



MARKET PERSPECTIVES

JANUARY 15, 2011

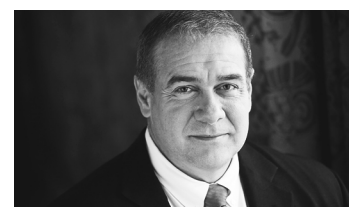
‘Europe’s Gordian Knot’

In antiquity, there is a curious story of a Phrygian king named Gordias who tied his ox cart to a pole as a sign of gratitude to the gods. To ensure that it could never be removed, he secured the cart with a massive knot made from a bark that hardened with time. To confound matters, the knot had no exposed ends, making it impossible to undo. According to legend, whoever ultimately untied the knot would be destined to rule the continent. Over the centuries, many tried to disentangle the complex mass, but to no avail.

The legend concludes when a young Alexander the Great was forced to winter in Phrygia. He immediately understood the impossibility of untying a knot that had no beginning or end. The solution: he drew his sword and cut the cord in order to create two ends. He was then able to successfully untie the knot and fulfill the prophecy. As lore would have it, Alexander regarded his victory over the Gordian Knot as the most decisive battle he fought en route to conquering all of Asia.

To this day, the metaphor of the Gordian Knot is used to describe any problem so large, complex, and intractable that it cannot be solved by conventional methods. Instead, it must first be addressed with a single bold stroke that changes the rules of the game. This analogy is well-suited for the rapidly unfolding crisis in Europe. A highly interconnected economic system with intractably diverse structural problems but one hard currency – this is Europe’s Gordian Knot.

The current European crisis cannot be unwound, at least not without unwinding the entire monetary system. Since a lot of blood, sweat, and tears went into the creation of the euro, abandoning it is not an option. Neither is the current policy of serial and ever-expanding bailouts, which is not a sustainable path because it does nothing to address the structural issues facing the diverse European economies.



BY SCOTT MINERD

Chief Investment Officer,
Guggenheim Partners, LLC

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Ultimately, I believe the answer to the European crisis will be an Alexandrian-style paradigm shift: the realization that monetary union is not sustainable without increased political and fiscal union. In other words, the endgame for Europe is federalization.

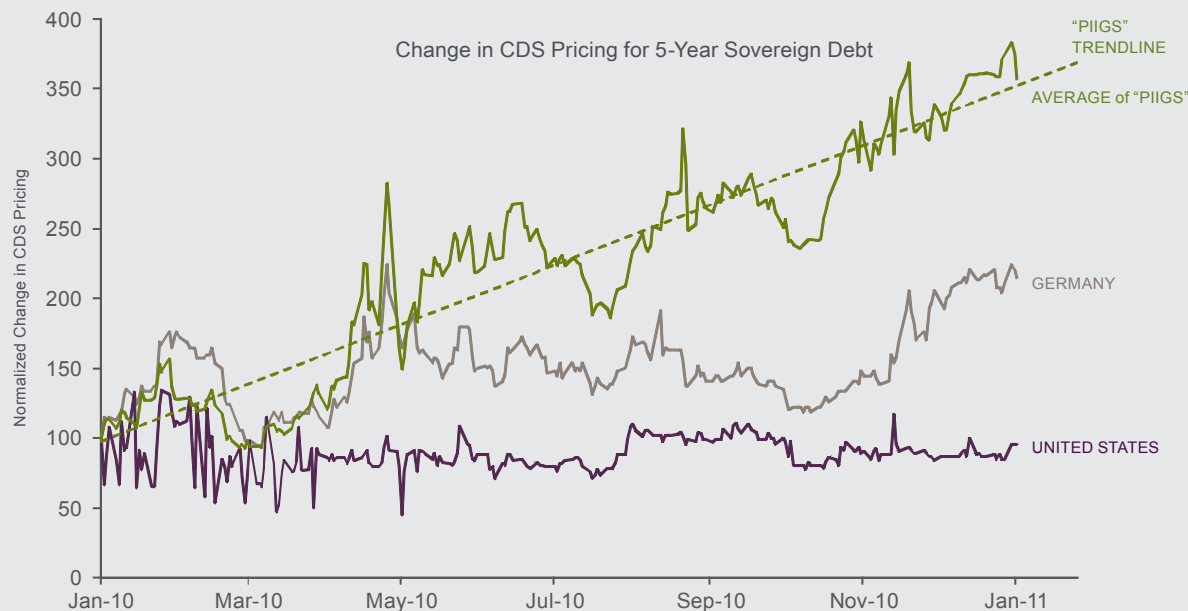
‘The Crisis Unfolds, Policymakers Postulate’

Just as the petrifying of the Gordian Knot made it more difficult to solve with the passing of time, so it is with the current crisis Europe. Time is not an ally. While policymakers postulate about what should be done in 2013, and whether or not inflation is a pressing concern, the borrowing costs for peripheral nations are increasing, massive amounts of sovereign debt are coming due, and deposits are flowing out of banking systems.

