

## DON'T Sell in May but DO Go Away

*Authored by Joe Terranova, Chief Market Strategist*

It's that time of year when investors start giving thought to seasonal trading patterns such as the Halloween indicator or "sell in May and go away." In theory, if you "sell in May," you potentially book higher profits from the market's historically best-performing months from November through April, and then you "go away" and hide-out in bonds or cash for the lower-performing summer months. When late October rolls around, you buy back into the market after the World Series, and start the cycle all over again.

As a student of market price action, I am a true believer in seasonality. "Sell in May" has been a valid strategy that has worked for investors from time to time, but not always. In fact, last year a "sell in May" strategy would have failed miserably. April 30 to October 31, 2009 was a phenomenal time to be in the stock market.

In last quarter's commentary, I suggested that a "baseball season of frustration" would overhang the capital markets this year. We won't have the aggressive momentum we had in the 2009 market, and investors will be heavily tempted to deviate from their investment strategies. In a year such as this, wouldn't it make good sense then to "sell in May and go away?"

Absolutely not. Instead, I advocate a "DON'T sell in May but DO go away" strategy. From now until the mid-term elections, we are going to go through a market period where investors will be repeatedly tempted to alter their investment plan. DON'T alter the plan, but DO take that all-important family vacation and turn away from the D.C. "sausage making."

We are in a quiet market environment with extremely low volatility. The leading market volatility indicator, the CBOE Volatility Index® (VIX®) came into 2010 trading around 22, spiked at 29 in February, and dropped to 16 in late March. When the market slows like this, investors tend to sit back and question their portfolio strategy in the absence of any significant appreciation.



Indicators suggest we are in the second year of a historic market recovery. Generally, you don't want to alter your plan in a recovery's second year. The fact is, this year you're not going to get the upside momentum you got last year. I still believe the capital markets will be higher on December 31 of this year than they were on January 1, but the road there is going to be frustrating and somewhat challenging. If you continually alter your plan, it will be harder to achieve any alpha. Don't try to outsmart a low volatility market when it's trying to digest and understand what the next catalyst will be to advance the bullish momentum.

I said we'd see a tortoise rally this year (not a hare) – and we are. But, psychologically, it's very difficult for investors to stay the course in a low volatility environment. One of the problems with the 2009 sell-off was that it was much shorter in duration than in past major bear markets. But the total damage was historically the second worst; only 1931 was worse.

Most bear markets have a longer duration, not the precipitous decline we experienced in the six months from September 2008 to March 2009. Longer duration sell-offs, typically 12 to 18 months, give investors more time to get back into the market, assuming they liquidated their equities and moved to cash. Everyone sits on the sidelines waiting for the right time to get back in. But what if the market quickly reverses? Before you know it, the train has left the station and there's no time to get on board. Investors are left "hoping" the economic recovery is muted and that a future sell-off will allow them to get back in.

That happened last year. Capital market pricing moved higher even though economists claimed the economics didn't line up with the rally. It didn't make sense to them then and it doesn't make sense to them this year. We're in a period where those looking at the market through economists' glasses are acknowledging that the recovery is not U-shaped but closer to a V. The tremendous amount of pessimism and doubt is slowly wearing off. Investors are acknowledging that the train has left the station and another one isn't coming. Therefore, underlying buying interest will support the market on any correction, keeping the decline shallow.

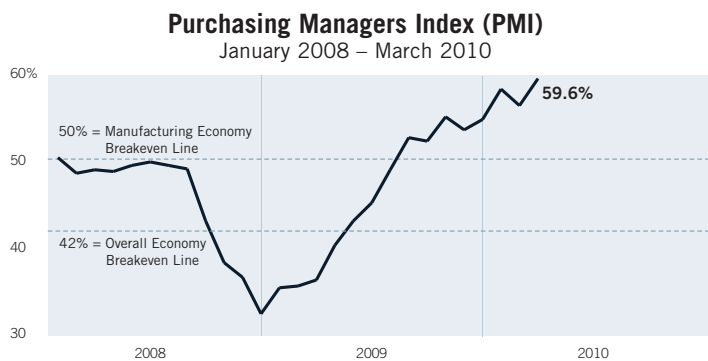
Stick to the investment strategy you adopted at the start of the year. For instance, I expected a big sell-off in commodities in early February, and we got it when oil dipped to \$70. That was an excellent buying opportunity to use a dollar-cost-averaging strategy. Dollar-cost-averaging and market neutral are two strategies that I believe will be advantageous this year.

