

It's the Tortoise, Not the Hare in 2010

Authored by Joe Terranova, Chief Market Strategist

I think we have all had enough conversation about 2009. Personally, I tried to focus on the opportunities Armageddon presented last year. As we enter into 2010, the 2009 comfort assets should continue to be favored in what should be a seamless transition.

When we look forward, we should ask, when will the Fed pull the plug on all the goodies it has been injecting into the markets for so long? We know it's coming in 2010, but the question is when will it happen? We know the Fed's asset purchase program will fade away this year, but I also have no doubt in my mind that the Fed will start to remove some liquidity. It's all a question of when. At the same time, I think it's a big mistake to believe that the Fed's first move of the year is an increase in the Fed Funds Rate. Instead, I think we will see a steady move by the Fed to unwind its bloated balance sheet.

In light of all the Treasuries that have been bought up in the past year, you need to ask yourself if the market itself can withstand any further selling of Treasuries. Supply is ample right now, and the U.S. has suggested that it will move the issuance of new debt from the short end of the curve to the six-to-seven year expiration.



If you're an investor, you're going to demand more yield as you go further out on the curve, right? So, here's a trend you should understand. Looking back to June 2007, we note a critical peak in the 10-year yield of 5.32 percent. Last year, in June, the 10-year Treasury yield had a high of 4 percent. At the moment, we've already challenged 3.75 percent. I see a clear downtrend in the 10-year Treasury yield. As the government issues more longer-term debt, it becomes harder for the Fed to control the longer-end of the curve; they can only control the front. As such, they really can't affect private sector borrowing costs for 30-year mortgages as much as they would like to. The steepening of the yield curve should

continue. My concern is, should the 10-year note break above 4 percent, you'll see a rather aggressive rise in 10-year yields at some point later in 2010. And this just may correlate with the Fed unwinding its balance sheet. An aggressive rise in yields will further crimp the consumer's strained balance sheet.

The U.S. budget deficit is about 13 percent of GDP. To reduce the real value of that outstanding government debt, you need to create some inflation. Longer-term debt will be issued, which may result in an oversupply situation.

What does this mean in the context of a possible near-term rate move by the Fed? Not a thing. Right now, a rate move won't matter. That only impacts the front end of the curve. What you need to focus on is the long term, where private sector borrowing costs are really focused. I see the 10-year note as the only true indicator of how successful this "inflation creation" the Fed is trying to accomplish will be.

I see no flight to safety in Treasuries right now. It may be that 2010 turns out to be one of those years in which the Treasury market itself will be an undesirable place to invest, in particular as we begin to see this rise in yield.

I believe that Bernanke is waging a war against deflation right now. So, I think the Fed will stay put. For any serious change in Bernanke's overly accommodative market strategy, we'd need to see a couple of things. First, a change in the labor situation, including notable improvement in the unemployment reports, on a consecutive basis. We'd also need to see housing prices not just slowing their decline, but actually showing some sense of rebound. And, I think we'd need to see the domestic economy grow at a pace well above expectations.

Where do we need to be before the Fed makes a big move? Let's look at the Q3 2009 numbers. GDP was perceived at 3.8 percent, but actually whittled itself down to 2.2 percent. The V-shaped economic recovery is not there to warrant the Fed changing course anytime soon.

Besides, there are too many forces pointing away from such a move. Longer-term yields are beginning to rise in anticipation of the Fed unwinding the balance sheet; we see more Treasury issuances leading to an oversupply; and we see this leading to investors being discouraged from investing in Treasuries.

In 2010, the money will flow. Massively. That is, so long as Bernanke and the Fed keep the stimulus going longer than the market perceives they will. Where will all the money

go, if not into the U.S. Treasury safe haven? Simple – all the places that are affected by the Federal Reserve’s continued accommodative monetary policies. For instance, if you told me all this activity was happening in Treasuries, but at the same time Bernanke also had a quick exit strategy, I certainly wouldn’t be very excited about equities or commodities. However, if you told me that money will likely be forced out of Treasuries and that Bernanke will remain accommodative for a longer period of time, then I think the trade we’ve seen over the past six months still has some time on its side. Right now, two indicators are important for investors: The VIX, which currently is below 20, and the CDS market. We’ve not seen the VIX at similar levels since August 2008. Credit spreads have declined dramatically, almost to pre-Lehman implosion levels. So, I anticipate that for the early part of 2010, we will see a continued environment of less volatility and contracting credit spreads. As I have been suggesting, 2010 may look a lot like 2004. I expect volatility to remain low throughout the year.



Source: Virtus Investment Partners

We also have some momentum going that I anticipate will carry over into the New Year. The new earnings cycle (Q4) starts January 11, with Alcoa reporting first. If there was ever a quarter in which earnings expectations have the ability to exceed, I think this is the quarter where we will really begin to see solid improvement and sales growth.

