MARKET PERSPECTIVES

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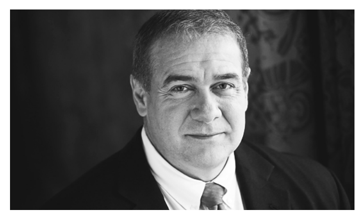
Enjoy the Good Times While They Last

(This article is an excerpt from Guggenheim's Investment Focus research report titled "Equity Macro-Themes." Please click here to view the entire report.)



BY SCOTT MINERD

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In the years leading up to the recent financial crisis, I gained a reputation for being permanently bearish. As I shared my macro-economic outlook with clients in 2005 and 2006, in particular, the most common response was something along the lines of, "Great, now that I'm totally depressed, what else is there to talk about."

Today, however, I'm starting to have the opposite problem – people think my outlook is far too sanguine, at least with regards to the United States.

For example, I'm bullish long-term on U.S. equities, I think U.S. GDP will beat consensus expectations, I don't believe interest rates are going through the roof, and I don't believe inflation is the problem that everyone advertises it to be, at least not today. (None of these statements are forever, mind you, but they apply to a period meaningful enough to make a real impact on asset allocation and annualized returns).

Neither sanguine nor cynical, I think Lawrence Strauss at *Barron's* did an exceptional job capturing the essence of my current take on the world. Following a recent interview where we discussed the current investment landscape at length, Lawrence boiled everything down to a single phrase, which ended up being the title of the piece he published: *"Enjoy the Good Times While They Last"*

The "good times" relate to the fact that the U.S. economy is clearly in an expansionary portion of the business cycle with the majority of indicators moving in the right direction. For example, in February, there were gains in 9 out of the 10 inputs to The Conference Board Leading Economic Index (LEI). This included solid improvements in employment, consumer expectations, and manufacturing.

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The lone drag came from the housing market, an area that should continue to lag the rest of the economy for some time.

Overall, I believe long-term growth in the United States will be even stronger than the market is currently discounting.

The vast amounts of monetary and fiscal stimulus that have been unleashed in the system have created a rising tide of liquidity that's lifting asset prices for just about everything except real estate. The equity markets have particularly benefited, as we have already seen.

"On a relative-value basis, the U.S. equity markets should prove to be one of the more attractive places to invest during this expansionary post-recession period."

Inflation and the Expiration of QE2

Going forward, the burning questions seem to be: what will happen once the accommodative monetary spigots are turned off, and when will the specter of inflation reach the United States as it has begun to do in other global markets?

First off, I don't believe quantitative easing will be immediately inflationary. Nor do I believe that its expiration will lead to a meaningful increase in interest rates. To be sure, rates will bounce around, but they should trade in a band that stays around historically low levels for an extended period of time.

With regard to inflation, I believe current price pressures are specific and transitory rather than structural and broad-based. While transitory price pressures may cause concern, I expect the Federal Reserve will hold off on the tightening front until 2012.

Post QE2, I expect that we'll see continued fiscal policy support, as the current Obama Administration will likely remain committed to its pro-economic growth agenda through the 2012 presidential election. So far, this is all the good news.

The bad news is that there are massive structural problems in the United States that are not being addressed. The nation will someday have to face its deficit spending addiction, and eventually inflation will sneak up on policymakers when they least expect it. But those periods are not today. And they are not immediately pending either.

The Right Question to Ask

The reality is that the whole world is in the midst of kicking the can down the road. For investors, the most important questions should be: where are the investment opportunities during this interim period of expansion, and how does the U.S. economy stack up relative to the rest of the world?

In this regard, I believe there is a chain of economic dominos that bodes well for capital flows to U.S. markets. Given the turmoil in the Middle East and North Africa, the overheating in the emerging markets, the debt crisis in Europe, and the disaster in Japan, the U.S. economy is well-positioned to attract an increasing share of global capital.

On a relative-value basis, the U.S. equity markets should prove to be one of the more attractive places to invest during this expansionary post-recession period.

