Market **Perspectives**

By Scott Minerd, Chairman of Investments and Global CIO

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Europe Must Act Now

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In recent conversations—whether with the U.S. Federal Reserve, the European Central Bank, the U.S. Treasury, or the International Monetary Fund—one theme is playing large and loud: things in Europe are bad and policymakers appear already to have fallen behind the curve. Quantitative easing in Europe is coming, but too slowly to avert a severe slowdown and perhaps even a hard landing.

The depreciation of the euro, while welcome, will not be enough to lift the economy out of the doldrums and more must be done both in terms of monetary policy and fiscal reforms. In plain language, France must start taking significant steps to reduce social benefits and improve its fiscal balance (a bitter pill to swallow). Germany must reduce its fiscal surplus, which Chancellor Angela Merkel appears ready to do through increased military and infrastructure spending. Italy must move to reduce its fiscal structural imbalance. Others on the periphery must do their part too by staying the course on austerity and continuing with further structural reform. The European Investment Bank stands ready to support infrastructure investment, but at a scale that currently appears too small to make much of a difference.

In the meantime, the ECB will work as quickly as it can to expand its balance sheet. The problem is simply that there may not be enough assets to buy. Mario Draghi, ECB president, has made it clear that the ECB must increase its balance sheet by at least €1 trillion—a tough mandate as the balance sheet will continue to shrink in the coming year as the earlier longer-term refinancing operation assets roll off. The reality is the ECB will need to purchase at least another €1.5 trillion in assets, and even that may not be enough.

The ECB plans to expand its balance sheet to levels last seen in 2012 through its targeted long-term refinancing operation program and the purchase of covered bonds and ABS in an attempt to revive lending and economic growth. But doubts remain that there are enough assets for the ECB to buy and if it can buy them fast enough to avert a recession.

Can the ECB Buy Enough Assets in Time?

Source: Bloomberg, Guggenheim Investments. Data as of 10/28/2014.

The much heralded asset-backed securities purchase program will only yield about €250 billion to €450 billion in assets over the next two years. More LTRO (or the newer targeted LTRO) will prove a challenge as sovereign bond yields in Europe are so low that a large balance sheet expansion through this means seems impractical. Perhaps there is another €500 billion to €750 billion to do over the next year or two. Outright purchases of sovereign debt would prove politically difficult, as many would interpret such purchases as violating the ECB's mandate, and the matter would probably end up in the European courts.

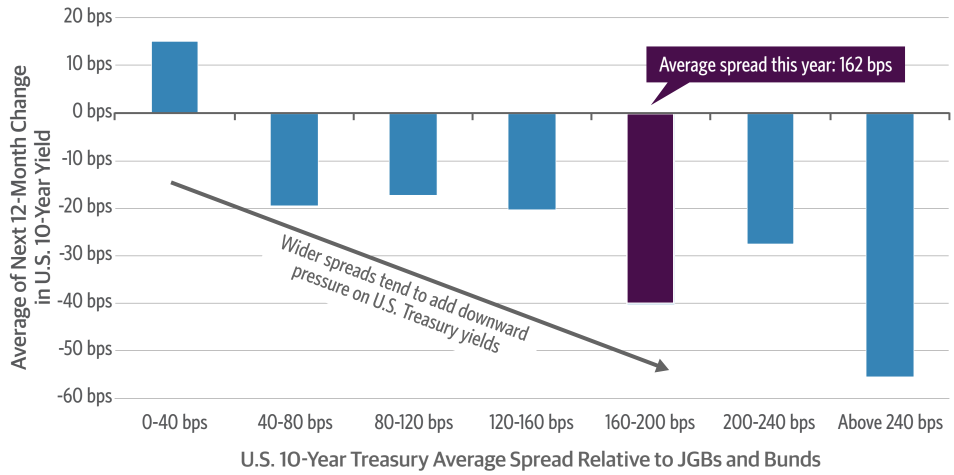
Current Tools Will Not Get Job Done

The bottom line is that none of the tools currently on the table will get the job done. There are not enough assets to purchase or finance and the timetable to get anything done is too long. Policymakers do not have the luxury of a year or two to figure this out. The ECB balance sheet shrinks virtually daily and as it shrinks, the monetary base of Europe is contracting and putting downward pressure on prices. Europe is clearly in danger of falling into the liquidity trap, if it is not already there. The likelihood of a "lost decade" like that experienced in Japan is rapidly increasing. The ECB must act and act quickly.

How is this affecting the markets? The recent rally in U.S. fixed income is materially different than when rates last approached 2 percent. Previously, the Federal Reserve was actively managing the yield curve to reduce long-term borrowing costs in order to stimulate the economy. The current rally is caused by a massive deflationary wave unleashed upon the United States by beggar-thy-neighbor policies in Europe and Asia.

Wide spreads between yields in the United States and overseas could prevent U.S. Treasury yields from rising. Despite falling 32 basis points since mid-September, the U.S. 10-year Treasury yield remains 142 basis points higher than the German 10-year bund yield and 184 basis points higher compared to Japanese 10-year government bond yields. Given sluggish economic growth trends in the euro zone and Asia, it would be hard to justify a large increase in U.S. Treasury yields without a meaningful economic improvement overseas.

Wider Spreads Keep U.S. Treasury Yields Low*



Source: Bloomberg, Guggenheim Investments. Data as of 10/28/2014. *Note: Data is in monthly frequency from 1990.

Rate Hike in 2016 or Later?

The precipitous decline in energy and commodity prices, and competitive pressures on prices for traded goods, will probably push inflation, as measured by the Fed's favored personal consumption expenditures index, back down toward 1 percent. This raises the likelihood that any increase in the policy rate by the Fed will be pushed into 2016 or later.

With inflationary expectations falling and the relative attractiveness of U.S. Treasury yields over German bunds and Japanese government bonds, U.S. long-term rates are likely to continue to be well supported with limited room to rise, a dynamic that could push them lower from here.

In the real economy, the decline in energy prices should offset the effect of reduced exports, which is supportive of U.S. growth in the near term. This should help equities recover from the recent storm of volatility as we move deeper into the fourth quarter, which is a time of seasonal strength for the stock market. However, this may prove to be the rally to sell. Results from currency translations for large, multinational companies will likely weigh heavily on S&P 500 earnings in the first half of 2015.

It is too early to be making decisions for next year, but the events overseas provide ominous portents of things to come. If we do get a sign of a bear market in U.S. equities, it could be that the events in Europe presage what lies ahead for the United States. Is it too late to change these shadows of dark foreboding? It is hard to tell but time is not on our side.

Important Notices and Disclosures

INDEX DEFINITIONS

LTRO refers to the ECB's Long-Term Refinancing Operation program.

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Mr. Minerd is Chairman of Investments and Global Chief Investment Officer. He guides Guggenheim's investment strategies and leads its research on global macroeconomics. Prior to joining Guggenheim Partners, Mr. Minerd was a managing director for Morgan Stanley and Credit Suisse. He is involved in leadership roles at a number of civically minded organizations, including The Union Rescue Mission and Strategic Partners Among Nations. He received a B.A. from the Wharton School at the University of Pennsylvania and completed graduate work at the University of Chicago Graduate School of Business.

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