GUGGENHEIM

Market Perspectives

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The Canary in the Coal Mine

Early coal mines lacked ventilation systems, so miners brought caged canaries into new seams to detect the presence of methane and carbon monoxide. If a canary stopped singing – or worse, died – the mine would be evacuated until the dangerous gas buildup could be cleared. Other animals were tried for this purpose, but canaries have become recognized for their natural ability to detect small but potentially lethal concentrations of toxicity.

The recent string of surprise downside moves in markets may be the canary in the coal mine for global investors. Ongoing monetary stimulus is leading to heightened volatility, and the bull market which has been in place since 2009 is becoming overextended. To recount some of the recent disturbing developments, Japanese equities, which have nearly doubled since November 2012, fell almost 10% in three days in late May, and have continued to fall in June. This price move of approximately five standard deviations was eerily similar to the collapse in gold that occurred in April of this year.

The 12% crash in the Dow Jones Utilities' Average, which occurred within an hour of market open on May 23, 2013, was largely overlooked. Several technical explanations for the crash were put forth, and the index nearly recovered by the end of the day. Oddly, a parallel series of events played out in the Flash Crash on May 6, 2010. Fat fingers were blamed for the outsized sell orders that swamped the market in that technical downturn. Equities, though, subsequently sold off to the lows of that day and eventually moved lower, despite the technical explanation.

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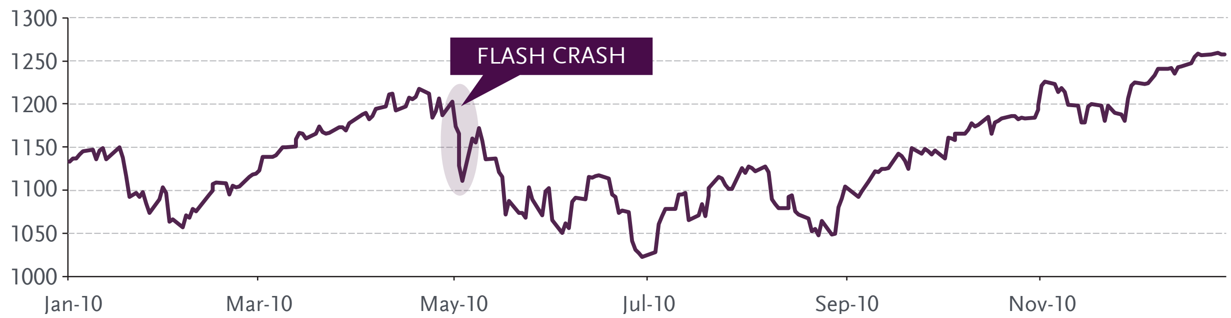
RECENT MARKET CRASHES

Three abnormal "tail risk" events have occurred during the past two months. These disturbing developments are reminiscent of the May, 2010 "Flash Crash," in which markets did not recover to their pre-crash level until October, 2010.

EVENT	DATE	%CHANGE	STANDARD DEVIATIONS*
Flash Crash	5/6/2010 (Intraday)	-9.2%	7.74
Gold Crash	4/12/2013 – 4/13/2013	-14.1%	5.75
NIKKEI Crash	5/23/2013	-7.3%	4.73
Dow Utility Crash	5/23/2013 (Intraday)	-12.2%	10.13



Source: Bloomberg, Guggenheim Investments. Data as of 5/31/2013. *Note: We assume a normal distribution and use a 10-year horizon to calculate the standard deviation of historical daily return.