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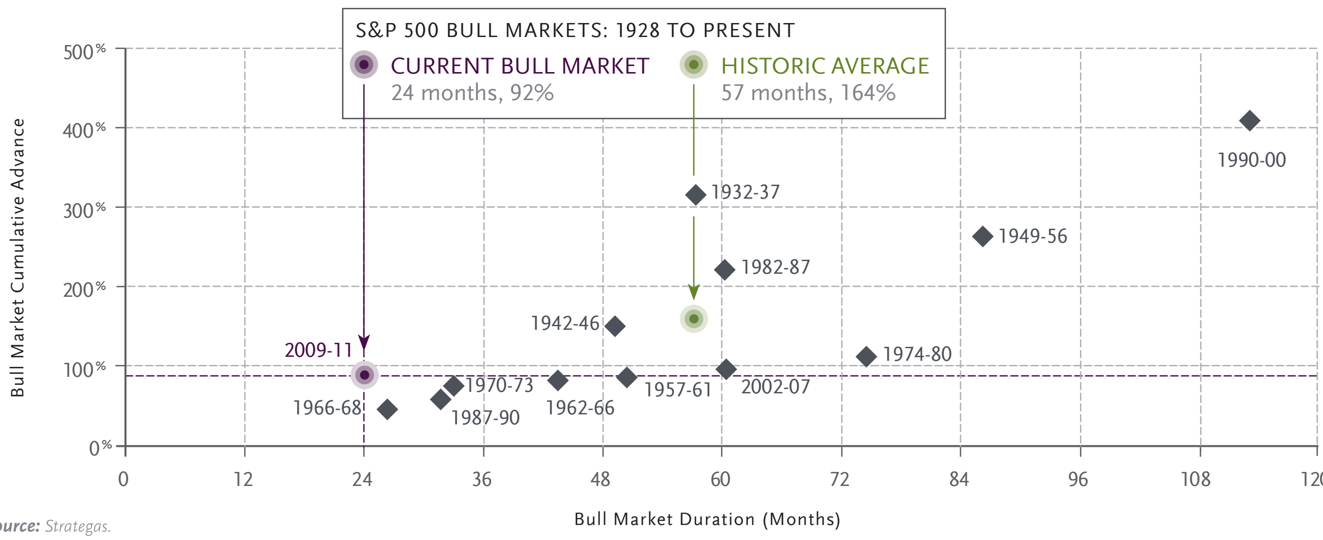
IF THE CURRENT BULL MARKET WERE TO END TODAY, IT WOULD BE THE SHORTEST ON RECORD

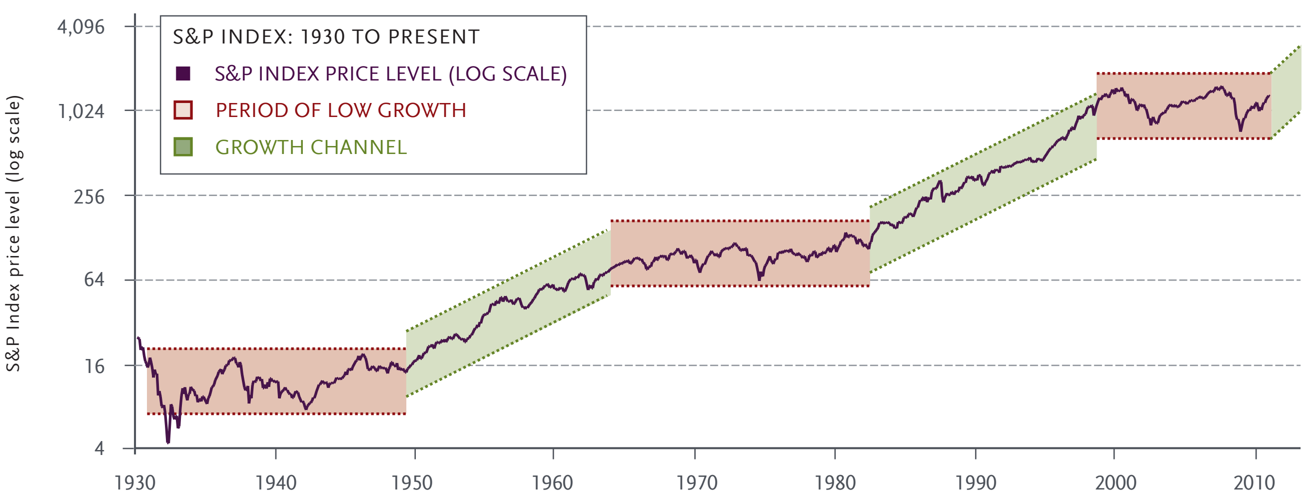
On March 9, 2011, the bull market in U.S. equities celebrated its second anniversary in rather dubious fashion by losing 5% in two weeks. We viewed this as a healthy pause since the current rally had extended far beyond its 200-day moving average. We do not, however, believe that the current bull market is at risk of being interrupted in a meaningful way. If fact, if it were to end today, it would be the shortest bull market on record. On a fundamental basis, we believe the macro-drivers are in place for continued growth.



