GUGGENHEIM

Market Perspectives

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Rising Interest Rates Must End Soon

The yield on the benchmark 10-year U.S. Treasury bond has risen by more than 84 percent from May to early September, one of the most violent and rapid increases on record. This spike has caused severe convulsions in the bond market, leading many investors to wonder how long the torment can last.

If history is our guide, the answer is that it may be over soon. Investors would be wise to remember that "soon" is a period of time, not a matter of degree. I make this point to be clear that while long-term interest rates still have room to increase in this historic bear market—maybe even significantly—now may be the most opportune time to purchase longer duration fixed-income securities in the past two years.

Largest Rise in 50 Years

On June 19, Ben Bernanke amplified signals that the Federal Reserve was preparing to taper bond purchases as part of his roadmap to unwind quantitative easing. His words, intended to calm markets, did just the opposite, spurring an unprecedented rise in rates. Rates began to move sharply higher in early May when the Fed turned hawkish and really took off after Bernanke's comments.

The increase in U.S. Treasury yields of more than 115 percent since their bottom in July 2012 is greater on a percentage basis than any cyclical increase from trough to peak in the past 50 years. Previously, the largest such increase was 94 percent between

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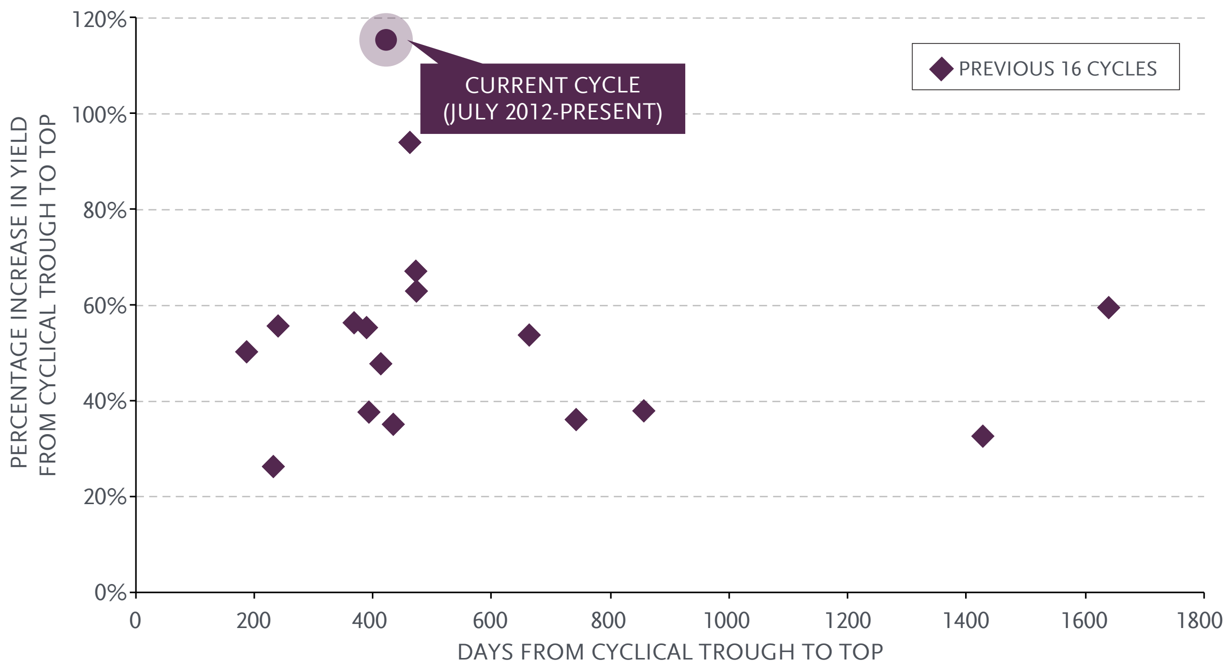
THE GREATEST RISE

Over the past 50 years, 10-year Treasury yields have increased more than 20 percent over 200 days a total of 17 times. Studying these cycles, the increase of more than 115 percent since July 2012 is greater on a percentage basis than any other cyclical increase from trough to peak in the past 50 years. The largest cyclical uptrend within the previous 16 cycles was 94 percent between December 2008 and April 2010.



