VIRTUS
INVESTMENT PARTNERS

Embracing Pessimism

Authored by Joe Terranova, Chief Alternatives Strategist

Crisis, panic, overreaction. It doesn't matter which particular crisis we're talking about. Historically, when operating in a market environment of rising or declining prices, you'll find that people tend to panic and react the same way, every time. Keep this point in mind as we wind our way through the current crisis; keep this in mind as you come to realize what a historic opportunity may be presented by the financial crisis of 2008–2009.

FEAR EBBS AND FLOWS

Looking back to the fall of 2008, there were several misconceptions about what was occurring in the marketplace. The first was that hedge funds would continue to be sellers of equities through the remainder of the year. This was dead wrong. Instead of selling, hedge funds largely moved to the sidelines. Of all the players on Wall Street, hedge funds typically first recognize dynamic shifts in the marketplace. In the first week of October, following the growing drama and endless debate over TARP in Washington, the hedge fund sector got out. Massive deleveraging in October, not at year-end, was, in fact, the main cause of the short-lived December rally. Few people read this move correctly.

I remember the page turning on 2008 into 2009 with the feeling of "wow, it's finally here." It appeared that between the administration's constant cheerleading and several early indicators suggesting the worst may be behind us after all, the market lifted a little. We all started to convince ourselves that this rise would be sustainable—we were going to be OK. It was a new day, supported by a new administration. We were optimistic. 1931 was the worst market ever with the S&P 500® Index down 43.3%; in 2008 the S&P was down 37.0%. There was hope that the second largest market decline in the history was just that: history.

But, as we soon learned, this was not to be. The inflated, euphoric market of the past few years left a mark that will not fade quickly. If you look closely back to the fall of 2008, I think you will note that we never really accepted the reality of what was potentially in front of us. I believe most of the market had convinced itself that we were staring at a classic V-shaped recovery meaning that we were going to deleverage quickly with a massive injection of policy-induced stimulative action that would ultimately lead us out of this crisis moment. The mistake was thinking we were in the middle of a crisis *moment*.

What actually occurred in the first quarter of 2009 was the embracement of the true reality and scale of the challenges we were facing—challenges not only in the market, but economically, impacting the entire financial system. The realization set-in that we should expect more market losses to unfold. Clearly, the economic numbers and earnings guidance were going to look terrible. Pessimism finally reigned supreme in Q1. The market's reaction to the immediate past six months was akin to the classic human reaction to some horrible news. You spend the first period in denial and it's not until you move out of denial and into accepting the reality of your condition that you give yourself a chance to improve, at least psychologically. The market is no different; psychology plays a big part. It's a mental game. A lot of what we experience in the market is mental. A lot of the current questioning of our financial system is mental. And so, in this winter of our discontent, following a steady stream of bad numbers, we finally accepted how bad things really were. As March began, the market actually embraced pessimism. In March, the panic of the past few months reached a crescendo.

The arrival of this crescendo was highlighted for me when I was on a speaking tour in California. On March 9, I was in my hotel watching an interview with legendary investor Warren Buffett. At the very end of the interview, Becky Quick asked if he was still greedy when others are fearful. He sheepishly replied, "of course." There it was, right in front of me, even Warren Buffett was fearful. What happened, Warren, to being greedy when others are fearful? This was an interview that focused primarily on the bad economy and the depth of recession.

continued

I believe there has been no more historic a moment in our lifetimes than this—a moment that is possibly as opportunistic as we may ever see. This is a moment to be greedy when others are fearful. I firmly believe that now is the moment to step back into the market. Investing is about risk and reward, pure and simple. I advocate analyzing balance sheets and buying into cash-rich companies.

The market has embraced its pessimism. And so, it's time to step back in.

SUPPORT REVIVAL

There is a new administration in Washington with an optimistic, if somewhat cheerleading, President. Whether or not you agree with President Obama's policies, I believe we can all agree that his ability to communicate with the market, the American citizens, and the world should provide confidence in moments of crisis. Unfortunately, Treasury Secretary Geithner does not possess the same dynamic oratory skills of the President. He does, however, fully understand the scale and depth of the market's ills. Fed Chairman Ben Bernanke has stepped-up to be the true market ambassador his role requires. Incidentally, if you didn't have an opportunity to see the March 15 Bernanke interview on "60 Minutes," I recommend you watch a replay. The timing was critical and I believe that his comments were spot-on. He spoke of the expectation of the first quarter being horrible. He spoke of a bottom, corroborating much of what I've been saying for months now, though the one point I would add is that I believe that some key commodities have also found a bottom—oil for example. Perhaps most importantly, however, in Bernanke's interview there was a sense that, through all the bad weeks and months we've just experienced, market pessimism has also found a bottom.

From this point on, I believe we're going to see a slow, gradual shift from pessimism to optimism. On *Fast Money* the other night we were discussing the recent 500 point rally. I was asked: "What was that all about? The various Fed programs? New government reports?" I replied that I thought that pessimism has finally bottomed. The realization had hit that the world is incredibly underinvested. And at the end of the day, I believe that this little detail will drive everything higher.

