BARRON'S
THE DOW JONES BUSINESS AND FINANCIAL WEEKLY www.barrons.com FEBRUARY 5, 2018

**An Interview With Scott Minerd
Global Chief Investment Officer,
Guggenheim Partners**

The Bull's Days Are Numbered

by Vito J. Racanelli


Brad Swonetz for *Barron's*

Time is running out for the bull, says Scott Minerd, a founding managing partner and global chief investment officer for Guggenheim Partners, the New York-headquartered investment firm, which manages $295 billion. Minerd sees upside for U.S. stocks, before a recession arrives in late 2019 or 2020 that will derail this mighty market and prove painful for bonds, as well.

Minerd, 58, based in Guggenheim's Santa Monica, Calif., office,oversees client accounts invested in a broad range of fixed-income and equity securities. Guggenheim's taxable fixed-income mutual funds are in the top decile of their respective Morningstar categories for either the trailing three- and or five-year periods.

In a recent chat with Barron's, Minerd also explained the perils facing municipal bonds, given the new tax law's restrictions on deductibility of state and local taxes. Two things he's bullish about: international stocks and active management, especially in fixed income.

Barron's: **Scott, are you a bull or a bear?**

Scott Minerd: I'm a bull for the next year or so. For equities, I see higher prices; for fixed income, it's hard to say. I'm a near-term bear on short-term interest rates, and long-term interest rates have limited room to rise. There is another 15% of upside in

(over please)

the stock market from 2017's close, but after a 300% run [from the 2009 lows], the question is how to time the exit. What are the signs?

Valuation is a poor timing tool. Looking at corporate credit and high yield, valuations are rich. But equities are fairly priced, based on current earnings, the economy gaining momentum, and the tax cut. Bull markets don't die from old age. They typically get shot in the head by the central bank, or by an exogenous event.

How would you characterize investor sentiment toward bonds and stocks?

Complacent, with cognitive dissonance. When you think about all the exogenous events that could possibly happen, such as a missile launch by North Korea, people have assumed that since the event is unthinkable, it won't happen. Greed has overtaken fear. This is speculative wave. In the wake of highly stimulative tax cuts and the rising tide of global liquidity from central banks, the risk of a full-blown mania in stocks is increasing. Compared to prior manias, such as the run-up of 1999 into 2000, a similar acceleration in prices could push the Standard & Poor's 500 to 3600, though this isn't my upside base case.

Now, individual investors aren't in the market yet, and that's why I'm still bullish. We don't have all the pieces in place [for a bear market]. Buying hasn't reached frenzied levels. But the Dow Jones Industrial Average is starting to look like it is going parabolic, and parabolic markets are unsustainable.

How will the Federal Reserve's change in leadership affect the credit markets?

The Fed has a number of concerns to address. First, it is afraid of a recession arising or an exogenous event occurring while rates are so low. It is loath to go back to zero [rates] or engage again in quantitative easing. As the economy picks up steam and the labor market goes past full employment by its measures, the Fed feels that it needs to buy an insurance policy against the ultimate rate reduction it will have to do in the next downturn. Given the [flattening] shape of the yield curve, it is also concerned about being too restrictive.

With new Fed head Jerome Powell and new appointments to come, the Fed might decide it would be appropriate to revisit the inflation target. The Fed is treating its 2% inflation target like a ceiling. A 1%-to-3% band gives it more of a freer hand. With Powell coming in and the new appointments to the broad of governors, the Fed won't have enough time to get a consensus. It might end up hiking rates four times, because when it sees unemployment drop to levels like 3.5% or lower, it will become increasingly concerned about wage pressures and feel that it is slipping behind the curve. Then the question will be, where is the level of full employment? It is probably premature to think the Fed will adjust to 3% immediately. Over the next decade, we'll see a downward migration in the Fed's view of what full employment is.

How does the new tax law influence your outlook?

The most powerful part of the tax cut is the [accelerated] expensing of capital expenditures, which will be highly stimulative. It adds half a percentage point or so to our outlook for GDP [gross domestic product] growth, raising our view to 2.5%. That probably weighs in favor of putting more pressure on the Fed to keep raising rates.

The restrictions on deductibility of state and local taxes and mortgage interest will probably lead to some unintended consequences in high-tax states, such as Connecticut and New Jersey, which are already experiencing emigration, in terms of their tax base getting smaller. This will put pressure on home values and probably encourage more emigration. BBB-rated New Jersey could slip into junk. Connecticut, AA-rated, has a worse trajectory than New Jersey. Illinois is in deep trouble, and this will exacerbate its problems. In municipal debt, the next recession is going to be problematic for all of these states.

> "When the presumptive crash for bitcoin occurs, it will tell us that the sea of liquidity is receding. As that happens, it will spill over into other markets."

As for policy, infrastructure is low-hanging fruit, and there is a real opportunity to get another significant piece of legislation passed, which would be good for the economy and the long-term outlook.

Speaking of recession, why is Guggenheim expecting the next one to come in late 2019 or 2020?