The challenge in 2010 is to adhere to the directional bias in your desired asset class. Be patient and wait for opportunities to come to you.

The uptrend in stocks, despite the small setback in the first quarter, remains in place. However, we have seen a significant slowdown in momentum over the first quarter in the S&P 500. I still do not believe we will see any deep dive in the marketplace. Rather, any sell-off continues to be a shallow correction and should be seen as a buying opportunity. I view that as a positive sign for equity prices longer term.

What makes me cautious, and confirms that we are entering the “baseball season of frustration,” is that, psychologically, we are beginning to acknowledge that it is not a U-shaped recovery; it is actually a V-shape. Attention is shifting away from macroeconomics. What’s left? A clear focus on corporate earnings. I expect earnings exuberance to highlight the April and July releases, setting the bar awfully high for corporations to beat and raise. The bar and expectations should be muted for the October release.

Economists have been the last to recognize the economic and capital markets recovery. We’re at a point where it’s hard not to acknowledge improving fundamentals, in particular the growth in manufacturing activity. The Institute for Supply Management’s Purchasing Managers Index (PMI) confirms that improvement. It has been rising since early 2009 and suggests that we are entering a period of stronger-than-expected global economic growth.



A PMI in excess of 42%, over a period of time, generally indicates an expansion of the overall economy. A PMI in excess of 50% generally indicates expansion in the manufacturing sector. The PMI in March 2010 came in at 59.6% which indicates growth for the 11<sup>th</sup> consecutive month in the overall economy, as well as expansion in the manufacturing sector for the 8<sup>th</sup> consecutive month.

Source: Manufacturing ISM *Report on Business*®

In the first year of an economic recovery, the heavy lifting is done by government spending; in the second year, it transitions to private sector spending. Most economists have been fearful that with high unemployment and tight credit, the private sector could not take the transitional handoff from the government.

In a recovery’s first year, consumer spending contributes around 64% of gross domestic product (GDP) but in the second year it ramps up closer to 80%. In fact, in eight recessions post World War II, 84% of GDP growth in the recovery’s second year came from consumer spending. This is consistent with the current recovery and defies logic. Economists are surprised. Even I’m surprised and I’m the eternal optimist about this recovery. It shows the resiliency of the American consumer, particularly the affluent consumer. You just can’t bet against them.

The final missing ingredient from this economic recovery has been job growth. The market is anticipating, in early April, one of the best job reports from the Labor Department that we have seen since 2006. We are finally going to create jobs.

I am a huge advocate of corporate bonds in 2010, especially high yield and investment grade. In a low volatility environment, corporate bonds tend to outperform. Corporations are beginning to feel confident again. Balance sheets are in excellent shape and flush with cash. Companies are starting to deploy cash for buybacks, and we’re seeing a lot of M&A activity. Productivity is high. Credit spreads continue to narrow, and the default rate continues to decline.

I’ve suggested you drive three speeds – overweight, market weight, and underweight. Until now, I have had corporate bonds as overweight. In the upcoming quarter, investors may consider shifting to market weight.

Clearly, the U.S. dollar has been making a counter trend move lately. However, in my opinion, the secular downtrend remains in place. The dollar hit a major low last November that I think was more of a cyclical low, driven by sovereign debt fears around the world, first by Dubai and then Greece. For me to gain confidence that the dollar has achieved another secular low similar to 1974 or 1992, I would need to see a dramatic shift from an account deficit to an account surplus, as we did in each of those years.

The dollar’s recovery is more about the euro. Difficulties in the euro regions will remain in place as long as there is dissension within the European Union on how to handle Greece’s debt crisis. Greece needs 10 billion euros by May, and the International Monetary Fund (IMF) will likely need to get involved. I believe this situation will not be resolved until the May funding date and that will lend support to the dollar on a cyclical basis. I still expect the dollar to resume its downtrend as we move to the back of the year.

Opportunity exists in any currency crisis. The IMF estimates that by 2014 Canada and Germany will be the only G7 nations not to have a debt-to-GDP ratio of 100%. Clearly, there is opportunity in both those nations. I also view Russia as an investment opportunity.

Commodities are a favorite theme of mine. When the dollar rises, commodity prices tend to fall, yet prices have held up resiliently against the dollar's recovery. That suggests there is further upside, and I would encourage investors to add to their commodities positions if there are any sell-offs similar to that in the first week of February 2010. I still believe the spot price of oil goes to \$90 before it goes to \$60.

