



Market Perspectives

BY SCOTT MINERD | CHIEF INVESTMENT OFFICER

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Winning the War in Europe

In centuries past, there have been many wars fought to bring Europe under one economic and political union. The Napoleonic Empire, the Prussian Empire, the Third Reich, and even the Ottoman Empire further to the east ultimately failed to achieve this goal. Today, in many ways, Europe is engaged in another war – a war to preserve the hard-fought gains of monetary and fiscal union built over the past five decades beginning with the Treaty of Rome in 1957.

The battles of this conflict, like previous European wars, are being fought across a broad theater. The Argonne, Waterloo and Normandy are among the many famous battlefields of the past. Greece, Portugal and Ireland are among the theaters of war in which European Union is currently engaged.

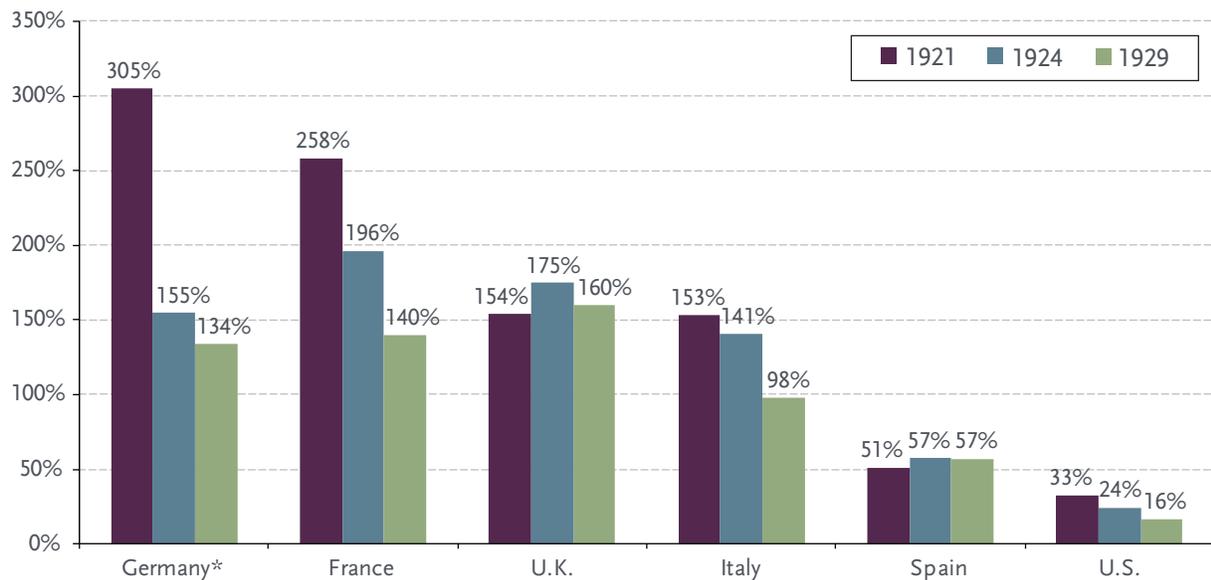
Just as past European conflicts resulted in grave economic costs and massive amounts of debt, this fight has taken a similar path. In the latest incursion, Greece has obtained a temporary cease fire in the form of a new €130 billion bailout plan, once again dodging an immediate threat of default and destabilization. Yet this plan will only reduce Greece's debt to approximately 120% of the nation's gross domestic product. Waiting in the wings are Portugal and Ireland, Italy and Spain – and later down the road, Belgium, and who knows what other European states – which may soon require their own restructurings.

Highly indebted nations as a result of war are common in the European experience. In fact, today's experience doesn't look all that different from another period in history when European nations were saddled with huge debts, had little means to repay them, and stumbled through a series of bailout plans that ultimately failed to solve the fundamental problems.

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EUROPEAN DEBT AFTER THE GREAT WAR

In the years following World War I, European nations were buried in debt. Germany, slapped with punitive war reparations, routinely defaulted on its payments even after several restructuring efforts were attempted in 1920s.



Source: Reinhart and Rogoff, Guggenheim Investments. *Note: German debt to GDP ratio includes reparation obligations.

The Interbellum

As the clouds of conflict lifted in 1918 and the Great War came to an end, the victorious Allies embarked on a plan – several plans, actually – to force Germany to pay for the incalculable destruction throughout Europe. The initial bill for war reparations was set at 269 billion gold marks, an amount that dwarfed the size of the German economy, amounting to approximately 300% of GDP.

