GUGGENHEIM

Market Perspectives

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2012 Outlook

The Triumph of Optimism

There is an old proverb that describes three methods of gaining wisdom: "First, by reflection, which is noblest; second, by imitation, which is easiest; and third, by experience, which is bitterest." At year-end, many of us turn to the nobility of reflection in hopes of gleaning wisdom for the new year. Recently, my own ruminations on the past helped me solidify my outlook on the future.

Five years ago, while bulls abounded, I remember sitting through product design meetings, client strategy sessions, investment committee meetings, internal portfolio manager and sector manager meetings—all of them focused on what I called "the coming crisis of biblical proportions." During those long weeks and months, we planned for crises, disasters, and even unthinkable scenarios like zero percent short-term interest rates and policies that would require central banks to purchase government bonds. Many thought me crazy. At a certain point in 2007, I might have agreed. But sure enough, just about every nightmare economic and financial market scenario imaginable materialized; it was only a matter of time.

When I look back over the past five years and consider where we are today, I feel two distinct emotions: gratitude and optimism. Gratitude because these crises have created tremendous investment opportunities. Optimism because I see the dark clouds finally breaking.
Today, there is positive economic momentum in the United States, progress in Europe, and global policy accommodations being implemented that are pro-cyclical and supportive of longer-term economic growth.

Of course, there is always the possibility of a cataclysmic event. The "unthinkable" can always happen; however, unceasingly discounting for such events has never been a successful long-term investment strategy. As an investor, I have found that the best time to be an optimist is when there is a parade of pessimism marching down Main Street.

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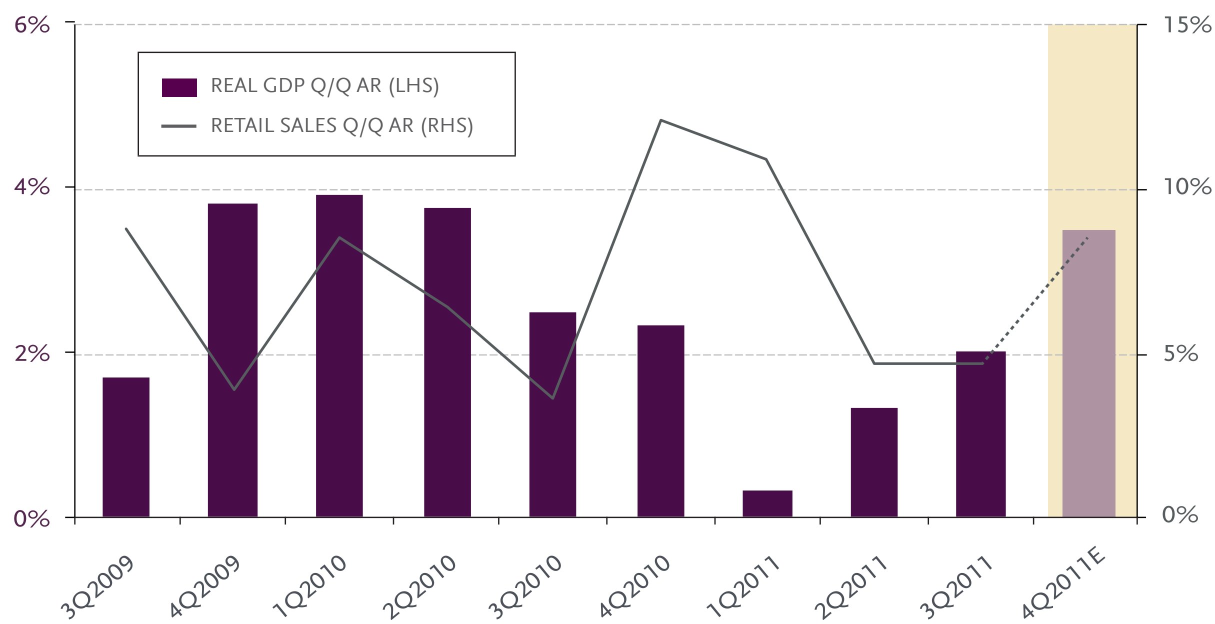
The Case for Optimism

These days, it seems that everywhere I go someone tells me something negative. It is the mirror image of five years ago, when everywhere I went someone told me something positive. From the talking heads on television to the man on the street, today's sentiment is dominated by pessimism. But when I piece together the puzzle, the picture that I see contradicts the prevailing doom and gloom.

