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An Interview With Scott Minerd
Chairman of Investments and Global Chief Investment Officer, Guggenheim Partners

Getting Ready for the Fed's Rate Move

by Lawrence C. Strauss

A rate hike by the Federal Reserve is looming, and investors need to be ready. That's the view of Scott Minerd, global chief investment officer at Guggenheim Investments, the asset-management and investment-advisory arm of Guggenheim Partners. The firm oversees about $220 billion. U.S. stocks should do just fine for the time being, even after that first rate increase, and floating-rate bonds are a good bet, Minerd predicts. Although the firm caters to high-net-worth investors, it does have retail funds. One is the Guggenheim Macro Opportunities Fund (ticker: GIOIX), whose assets total $3 billion. Its three-year annual return of 6.91% is at the very top of its Morningstar category, having easily beaten the Barclays U.S. Aggregate's Bond Index's 3.14%. Barron's spoke with Minerd recently by telephone.

Barron's: **What are the key macro themes that you're focusing on?**

Minerd: The liftoff of rates by the Fed is a major consideration, along with what the world looks like in the period that follows. I've been spending a lot of time looking at data to try to get a handle on a number of factors, one being: When will the Fed raise rates? Another is: How do markets typically react in the period leading up to a Fed increase in rates, and then, how does the market behave in the subsequent period of rate-tightening? The big question, though, is how long and how high will the Fed go, and what does the timeline around an increase in the fed-funds rate look like? That has important implications about changing portfolio allocations over the coming years.

Gregg Segal for *Barron's*

"When asked about the secret of his great wealth, Baron Rothschild said he sold too soon. It is not a bad idea to take some profits in equities." –Scott Minerd

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When will the first rate increase occur?

I expect the Fed to do something in September, but it could still move into early 2016. What has changed, though, is that the Fed seems anxious to begin raising rates, because it perceives a risk that if the economy begins to accelerate, the possibility of an asset bubble increases, as well. The policy makers fundamentally believe that even if they increase rates by, say, 0.5%, or a half-percent, that monetary policy is still highly accommodative and supportive of economic growth. They want to avoid a situation where, should they feel they suddenly had fallen behind the curve, they have to take more dramatic moves. What they would like to do, I think, is raise rates slowly over a period of years and watch the impact of each rate increase unfold.

What will a rate increase mean for stocks?

A rate increase is not necessarily a bad thing for equities. When that has happened in the past, there is a short-term shock. But historically, the trends for equities have been pretty good. For the six-month period leading up to a Fed tightening, the Standard & Poor's 500 has returned about 9.5%, on average. There's also the backdrop of the strong seasonal factors this time of the year, notably the old saying to "sell in May and go away." And the New York Stock Exchange's accumulated advance/decline has broken out to new highs. But the market averages about a 10% return for the year following the beginning of the Fed tightening. There can be some noise between here and there, but over the next 12 to 24 months, it looks like equities will be substantially higher than where they are today.

Why are you more bullish, longer-term, on equity markets outside of the U.S.?

On a valuation basis in the U.S., the total market cap to gross domestic product is around 130%. It's substantially higher than in any of the developed markets in Europe, and it is certainly higher than either China or India. For the U.S., it's the highest reading, with the exception of the Internet bubble when market cap to GDP reached roughly 150%. For India, that number is around 80%, compared with closer to 150% at the height of the cycle back in 2007. China is currently around 50%, versus about 100% back in 2007. The euro zone is around 50%, versus around 80% back in 2007. There is a lot more headroom for improvement and appreciation in those markets than in the U.S. One thing I talked to Barron's about back in 2010 was the magic of quantitative easing. [See "Enjoy the Good Times While They Last," Nov. 8.] The result of QE is to inflate asset prices, and the market in which QE is happening is where you get the best increase for those assets. Back in 2010, it was in the U.S.; today it is in Europe. So this rising tide of liquidity is going to be good for all markets in the world, including the U.S. But the countries and regions where they are just getting started with QE – namely Europe and possibly China at some point – have a lot more prospects for improvement in equity performance than we do in the U.S.

Where do you see the best opportunities for U.S. stocks?

Energy is certainly a place where you need to be shopping. If you have a five-year time horizon, a portfolio of energy stocks will perform quite well – though in the near term, we're likely to see more bad news in energy. The risk for these stocks is that oil could drop to below $40 a barrel in the coming months. But the large integrated oil companies pay healthy dividends, and that will cushion you. Another theme to look at is companies that are not so exposed to foreign-exchange depreciation. Thanks to the strengthening dollar, the multinationals will have a hard time with earnings, but a lot of domestic companies will do well. And this is probably good for U.S. discretionary-consumer companies, which, with the dollar strengthening, benefit from lower import prices.

What's your take on the bond market?