Other European nations had borrowed heavily to fight the Great War. Many ended the war with astronomical amounts of debt, including Great Britain (154% of GDP), France (258% of GDP) and Italy (153% of GDP). Then, as now, there were strict demands for austerity measures, flat refusals to accept losses on certain debts, and constant infighting over bailout plan after bailout plan. Deadlines were missed; new plans proposed; the populous rose up in arms; and the whole process started over again. This serial restructuring saga continued throughout Europe for the entire interwar period.

Without the realistic ability to pay its enormous war debt, Germany spent the next 14 years on a path of multiple restructurings, occasionally paying installments (often in coal and timber) but more often defaulting on its financial obligations. Other European countries, particularly war-ravaged France, demanded full payment from the fledgling Weimar Republic. Initially, with its economy decimated by war and austerity measures, Germany responded by printing more and more money. In a startling surprise, the world was aghast as it watched Germany slip into hyperinflation where, at its height, one U.S. dollar was worth 4 trillion German marks.

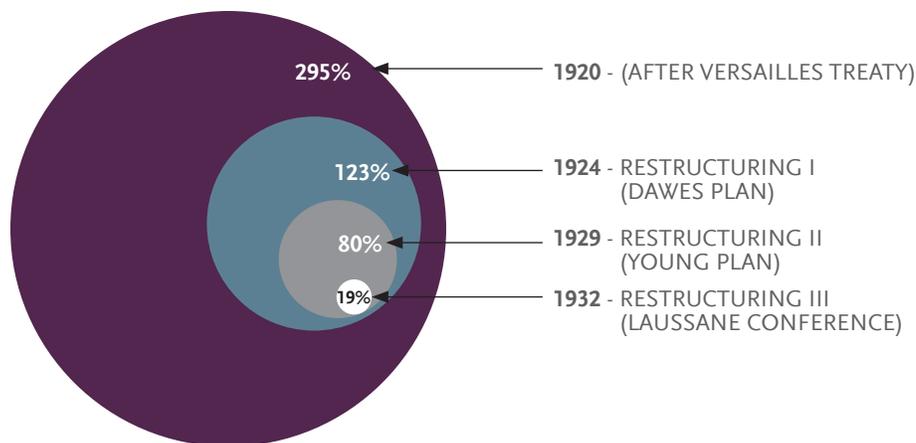
Drawing parallels with Weimar may seem ironic – as Germany is now the strongest economy in Europe and the leading advocate for austerity measures in Greece – but if one digs deep enough into the Interbellum, there are many similarities today. Germany wasn't the only debtor-in-crisis back then, just as Greece is not today, but it was the poster child for Europe's post-war economic angst.

The Dawes Plan

The first indication that things were not going well came early on. During the 1919 Paris Peace Conference, British economist John Maynard Keynes resigned as the principal representative of the British Treasury and stormed out of the conference to protest the high reparations demanded of Germany. Keynes, one of the fathers of modern economics, warned that punitive reparations would cripple the German economy and could lead to future conflict. It didn't take long for the rest of Europe to realize that Germany had neither the ability nor willingness to pay the full amount.

GERMANY REPARATIONS AS A PERCENT OF GDP

War reparations debt initially dwarfed the German economy as a percent of GDP. After many defaults, Germany's debt was restructured in 1924, 1929 and 1932. The 1932 plan was drafted but then vetoed by the United States.



Source: - "Historical Statistics of the World Economy: 1-2008 AD"- Angus Maddison 2009, Reinhart and Rogoff, Guggenheim Investments.

In August 1924, the Allied powers approved the first major restructuring package, known as the Dawes Plan. It was named for its principal architect, Charles G. Dawes – an American financier and later U.S. Vice President during Calvin Coolidge’s second administration. Without addressing the dollar amount owed, the Dawes Plan outlined a series of financial reforms for Germany, including currency stabilization, new taxes, and massive new loans primarily through American banks to help stimulate economic growth and pay off debts. Hailed as an international hero in 1925, Dawes won the Nobel Peace Prize for his work.

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The Young Plan

Within four years, however, it became clear that more needed to be done. In 1929, American businessman Owen D. Young (co-author of the Dawes Plan) led another restructuring effort. The Young Plan called for a more than 50% reduction in Germany’s reparations debt, extended the payments over a 58-year period, and imposed additional taxes. For his bold debt reduction plan, Young was named Time Magazine’s “Man of the Year.”