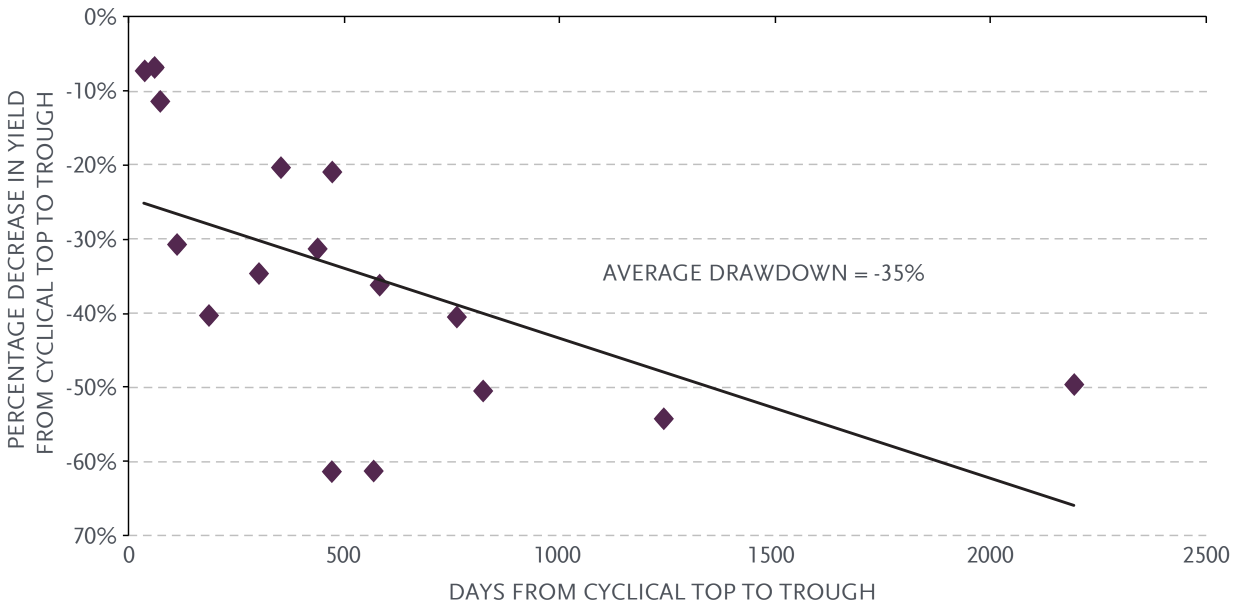
Source: Bloomberg, Guggenheim Investments. Data as of 9/16/2013.

December 2008 and April 2010. With history as our guide, we are now only days from the average length of such bear markets. The average time from trough to peak is 423 days. Now as Fed policymakers meet to discuss tapering asset purchases, it has been 420 days since rates last bottomed in July 2012.

Once rates peak, the average decline of the previous 16 interest rate cycles is 35 percent. That means, if 3 percent was the top of the current interest rate cycle we could expect rates to fall below 2 percent before another meaningful sell-off. Similarly, if rates continue to rise and top out at 3.5 percent, the trough could be 2.25 percent if averages hold. Whether rates on 10-year Treasury notes continue to rise from here or not, this could be a relatively good entry point to purchase long-duration bonds.

HOW FAR CAN RATES FALL?

Historically, once interest rates fall, the average drawdown from peak to trough is a decline in rates of 35 percent.



Source: Bloomberg, Guggenheim Investments. Data as of 9/16/2013.