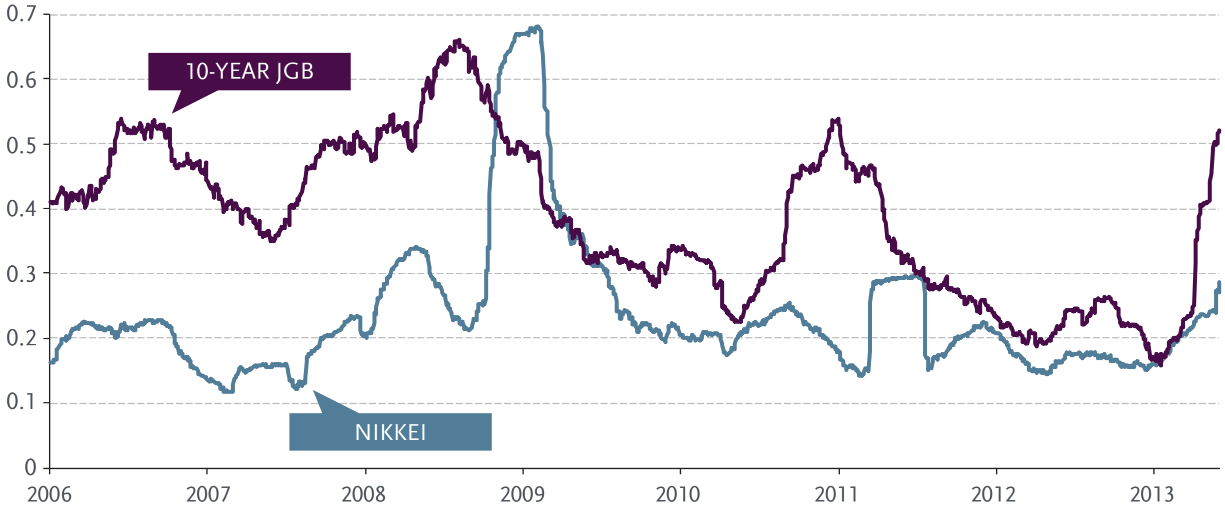
Crashes that occur in bull markets, irrespective of their causes, do not bode well for short-run performance. The damage from April's gold crash could take months or years to consolidate and repair. Investors should be prepared for this type of price action in other markets, including high yield bonds and U.S. equities.

Even U.S. Treasuries may not be immune from a sudden contraction. Between January 1, 2013 and June 3, 2013, yields on the 10-year Treasury note have risen from 1.76% to 2.12%. Yields on Japanese government bonds have almost tripled in recent months, indicating they are susceptible to further downside as well.

These dramatic swings are likely a consequence of the rapid expansion of central bank balance sheets and the uncertainty over the pace and size of future monetary accommodation. With new liquidity flooding the system, causing asset prices to rise, many investors believe they are "missing out." This is especially true for investors who have been underinvested in risk assets such as equities and below investment grade debt, causing them to trail their benchmarks.

NIKKEI AND 10-YEAR JGB – ANNUALIZED 90-DAY VOLATILITY*

One third of the Nikkei is comprised of foreign investment, making it highly vulnerable to swings in capital flows. Japan's stock market appears to be an early domino to fall from the effects of continuing unorthodox monetary policies pursued by global central banks.



Source: Bloomberg, Guggenheim Investments. Data as of 5/31/2013. *Note: The volatility on the JGB is the yield volatility.

Increasingly extended prices and nervous buyers and sellers have damaged the market's psychology. Many investors now face a dilemma of whether to jump into the market after the robust rally since November 2012, or wait for a correction. Meanwhile, those holding long positions are becoming more concerned with the prospect that a minor adjustment to quantitative easing could result in a loss of profits accumulated during the past months.

The United States and Japan have improving economic fundamentals, but market participants know that continued monetary expansion is required to drive further positive performance. If the Federal Reserve allows interest rates to rise too much, it risks knocking the legs out from under the housing market, which is the main pillar of the current economic expansion. Investors in Japan are similarly aware that ongoing policy accommodation is necessary to maintain buoyancy in that market.

These waves of monetary liquidity are like the tides of the ocean. It is practically impossible to gauge the direction of the tide while standing on the beach, and certain waves may roll in more or less forcefully regardless of the direction of the tide. The Fed and the Bank of Japan have indicated that they will keep the printing presses rolling, so investors realize that no matter what happens in the immediate-term, the water level will climb over time.

This is where we are today. The tide is rising for U.S. and Japanese markets and asset prices will ultimately move higher. The size and violence of each wave that advances or recedes will continue to increase due to the surge of liquidity from central banks. These tides of liquidity are strong, as are the currents underneath. We must guard ourselves from the risk of being pulled under.

How do we do this? Reducing spread duration and increasing asset quality are two ways. Placement on the yield curve and relative value selection are also important contributors to performance in times like these. We must continue to have discipline as investors. Selling on strength as spreads tighten, and using backups to add to positions are tactics which are likely to serve us well. I do not anticipate that the next few months will be an easy ride, and it appears as though the canary in the coal mine has died. Those who remain in the mine without an evacuation plan are likely to die next.

*Assets under management are as of March 31, 2013 and include consulting services for clients whose assets are valued at approximately $37 billion. **Past performance is not indicative of future results. There is neither representation nor warranty as to the current accuracy or, nor liability for, decisions based on such information.**

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