

Shake, Rattle, and Roll

Authored by Joe Terranova, Chief Market Strategist

Anybody who listens to the classic '50s tune Shake, Rattle, and Roll comes away feeling upbeat. You can't help it. Lately, I think the market and the investment world, in general, has taken the song to heart.*

We experienced the shake as we moved past March into April. It was the shake-out of the *Armageddon trade*. Hedge funds spent the better part of April unwinding their short positions and, with a little help from the mutual fund world, this massive unwinding extended into May.

In June, we saw the inflation scare come in on the back of rising yields and a massive supply of debt issuances by the government. Suddenly, we were in the rattle mode. Uncertainty prevailed. We all watched as the markets pulled back from previous highs.

In my commentary from the first quarter, *Embracing Pessimism*, I suggested that a huge opportunistic moment was upon us and, in rattle mode, we worried those investors would likely return to the markets once the S&P hit the 925-950 level. We worried about missed opportunities.

Now, as we segue into July, we prepare for the roll part of this process – the resumption of the uptrend that looks a lot like the staircase climb of 2003.

Recall that the Dow hit a low of 7,500 in March of 2003. The SARS outbreak and the beginning of the Shock and Awe campaign in Iraq encouraged that capitulation moment. By year's end, however, the staircase climb had breached the level around 10,000 on the Dow. There was limited pullback throughout the year in 2003 and very shallow corrections. The deep dive forecasted by many analysts never actually materialized.

The Deep Dive Never Materialized
Dow Jones Industrial Average Closing Values 1/1/03 - 12/31/04



Past Performance is no guarantee of future results. Source: Virtus Investment Partners

Right now, we hear the same sort of thing: analysts are once again calling for the deep dive. I don't see it. I think many of these so-called market experts are still too focused on the headlines from January and February, about the challenged economy and the challenged consumer. I hear analysts talking about all the green shoots of Spring turning into the brown weeds of Summer. They also dismiss the importance of the "second derivative," when few actually understand what it really is or why the measure is key to understanding the trajectory of the current recovery stage. Think of the second derivative as being a measurement of the rate of change in change. For example, in the current run of economic studies and reports, most of us will immediately note that the situation looks "less bad." More specifically, the rate of contraction is easing – the declines are moderating. Add to this measure the fact that roughly \$3 trillion is still sitting on the sidelines in money market accounts, not yet convinced about market stabilization. This amounts to about 40 percent of the S&P. This leaves an overhang of bearish sentiment, which lines up favorably to the second half of the year, for all risky asset prices. This huge pool of uncommitted

*a classic Big Joe Turner tune made famous by Bill Haley & His Comets in 1954

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money market funds clearly positions the roll part of the process to occur.

Across the globe, financial data is improving. The macro view is improving by the week, it seems; stabilization appears on course. In my view, we should be looking at a return to growth by the third quarter of this year. Finally, whether you believe the results of the latest round of bank stress tests or not, the fact the markets were able to, and continue to be able to, absorb such a massive equity issuance in such a short period of time seems a hugely favorable development, far beyond the conservative assessments on the course of financial stabilization from the Fed and this administration. I think that some camps have simply failed to highlight these new issues of corporate debt – which have been quite robust across a number of sectors.

By my read, we have the market sentiment in place, we have the economic numbers in place, and we have the earnings valuations in place to surprise us to the upside in the second half of 2009.

Emerging Markets

What have been the big sources of stabilization since January? Emerging market stocks are up over 40 percent – they are among the best performing asset classes. There is no reason to doubt the credibility of the emerging market investment theme. On a number of occasions, I've referred to the stimulus package coming out of China and its effect on the world. I think the emerging market world, excluding Russia but including China, India, Brazil and other South American countries such as Chile, will continue to provide tremendous opportunity in the next 12-18 months as we move through this recovery phase.

High-Yield Bonds

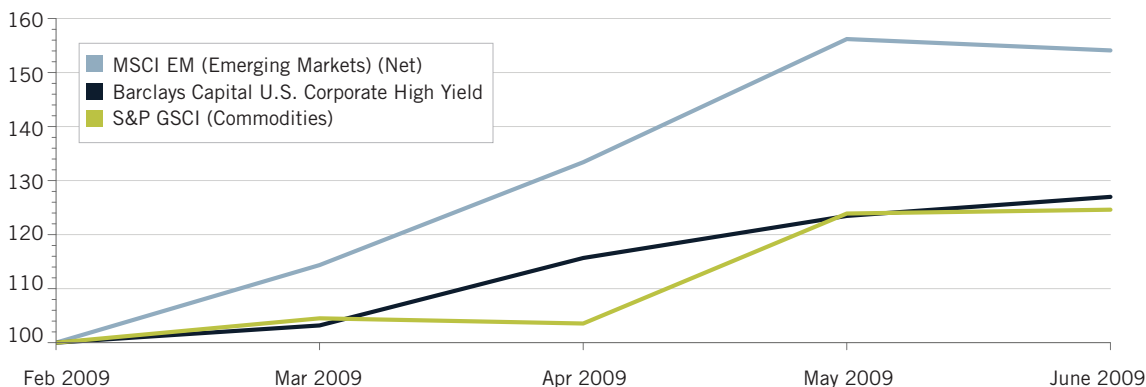
Another asset class that has shown a particularly positive signal this year, with upwards of 35 percent in returns, is high-yield corporate bonds. Clearly, the corporate bond sector is the place to be if some sort of correction actually does transpire this year. Investment grade bonds may provide a tremendous opportunity, as well.