The cyclical recovery will soon transition into a *quality* recovery, as bottom-line earnings drum beats quickly become those of top-line sales. I expect that this will create some earnings exuberance for 2010. However, these higher expectations may lead to some disappointments. Expect a continued recovery in the capital markets in the first quarter, but be somewhat cautious as we near the one-year anniversary of Armageddon and the two-year anniversary of the Bear Stearns collapse. By March of this year, I’d begin to worry about possible *earnings exuberance exhaustion*, in which the expectations rise a bit too much and are met with some modest disappointment. Also, by the end of the first quarter, Washington will begin to focus on mid-term elections, which should also mark the point where Bernanke and the Fed start seriously thinking about edging-out the stimulus program from the marketplace.

The second quarter of 2010 may begin a *baseball season of frustration* in the capital markets. During this year’s baseball season, I think investors will be tempted to deviate from their initial investment strategies. They will be tempted by a market that does not appear to accelerate with any real momentum, at least until the election element is removed near the end of the year. I don’t see a big washout in that quarter as other market watchers are currently forecasting. I expect the S&P to remain well supported at 1,000 on any real challenge. I expect the end of the year to be similar to the beginning of 2010 in terms of performance. In a word: bookends.

The open and the close of 2010 should see decent performance. As to the middle part, well, as I said, it may be a baseball season of frustration. Possibly, some investors will see underperformance by overplaying their hands in a low volatility period. I’m not forecasting a deep dive, but rather a series of modest corrections throughout the season.

Following this, I see a decent election relief rally that should resume the upward momentum I expect from the first quarter.

To that end, the elections will be messy and, in the end, a real hindrance to the recovery, with an aggressive grassroots battle from both camps. On the state level, voters are frustrated. There are only two ways out from budget shortfalls on that level – an increase in sales tax or income tax. Some states have enacted both. On the federal level, Treasury Secretary Geithner will be a central figure in the election, and the Right will certainly beat him up a bit. What about the Left? Well, I think the Left is more interested in protecting Main Street rather than Wall Street. I don’t think Mr. Geithner will find much cover from his base on the Hill. This in turn may create more uncertainty on the financial regulatory and policy fronts.

I think there is seasonality to the dollar. Generally, September and October are the weak dollar months and January and February are the stronger ones. I think the market is anticipating a bit of strength in the dollar, which is why we’ve seen the recent correction. I would say, though, that this correction is cyclical, and I think that the dollar will continue its path lower, though in a much more orderly fashion. In 1978 and 1992, we had two historic bottoms for the dollar. I don’t see that same scenario this time. In both of those instances the account balance of the U.S. went from a deficit to a small surplus. I don’t see that happening.

Housing is another area we need to watch closely. I don’t believe in the strength we’ve seen lately. Much of the improvement on the housing side continues to be artificially induced on the back of the homebuyer tax credit and the Fed supporting the mortgage backed securities market and low interest rates. I don’t see any of these three elements as sustainable; I just don’t see home prices improving all that much in 2010.

So, housing, jobs, and the dollar don't look all that good in the year ahead, but that doesn't make me a bear. Far from it. There will continue to be tremendous opportunities in the year ahead. I've been a big proponent of the corporate bond market because I think that 2010 may prove to be one of the best years ever in that market. Corporate balance sheets have held-up extremely well and I see further room on the upside in corporate bonds. Remember that corporate bonds do very well in a low volatility market. If you're not going to stay in Treasuries, corporate bonds may be a good place to park investment dollars this year.

Not all boats will rise in 2010, that is clear. Investors need to focus less on the "old world" and more on the "new world." We've seen increased levels of spending and investment on the part of the new world country governments, such as those of China, Brazil, and India. As we move into 2010, I think the new world theme will focus more on *consumer* spending, rather than on government spending. This is a story on which we all need to focus over the next few years: new world consumer spending patterns and the global rise of the middle class.

In 2010, I still like the commodity currencies like the Canadian and Australian dollars, and I see no reason to change that view. At some point, I do see the Japanese yen replacing the U.S. dollar as the funding currency, as it used to be. Also, if there's one currency I like in either an up or a down dollar market, it's the British pound.

I think the seasonal effect in oil will be seen; we'll see a bottom in the first quarter. Start of the year oil prices will be challenged. I'm not in love with energy futures right now, which means that investors may move away from the ETFs. If there is a sleeper at all for 2010, I like natural gas and steel. The recent Exxon/Mobil-XTO deal speaks volumes about the trajectory of the U.S. natural gas market, and quite possibly where carbon emissions policy goes in 2010. By doing this deal, the biggest company in the world is telling us that natural gas will replace coal as the second largest source of energy, domestically. This deal will help to re-draft a lot of policy now in limbo on Capitol Hill and will elevate the position of natural gas in future energy policy like never before.

Looking at metals, I like platinum, because of the supply issues in South Africa. I also like silver, which is used heavily in industrial applications. Copper is another one to watch. We may see a correction in copper in the near term due to the rising global inventories. Structurally though, I believe you'll have the opportunity in 2010 to put on a copper trade, and be rewarded for it. Finally, in 2010, if we see significant price increases in aluminum and lead, for example, and zinc and nickel, you're looking at a global economy on the rise.

The comfort assets of 2009 will be favored once again in 2010; the difficulty for investors will be in maintaining the discipline to adhere to their initial investment strategy. Low volatility markets, with returns that come slowly, can be incredibly dangerous as they continually tempt investors to change course. The difference between 2009 and 2010 will be that the tortoise wins the race in 2010.

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