We're beginning to see a shift not seen in many years in the relationship between short- and long-dated commodities futures contracts. Short-dated contracts are beginning to rise in price valuation, much more than longer-dated contracts. This phenomenon called contango, when long-dated contracts trade at a premium, is coming out of the market, but we're not yet in backwardation, where short-dated contracts trade at a premium, but you're getting to the point where that is beginning to happen. This shift suggests bullish fundamentals going forward, as existing inventories are being utilized at a much faster pace than previously anticipated.

That means that there is real demand. We have a global environment where emerging markets are recovering and beginning to exhibit growth again. China alone is using one million barrels of oil more per day than it did a year ago. Copper usage in China is up 11% quarter-on-quarter. GDP growth is accelerating not only in China but also in India, to the point where the Indian central bank just raised the interest rate. When I see a central bank raising the interest rate, like in Australia or India, that's a good sign for their economy, for global growth, and what we want to see.

Much speculation remains that the Federal Reserve will raise interest rates this year. I disagree. I think the Fed will make every effort to keep private sector borrowing costs low and do whatever they can to help consumers finance their day-to-day credit needs.

The Fed is not, in this political year, going to challenge Main Street with higher borrowing costs. Instead, the Fed will try to remove some of the liquidity from the marketplace using unconventional methods from the quantitative easing measures used in 2009. You'll see things like the discount rate being raised, which does not really affect Main Street. They're not going to remove enough liquidity from the marketplace to force capital off bank balance sheets and create an inflationary environment.

I expect that 10-year Treasury yields will, at some point in the next few months, break out of the 3% to 4% trading range they have been in for the last 52 weeks. What is important is that a break above 4% is sustained. I view Treasuries as a bubble that will soon be unwound. There is a tremendous amount of debt issuance coming out of the U.S. Treasury. That enormous supply will most certainly have investors

demanding more yield. I don't view a rise in the 10-year Treasury yield as a warning sign for pending inflation, rather, a return to more normalized yield levels pre-Lehman crisis.

I think the yield curve, the spread between 2-year and 10-year Treasuries, is going to stay steep. That's great for financial stocks which are important for the long-term health of capital markets this year.

The signs suggest further upside in the capital markets this year, but the momentum is slowing. This should not be an excuse for investors to move to the sidelines. We've gone through periods where momentum and volatility slowed and yet the market recovered by the end of the year. This was the case in 2004 when volatility, as measured by the VIX, trended downward for the last few months of the year while the S&P 500 climbed to new highs.



I expect a similar pattern this year, in this “baseball season of frustration.” We've experienced phenomenal asset price acceleration over the last 12 months. Now momentum is slowing. It's not going to be fast and easy money anymore. The economic surprises that have been the catalysts for the rally are over. A transition to quality needs to occur. Earnings and valuations will drive the market forward for the first time in a long time.

The political environment will remain a major market theme. The administration will be empowered by the passage of health care reform to move faster on financial regulation reform. The landmark mid-term election will have both sides of the aisle after each other. The Treasury secretary will be battered. The Federal Reserve will come under siege. There's going to be pressure to get aggressive with the Chinese to revalue their currency, the yuan. The IMF will likely get involved in the Greek bailout, and the U.S. is the largest member of the IMF.

Despite all the noise in Washington, it's more bark than bite. After all, the market recovery is incumbents' greatest campaign talking point. The last thing they want is a sell-off.

Do you think that on Monday, March 22, the day after health care reform passed, the current administration was rooting for a higher or lower market close that day?

For much of April through October, I expect a market that will challenge investors to stay in the game and adhere to their predetermined strategy. I don't anticipate a big sell-off, but I also don't expect a 1999-style rally. I think momentum will be reignited at the end of the year when political rhetoric is removed and earnings expectations are lowered. We will begin to get comfortable with an improving labor market, but not so much that the Fed raises rates. I think the Fed will keep the easy liquidity environment in place, which is good for capital markets.

No doubt much of 2010 will be frustrating for investors. The challenge will be to stay true to the investment strategies we set for ourselves on January 1. Last year "sell in May and go away" didn't work. This year I don't see it working either, but please take my advice and DO go away. Time for a nice vacation – within the United States, of course. Smell some roses, as they say! Health and happiness.

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*This commentary is the opinion of Joe Terranova.*

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