Starting with the United States, the data from the world's largest economy actually paints a picture of healing and modest, but sustainable, expansion. There is wind in the sails of the current recovery: employment is growing; monetary policy is extremely accommodative; retail sales have been strong; there is a backlog in production; business inventories are lean. There is a host of data that supports the idea that economic growth could be substantially better than consensus expectations. My personal belief is that fourth-quarter GDP could be in excess of 3.5 percent, which is certainly nowhere near a recession. The seeds of a self-sustaining economic expansion are finally bearing fruit.

CONSUMER ACTIVITY IS A BOON FOR U.S. ECONOMIC GROWTH

Lower gasoline prices and modestly improving employment have all contributed to a rise in U.S. consumer activity. The growth in retail sales, which makes up almost one third of U.S. GDP, should provide material support to fourth-quarter GDP growth, which we expect to be around 3.5%.



Source: Bloomberg. 4Q2011 data are estimates by Guggenheim Investments.

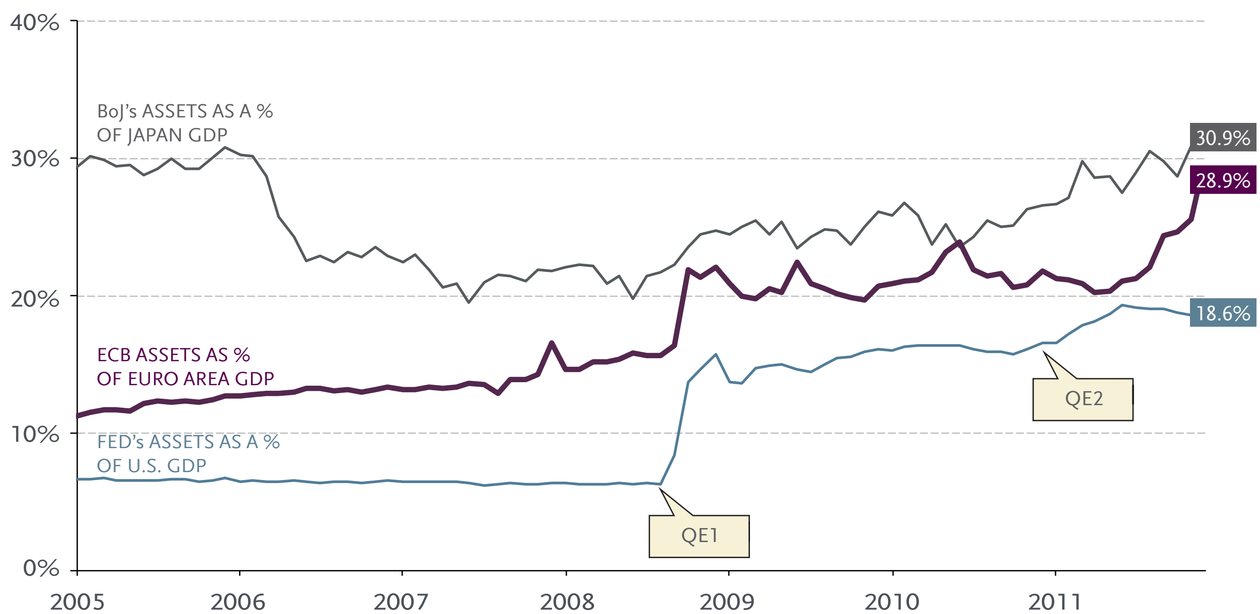
The reality is that the U.S. economy has momentum heading into the first half of 2012. Still, the market seems unconvinced of the sustainability of the current recovery. The doomsayers should have more faith in the U.S. government's ability and willingness to turn on the printing press at the first sign of any slowdown or crisis. As one of my dear friends and professional colleagues, David Zervos at Jefferies & Company, often quips, "The Bernanke Put remains in effect." All in all, the U.S. economy is finally finding its footing in the wake of the worst recession in generations. With the preponderance of economic data turning positive, I believe markets will eventually weary of pricing into the U.S. the problems from across the Pond.

There Is Progress, Even in Europe

In Europe, the outlook is certainly more sobering, but it is important to recognize how far the Europeans have come toward a solution. The progress may seem like two steps forward and one step back, but that is still a dramatic improvement from earlier this year, when the cognitive dissonance of European policymakers reflected denial at the expense of concerted effort.

EUROPEAN CENTRAL BANK, BANK OF JAPAN, AND THE FED: ASSETS AS A PERCENT OF GDP

Over the past six months, the ECB balance sheet has increased by €820 billion, more than 1.5 times the size of QE2. Its balance-sheet-assets-to-GDP ratio has reached 28.9%. This is higher than the comparable ratio in United States and it may soon surpass even Japan.