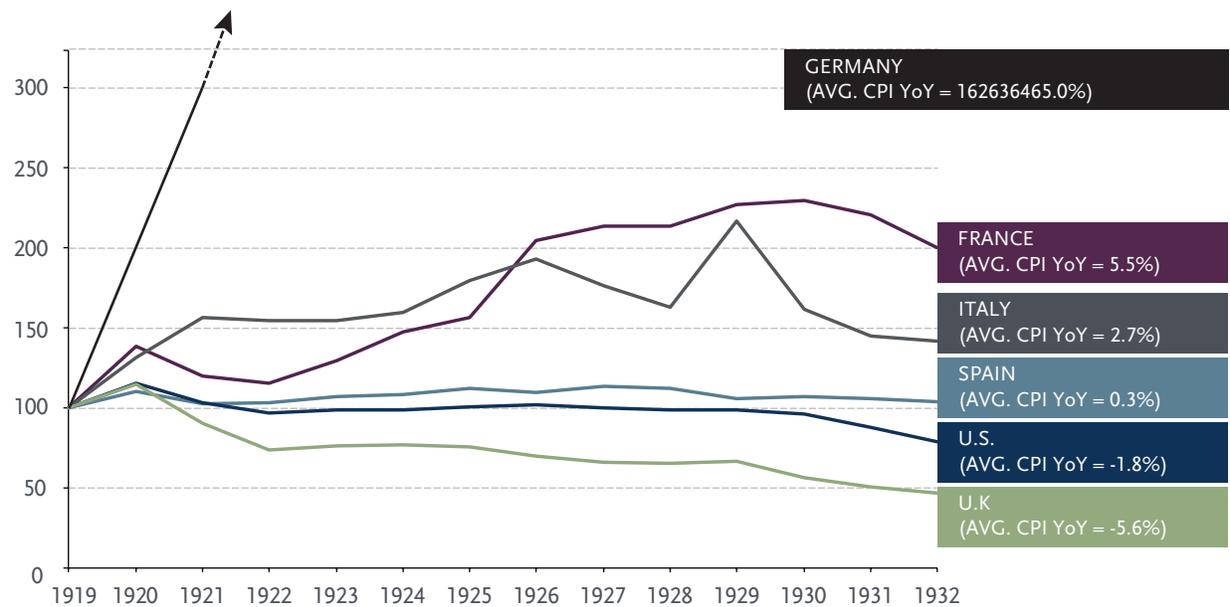
But this success was fleeting. Even with the substantial debt reduction under the Young Plan, Germany’s debt remained far too high at 123% of GDP. Then, just a few months later, everything went to hell with the stock market crash of 1929 and the onset of the Great Depression. All reparations payments were halted. Another restructuring attempt was made in 1932 but, by this point, there was little room for compromise. A plan to eliminate Germany’s war debt was proposed, but it was contingent on the United States agreeing to forgive debts owed to it by other European nations. The U.S. Congress flatly rejected that idea – which, today, sounds somewhat like the European Central Bank refusing to take a loss on its Greek debt holdings.

The Road to Debasement

While the restructuring attempts were ongoing, a common theme developed in many debt-strapped nations. Currency debasement emerged as the primary economic strategy, as one nation after another abandoned the gold standard in an attempt to inflate away its indebtedness and kick start its economy. In almost every case, countries that quickly left the gold standard during the economic turbulence of the interwar period appear to have recovered from the Great Depression faster than countries that remained on gold.

INFLATION IN THE POST-WWI PERIOD*

Unsustainable debt and frantic printing of money lead to a period of severe hyperinflation in Germany. At the height of the crisis in 1923, one U.S. dollar was worth 4 trillion German marks.



