

Let's See How Far We've Come

Authored by Joe Terranova, Chief Market Strategist

We've seen the Embrace of Pessimism and Shake, Rattle, and Roll, which I think were fitting titles for the first two quarters' commentaries this year. For the third quarter, I think it's time to take a look at how far we've come since March. Then, it seemed like the end of the world as we knew it. Now, here we are on the first anniversary of the Lehman Brothers collapse and Fed leadership is already telling us that the recession is "probably over." Well, most of us sense that the worst is certainly over, but who would have thought it would end so quickly?

The term "the new normal" has gotten a lot of traction lately. There is no "new normal" in the market right now – it's simply normal. The market is back to normal. What I mean is that when I see the volatility in the market, there are times when it is painfully boring in terms of the lack of price action. That's normal; it is a normal market that has repriced itself at a higher level. It gets quiet because there is an absence of any selling. It lulls you to sleep as you wait for a surge of buying that will just take it higher and higher.

I know what I'm saying here will be disputed, but just as I've said over the past six months, the market found the bottom. The fundamentals of the economy and the market are back to normal.

When I call it normal, what will everybody else say? They will play the other side. They will tell me about rising unemployment through 2010, they'll tell me about heavy regulation out of Washington.

"Analysts tell us the next big shoe to drop is the commercial real estate market. I think they're wrong. The commercial real estate shoe is a slipper, not a heavy boot."

Commercial real estate may well be a problem for select regional banks, but by no means will it be a systemic problem. Among the bigger Wall Street lenders, commercial real estate is almost a moot point. The major holders of commercial credit are not institutions like JP Morgan or Goldman Sachs. What we may see is the rise of some super-regional banks before too long. For those regional banks that can no longer write down bad commercial debt, they'll likely be gobbled up by larger regional banks.

In terms of new policy and regulation aimed at reining in speculation and volumes of other financial market reforms now being debated in Washington, I believe some of what

I hear, but not all of it. Six months ago, lawmakers were certainly full of fire and fury, but that storm has largely passed. Health care has replaced market reform as the topic of the day. But I also believe that President Obama has his eye squarely on his legacy and that reform of financial markets will happen. It just may not be to the extent that either he or his party's leadership on Capitol Hill first framed it earlier in the year. It's the same with health care and energy market reforms. The health care bill may end up costing only \$450 billion, as opposed to \$900 billion, and only cover 15 million people instead of 40 million people over the next 10 years. The point is that he will get something done. The President came to Wall Street recently for what some have described as an effort to "bury the hatchet." The market came away with the message that whatever regulations are coming, they simply won't be as big or bad as you think. He came to calm the markets and I think he was successful, to some degree.

But, because of the uncertainty and fear revolving around the legislative process – and Washington, DC policy in general – I think the healthcare sector is extremely undervalued right now.

Midterm elections are coming next year, adding yet another wrinkle to the process. We can expect all major policy initiatives to hit the proverbial wall by the end of the first quarter next year. So, there will be a huge push to get health care, climate change, and financial reform done before the second quarter of 2010. After that, official Washington is back in campaign mode.

Of course, at a certain point following the 2010 midterm elections, we can expect to move into an entirely new tax period. Expect significant changes to personal and corporate taxes; this will be detrimental to the bottom lines of consumer and corporate balance sheets. Until all that transpires, however, we're now in a very normal market.

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“One year after Lehman Brothers fell, and we're back to a normal functioning market. There will always be concerns, which will be priced-in accordingly, but there is nothing overwhelmingly bearish out there right now.”

For many months, investors have been waiting for something to knock the legs out from under the table, something that I think isn't coming. These investors have missed out on all the food on top of the table.

Repeat after me: Don't listen to the economists. Lest we forget, not one of them called last year's market implosion accurately. Perhaps even more critically, economists have also gotten it terribly wrong in the past six months about the recovery. We've moved from 650 in the S&P to almost 1,050 and through this period there has been a continued chorus of bearishness from economists who still caution against all the “hype.” Well, if you've sat out the past six months and listened to them, you've missed out. The rest of us have understood that it's not been hype that's been driving the market.

Ironically, I think that the bearish sentiment that has prevailed over the past six months is one of the reasons that the market continues to move unabated, without any meaningful correction. The recovery is clearly V-shaped. Many investors have only recently realized that it is very difficult to position for a recovery that moves this fast.

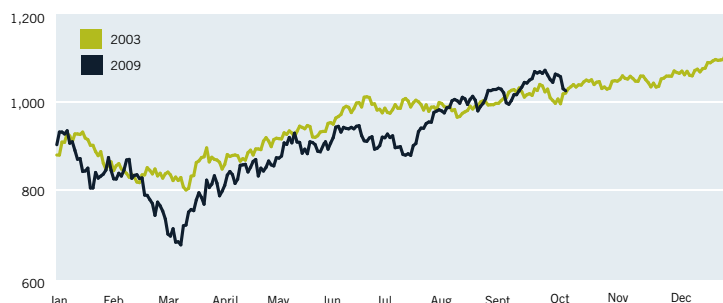
This is one reason that I think gold will continue to move higher. Recall that a lot of people got off the gold train earlier this year. If you look closely at the last six to eight weeks, the market has been signaling that it's not really loaded up long. It's not positioned for it. I think gold is a good representative of where the market has been, and how far it has come.

