disappoint.** In the wake of the second quarter's correction, speculative capital moved out of risk assets and positioned for further downside in the third quarter. That strategy has led to significant year-to-date underperformance, in particular for the hedge fund community. For the fourth quarter, the temptation will be to quickly catch up with 'home run" types of investments. I expect that strategy will be wrong. As an example, **I would discourage investments in steel and coal,** as the fundamentals do not provide evidence that the year-to-date decline can be reversed.

2. The FOMC's introduction of QE3 has raised concerns about **inflation**. The widening spread between TIPS and the 10-year Treasury represents those expectations. In the third quarter, the spread widened nearly 30 basis points. Additionally, inflation expectations are evidenced by the rise of precious metals prices over the past eight weeks. Continued allocations to both TIPS and precious metals are warranted. However, benign core inflation readings remain in the U.S. (1.6% in August) and in emerging markets. Money supply growth at 6.3% is down from 10.4% in February 2012. **Overweight inflation positioning is not currently warranted.**



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3. **The search for yield will continue.** The 10-year Treasury began the third quarter with a yield of 1.65% and finished the quarter with a yield of 1.63%, despite extensive monetary easing globally and here in the U.S. I expect that what will matter most to the Treasury market will be the absence of growth. Continue to expect Treasuries to trade consistent with growth expectations. **In that environment, dividend-paying stocks will be favored. I would also maintain overweight exposure to high-yield corporate bonds.**

4. **The impact of QE3 on supply for the mortgage-backed security market is significant.** With the FOMC committing to $40 billion in monthly bond purchases and $27 billion rolling off, the Fed will be the major buyer of monthly issuances. The availability of supply for the private sector will be no more than 45% of the new issuances. **Remain overweight.**

5. **Rising tensions between Israel and Iran have placed oil at the top of business and mainstream headlines.** Consistent with my long-standing belief that sometimes the best investment is not to make one, I believe this applies to oil now. I fear the volatility surge that would accompany any Middle East conflict will raise emotion levels for investors and diminish returns. As far as **the spot price of oil goes, I expect it will trade within the range of $85 to $100,** supported on the downside by Middle East conflict concerns and limited on the upside by an already agreed upon massive global strategic petroleum reserve (SPR) release should a spike above $125 in Brent crude present itself.

6. While most of the world is challenged by limited growth and rising government debt, **the U.S. appears to have a potential elixir that all nations desire. It is called "the blessing of shale."** The domestic surge in the production of shale oil and gas will be a favorable condition for the economy over the next few years. For now, it is a favorable investable theme. Last quarter, I suggested investments in shale transportation via MLPs, which remains unchanged. **In the upcoming quarter, let's expand upon this theme to include domestic natural gas producers, both liquid and dry.** Natural gas investments should be viewed as longer term. I expect the trough for spot natural gas prices is in place.

7. The trough for the U.S. housing market also appears to be in place. Additionally, the auto industry is reaccelerating growth. The combination of the two should prove beneficial for **insurance companies specializing in auto, property, and casualty coverage.**

8. **The evidence does not suggest reflation trades should be increased back to overweight.** In the wake of the FOMC's QE3 announcement, reflation assets experienced a temporary rise that has moderated. As in 2009 and 2010, the expansion of the Fed's balance sheet equated to a lower U.S. dollar and higher reflation assets. **What I expect will be different this time around is the position of monetary policy makers in the eurozone.** The eurocurrency cannot react in an appreciative fashion similar to 2009 and 2010 as the counter to a lower U.S. dollar. Much is at stake, and I would argue that the eurozone needs the cheapest global currency in order to position peripheral European nations for any chance of resurrecting growth and climbing out of their current recessions. The periphery is uncompetitive; Germany is truly the sole competitive economy in the eurozone. **A weak euro is essential to ending the debt crisis.**

9. **Ahead of the upcoming holiday season, investors should increase allocations to select consumer discretionary equities.** The qualities of those favored companies include an increase in 2012 market share, strong year-to-date performance, and a U.S.-centric focus. As examples, I offer TJX Companies Inc. (TJX), Limited Brands (LTD), and Dick's Sporting Goods (DKS).

10. View **growth and value as equals in the fourth quarter.** Favor **large cap over small cap.** The perfect blend of **growth and income** should reward investors.

11. My Q3 playbook highlighted **emerging market** exposure beyond the BRICs via Colombia, Chile, Taiwan, Mexico, and South Korea. Valuations for those markets are stretched. Investors may begin to pare back holdings with the intent of reallocation back toward India and Brazil.



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## Q4 Playbook

### Health & Happiness

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It would be rather easy, given the third quarter's strong performance, to make the tone of this quarter's playbook one of "selling a potential market top." Quite candidly, I believe that is irresponsible. My job, and yours, is not picking market tops; rather, it is identifying evidence that suggests favorable market conditions are reversing.