Source: Bloomberg, Guggenheim Investments. Data as of December 28, 2011

As evidence of progress, take the policy changes at the European Central Bank ("ECB"). Since Mario Draghi took the helm in November, there has been a 180-degree change in policy—two immediate rate cuts and an unprecedented three-year lending operation to provide liquidity to the financial system. The lending operation, which is scheduled to dole out a total of €489 billion, is particularly interesting. Essentially, the ECB has created a potential means whereby the banks could be used to recapitalize Europe, if necessary.

"Quantitative easing and a depreciated currency will prove a potent policy mix to alleviate the strains in Europe."

Over the past six months, the ECB balance sheet has increased by €820 billion (more than 1.5 times the size of the Federal Reserve's QE2 program), and its balance-sheet-assets-to-GDP ratio has reached 29 percent. This means that the ECB's balance sheet, in proportion to the economic union that it serves, is already larger than that of the Federal Reserve. At the current rate, it will soon surpass the Bank of Japan ("BOJ") ratio as well. What all this means is that the ECB is taking measures to put air bags of liquidity into the system to safeguard against a crash.

Liquidity alone will not solve Europe's problems, but it will help buy time. On the fiscal side, I see Europe in a slow march toward structural solutions. I expect that additional rounds of crises, along with many more summits, will be required to completely address these issues, but it is worth noting that policy progress has been made.

I believe the ECB will eventually deem that there are sufficient reforms in place to warrant substantially more accommodation. This will likely include further rate reduction and quantitative easing (as opposed to the "closet QE" we have seen thus far). As ECB officials have vowed to not purchase sovereign debt directly, I believe they will utilize the International Monetary Fund and/or other financial institutions as the vehicles to prop up the governments around Europe. Directly—or more likely indirectly—the ECB will end up financing the European sovereign powers.

Such ECB actions will result in a weaker euro, probably declining to parity or even lower against the U.S. dollar, but this too will be good for struggling European economies. A depreciated currency will help soften the economic pain of the recession (which I believe the euro zone is already in), especially in countries like Italy where a lower exchange value of the euro will make manufactured goods more competitive and drive export growth. Export growth will lessen the pain of austerity and make budget reforms a more palatable option for European nations. So, we are already beginning to see a path to resolution of the European crisis. Quantitative easing and a depreciated currency will prove a potent policy mix to alleviate the strains in Europe. This will buy time for policymakers to affect the tough structural changes necessary to form a closer fiscal union, or what I would call federalization.