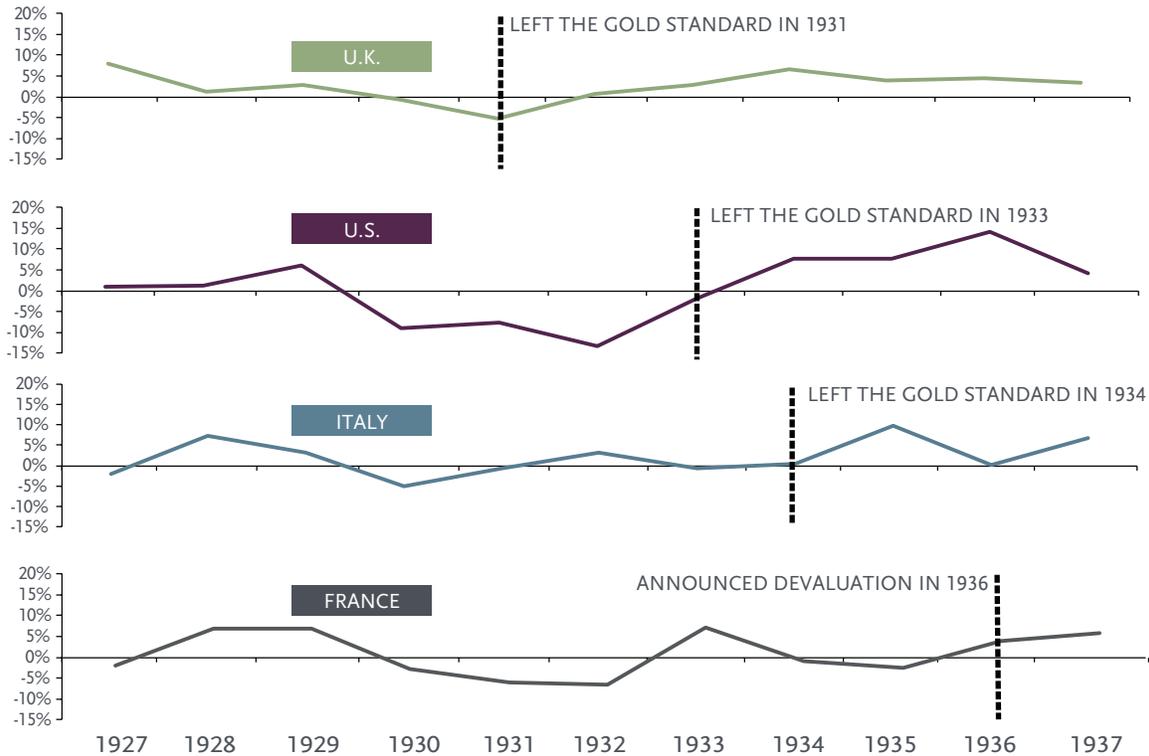
Source: Reinhart and Rogoff, Guggenheim Investments. *Note: Inflation for the above countries is the respective Consumer Price Indices normalized at 1919 levels.

In a renowned 1991 study, then-Princeton University professor Ben Bernanke asserted that “a mismanaged interwar gold standard was responsible for the worldwide deflation of the late 1920s and early 1930s.” He concluded that countries that held to the gold standard longest, such as the United States, had a more difficult path to recovery. Spain, which never returned to gold during the interwar period, largely avoided the declines in prices and output that plagued other nations. France, which gradually returned to gold from 1926 to 1928, was able to cut its debt-to-GDP ratio from a high of 262% in 1922 to 140% by 1929. Great Britain returned to gold in 1925 and saw its economic output drop by 3.7% the following year. Britain never made much of a dent in its debt-to-GDP ratio, which stayed around 150% to 160% of GDP throughout the entire post-WWI period. As worldwide economic conditions rapidly deteriorated in the early 1930s, most nations abandoned gold once again.

In the end, the only solution was to debase the currency. *(For a more in-depth discussion of that topic, read one of my previous commentaries, [The Return of Beggar-Thy-Neighbor.](#))*

REAL GDP GROWTH AFTER LEAVING GOLD STANDARD

Currency debasement emerged as the primary economic strategy of debt-strapped nations in the interwar period, as one government after another abandoned the gold standard in an attempt to inflate away its indebtedness and kick start its economy.