MORE INDICATIONS

An interesting research note came across my desk that said that after 22 consecutive weeks of equity outflows from hedge funds, the string had finally been broken the week of March 13. On March 6, when the S&P futures fell to 665.75, what did we see? Hedge funds were net buyers. There were actually inflows into equities. The following week, we saw the same thing. What does this tell me? On several levels, investors are now throwing in the towel—Main Street is saying "I can't take it anymore." We now see this with the hedge fund guy too. The hedge fund guy who has been sitting on the sidelines for months, the guy who got out first, appears to be back, ready to take ownership of the bottom. I believe this may signal that it is time to step back in.

I often hear that until the government works through its new fiscal policy and steps-up the next wave of market regulation, it's still much too early to get back in. But, uncertain as it all might seem, it's also pretty obvious, with regard to how each element of the market—from investors to policymakers—has reacted, that this crisis is playing-out the way we've seen in history again and again. We saw massive deleveraging, followed by a "hope" rally, then further contraction, and, at long last, the crescendo of pessimism. Despite all this, I'm still asked every day: Is it safe again to invest? Let me ask you this: What market valuation is really necessary to answer this question? Should you wait until the market moves off the current lows and moves back above the 9,000 level? No. I posit that the time to step back in is now, when valuations are attractive and the underlying themes of these valuations remain structurally intact.

Let me clarify. I'm not suggesting investors should go forth and buy the financials. Far from it. What I am saying is that over three to five years, the cost of housing and the cost of food, the cost of healthcare and the cost of energy will clearly be higher than they are today—much higher. The emerging economies are showing surprising resiliency throughout this crisis. Brazil, India and China (BIC) are now beginning to restock their commodities. On the day the S&P hit a low of 665.75, China announced its growth target would be 8 percent for the year. The Chinese PMI in February was the highest since July 2008. In the midst of this crisis we're experiencing, the rest of the globe (not counting Eastern Europe) remains fairly resilient and a driver of growth. The Chinese banking system is in far better shape than ours and, as such, will be another contributing factor to the recovery, in particular lifting four key sectors: healthcare, food, housing, and energy. These four areas will experience higher costs because the world continues to grow; through this crisis, the world continues to put a strain on supplies of these goods and services.

continued

I'm not concerned about inflation, not yet. The massive amounts of liquidity recently injected into the economy may not produce an inflationary sting for years, if at all. The concerns that I have are more about deflation. We're not seeing commodity prices going up out of inflation concerns. They're going up because there is an underlying concern about how producers will manage to expand future supply. Commodities are not going up because of a fear of inflation three to five years down the road, otherwise the price of gold would be $1,500 an ounce. This is a supply and demand concern more than anything else—and that is a wholly investable theme.

The opportunity we see before us now may truly be historic. Six months ago, who thought they would get the chance to invest in energy at the levels now available? Did anyone think they would get the opportunity to invest in natural resources or infrastructure names at current valuations? We're looking at valuations right now that, when we look back in five years, will likely be compared to the historic investment opportunities in the 1930's, if not more so. So, when will the rest of the investment community move from the sidelines back into the marketplace? The conditions that currently exist suggest to me that the time is now.

The great irony I see coming is that the Obama Recovery may look more like a W, when it's really a V-shaped recovery everybody is hoping for. We're already halfway there. The next peak may be in 2010, following the mid-term elections. We may see taxes raised soon after, which may produce the second dip in the W-shaped recovery.

I want to see people get ahead of that W moment. I don't want to see people waiting to invest until the back half of 2009 or early 2010, when the S&P is at 925 to 950; that's not the time to get back in. People need to look at their portfolios right now and see how underinvested they really are in the sectors that matter most. Right now, we are supply-challenged in basic materials and commodities. So, I suggest that an attractive place to achieve strong possible returns is in the basics.

In crisis moments we're always going to spend to try to produce the things that we need the most. What does the world need the most? The stuff that makes the world go 'round: energy, food, housing and healthcare. These are the basics. The rest come along for the recovery ride—beneficiaries of those four critical components that are the stimulative drivers of growth.

When the entire world de-levers, all of these basic elements come under pressure; it's a classic fire sale. And like any fire sale, as I always say, last in, first out. In the current situation, the last elements into our financial crisis fire sale were these basic components and I anticipate that they will be the first to start the growth going again—the first to recover.

The winter of our discontent is over. The market has finally embraced its pessimism, and we are presented with a historic chance to get back into the market at values we may not have the opportunity to experience again in our investment lifetime.

For more information, contact Virtus Investment Partners
at 1-800-243-4361 or Virtus.com

This commentary is the opinion of Joe Terranova.

Mutual Funds distributed by ***VP Distributors, Inc.****, member FINRA and subsidiary of Virtus Investment Partners, Inc.*

2011 4-09 © 2009 Virtus Investment Partners, Inc.