We use six indicators. We have a labor market becoming unsustainably tight, a Fed raising rates into restrictive territory, and a Treasury yield curve flattening. Two other factors, growth in hours worked and consumer spending, are weaker than you want them to be. However, leading indicators are rising, not declining. This suggests a recession could come in late 2019 or 2020 with over 90% confidence. The caveat is an exogenous event—like the Asian financial crisis of 1998—that causes the Fed to reverse its rate-hiking policy, which would extend the expansion.

Do you prefer U.S. stocks, or the rest of the world?

We like Europe because of the solid growth. The acceleration of growth on the periphery is much better than in the core. Countries such as Italy, Spain, Portugal, and Ireland look promising. In emerging markets, Chile, Brazil, and China look interesting. In debt, I would stay away from emerging-market and euro-denominated debt. The latter is extremely overvalued, with the European Central Bank engaging in quantitative easing and buying corporate debt.

What do you think about bitcoin?

It is a store of value and a medium of exchange. Cryptocurrencies are a viable concept. Choosing the currency that is going to survive is difficult. It might not be bitcoin. The question is, will it come crashing down from $18,000 or $50,000?

When you get thin and narrow markets and lots of capital chasing something, it tells you the animal spirits are high. When the presumptive crash for bitcoin occurs, it will tell us that the sea of liquidity is receding. As that happens, it will spill over into other markets. Will that happen simultaneously? I doubt it. The place most vulnerable is high-yield debt, in particular CCC-rated bonds. When you look at bonds issued by utilities and media companies with a lot of debt that are going to lose the ability to deduct interest, you suddenly discover that any number of these companies are under financial strain, especially if there is a recession on the horizon.

It will be like the energy-credit crash a couple of years ago. Once people start to see that their high-yield bond mutual fund is down 2% and put in their redemption notice, the high-yield fund manager sells. Most managers sell what's easy because they've got to get the cash quickly. The idea that the selling pressure will be contained in one sector is like animal spirits in reverse. As the cash comes out, it will push prices down for index funds and mutual funds, and that causes people to want to sell more and the cycle builds.

When and how is the bull market going to end?

I'm looking for a flat yield curve, probably by the first quarter of 2019. Historically, once the yield curve goes flat, stock returns for the next 12 months approximate zero. Then, a year later, you get the recession and bear market. The No. 1 indicator I'm looking at is the shape of the yield curve. If you listen to what the Fed is saying about how it is going to raise rates, and you look at how the curve is behaving, meaning long rates aren't really rising significantly, the curve will be flat by the end of the year.

On the S&P 500 index, the current level [2819] is roughly where we could be a decade from now, indicating about a 1% annual return. Total stock-market capitalization as a percentage of GDP is about 145% now. Normally, the ratio is less than 100%. At the market bottom, it was 60%. Elevated stock valuations portend weaker returns over the next decade, and retaining some dry powder in the final year of expansion will allow equity and credit investors to take advantage of more attractive valuations.

One caveat is an exogenous event. Another would be if the world suddenly becomes concerned about a big selloff in high-yield. Both would cause the Fed to go on hold or reverse course and allow the speculative boom to continue.

Where can active fund managers add value, particularly in fixed income?

Passive funds follow an index, so when valuations become rich in one sector they don't have the option to underweight and move to another sector. Being able to rotate sectors is a great way to add value.

Good, old-fashioned bottom-up credit work is a powerful contributor. There's a difference in the bond market versus the public equity market: There is more information asymmetry in fixed income than in equities. With a large-cap stock, for instance, all the information is in the market and priced every day. With equities, the average investor can benefit by having a fund manager do the work for them. Even for institutional investors, it's difficult to have a team that is expert in asset-backed securities, and another in municipal bonds and another in corporate bonds. At Guggenheim, there are 275 people dedicated to all of fixed income, just doing security selection and managing money. That isn't really the budget for most small pension funds.

Exchange-traded funds are a phenomenal innovation, but the application of indexing has gotten to an extreme place, and might not be appropriate for certain asset classes. There is also idiosyncratic risk around indexing and ETFs that goes back to the active-management point. When you consider that the Bloomberg Barclays U.S. Aggregate Bond index represents only about 45% of the total fixed-income universe, an investor in an ETF that mimics the BB isn't getting exposure to a large portion of bonds that actively managed funds invest in.

People somehow presume that because a bond isn't in the index, that makes it bad. If you are eliminating more than half of the investment universe right out of the gate, you are missing potential opportunities. You are reducing your diversification needlessly.

Thanks, Scott. ■

Morningstar Rankings As of 12.31.2017	Ticker	1-Year		3-Year		5-Year	
Guggenheim Macro Opportunities Fund	GIOIX	119 out of 340	32%	28 out of 275	9%	1 out of 168	1%
Guggenheim Total Return Bond Fund	GIBIX	21 out of 986	3%	5 out of 847	1%	3 out of 778	1%
Guggenheim Investment Grade Bond Fund	GIUSX	19 out of 986	2%	7 out of 847	1%	n/a	n/a
Guggenheim Limited Duration Fund	GILHX	29 out of 513	7%	16 out of 462	5%	n/a	n/a
Guggenheim Floating Rate Strategies Fund	GIFIX	108 out of 231	43%	66 out of 205	26%	8 out of 165	4%
Guggenheim High Yield Fund	SHYIX	202 out of 699	32%	19 out of 609	4%	16 out of 501	4%