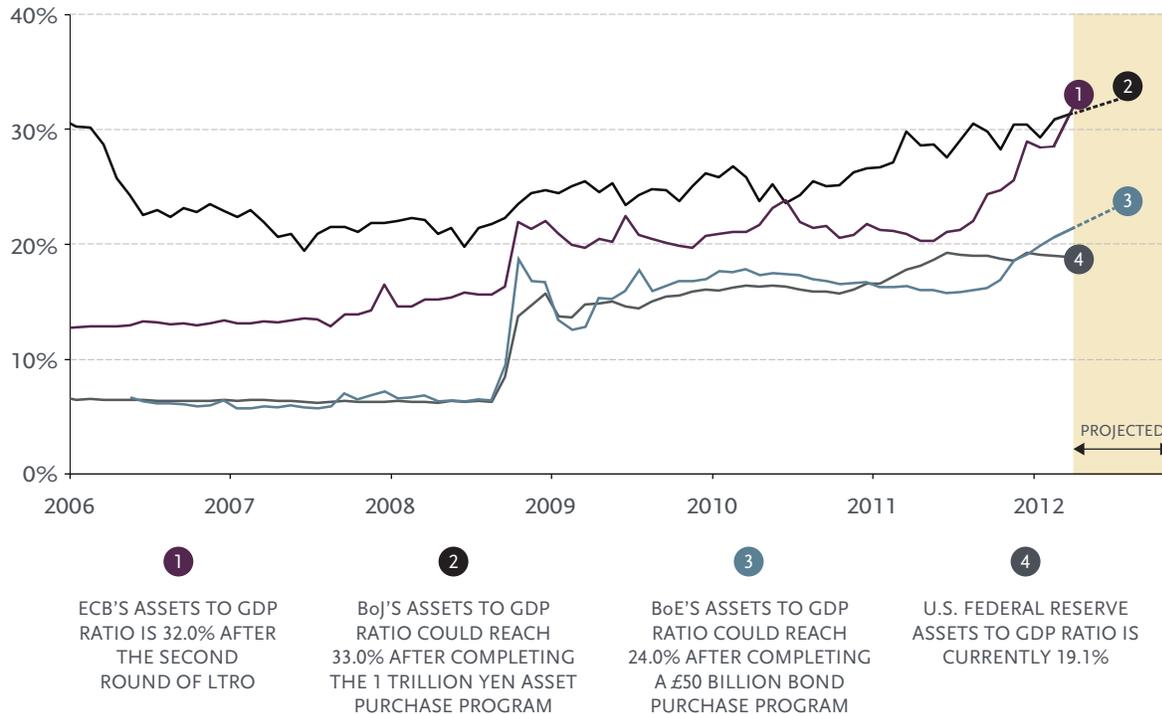
Source: Angus Maddison- *Historical Statistics of the World Economy: 1-2008 AD*, Reinhart and Rogoff, Guggenheim Investments.

Monetary Elixir

The strategy of currency debasement is alive and well today in the highly aggressive monetary easing of the U.S. Federal Reserve, the European Central Bank, the Bank of England and the Bank of Japan, among others. And it is not likely to end any time soon. The interwar period of the 1920s was primarily a time of very easy monetary policy and robust economic expansion – despite the structural problems associated with the over-indebted nations of Europe. That sounds a lot like today, with the Fed pledging to keep interest rates zero bound until 2014 and to provide whatever liquidity is necessary to support economic growth. And now, the ECB seems to be reading from the Fed's script, providing the banking system with low-interest loans topping €1 trillion.

A WORLD AWASH IN LIQUIDITY

Central banks are pumping liquidity into the system on a global scale. Assets-to-GDP ratios at the major central banks are rising rapidly, with the European Central Bank recently surpassing the Bank of Japan as the largest quantitative easer in the world.



Source: Bloomberg, Guggenheim Investments. Data as of 3/5/2012.

Today, as it was after the Great War, financial markets and monetary policy are playing central roles in the European debt drama. Private investors holding Greek debt are taking haircuts by “forgiving” 53.5% of their principal and exchange their remaining holdings for new Greek government bonds. Additionally, the ECB has indicated it will distribute profits from its Greek bond purchases to national central banks in a bid to bolster Greece’s aid package and stimulate growth. While pro-growth policies are being advocated, austerity measures are being enforced by policymakers in an effort to reduce or at least slow the growth of mounting debt. This sounds a lot like pushing down on the accelerator while standing on the brake. You aren’t likely to go very far.

For now, we have postponed an immediate crisis, but how long can it be before another struggling nation steps forward? With unsustainable debt levels throughout Europe today, it is just a matter of time before the serial restructuring saga resumes.

What This Means For Investments

Given my view on the global liquidity glut, it probably will come as no surprise that I remain bullish on U.S. investments, including equities, high yield bonds, bank loans and other risk assets, as well as art and collectibles. I believe the United States has entered a period of self-sustaining economic expansion, driven primarily by the aggressive monetary policy of the Fed, which is now being reinforced by the ECB. The United States has become the economic locomotive of the global economy, and that is why the Fed Chairman is showing no sign of taking his foot off the monetary gas pedal. He knows that U.S. growth is necessary to reduce domestic unemployment and to provide support to the struggling economies in Europe and Asia.