Surprisingly, in recent days there has been rhetoric suggesting that the euro-zone crisis is waning. Such speculation is based on the better-than-expected bond sales by Portugal, Italy, and Spain, as well as the recent votes of confidence cast by the governments of China and Japan. However, the spate of positive sentiment has only served to bring the bond market’s perception of European sovereign debt default risk down a notch from significantly elevated levels.

‘MORE OR LESS CONCERNED?’

While recent news has modestly assuaged credit fears regarding the ability of Portugal, Ireland, Italy, Greece, and Spain (“PIIGS”) to finance themselves, a normalized look at the past 12 months shows how the CDS market has grown increasingly concerned.



Source: Bloomberg. Base date is January 13, 2010.

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As one of our managing directors, Jeff Carefoot, summarized in response to the recent news of an oversubscribed Spanish bond offering:

We've gapped in from the wides for sure. Spain brought 3.9 billion euros of debt at substantially higher levels, although it was inside 'expectations'. The problem remains that 192 billion euros of debt was the 2011 schedule in the Spanish budget, so there's only 188.1 billion euros to go? I'm not sold on the party. Although a C- is technically a passing grade, my father never would have accepted it and neither should investors.

“It may go kicking and screaming, but eventually the ECB will have to dramatically increase the supply of money.”

I couldn't agree more with Jeff's assessment. His ultimate recommendation for investors in Spanish debt: “Sell.”

The reality is that the crisis continues to deepen. For the first time in history, western European sovereign debt is considered riskier than emerging market debt. Although the momentary direction seems positive, the overall momentum remains decidedly negative. As of January 13, the average cost for credit protection against default for the 5-year sovereign debt of Portugal, Ireland, Italy, Greece, and Spain (the “PIIGS”) is 8 percent more expensive than one month ago, 42 percent more expensive than three months ago, 57 percent more expensive than six months ago, and 260 percent more expensive than just one year ago.

There is a plethora of proof that the crisis isn't abating. Greece's long-term issuer default rating was just cut to junk by Fitch with a negative outlook. In addition, the problems in the Irish banking system continue to expand. In November alone, 27 billion euros of domestic deposits (5.4 percent of the total deposit base) fled Irish banks. Total deposits were down 15.1 percent year-over-year and deposits from non-Irish residents declined 28.6 percent. Keep in mind that the crisis in Ireland didn't broadly surface until late in November. I realize that I said the same thing last month about the situation in Ireland, but with data trending like this I cringe thinking about what the next set of monthly data may reveal.

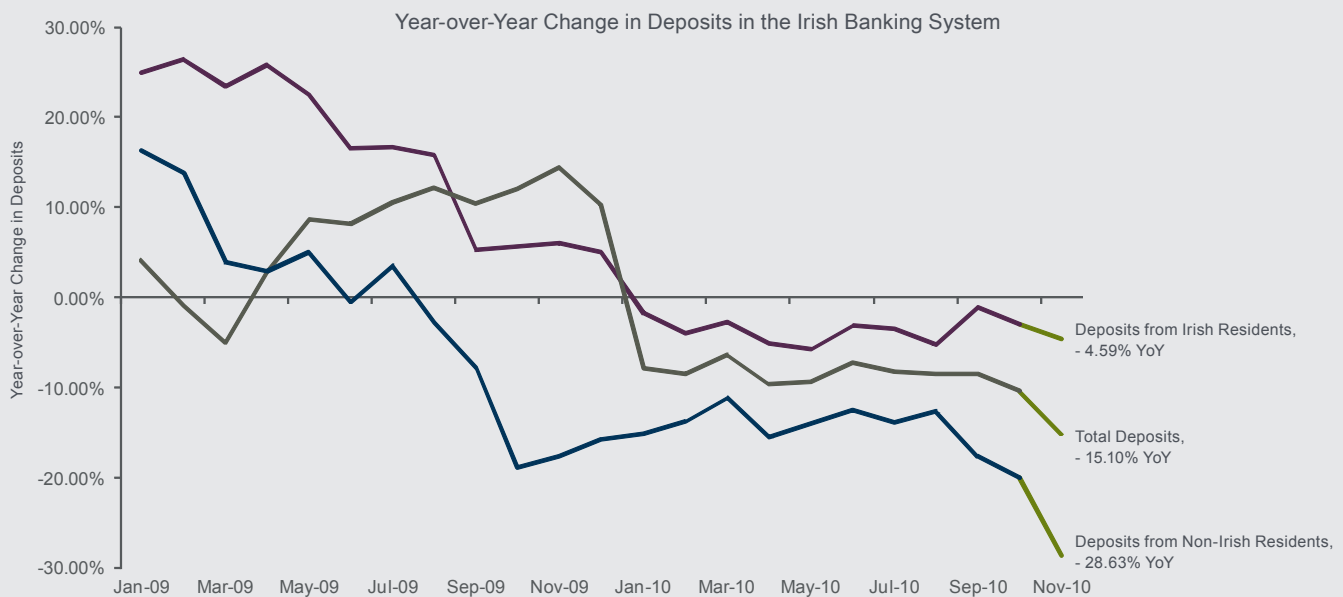
‘Forcing the Hand of the ECB’