In hindsight, many investors complain they did not "sell the top." However, absolute market tops are generally traced out without any changing fundamental evidence. The difficult truth is that investors do not acknowledge the evidence that supports reducing holdings when price reversals lower gain momentum. An "inside baseball" phrase for this is "investors froze."

Within this playbook I have identified the absence of the euphoria that accompanies secular tops. I also offered four indicators that I am gauging to determine if a modest correction is about to unfold. Otherwise, until the evidence presents itself, I suggest that investors should remain allocated to what is an appreciating market.

Finally, after 20-plus years as a market participant, I believe less in the existence of "market wizards" than I do in the existence of disciplined money managers. Successful investing really is all about maximizing winners and minimizing losers.

As baseball approaches its Fall Classic, let me remind you – the value is not in the home run hitter, but in the .325 hitter. Trust me, I know. I am a Yankees fan!

I wish all of you an abundance of life's two greatest assets – ***Health & Happiness!***

**PERFORMANCE AS OF SEPTEMBER 30, 2012**

| | Closing Price 9/30/12 | Q3 2012 | YTD 2012 |
|---|---|---|---|
| S&P 500 Index (SPX) | 1440.67 | 5.76% | 15.07% |
| Dow Jones Industrials (INDU) | 13,437.13 | 4.32% | 10.38% |
| NASDAQ 100 Index (NDX) | 2799.19 | 7.01% | 23.87% |
| Russell 2000® Index (RTY) | 837.45 | 4.88% | 13.85% |
| | **Closing Price 9/30/12** | **Q3 2012** | **YTD 2012** |
| U.S. Dollar Index | 79.89 | -2.07% | -0.92% |
| Euro/U.S. Dollar | 1.30 | 1.52% | -0.78% |
| | **Spot Price 9/30/12** | **Q3 2012** | **YTD 2012** |
| WTI Oil | 92.10 | 8.51% | -6.72% |
| Brent Crude Oil | 112.15 | 14.88% | 5.04% |
| Gold | 1773.50 | 10.27% | 12.41% |
| Copper | 375.35 | 7.17% | 8.78% |
| Natural Gas | 3.32 | 17.56% | 10.71% |
| | **9/30/12** | **6/30/12** | **12/30/11** |
| U.S. 2-Year Treasury Rate | 0.23% | 0.30% | 0.24% |
| U.S. 10-Year Treasury Rate | 1.63% | 1.65% | 1.88% |
| CBOE SPX Volatility Index (VIX) | 15.73 | 17.08 | 23.40 |
| | **Closing Price 9/30/12** | **Q3 2012** | **YTD 2012** |
| Technology (XLK) | 30.83 | 7.31% | 21.98% |
| Consumer Discretionary (XLY) | 46.79 | 6.88% | 20.43% |
| Financials (XLF) | 15.59 | 6.53% | 20.31% |
| Health Care (XLV) | 40.12 | 5.57% | 16.16% |
| Consumer Staples (XLP) | 35.83 | 3.03% | 10.65% |
| Materials (XLB) | 36.80 | 4.28% | 10.48% |
| Industrials (XLI) | 36.53 | 2.41% | 8.68% |
| Energy (XLE) | 73.44 | 10.64% | 6.73% |
| Utilities (XLU) | 36.39 | -1.62% | 0.68% |

*Past performance is not indicative of future results.*



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Joe Terranova is Chief Market Strategist for Virtus Investment Partners and a member of its Investment Oversight Committee. Mr. Terranova is a regular contributor to CNBC, appearing as a full-time panelist on the highly-rated daytime program *Fast Money* and a frequent panelist on *Fast Money Halftime Report*. He is the author of the book *"Buy High, Sell Higher,"* published by Business Plus. He is also in demand as a keynote speaker for the investment industry, known for his insightful viewpoint.

Prior to joining Virtus in 2008, Mr. Terranova spent 18 years at MBF Clearing Corp., one of the largest firms on the New York Mercantile Exchange, where his work as Director of Trading was the subject of a June 2004 feature in *Futures* magazine. Earlier in his career, he held positions at Swiss Banking Corp. and JP Morgan Securities.

Mr. Terranova is perhaps best known for his risk management skills, honed while overseeing MBF's trading operations during the calamitous U.S. markets of the first Gulf War, 1998 Asian Crisis, 9/11, and 2006 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 2008, he cautioned investors to move to the sidelines in commodities, and in 2009, encouraged them to ignore the global "embracement of pessimism" and overweight equities.

Mr. Terranova holds a bachelor's degree in finance from the Peter J. Tobin College of Business at St. John's University in New York.

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