Commodities

Finally, there are commodities. Structurally, commodities are the backbone of this recovery. There are several strong forces now driving the commodity complex, such as paper asset demand, so I dismiss the notion that the current drive higher won't continue to be constructive through the next 12-18 months. If you go back to look closely at the Chinese growth euphoria between 2004 and 2008, we had a similar pattern: a very bullish tone to commodities, following the staircase climb of 2003. So, if I'm correct in my thinking that 2009 is a repeat of 2003, then the expectation would be that 2010 to 2014 will be very constructive for commodities.

The support for my position is actually quite deep. Know that there is clear emerging market demand for commodities. Despite the pace of this horrendous credit crisis, emerging markets still provide demand for commodities. Also, the potential supply constraints for energy commodities and raw materials in general cannot be understated, in particular from the current administration. Certain policies advanced by President Obama's budget plan aim to tax and thereby restrict or discourage investment in the production of certain fossil energy sources. The growth of future supply has never been more challenged than it is today. Finally, fiscal policy will remain easy for the foreseeable future, which will keep the dollar under pressure, and thus support commodity prices as again being the favored asset class of investors, along with emerging market stocks and high-yield corporate bonds.

2Q 2009 Performance
Emerging Markets, High Yield and Commodities



Past Performance is no guarantee of future results. Source: Zephyr StyleADVISOR

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Fed Policy

The direction of this administration's fiscal policy has raised the specter of inflation in the near term. Is the threat of inflation really as strong as many people now believe it to be? It is important to understand the environment under which we're currently operating in order to answer this question correctly.

Right now, we are still operating in a deflationary environment. I find it interesting that the same people who point to the looming dive in the marketplace also talk about the looming threat of an inflationary environment. However, we're beginning to see economic forecasts for 2010 that project modest growth, at best. If that's the case, we will still be in a deflationary environment. The micro data continues to be mixed in business activity and on the consumer level. The aggregate U.S. output gap remains large. These factors will need many years of above-trend growth to eliminate this output gap. This suggests to me that inflation will remain anchored at low levels. I just don't see the inflation outbreak that market analysts have been discussing lately. It is a topic very much in vogue, but I don't see the threat being genuine for years to come, if at all. I believe that monetary tightening is still down the road, as well; the futures market in June told us as much.

If you go back to 1970, you'll see that the Federal Reserve has been consistently unable to make that initial bump to the fed funds rate until the unemployment rate peaks out. Right now, unemployment is expected to continue to rise through the end of '09, and well into 2010 before peaking out. The expectation now is that unemployment will tag 10.5 percent before it peaks. With this in mind, we can expect easy fiscal policy going forward. We also know the Fed's exit strategy (raised rates). The question now becomes will there be the political will, at the appointed moment, to carefully see the strategy through? So far, it doesn't look like it. Fed chief Ben Bernanke has not yet been asked to remain for another term. This isn't a good sign, in my estimation. It's similar to the way, after a death-defying plane trip through a terrible storm, the pilot is asked to give the controls to the co-pilot to perform the perfect landing. I think the pilot needs to navigate this trip through to its end. If nothing else, for Bernanke to get the nod from Obama at this point is another tacit vote of confidence that the strategy is working, which is something the market sorely needs.

The eventual rise of the fed funds rate will encourage banks to keep reserves with the Fed. The effect of this will be a soaking-up of liquidity, all the liquidity that his strategy has heretofore provided. Here is the challenge: Does Congress have the political will to allow Bernanke to follow this path, despite the fact such a credit-restrictive path will be extremely unfavorable to Main Street? In addition, if you look at the Fed's newly

expanded balance sheet, a lot of the securities the Fed purchased to support risky asset prices have been shorter-term maturities. These are, of course, much easier to liquidate if necessary. Right now, there is quite a bit of flexibility in being the liquidator – it may actually be a lot easier to liquidate at this point than some people make it appear.

My expectation is that Treasury yields will come down and gravitate towards 3.25 percent, possibly as low as 3 percent. I expect a historic supply of Treasuries, but I also think the selloff in Treasuries is unsustainable in the current environment. The FOMC (Federal Open Market Committee of the Federal Reserve, which is tasked with setting rates) has a strong commitment to keeping interest rates and private sector borrowing rates at historically low levels, understanding that this is a fight to reflate the economy. That said, the 10-year Treasuries will likely now reverse and sell off, heading back down to the 3.25 level.