The European Central Bank is under immense pressure because problems are emanating simultaneously from the banking system and the sovereign debt market. Between backstopping the banks and bailing out the peripheral nations, at some point, the crisis will force the ECB into aborting its policy of keeping the money supply stable. It may go kicking and screaming, but eventually the ECB will have to dramatically increase the supply of money, following the path the United States has taken with multiple rounds of quantitative easing.

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‘WITHDRAWING FROM IRELAND’

In November alone, 27 billion euros of domestic deposits (5.4 percent of the total deposit base) fled Irish banks. Total deposits were down 15.1 percent and deposits from non-Irish residents declined 28.6 percent year-over-year. Keeping in mind that the crisis didn't broadly surface until late in November, these trends may grow especially grim once the December data is released.



Source: The Central Bank of Ireland. Data includes all banks that operate in the Irish domestic banking market servicing Irish households and non-financial corporates.

If the money supply does not expand, then the euro is likely to stay strong. As long as the euro stays strong, the economic problems in the peripheral nations will continue to deteriorate. Vital to the success of any austerity program is debasement of the currency. The ultimate expansion of the ECB balance sheet will cause the value of the euro to decline and have a dramatic effect on the pan-European outlook. The timing of such critical events is something I hope to explore in a subsequent commentary.

‘Merkel, Sarkozy, and Alexander the Great’

Admitted or not, flashing across the political mindset in Europe is the realization that monetary unification will inevitably require a greater degree of political and fiscal unification. Critics of the euro have been saying this since its inception, but the current crisis is forcing the issue to the forefront of pan-European policy.

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As The Wall Street Journal aptly summarized in a front-page article on December 27:

Ever since [the creation of the euro], economists have warned that monetary union, without a parallel authority to regulate taxes and spending, was destined to fail because there was no way to enforce the fiscal discipline essential to a currency's health. Now, as Europe's year of crisis grinds to a close, the Continent's leaders are contemplating what many long resisted: a United States of Europe.

The federalization of Europe isn't as far-fetched a concept as one might think. Remember that the United States of America initially operated under a loosely constructed confederation of sovereign states.

Prior to the Articles of Confederation, the individual colonies accumulated varying degrees of debt while fighting the Revolutionary War. The colonial debt burdens were highly divergent depending on the level of commitment to the war and the economic benefits accrued as a result of independence. Similar to the situation in Europe, some states suffered under far heavier debt burdens than others and economies prospered in varying degrees.

Without a tax base or the ability to consolidate debts, the make-shift Continental Congress was unable to assist individual states. Therefore, in 1787, it convened to address the financial viability of a confederation of unified states. Broad and sweeping changes were necessary, but under the Articles of Confederation such change could not occur without great difficulty. In response, that convention seized the opportunity to forge the Constitution of the United States of America, which curiously needed only a two-thirds vote to be ratified rather than the unanimity previously required in order to amend the Articles of Confederation.

It was reported that during the debate, John Jay, an American founding-father who co-wrote the Federalist Papers, argued in favor of the fiscal benefits of federalization. He said, in effect, that without a federal government the states would no sooner become independent than they would become insolvent. He argued that it should *not* be said of America that "her infant glories and growing fame were obscured and tarnished by broken contracts and violated faith."