Source: *Strategas.*

MULTI-YEAR RALLIES FOLLOWING EXTENDED PERIODS OF LOW ANNUALIZED RETURNS

Over the past 80 years, there have been only three periods of prolonged non-performance in the U.S. equity markets, all of which were tied closely to severe economic shocks and restructuring of the U.S. economy: the Great Depression, the period surrounding the recessions in 1969-1970 and 1973-1975, and the decade between the dot com recession and the recent financial crisis. Following the past experiences of severe recession and shock, once economic growth took root again there were multi-year rallies in the U.S. equity markets.



Source: *Bloomberg, Guggenheim.*

U.S. Equity Markets and the Case for Mean Reversion

I once had a finance professor at the University of Pennsylvania Wharton School who had an immutably bullish outlook on U.S. equities. He espoused that stocks were far and away the best asset class for long-term investors, regardless of market timing. In fact, he went on to gain notoriety for publishing a book entitled *Stocks for the Long Run*.

Without taking anything away from the impressive work of my old professor, Dr. Jeremy Siegel, the problem I always had with his thesis is that it's highly dependent on your definition of "long run." As John Maynard Keynes is famous for saying, "The long run is a misleading guide to current affairs. In the long run we are all dead."

Even if we look at a holding period of 10 years – which I would venture to guess qualifies as "long run" for the vast majority of investors – we can see that there have been a number of periods where U.S. equities delivered annualized returns far lower than bonds.

The most recent decade ending in 2010 was one of these periods, which is why allocations to equities have generally declined across investor classes from where they were five or ten years ago.

Whether you have been burned by the "lost decade" in equities or not, it's important to not throw the baby out with the bath water, especially at a time when returns are poised to revert back to historic norms.

As I often say, mean reversion is one of the most powerful statistical forces in finance. The only markets that don't eventually revert back to a well-established mean are those that are going out of existence.

If you think the U.S. equity markets will close their doors in the near future, then by all means, stop reading now. However, if you believe the U.S. stock market might stick around for another generation or two, then there's a strong statical case for long-term U.S. equity returns to average something on the order of 11 percent per year, which is the historic average for a 10-year holding period when you include dividend reinvestment.

"Following periods of abnormally low equity returns, there is a strong historic tendency toward reversion to mean returns of approximately 11 percent per year for a 10-year holding period."

What Follows an Anomalous Decade of Low Returns?

To explore the precedence for mean reversion following extended periods of underperformance, the Guggenheim Equities Team recently studied data on the Standard and Poor's Total Return Index as far back as 1926.

Looking at annualized returns on a rolling quarterly basis, we found that in only 7 percent of the periods did the S&P Index register annualized total returns of 2 percent or lower over a 10-year holding period (which is our proxy for a "long-term" investment horizon).

Each of the instances of dramatically low returns occurred around three distinct periods: the Great Depression, the 1973-1975 recession, and the recent 2008-2009 financial crisis.

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PROVING FAMA AND FRENCH: DATA ON MEAN REVERSION

In 1988, Eugene F. Fama and Kenneth R. French proposed that stock returns are mean reverting and contain predictable components that are weak over shorter horizons but more powerful over longer horizons.

In support of this basic thesis, the table on the right presents data on S&P 500 Index returns broken down by various holding period lengths. On average, there is not a tremendous variability in the annualized return. What is most noticeable, however, is that the volatility of returns (measured by the standard deviation) declines dramatically as the holding period increases.