The great bull market in bonds, which began in the early 1980s, is still intact, and there is some risk in the near term that, given QE in Europe and just the attractiveness of relative yields in the U.S., we could see yet another spike down in interest rates. But having said that, the best parts of the bond-market rally are behind us, and it is time for investors to start considering how to position themselves for a Fed rate increase later in the year. After the Fed increases rates, the best-performing asset classes are floating-rate securities, typically led by leveraged loans. The likelihood that we are going to have an adverse credit event in the next couple of years is very low. The reason the Fed is raising rates is because the economy is getting stronger. Strong economies are not associated with increasing default rates, but rather with tightening credit spreads. We see leveraged loans, or bank loans, as one of the most attractive asset classes in this type of scenario. History shows us that in the period after the beginning of a Fed rate increase, bank loans are the best-performing category.

What kinds of bonds do you hold?

We are overweighting floating-rate securities, but there is also the risk of another move down in rates. We've been trying to avoid the belly of the curve, typically bonds with maturities under 10 years, and we've been extending into longer-duration fixed-income holdings – that is, securities whose maturities are 10 years out and longer. As the Fed begins to raise rates, the yield curve is going to flatten more. As that happens, the longer-duration securities don't have as much room to have an increase in rates as the short-duration securities do, given how low rates are at the short end of the curve. So we are positioning our portfolios with a barbell approach. The aim is to allow a fixed-income investor to participate in the increase in yield on short-term rates, but also to insulate them from the risk that there is another downward spike in interest rates. Hence, some exposure to the longer end of the curve, as well.

What worries you as an investor?

My No. 1 issue is evaluating the impacts of macro prudential policy, as it's called. It's a term that got coined by the policy makers to explain the cobwebs of overlapping regulation created in the wake of the financial crisis. It includes things like Dodd-Frank, the Volcker Rule, and Basel III. Here's my concern: Prior to the financial crisis of 2008-09, policy makers believed that it was hard to identify when an asset bubble would occur. But once a bubble developed and then subsequently collapsed, the tools existed to clean up the mess. That meant that capital, usually in the form of credit, would sometimes be allowed to float to marginal borrowers that ultimately could default.

Under the new regime, the theory is that regulation will restrain the availability of credit to the extent that even some good borrowers may not access capital, the purpose being to avoid allowing bad loans to exist. What ultimately happens, I would argue, is that growth, on balance, becomes lower over business cycles, and there will be less upward pressure on interest rates. So credit is basically only accessible to certain borrowers, some of whom are likely to become overlevered and will allocate capital into marginal investments.

At the same time, other, more speculative borrowers will be forced to access capital in the shadow banking system. In this scenario, the policy ultimately results in less-productive investment, leading to lower levels of productivity, and the economy will be less resilient to increases in real interest rates. As the Fed begins to raise rates, there will be less headroom for rate increases before it induces a recession.

So under that scenario, how much could the Fed raise rates?

Despite all of this macro prudential pol-

icy, nonfinancial sector debt to GDP stands at around 230%, among the highest it has been since the 1950s. That would suggest, based on some work that we've done, that once the Fed begins to raise rates to somewhere around 2.5% to 3%, that will become the terminal level, as I call it, for the short-term rate before we push ourselves into another recession. I spend a lot of time thinking about a road map for our clients. If you look at the Fed starting to raise rates, say late this year or early next year, and doing it slowly by 100 basis points, or one percentage point, a year, either in late 2017 or early 2018 they are going to get to this terminal level. History shows us that once they get to that level, within 12 months we typically have a recession. I'm trying to figure out how to transition the portfolio from what today is a very positive view for taking on risk assets into a period where we will ultimately face some very tough challenges once rates are high enough. Also, with such a high level of debt in the economy and with this macro prudential policy, the real returns on capital, whether from bonds, stocks, or anything else that we've gotten used to over the past 30 years, are probably not going to be the kinds of returns we are going to be able to get over the next 30 years.

Turning to asset allocation, what are a few of your key themes?

The No. 1 thing is that people who have allocated to equities in the U.S. have done very well, but it is probably time to start re-allocating some of that money, probably into international equities. And I would hedge the currency, because the bull market in the dollar is still intact. Elsewhere, I'm bullish on Chinese equities, but hedging the currency is a good idea there, too. So diversifying internationally, given the high valuations on U.S. equities, makes sense.

It's also important to remember that valuation is a very poor timing tool. Markets that are overvalued and get more overvalued are called bull markets. So the U.S. market, although overvalued, will continue to go higher. To paraphrase Baron Rothschild when asked about the secret of his great wealth, he said he sold too soon. It is not a bad idea to take some profits in equities. As for fixed income, the urban legend of the bond bubble is like Sasquatch. I've been looking for both of them, and I haven't found either. Credit is paying some pretty good returns, especially in areas like bank loans and high yield, and that's a pretty good place to be for the next couple of years.