It was this Alexandrian-style paradigm shift in American government that paved the way for the Articles of Confederation to be replaced by the United States Constitution, and for Alexander Hamilton to ultimately absorb the debts of the states as a part of the process of federalization.

As Solomon said, "There's nothing new under the sun." The federalization of independent sovereign states for the purpose of financial and political stability has happened before. The application to the current crisis in Europe really isn't as crazy a concept as one might think. At the end of the day, it's all been done before.

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Returning to modern day, the escalation of the current crisis in Europe will represent the Alexandrian moment for Germany and France, who have long desired to extend their influences across the continent. I believe that politicians are on board for greater European fiscal union; however, they still need to sell it to their constituents. Ironically, their lack of action may ultimately do the selling for them as the crisis deepens. It's only a matter of time before Germany and France find the political will to lead the European Union into a new era of fiscal unification. Ultimately, the German and French motivation is the same reason Alexander the Great cut the Gordian Knot – the promise of ruling over a unified continent.

‘What Does This Mean for Investments?’

First off, I don't believe the crisis in Europe will derail the economic recovery in the United States. Considering the magnitude of the stimulus being pumped into the U.S. economy, I expect 2011 growth in the neighborhood of 3-4 percent. This makes the U.S. market look like one of the more attractive places for capital relative to the other markets, which should be good for the dollar.

With that said, as the crisis in Europe plays out there will certainly be ripple effects in the U.S. financial markets. I expect a correction in the U.S. equity markets, but I also know that bull markets are able to persevere through adverse shocks to the system, (e.g., see my discussion of the 1987 experience in my previous commentary). What will the magnitude of the correction be? I believe we'll see a 5-10 percent pullback for U.S. equities at some point. Notwithstanding this correction, I still believe the total return for the S&P 500 will reach double digits in 2011, and average somewhere in the 7–10 percent range per year over the course of the next decade.

Emerging market equities continue to be attractive, but primarily over longer time horizons. The best way I've heard it paraphrased is that there's definitely more upside in the emerging markets, but it's not early anymore. China is dramatically behind the curve and will have to raise rates over the next six months if they hope to reign in their problems with inflation and the looming property bubble. A slowdown in China will cascade through the emerging markets. So, while in the long run emerging markets are the place to be, in the short run I wouldn't necessarily allocate new money there.

In commodities, I expect to see softness in industrial metal prices as international demand declines in light of slowing economic growth. Over the first half of the year, I anticipate that the value of the U.S. dollar will appreciate relative to other world currencies. In light of this, I don't expect the price of gold to go up meaningfully in U.S. dollar terms in the near term, although it will continue to rise in other currencies. In the long-run, the bull-market case for gold remains solid.

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In terms of interest rates in the United States, my view continues to be that of a period of sustained low rates with only marginal room to rise. The core of the story for why rates must stay low has to do with the continued depression in the housing market. Estimates for the current level of shadow inventory – i.e., the number of homes in some stage of default or foreclosure – broadly range from 4 million to 8 million units. Specifically, on November 17, Fed governor Elizabeth Duke told Congress that the Federal Reserve expects an additional 4.25 million foreclosure filings in 2011 and 2012.

When long-term interest rates rise, housing activity slows. Rates above 4 percent would create a myriad of issues for the housing market, not the least of which would be hamstringing the ability of financial institutions to work through the backlog of foreclosures on their balance sheets. Since the backup in interest rates began approximately eight weeks ago, we've started to see housing activity wane and housing prices decline again. If housing prices decline meaningfully, there is significant risk of another wave of mortgage defaults. The story in housing remains a compelling reason yields on the 10-year note above 4 percent are simply not sustainable at this juncture.

Further evidence against rates rising meaningfully comes from the historic relationship between the Fed funds rate and the 10-year Treasury yield. Over the past 30 years, the 10-year note has never been able to sustain a spread to the Fed funds rate greater than 375 basis points without precipitating a major rally. Currently, a spread of 375 basis points would translate into a 4 percent yield on the 10-year Treasury, which further leads me to believe that this is a pretty hard ceiling. I don't necessarily think yields will get to 4 percent, but I do think they may test 3.80 before coming back down to the 3 percent range in the second half of the year.

In conclusion, I believe 2011 will be characterized by a preference for dollar-denominated assets as a result of deteriorating economic conditions in Europe and the overheating in Asian markets. As assets flee Europe it should strengthen the dollar and push yields down as investors buy Treasuries as a safe haven asset.

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