Earnings

Corporate earnings have been surprisingly resilient throughout this challenging period. Costs have been cut across the board in most sectors. We're seeing healthy productivity, almost across the board. Labor is being shed. I think industry has managed the bottom line quite well through this crisis. S&P earnings in 2008 were \$49-\$50 a share. If you look closely right now you'll see this number inching higher. In fact, 45 percent of the S&P companies have raised their earnings recently. I see analysts getting comfortable again with earnings per share levels somewhere north of \$60. And, if you factor in a fair value of 15-times earnings on top of that, you get to where we are right now.

Implied S&P 500® Index Levels
at Various Earnings and P/E Combinations

	\$50	\$60	\$70	\$80	\$90	\$100
13x	650	780	910	1040	1170	1300
14x	700	840	980	1120	1260	1400
15x	750	900	1050	1200	1350	1500
16x	800	960	1120	1280	1440	1600
17x	850	1020	1190	1360	1530	1700
18x	900	1080	1260	1440	1620	1800

Earnings

Source: Virtus Investment Partners

I don't believe that we should be uncomfortable with the earnings adjustments higher. Given that we've already marked all asset prices to Armageddon levels and also marked corporate earnings to Armageddon levels, there is almost a natural tendency to re-rate our thinking to the upside. The banking/financial sector has indeed stabilized. When the conversation veers toward green shoots, there are clearly some

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notable examples in this sector. The fact that JP Morgan, Goldman Sachs and Morgan Stanley are ready to pay back the TARP funds is incredibly favorable for the market and across the economy.

While many of the regional banks will continue to be challenged by their loan exposure to the commercial mortgage market, I don't support the notion that the next shoe to drop will be in the commercial mortgage market. I don't foresee anything in this sector that could possibly destabilize the system further.

Currencies

I think one big lesson learned over the past four to five months is that investors need to craft a strategy involving more exposure to currencies within their portfolios. The movements of currencies so far this year have shown us how directly they can drive markets themselves. The relative strength of emerging market currencies can't be understated. In addition, and as I've said previously, I believe the dollar will continue to be weak, and U.S. fiscal policy will continue to be easy. Where will the money flow? I think the Euro will be a big recipient of all this added liquidity in the current anti-dollar play, but it will hardly be the only one. I like commodity currencies and emerging market currencies in a general sense as the best anti-dollar trade. The British Pound has been under a lot of pressure lately as have many of the Baltic region currencies. And I think the Japanese Yen will continue to operate in a bipolar pattern.

Energy

The United States continues to import roughly 60 percent of its crude oil to meet domestic demand. And, with the coming taxation on domestic producers, I don't see that number getting any lower any time soon. Clearly, the administration is focused on new tax issues across the regulatory and budgetary landscape to drive energy policy and consumption trends.

Fortunately for the United States, we have a ready and abundant supply of energy to serve as a perfect bridge fuel, away from foreign oil and onward to a more renewable-dependent future, as espoused by the administration. I believe that natural gas is the answer. Unfortunately this administration has not yet committed to natural gas as

the perfect bridge to the future, despite huge advances in exploration and production technology and the discovery of vast new reserves of both conventional and unconventional plays, on- and offshore. This continued reluctance to designate natural gas as the primary bridge fuel to a more renewable future does not bode well for this recovering economy. Continued dependency on foreign sources will only serve as a drag on the U.S. economy on a number of levels, geopolitical and financial. Until this administration develops a reasonable strategy, investment in energy – across the broad energy landscape – remains one of the top themes for investors.

Regulation and Policy

We have an ambitious, aggressive administration in Washington D.C. right now, with supportive leadership in both Houses of Congress. In many ways, the administration's agenda has been largely unchecked due to the state of disarray in the opposition. I actually anticipate the majority deepening its control of Congress in future elections. We're looking at a budget deficit that will continue to rise and higher corporate and individual taxes once the Bush tax cuts expire next year. And, I expect to see intrusive regulation in the financial markets. Topping off all of this will be the advent of a national health care system. As it stands, nothing short of a geopolitical crisis involving the Middle East, Israel or North Korea could derail this administration's aggressive agenda – and check its unchecked power. Only this sort of crisis could divert the attention of this administration and attending leadership.

How does an investor invest in such an atmosphere? Throughout this commentary, we have highlighted that the emerging world, and in particular exposure to emerging market equities, is one of my favorite themes. I've noted that exposure to currencies in this new world order is now mandatory, given that dollar weakness will continue to be a common theme over the next 12-18 months. The corporate bond world continues to provide historic opportunities both for high-yield and investment grade bonds. Commodities and raw materials are investible themes that extend well beyond the next 18 months, and quite possibly beyond 2014.

The month of June had been highlighted by a rattle, after a period of shake. But the roll is coming.

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This commentary is the opinion of Joe Terranova.

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