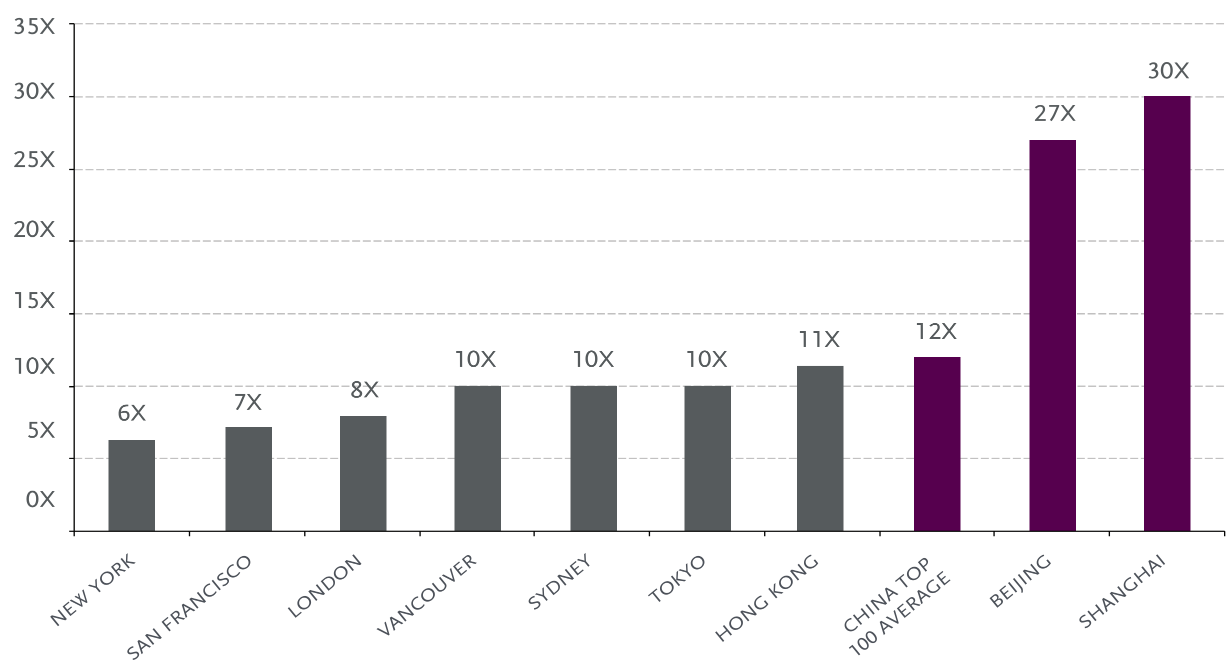
Concerning China

Over the next 12 months, I believe China will replace Europe as the headline story in the global financial markets. Even now, the news has become increasingly negative out of China. There are reports of growing social unrest, slowing industrial production, declining property values, and rising fears of a hard landing for the economy. But before hitting the panic switch, remember that the resources of the Chinese government are substantial.

In a worst-case scenario, it could cost as much as $1.5 trillion to recapitalize the Chinese banking system should the housing market utterly collapse. To put that in perspective, $1.5 trillion represents about 20 percent of China's 2011 nominal GDP, which is estimated to be about $7.0 trillion. Conversely, the $1.5 trillion price tag would represent less than half of China's foreign exchange reserves, which are currently around $3.2 trillion. So, although China may be in trouble, the government likely has both the financial resources and the political efficiency to address the ramifications of a dramatic correction in real estate prices.

UNSUSTAINABLY UNAFFORDABLE? HOUSE-PRICE-TO-HOUSEHOLD-INCOME RATIOS IN CHINA

The sharp contrast in housing affordability between Chinese cities and the rest of the world is alarming. China's real estate prices are a result of the structural imbalances created by its rapid investment-led growth over the past decade. The housing bubble in China poses the biggest risk to its economic stability and growth in 2012.



Source: Bloomberg, China NBS, Guggenheim Investments. China data as of September 2011, all others as of 3Q2010.

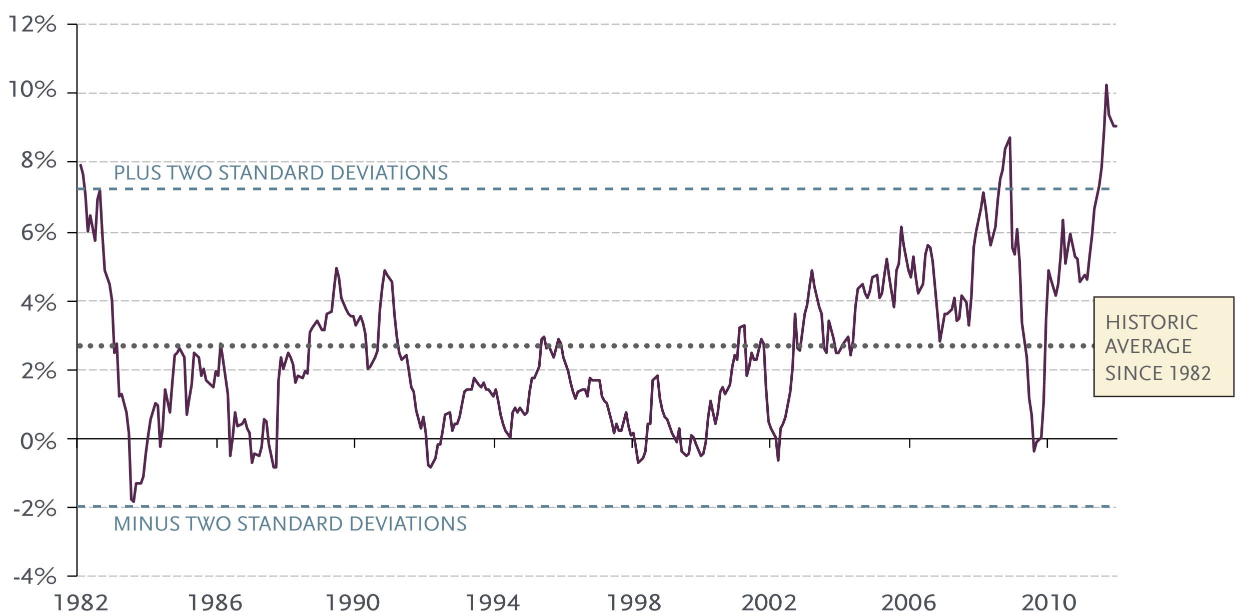
What this Means for Investments

Having looked around the world and decided that maybe things are not as bad as advertised, we are left with the usual question: "What does this mean for investments?" I believe we are in a fortunate environment—one that offers exceptionally high risk premiums for certain asset classes. In other words, investors are being well compensated in certain asset classes relative to the downside risk that they are being asked to bear. I would like to emphasize that my view pertains to long-term investment horizons of three to five years. The near term will require willingness to stomach short-term volatility and ride out the bumps as they come.