Buying Opportunity Near

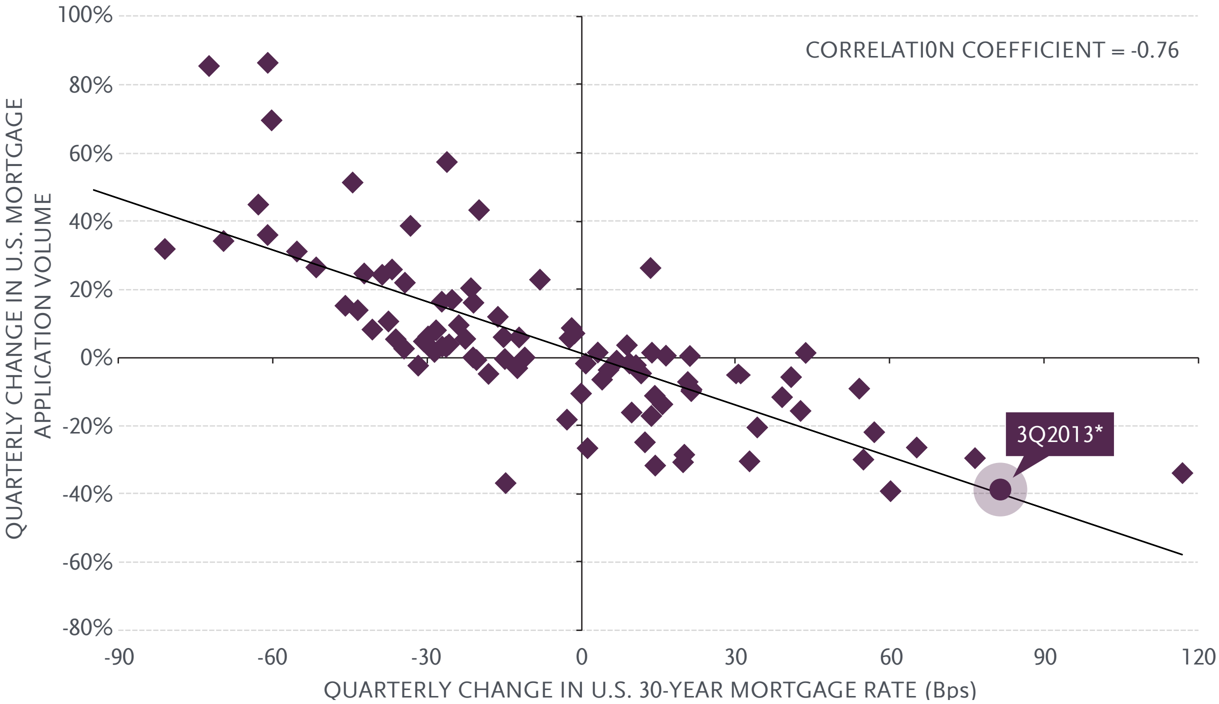
The reality of how badly higher interest rates are hurting the economy is slowly becoming apparent and may soon prompt a reversal of fortune for bond investors.

So, what should an investor do? Now may be the time to consider adding to fixed-income assets, especially longer-duration bonds. Given the strong, negative sentiment, history tells us that a buying opportunity cannot be far away. While there is additional downside risk, no one can pick a top or bottom in markets with complete precision. But if history is any indication, 10-year rates may be heading back to 2.25 percent or lower, meaning the bet may pay off.

Why should interest rates decline? Since the Fed turned hawkish in May, higher interest rates have sent mortgage rates skyward. The abrupt rise in mortgage rates is having a material impact on housing activity. With mortgage applications declining, the critical tailwind of housing in the current expansion may soon become a headwind. More than half of all economic growth since last year came from housing-related activity.

HIGHER INTEREST RATES DETER MORTGAGE APPLICATIONS

As interest rates for U.S. 30-year mortgages decline, mortgage applications rise and as interest rates rise, applications for mortgages decline.



Source: Mortgage Banks Association, Bloomberg, Guggenheim Investments. Data as of 9/16/2013. *Note: Data for 3Q2013 is based on latest available data.

Additionally, aggregate wages have begun to stagnate, leading to poor retail sales with autos and home suppliers being the sole bright spots. Without the wealth effect from housing to fuel consumption, it will be hard for the economy to overcome increasing challenges associated with the contracting fiscal reality.

