

Market Perspectives

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Keep Calm, Carry On



“Keep Calm and Carry On.” Five words, six syllables, printed 2.5 million times as Britain prepared for World War II—precisely 72 years ago this week. The now iconic red and white posters were designed by the British Ministry of Information. Their purpose: to harden citizen’s resolve during unprecedented crisis in Europe. They were sage words in September, 1939. And they remain wise today even as the European debt crisis threatens a conflagration of global financial markets.

In August, the world finally awoke to Europe’s intractable structural issues. Investors sold off risk assets across the globe and fled to safety in U.S. Treasuries. Political dithering has temporarily crushed investor confidence and put markets on edge.

When it comes to the fundamentals of sound investing, it’s important to see beyond short-term volatility and focus on long-term value. The fundamentals, at least in the U.S., remain healthier than the market’s recent slump implies. Most likely, the future will be brighter than fearful investors anticipate. The arbitrage between fear and fundamentals is a rare opportunity for far-sighted investors.

The not-so-secret safety net in this equation is that the world’s central bankers are yet again turning on their trusty printing presses. The world is awash with liquidity; vastly more dollars, yen, and now even euros are sloshing around. U.S. markets, the world’s largest and most liquid, are the primary destination. This bodes well for U.S. stocks and select categories of bonds that have been unduly punished. Over a two to three year horizon, I am extremely bullish on a number of investments. But in the near term, I expect volatility will persist until global economic data provide greater clarity.

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Europe in Crisis

In Europe, the moment of truth is near. To save the euro from extinction, Germany must work with other European Union states to create what will most likely be a Eurobond program to bail out Portugal, Italy, Ireland, Greece and Spain (PIIGS). A break up of the euro would deal a crippling blow to the banking system, triggering a systemic financial crisis—one that could potentially make the U.S. subprime crisis in 2008 look like a dress rehearsal. The cost of cleaning up such a disaster would be exponentially greater than restructuring the debt of certain European nations.

Indeed, Christine Lagarde, who became managing director of the International Monetary Fund in July, bluntly called out the Germans in her speech at the Jackson Hole conference in late August: “We need urgent and decisive action to remove the cloud of uncertainty hanging over banks and sovereigns...We must act now. Decisive action will bolster the confidence that is required to restore and rebalance global growth.”

In time, I believe German and other European policymakers will figure this out. The question is whether they will do so before the crisis takes a dramatic turn for the worse. Averting calamity will take more political will than has been shown so far; but, behind the scenes I believe officials are beginning to devise a bailout plan that can be sold to the political electorate, especially in Germany.

Realistically, it will likely be recession that forces Europe to act. Growth in the region slowed to 0.2 percent in the second quarter, the slowest rate since emerging from recession in 2009. Importantly, pain has spread to Germany, whose influence weighs heavily on the European Central Bank (ECB), which happens to be located in Frankfurt. In the second quarter, German economic growth fell below the euro area average. This is the first time in eight quarters that the Rhineland economic engine hasn't led the monetary union.

France, Europe's second-largest economy, didn't grow at all in the second quarter. By the end of 2011, I expect that the euro area will be in recession, prompting comprehensive political action. Ultimately, the solution will most likely require issuing Eurobonds to purchase the debt of troubled periphery nations. As a quid pro quo for restructuring those debts, euro zone states will have to agree to harmonize their fiscal policies—especially with regard to labor and social entitlements such as retirement programs and healthcare benefits. Until these goals are met, I expect the crisis in Europe will only worsen.

Uncertainty in Asia

Asia's major economies face headwinds, too. As Japan comes back on line, there is talk of austerity and a reduction in government spending. Measures such as these would create additional drag that would offset, at least partially, Japan's economic recovery.

