GUGGENHEIM

February 5, 2018

Global CIO Outlook
A Time for Courage

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In what otherwise might have been another quiet Monday with investors lulled to sleep by the low volatility world of the past year, I was surprised to be suddenly overwhelmed with a deluge of calls late in the day from clients and the media asking for an explanation of the collapse in equity prices. My answer in a word was simply "rates."

The backup in bond yields has been significant, with the 10-year Treasury rising 23 basis points in the last month, and hitting a recent peak of 2.88 percent. The tax cut euphoria drove stocks up at an unsustainable pace, but concerns have been building about bond market supply congestion following the Treasury Department's refunding announcement, and Friday's employment report has increased speculation that the Fed may need to become more aggressive to head off potential inflationary concerns.

Contributing to inflation worries is impressive wage growth. Hourly earnings were up 0.3 percent in January and upwardly revised for December to 0.4 percent, supporting the concept of wage growth of 4 percent or more for 2018. These data are trending up even before we fully digest changes to the minimum wage and the effect of wage increases and bonuses related to the new tax plan. These are likely to give a lift to consumption, which will reinforce more labor demand, and thus drive unemployment lower.

Dare I say that some in the market are becoming concerned that the Federal Reserve may be falling behind the curve, especially as evidenced by the recent steepening in bond yields? This is also a possibility. The consensus for future rate hikes, until today, was moving to four rate increases in 2018, and possibly more.

I think that the setback today (the largest one-day point decline in history) is not over, but we are approaching a bottom. This correction is a healthy development for the markets in the long run, and the equity bull market, while bloodied, is not broken. The lower bond yields will help, but the curve steepening speaks more of flight to safety in times of market turmoil than concerns over the economy.

Ultimately, my previously held market views are intact. I still hold the opinion that the favorable economic fundamentals that are in place: where we are in the business cycle, the breadth of the market, and levels of current valuations are supportive of equities. Buying here will probably make investors happy campers later in the year, but the tug of war between stocks and bonds is just getting under way. This may be the big investment story for 2018.