It is safe to say that if rates move significantly over 3 percent it would be devastating for an already struggling American economy, prompting policymakers and investors to realize the growth the Fed hoped for is nothing more than a mirage.

Adding impetus for rates to move lower will be fiscal developments that should translate into lower-than-expected new U.S. Treasury debt issuance. The U.S. federal budget is shrinking, and tax receipts in 2014 are expected to rise thanks to higher taxes and strong capital gains receipts following strong 2013 stock market gains, thus reducing the supply of government debt.

Could recent market convulsions have been avoided? The simple answer is yes. Dr. Bernanke's expected January 2014 departure as chairman after eight years overseeing unprecedented growth of the Fed's balance sheet may have left him with an urgent desire to show an exit strategy. Were it not for his impending exit, I suspect he would have otherwise let the economic data unfold for another three or six months before considering tapering.

Investment Implications

There has been much talk in recent months of the end of the 30-year bull market in bonds, but the coming bear market likely remains several years away. I believe rates will stay low and hover in a trading pattern for the next three to five years, similar to the 1940s, the period most analogous to today. During the 1940s and early 1950s, interest rates remained artificially low and oscillated between bear and bull markets for nine years. If I am correct, U.S. bond investors should expect yields to similarly remain low for the foreseeable future, but volatility like that seen this year could become a more regular occurrence.

In the near-term, if these dynamics play out as I expect, investors might begin planning to add longer duration, high-quality assets such as investment-grade corporate bonds to their portfolios. If rates peak in the near-term and reverse course, these assets, in particular, will be the primary beneficiaries.

As we move through the turbulence of tapering and look at the fundamental factors on the horizon, investors must have their antennae up to monitor the timing of these changing dynamics. While I see relief from rising rates soon, now is a time for bond investors to have patience, a watchful eye, and a strong resolve.

This year, equities have stolen the spotlight with strong returns, but are now badly in need of consolidation. Meanwhile, fixed-income investors seem overwhelmed with fatigue and have begun to throw in the towel after a discouraging year marked by poor performance and negative returns. This may just be the time to dust off this unloved asset class and consider history. Now may be the best time to buy bonds in years.

ABOUT THE AUTHOR

Scott Minerd joined Guggenheim in 1998. In his role as Global Chief Investment Officer, Mr. Minerd guides the firm's investment strategies and oversees client accounts across a broad range of fixed-income and equity securities. Previously, Mr. Minerd was a Managing Director with Credit Suisse First Boston in charge of trading and risk management for the Fixed Income Credit Trading Group. In this position, he was responsible for the corporate bond, preferred stock, money markets, U.S. government agency and sovereign debt, derivatives securities, structured debt and interest rate swaps trading business units. Prior to that, Mr. Minerd was Morgan Stanley's London based European Capital Markets Products Trading and Risk Manager responsible for Eurobonds, Euro-MTNs, domestic European Bonds, FRNs, derivative securities and money market products in 12 European currencies and Asian markets. Mr. Minerd has also held capital markets positions with Merrill Lynch and Continental Bank. Prior to that, he was a Certified Public Accountant and worked for the public accounting firm of Price Waterhouse. Mr. Minerd is a member of the Federal Reserve Bank of New York's Investor Advisory Committee on Financial Markets, helping advise the NY Fed President and senior management at the bank about the current financial markets and ways the public and private sectors can better understand and mitigate systematic risks. Mr. Minerd also works with the Organization for Economic Cooperation and Development (OECD), advising on research and analysis of private sector infrastructure investment, and is a contributing member of the World Economic Forum (WEF). He is a regularly featured guest and contributor to leading financial media outlets, including The Wall Street Journal, The Financial Times, Bloomberg, and CNBC, where he shares insights on today's financial climate. Mr. Minerd holds a B.S. degree in Economics from the Wharton School, University of Pennsylvania, Philadelphia, and has completed graduate work at the University of Chicago Graduate School of Business and the Wharton School, University of Pennsylvania.

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