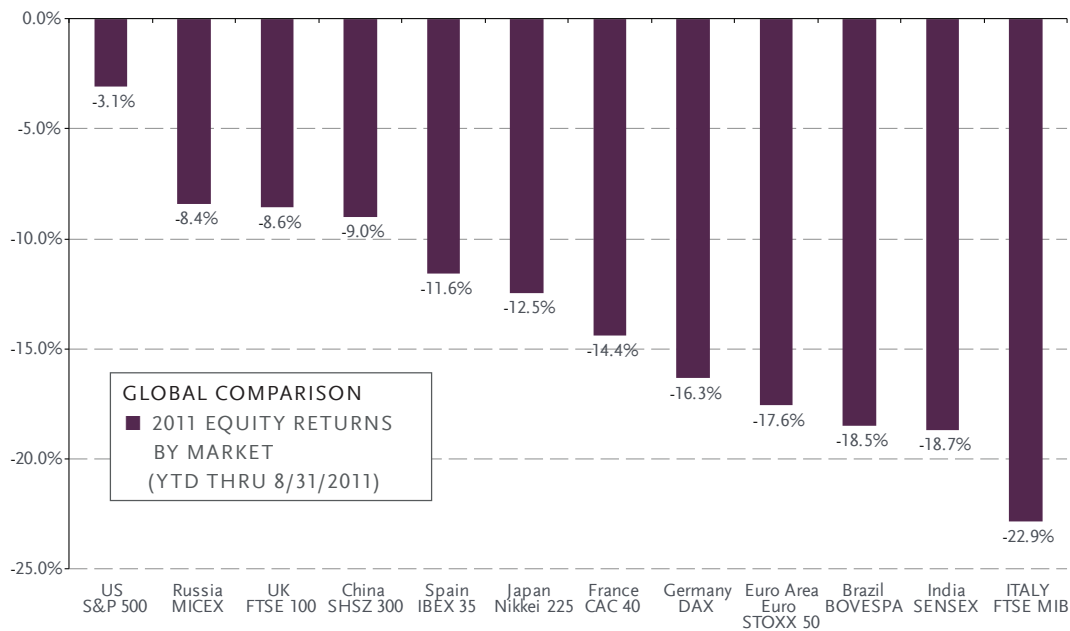
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At the end of August, the Democratic Party chose a deficit hawk, Yoshihiko Noda, as Prime Minister. In his previous post atop the Finance Ministry, Noda pushed for temporary tax hikes to finance reconstruction of the Tohoku region devastated by the earthquake, tsunami, and nuclear power plant meltdown. But with Japan in recession since the start of the year, it is far from certain that such austerity measures will pass. Another funding idea, issuing special reconstruction bonds, could also run aground following Standard & Poor's downgrade of Japanese government bonds earlier this year. What's left? Additional monetary accommodation. And I believe the Bank of Japan will once again rise to the occasion.

The longer Japanese and German economic growth remains in the doldrums, the more Chinese exports will suffer. Overcapacity will grow worse, saddling banks with more non-performing loans and driving down prices for select manufactured goods. The upside, for the rest of the world, at least, would be a reduction in a major source of global inflationary pressures. How China manages these risks will be an issue of growing concern over the next 12 to 24 months.

DESPITE GLOBAL JITTERS, THE U.S. REMAINS THE BEST PERFORMER IN 2011

Indicative of the uncertainty embroiling the global economy, leading stock market indices worldwide have experienced broad declines in 2011 through the end of August. The U.S. stock market has been far and away the best performer on a relative basis, handily beating the returns in other developed economies and even emerging markets.



Source: Bloomberg.

Policy Response: Torrents of Liquidity

With Europe and Asia facing headwinds (gale force in the case of Europe), the place to be for investors is in dollar-denominated assets—namely, equities and select pockets of fixed income. This will require a stiff upper lip. For as Baron Rothschild is thought to have said centuries ago: “The time to buy is when there’s blood in the streets even if the blood is your own.”

Fortunately, blood isn’t the only current that matters to investors. As I’ve stressed, I expect the world’s major central banks will inject even more liquidity into their economies. Indeed, the spigots have already opened. Since April, the ECB has quietly expanded its balance sheet by about 200 billion euros. During just two weeks in mid-August, it purchased Spanish and Italian government bonds worth nearly 35 billion euros. In our country we call that quantitative easing.

It’s only a matter of time before the ECB eases, reversing course after having ratcheted up its main policy rate to 1.5 percent in two steps beginning in April. I’ve frequently said that the ECB is a German central bank. But with the German economic locomotive stalling in the second quarter, the ECB will reduce rates and expand its balance sheet further if it hopes to avoid a pan-European recession.