Investors care about their returns. Looking at returns this year, it's clear that the last moment of opportunity for potential bearishness is the period beginning with Labor Day and ending with the start of the World Series. This is your last shot for the real correction to occur, if it ever does. If it doesn't happen by then, and you're a money manager on the sidelines, you'll be forced to chase — you'll have to buy the market.

The most important number on the screen right now is the percentage of change year-to-date on the S&P and NASDAQ. This doesn't have to be complicated. Right now, keeping it simple might be the right idea. We've all spent the last six months analyzing balance sheets, stress-testing

institutions, interpreting unemployment reports, scouring housing data, checking regional price comparisons, and, at the end of the day, it all boils down to that percentage change year-to-date on the S&P and the other major indices. By the time the World Series hits, no other measure will matter. What will it say? Well, if it's in the same range we saw around Labor Day, I wouldn't book any vacation time for the end of the year if you're a money manager because you've got a lot of work to do. You can't have a second consecutive year of not meeting the benchmark.

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We saw a very similar situation in the 2003 market recovery. The market bottomed in March after the initial assault began in Iraq. And then we experienced a gradual stair-step climb for the balance of the year. The market managed to tack on 10 percent from the middle of November to the end of the year. Then, as now, it was a chase for performance. So, for all the economic data you might continue to pore over, the fact is, at this point, it's all about performance. In many ways, 2009 appears to look very much like a repeat of 2003. I believe there is further upside to come.

What's interesting, and at the same time rather mundane about this “back to normal” market, is that the same old investible theories that have worked all along in the second and third quarters will also work in the fourth quarter. Corporate bonds, currencies, and commodities.

Corporate Bonds. I believe that this market continues to provide a good investment opportunity. I think default rates will peak-out in the 12-15 percent range sometime this fall which, incidentally, is well below the 18 percent range that was priced-in this summer. If you look ahead six to nine months from now, I think the default range will be back down around 6-7 percent. The corporate bond market presents a terrific opportunity. It's also a good chance to get ahead of the eventual upgrade cycle of the rating agencies.

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Currencies. All year I've been talking about currencies. Just look at what the dollar has done. We're now entering a period when those who did not heed the call to invest into currencies — in particular the commodity currencies such as the Australian and Canadian dollars — will be terribly disappointed. As you may know, the September-October-November period is traditionally terrible for the dollar. How far the dollar has fallen since the Lehman crisis emphasizes just how important exposure to these other currencies has really been in the past year.

I'm not suggesting that we're on the precipice of a massive growth surge in the U.S. economy. Far from it, actually. Looking at GDP, I expect the third and fourth quarters to be positive, and I expect the first and second quarters of 2010 to be GDP-positive as well, but perhaps not as positive as the final two quarters of 2009. I expect the 2010 GDP growth trend to be slightly below this year's.

Commodities. Risky asset prices are in the midst of a liquidity-driven rally. Powering the rally is a historically easy monetary policy, adopted by the Federal Reserve, which will continue to remain in place. The fear of a double dip recession is too great, particularly after the big unemployment report on October 2. The Fed isn't pulling back until a peak in the unemployment rate is established. It is not the time to take the training wheels off. In fact, the entire G3 can't pull back. Easy monetary policies must remain.

Massive liquidity, low interest rates, and a resurrection of emerging market demand is the perfect storm for commodities. This is the time to be positioned for rising

commodity prices. For instance, I believe oil will rise above its current \$75 high for the year before the end of calendar 2009. Investors also need to heed the tech sector. This sector has learned much from the last market storm in 2000. While all other sectors have struggled through this downturn, the tech sector was well prepared. They had plenty of cash on hand, kept costs lean and inventories low. That's why technology is such a favored sector right now — because of its ability to weather the storm.

When you look at fiscal policy, I think Fed Chairman Bernanke has done a great job. I'm glad he was reappointed. I don't believe that you change the pilot in the middle of an emergency landing. I think he has plenty of tools at his disposal to help soak up the liquidity the Fed has provided. And, I also think we'll be operating in a low interest rate environment throughout 2010, while jobless rates remain high.

There's no way interest rates will rise while the jobless numbers continue to. That said, this doesn't prevent the yield on the 10-year Treasury from rising very quickly to 6 percent once the Fed does decide to move interest rates. I do believe we will see a very fast rise in the 10-year yield once we flip the switch on interest rates.

"It's time to stop looking for reasons why you shouldn't get back in."

We don't have to worry about how sturdy the legs of the table are anymore; the legs are sturdy. Of course, we should still expect some modest correction in the market. Markets move. But through it all, remember that the table won't collapse.

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This commentary is the opinion of Joe Terranova.

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