As I originally mentioned, there is always the possibility of a crisis erupting unexpectedly. Very few anticipate nuclear meltdowns, the bubonic plague, or a universal flood where the only hope is to pack our animals into an ark to survive the storm. Such events may occur, but constantly investing with catastrophe as the expected outcome has proven to be a foolish strategy. Better is to look for periods when the tide is turning, to identify inflection

U.S. EQUITY RISK PREMIUM NEAR HISTORICAL HIGH

The equity risk premium is calculated by subtracting the risk-free rate (real 10-year Treasury yield as proxy) from the market return of equities (S&P 500 earnings yield as a proxy). Over the past 12 months, declining real yields for U.S. Treasury securities and rising earnings yields for U.S. equities, has resulted in an equity risk premium currently near historical highs.



Source: Bloomberg, Guggenheim Investments. Data as of 12/30/11.

points, to gauge when the markets have become saturated with conventional wisdom and are in need of correction—regardless of whether that "wisdom" manifests itself as irrational exuberance or draconian dread.

Today, I believe the markets are so preoccupied with pricing for the most disastrous outcomes that they have essentially become vulnerable to upside surprises on any bit of good news. Through the travails of 2011, a number of the uncertainties have been taken off the table in Europe. This should clear the way for equity prices to improve over the course of the next year, both in the United States and in Europe.

Another positive sign is that global policies have clearly become more accommodative. As usual, policymakers have been late in recognizing and addressing problems, but over the past few months the number of steps taken to either reduce rates or stimulate economies is mind numbing. A backdrop of accommodative policies is pro-cyclical and good for economic output. I expect that the current era of accommodative monetary policy will eventually lead to meaningfully higher nominal prices for a number of risk assets, such as equities, high yield bonds, bank loans, and even real estate. In the near term, there will likely be patches of difficult weather, but overall I believe that things are looking up. If I am correct about the U.S. economy's growth and momentum, then U.S. equity prices should be significantly higher over the next 12 to 18 months.

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While equities and other select risk assets are cheap, one asset class that looks particularly overvalued and represents a poor risk return is U.S. Treasury securities. I have remained bullish over the past five years on this asset class while many of my industry colleagues felt compelled to avoid, and even short, Treasury bonds. But there comes a time when an investment reaches price levels that no longer represent good value. I see little risk of an imminent, dramatic rise in rates, but I generally recommend using current strength as an opportunity to reduce exposure to Treasury securities while the Federal Reserve is still a willing buyer. There is a historical precedent for Treasury prices remaining inflated for a number of years under the support of Federal Reserve purchases—it happened during the 1940s, prior to the Treasury Accord of 1951. During that period, the yield bottomed at around 1.65 percent, very near where we are today. In a future commentary, I hope to share more about this topic in the context of Keynesian economics, financial repression, and inflation. For now, suffice it to say that I do not believe Treasury securities represent good value for long-term investors.

The Sun Will Come Up Tomorrow

To conclude, the current environment reminds me of a story from the European exchange rate crisis in 1992. I was in Rome working on the restructuring of Italy's Eurobond debt. At the time, Italy was in big trouble and there was no promise that it could reestablish itself as a credible capital markets borrower—the prospect of an IMF bailout was very real. In the thick of our work with the Italian government, I walked through the famed Roman Forum with several people from the Italian Treasury. I was taken aback by their relative calmness and felt compelled to compliment one of the government officials on his composure throughout the crisis. I'll never forget his answer, as he coolly replied, "Scott, look around. Rome has been here for over 2,000 years. The sun will come up tomorrow."

His words remind me that over the course of history there is a certain triumph of optimism. Betting against the column of progress of human history and the innovation of mankind has always proven to be a losing proposition. Yes, in the short run, there are times to become cautious, as the past five years have exemplified. But a stopped clock is correct for only a brief moment before time marches on. Circumstances change; markets are cyclical. Broad-based economic expansion and its attendant outsize investment returns follow contraction and panic just as the day follows the night. As dark as the current environment may seem, the sun will come up tomorrow. When it does, I believe it will shine favorably on the optimists of today.

ABOUT GUGGENHEIM

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