In August, the Bank of Japan, aiming to help the nation’s exporters, made massive and unsterilized interventions to weaken the yen from historically high levels. In the process, it added tremendous liquidity. It printed 4.5 trillion yen (\$58.6 billion)—the largest monthly amount in more than seven years—sold them into the foreign exchange markets, and then invested the dollars it bought into Treasuries, helping to push down U.S. interest rates. If Japan is to claw its way out of recession, the BOJ will have to intervene further to increase export competitiveness. (See my “Beggar Thy Neighbor” commentary.)

The preferred destination for the torrent of liquidity is U.S. financial assets. As I expected, U.S. rates have plunged toward 2.0 percent on 10-year notes as liquidity seeks safe havens. Once the turmoil subsides, other riskier U.S. dollar assets, such as high yield, and then ultimately equities, are likely to benefit.

The Next Act for the Fed: Creativity

Back home, the Fed’s August 9th pledge to keep the federal funds rate at a record low through at least mid-2013 has been a fairly potent form of quantitative easing. In his speech in Jackson Hole in late August, Chairman Bernanke stopped short of promising more quantitative easing—his favorite “monetary elixir.” But he telegraphed other moves.

I think the Fed’s next tactic will be to undertake a reshuffling of its portfolio after the FOMC meeting on September 20-21. There has been talk about extending durations. More likely, the central bank will maintain the size of its portfolio, but begin to buy mortgage

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securities while reducing its holding in U.S. Treasury securities. One thing that Dr. Bernanke has proved is that he is a very creative fellow. Indeed, both equities and gold rose after his speech at Jackson Hole—a sure sign that markets believe another wave of liquidity is on the way.

Worry Nigh about a Double Dip

Expectations of renewed recession in the U.S. appear overblown. Consider: we have yet to have a negative print on the Leading Economic Indicators (LEI), and no recession has ever occurred without at least four consecutive negative months. Nor has a recession ever been preceded by an accommodative Fed—and the Fed has been aggressively accommodative. The yield curve is very steep: the difference between 2-year and 10-year Treasury yields remains at historic highs. Going back to the 1970s, there has never been a recession that commenced with a positive spread between these two yields. Recessions have always occurred when the yield curve was inverted, indicating Fed tightening. Obviously, this is not the case today, strongly suggesting a double-dip recession won't occur.

In fact, I expect third-quarter GDP to rebound to around 2.0 percent from 1.0 percent in the second quarter. July's personal income number is consistent with a 2.0 percentage point contribution to GDP growth for the third quarter. The decline in crude oil prices also could add as much as 0.2 percentage points to GDP this quarter. (A decline in gas prices at the pump also stimulates consumption.) Finally, automotive production is expected to surge 14 percent this period, likely contributing as much as 1.3 percentage points to GDP. So while consumer confidence and manufacturing data raise legitimate concerns, I don't foresee a recession and, if anything, the surprise could be to the upside.

What this Means for Investments

The market's overreaction has created an incredible opportunity in U.S. equities. In particular, I see value in high-dividend stocks. Many companies with strong cash flows and stellar credit ratings pay more in dividends than their bonds yield—a situation which hasn't existed for such a large number of stocks since the 1950s. Without doubt, Europe's problems indicate that further turbulence, even a retest of recent lows on the S&P500, cannot be ruled out. Nevertheless, for investors with 2- to 5-year horizons, price dips represent buying opportunities.

In fixed income, I am a huge fan of tax-exempt municipal bonds. It's possible to find high-credit securities that are trading with nominal yields just shy of 200 percent of 10-year Treasury yields—far in excess of the historic ratio of 83 percent. With nominal yields (which do not reflect the tax advantages) of 4 percent or higher, select munis have yields higher than most BBB corporate bonds. What's more, if spreads between munis and Treasuries were to revert back to historic levels, there would be a significant opportunity for capital appreciation to augment coupon payments.

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The alternative scenario: if interest rates were to rise back towards 4 percent (a very unlikely development given the Fed's recent pledge to keep rates low until 2013), and spreads narrow to historic levels, tax-exempt municipal bonds could still be sold at break-even, if not a small gain, and then reallocated to higher-yielding corporate bonds as rates rise. (For the record, I believe 10-year Treasury bond yields will remain below 2.5% as the market awaits the September FOMC meeting.)