Thanks, Scott. ■

Read the fund's prospectus and summary prospectus (if available) carefully before investing. It contains the fund's investment objectives, risks, charges, expenses, and other information, which should be considered carefully before investing. Obtain a prospectus and summary prospectus (if available) at GuggenheimInvestments.com.

The opinions and forecasts expressed are those of Scott Minerd as of 3/21/2015, and may not actually come to pass. This information is subject to change at any time, based on market and other conditions, and should not be construed as a recommendation of any specific security or strategy.

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$220 billion in assets under management is as of 12.31.2014 and include consulting services for clients whose assets are valued at approximately $36 billion.

Guggenheim Macro Opportunities Fund (ticker: GIOIX) three-year annual return of 6.91% is as of 3.18.2015.

Average Annual Total Returns	Ticker	1-Year	3-Year	Since Inception	Inception Date	Gross/Net Expense Ratio
Guggenheim Macro Opportunities Fund Institutional	GIOIX	-2.69%	1.83%	5.35%	11.30.2011	1.25%/1.10%
Barclays U.S. Aggregate Bond Index		1.96%	2.50%	2.93%	-	-
BofA Merrill Lynch 3-Month U.S. Treasury Bill Index		0.12%	0.07%	0.08%		

Performance displayed represents past performance, which is no guarantee of future results. Investment return and principal value will fluctuate so that when shares are redeemed, they may be worth more or less than original cost. Current performance may be lower or higher than the performance data quoted. For up-to-date fund performance, including performance current to the most recent month end, please visit our web site at guggenheiminvestments.com. For additional information, see the fund's prospectus.

Unless otherwise noted, data is as of 03.31.2016. Data is subject to change on a daily basis. Partial year returns are cumulative, not annualized. Returns reflect the reinvestment of dividends. The referenced index is unmanaged and not available for direct investment. Index performance does not reflect transaction costs, fees or expenses. Index data source: FundStation.

The advisor has contractually agreed to waive fees and expenses through 2.1.2017, to limit the ordinary operating expenses of the fund. The fund may have net expenses greater than the expense cap as a result of any acquired fund fees and expenses or other expenses that are excluded from the calculation.

RISK CONSIDERATIONS This fund may not be suitable for all investors. • The fund's market value will change in response to interest rate changes and market conditions, among other factors. In general, bond prices rise when interest rates fall and vice versa. • The fund's exposure to high yield securities may subject the fund to greater volatility. • The intrinsic value of the underlying stocks in which the fund invests may never be realized or the stock may decline in value. • When market conditions are deemed appropriate, the fund may leverage to the full extent permitted by its investment policies and restrictions and applicable law. Leveraging will exaggerate the effect on net asset value of any increase or decrease in the market value of the fund's portfolio. • The use of short selling involves increased risks and costs. You risk paying more for a security than you received from its sale. Theoretically, stocks sold short have the risk of unlimited losses. • The fund may invest in derivative instruments, which may be more volatile and less liquid, increasing the risk of loss when compared to traditional securities. Certain of the derivative instruments are also subject to the risks of counterparty default and adverse tax treatment. • Instruments and strategies (such as borrowing transactions and reverse repurchase agreements) may provide leveraged exposure to a particular investment, which will magnify any gains or losses on those investments. • Investments in reverse repurchase agreements expose the fund to the many of the same risks as investments in derivatives. • The fund's investments in other investment vehicles subject the fund to those risks and expenses affecting the investment vehicle. • The fund's investments in foreign securities carry additional risks when compared to U.S. securities, due to the impact of diplomatic, political, or economic developments in the country in question (investments in emerging markets securities are generally subject to an even greater level of risks). • Investments in syndicated bank loans generally offer a floating interest rate and involve special types of risks. A highly liquid secondary market may not exist for the commodity-linked structured notes the fund invests in, and there can be no assurance that a highly liquid secondary market will develop. • The fund's exposure to the commodity markets may subject the fund to greater volatility as commodity-linked investments may be affected by changes in overall market movements, commodity index volatility, changes in interest rates, or factors affecting a particular industry or commodity such as droughts, floods, weather, embargos, tariffs, and international economic, political, and regulatory developments. • The fund's investments in municipal securities can be affected by events that affect the municipal bond market. • The fund's investments in real estate securities subject the fund to the same risks as direct investments in real estate, which is particularly sensitive to economic downturns. • The fund's investments in restricted securities may involve financial and liquidity risk. • You may have a gain or loss when you sell your shares. • It is important to note that the fund is not guaranteed by the U.S. government. • This fund is considered non-diversified and can invest a greater portion of its assets in securities of individual issuers than a diversified fund. As a result, changes in the market value of a single security could cause greater fluctuations in the value of fund shares than would occur in a more diversified fund. • Please read the prospectus for more detailed information regarding these and other risks.

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