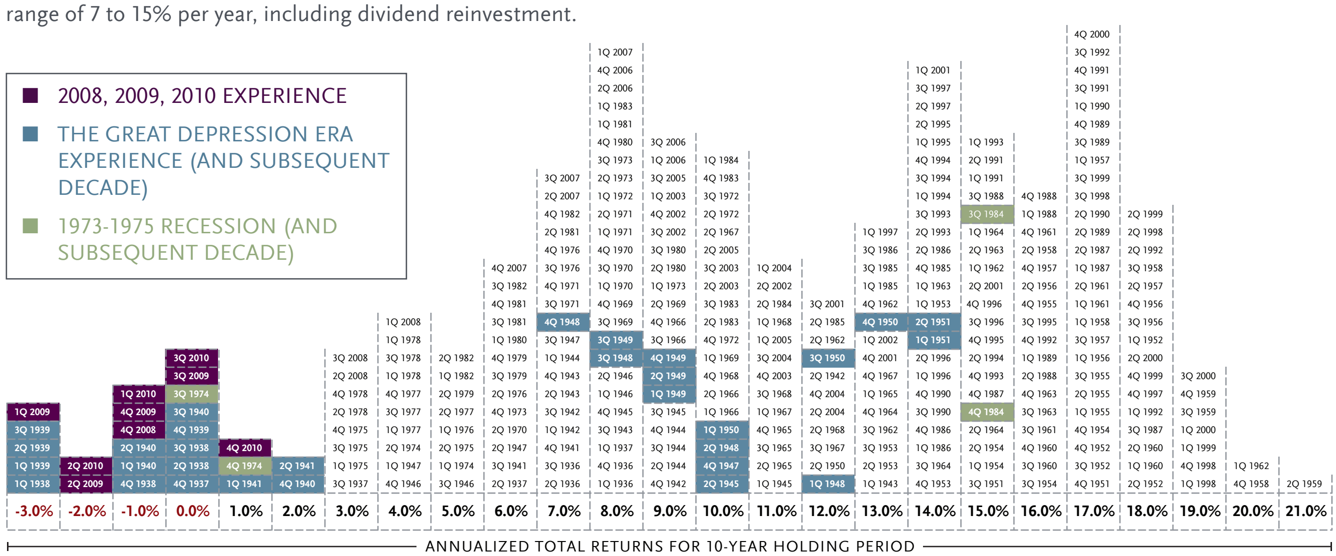
Looking at 10-year holding periods reveals that the "lost decade" from 2001 to 2010 was truly a long-tail event, with annualized returns approaching two standard deviations from the mean.

Annualized S&P 500 Total Returns (Dividend Reinvested Index, 1926 to 2010)

	Holding Period						
	One Year	Three Years	Five Years	10 Years	25 Years	50 Years	75 Years
# of Observations since 1929	333	325	317	300	257	137	37
Median Return	11.92%	10.94%	10.72%	11.00%	11.77%	15.16%	10.92%
Average Return	**12.24%**	**10.11%**	**10.14%**	**10.71%**	**11.38%**	**14.34%**	**10.83%**
Standard Deviation of Returns	**23.30%**	**12.17%**	**8.99%**	**5.64%**	**3.38%**	**2.38%**	**0.59%**
High Return	147.75%	44.92%	34.67%	21.26%	18.24%	18.99%	12.29%
High Return Date	2Q 1933	1Q 1936	2Q 1937	2Q 1959	1Q 2000	2Q 1982	2Q 2007
Low Return	-64.22%	-41.44%	-18.38%	-3.50%	1.96%	9.74%	9.64%
Low Return Date	2Q 1932	2Q 1932	1Q 1933	1Q 1938	3Q 1949	4Q 2010	3Q 2004
% of Periods with Negative Returns	27.33%	17.85%	13.56%	5.00%	0.00%	0.00%	0.00%

EXTENDED PERIODS OF LOW RETURNS ARE HISTORICALLY FOLLOWED BY PERIODS WITH 7-15% RETURNS PER ANNUM

The histogram below shows a frequency distribution for the annualized total return for the S&P 500 based on a 10-year holding period that's calculated on a rolling quarterly basis. The recent financial crisis ranks among the worst returns on record. If the experiences that followed the Great Depression and the 1974 recession are any indicator, then U.S. equity returns over the next decade should be in the range of 7 to 15% per year, including dividend reinvestment.



Source: *Standard and Poor's, Bloomberg, Guggenheim.*

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Since the recent performance of U.S. equities ranks among the worst in modern history, the real question is what can we learn from the other periods of extremely poor performance that may provide insights into future returns?

Following the experiences of the Great Depression and the 1973-1975 recession, stocks returned anywhere from 7 to 15 percent annually over the course of the next 10 years (see the histogram on the previous page). The average return of all the periods we examined was 11 percent, which is essentially perfect reversion to the mean return of the entire data series.

The moral of the story is that following periods of abnormally low equity returns (similar to what we've experienced over the past decade), there is a strong historic tendency toward reversion to mean returns of approximately 11 percent per year for a 10-year holding period.

I found this data exploration to be quite striking, especially in light of additional research and analysis that our equity investment management team has conducted on the near-term fundamental drivers of equity returns.

As we look ahead to what the future may hold, our view of the U.S. economic expansion, inflation, and the interest-rate environment are certainly central considerations. From a fundamental standpoint, we see favorable dynamics in each of the core drivers of equity returns: earnings growth, valuation multiple expansion, portfolio flows, and dividend growth. The combination of these factors constitute our equity macro-themes, which we believe point to long-run total returns for U.S. equity investors that are in line with the historic mean of 10 to 11 percent per annum. □

(Click here to read our entire U.S. equity market research report or visit www.guggenheimpartners.com for more information.)

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