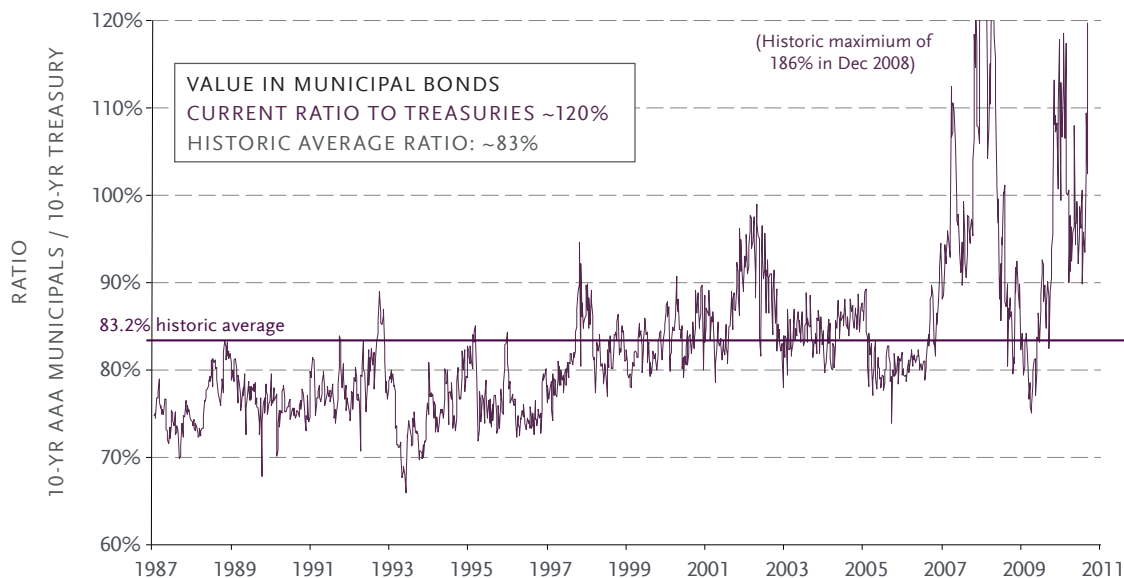
I also favor high-yield bonds and bank loans, both of which have attractive yields with less downside risk than equities. Single B corporate bonds yielding 9 percent or higher with 5-10 year maturities rival equities on a risk-adjusted basis if held to maturity.

The carnage of the present crisis has created a plethora of opportunities of the sort Benjamin Graham described 62 years ago in his classic book, *The Intelligent Investor*:

Price fluctuations have only one significant meaning for the true investor. They provide him with an opportunity to buy wisely when prices fall sharply and to sell wisely when they advance a great deal. At other times he will do better if he forgets about the stock market and pays attention to his dividend returns and to the operating results of his companies.

DISPLACEMENT YIELDS OPPORTUNITY: TAX-EXEMPT MUNICIPAL BONDS

Currently, tax-exempt municipal bonds have average yields that are historically high in relationship to the yield on U.S. Treasury securities with similar duration. With solid credit work, this dislocation presents an attractive opportunity for fixed-income investors to pick up yield without sacrificing credit quality.



Source: Bloomberg.

Today is a time to buy wisely—understand that first. Next, keep an eye on fundamentals and invest for the long term. By doing so, you will spare yourself the emotional hazards of near-term volatility.

Carry On

Perhaps I am too optimistic. If so, I believe most of our clients would say it's a first! After all, it is a scary world—just as it was when Britain printed posters urging the nation to “Keep Calm and Carry on.” As it turned out, though, those posters were never distributed. They were intended only for the worst case—a German invasion. That never happened, of course. Nor is the European debt crisis likely to spark a global recession today.

The important lesson for investors is to look past the emotions of the moment and study the data. Behavioral finance teaches us that we should not let emotion drive our investment decisions. Both fear and greed are dangerous emotions. The most important discipline is to stick to the facts. This doesn't mean that things can't get worse in the near term. But keep in mind that picking the absolute bottom of the market is a difficult game to play. Once calm is restored, I believe we'll look back on this period of uncertainty as an incredible time to put capital to work at attractive valuations. □

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