Virtus Vital Signs, December 2015
Market Insights from Joe Terranova, Chief Market Strategist
from an interview conducted on December 4, 2015

Brian Portnoy: *Hello, this is Brian Portnoy, Director of Investment Education for Virtus Investment Partners and welcome to Virtus Vital Signs for the month of December 2015. As always, I have with me Joe Terranova, our Chief Market Strategist and Senior Managing Director. Hello Joe!*

Joe Terranova: Good morning, Brian. It is amazing the year is coming to an end rather quickly.

Brian: *I know, unbelievable, and there is a lot going on, so let's dive into some of the big trends going on around the world. So, we had a big jobs report today, and the conventional wisdom is that this clears the way for a Fed rate increase. A couple of questions… Number one, do you agree with the conventional wisdom? Number two, what is the significance of that increase for everyday investors?*

Joe: The Fed will normalize rates in the coming weeks; that's completely expected and I believe it is fully warranted. There are two conditions—and they are capital markets related— that gives me the confidence the Federal Reserve will act. It is the improvement in equity valuations and the reduction of volatility. As it relates to what the individual investor should be doing, they should be monitoring over the coming year whether the conditions are in place for an acceleration in domestic economic growth that would warrant the Federal Reserve moving further and it not being a one-and-done rate hike.

Brian: *Okay, interesting. Now one of the discussion points in the markets these days is central bank divergence. So, we have the likelihood of the Fed increasing rates. It does not appear as likely and it may be even the opposite over in Europe. What is your assessment of that potential divergence and its consequences for how we think about things?*

Joe: Well the answer to my question left many scratching their heads saying okay, Joe tell us. Do you think the economic growth is going to be there, and in anticipation of the question you just presented, let me give you the insight of what I believe is going to happen. The world continues to battle deflation. Global central banks continue, through currency devaluation and monetary easing, to export their deflation to the United States, lifting the value of the U.S. dollar. I think it was very interesting this week that the ECB and Mario Draghi disappointed the markets with what they announced. I think that the markets now suspect that the Europeans are out of bullets as it relates to monetary easing, and that presents a dramatic shift in the thought process for investors. That means the potential is there—and this is a headline for everyone because it's against consensus, Brian—everyone believes the U.S. dollar continues to march higher and that is the overall consensus. I believe the potential is there in the first three or four months of the year for the U.S. dollar to actually find a peak relative to the euro currency on the foundation that the ECB does not have any more tools at their disposal. What does that mean? That means the value of the U.S. dollar begins to correct itself, benefits the export economy, and multinationals once again. So, within that process, I think it's going to be very difficult for Europe to heal itself, which is going to be imperative for global growth to accelerate. To go back now and answer your first question, I do not know that the economic evidence is going to be there for the Federal Reserve. I am very suspicious and in fact, I am very doubtful that the U.S. will have the economic evidence to begin a cycle of rate hikes in 2016 because of what we're seeing in the currency markets because I think the Europeans are out of bullets.

Brian: *That's really interesting, and so what you are suggesting is that, and this is against conventional wisdom from what I have heard, is that the dollar rally is going to taper off and maybe even reverse itself a little bit. That has pretty important implications for how we think about managing portfolios in 2016 in terms of the sectors that benefit or get hurt from that flattening or even reversal of the trend. Is that true?*

Joe: Yes, so here is what you need to do as an investor. You need to come out of the gates in January not looking to deploy capital. You need to be an observer. You need to have the same mindset that you had in 2015 since the summer…. Flat is the new up…. Preservation of capital…. What does my downside look like? Brian, the potential is there that you could see at some point this year a significant conversation as it relates to, is this going to be the year when both stocks and bonds provide negative returns for investors? I am not saying that's the result, I am saying that is the potential conversation that you could be having. I want to come out of the gates very early this year not aggressive, not aggressive at all, but very passive. I want to be an observer. I want to focus on the U.S. dollar. Has the U.S. dollar, will the U.S. dollar be able to find its peak? Yes, that is against conventional wisdom. I think what is going to move the market in 2016, is one of two things. An exogenous event, or secondarily, a consensus theme being incorrect, and that's going to push the market—and when I say the market, I mean the equities and the fixed income market—in one direction. Consensus is going to be wrong about something because I think you would agree with me right now. If you look at all the house views of the investment banks, everyone is basically saying the same thing. Higher dollar, U.S. orientation, emerging markets not just yet ready to heal. Consensus is overwhelming in one direction. Look for two things, the exogenous event and consensus to be wrong, and I suspect consensus could be wrong about the currency market and the U.S. dollar.

Brian: *Okay, that's really interesting… So the pundits are now coming out with their 2016 outlooks. As I read, for many of them there is consensus over sort of muted returns in 2016 for both stocks and bonds, not necessarily negative but definitely muted returns with a fair uptick in the amount of volatility. Is that a view that you would concur with?*

Joe: So, when you look at 2016, you have the overall mindset as you've had in 2015 that flat is the new up. Additionally, I am not a closet indexer. I believe that you can create alpha in your portfolio. That being said, I hold disdain in 2016. I want to not seek beta opportunities, I want to focus on alpha opportunities. Momentum names in 2015 have worked incredibly well. In 2016, you might want to be a little bit careful with that strategy. So, I think what you look for, Brian, is I never give a target on the S&P because I do not believe anyone knows where the markets are going, in particular if you are going to get the exogenous event. What I look for, is I look for particular asset classes to get tailwinds behind them, and the possibility exists that an environment if the U.S. dollar can begin to correct itself, then you will begin to see a little bit of the healing process for the multinationals. That will help some of the high yield corporate bond market as the significant global exposure, the exposure to the resource orientation. But again, I want to observe, and I also want to caution investors, and we are going a little bit longer on this call than we normally do, but it is good to do it because we are preparing for next year. Be very, very careful and conscious of something. Generally, the December to February period, the bottom third of the S&P 500 performers from the previous year that being 2015 tend to outperform. I do not want investors to chase that. I want investors to observe it. I want them to find the fundamental evidence to suggest that there is conviction behind that shift in performance. One of the ways you would do it is seeing a shift in the U.S. dollar. Currency markets have driven equity valuations over the last six months, and they are going to continue to do so in the first six months of 2016.

Brian: *Really interesting. So, it seems like the theme of the year looking out is potentially vigilance. Stay on top of the trends, understand what is going on, and being able to react to that new information as it comes in.*

Joe: Yeah, I would just lastly say, Brian, understand it is late cycle for everything. Most asset classes are valued fairly given their fundamental and their technical evidence, and that creates a difficult environment for money managers or investors, but again it is about alpha.

Brian: Okay, okay. Yeah, well we did go long this call, but I think it is worthwhile as we wrap up the year, and I think some of your comments today are fascinating. So, happy holidays to you and your family, Joe, and we are going to talk to you at the beginning of 2016.

Joe: Happy holidays, everyone!

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