Dr. Bernanke is borrowing a page from the playbook of former Fed Chairman Alan Greenspan, who explained that it is sometimes necessary for the Fed to take out an insurance policy to ensure that nothing will derail an economic expansion. For Greenspan, that threat was the 1998 Russian debt default and the collapse of Long-Term Capital Management. That was followed by a major bull market in equities from 1998 to the spring of 2000. In the wake of the European debt crisis, I wouldn't be surprised to see a similar result, with equities benefitting greatly from the Fed's accommodative stance.

For Dr. Bernanke today, the perceived threat is threefold: the European debt crisis, a slowdown in the emerging markets, and a potential hard landing in China. Because of those threats, Dr. Bernanke feels a great responsibility to keep the U.S. economy moving forward. So far, the formula seems to be working. The United States has added more than 1.6 million jobs over the past year. GDP is increasing at an encouraging pace.

The unemployment rate has fallen to 8.3%, from a high of 10% in 2009. And despite another very strong employment report in January, Bernanke told the Senate Budget Committee on February 7 that he believes the U.S. job market is a "long way" from returning to normal. Comments such as this are intended to send strong signals to the market that Fed policy will remain aggressive.

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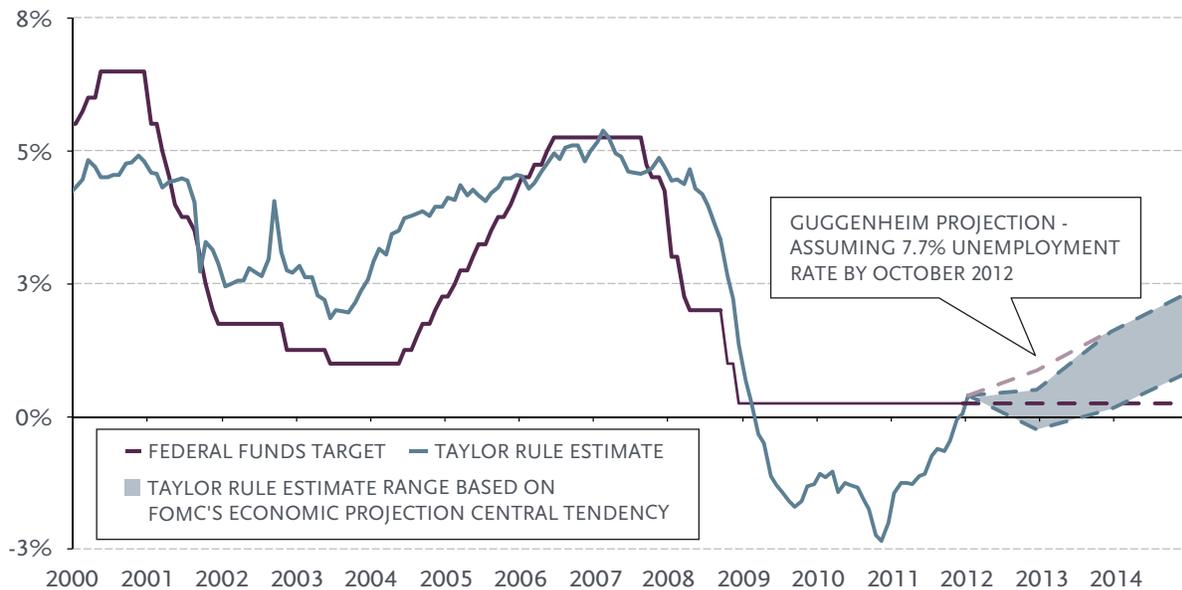
Helicopter Ben

Consequently, I believe the Fed will keep interest rates low, probably for a longer period of time than they should. We need only look back at the “deflation scare” of 2002-03 to gain insight into Dr. Bernanke’s thought process. At the height of the deflation scare, just like today, there was widespread worry that the economic expansion was going to stall out. The Fed pushed rates to historically low levels. And in November 2002, Dr. Bernanke (then a Fed Governor) outlined various anti-deflation options in his now-famous “helicopter” speech – referring to Economist Milton Friedman’s figurative notion of dropping cash from a helicopter to fight deflation. It is clear today that one of the key elements driving Fed policy is this preoccupation with deflation. Dr. Bernanke’s worst nightmare is that he will look back one day and see that he presided over a major deflationary spiral while he was on watch at the Fed. Helicopter Ben is not going to let it happen!

Of course, there are consequences for such actions. The monetary elixir of yesterday turns into the asset bubble of today, which turns into the market crash of tomorrow. Whether it was Internet stocks in the late 1990s, or housing in 2003-2006, we have gone from bubble to bubble many times before, and I believe we are setting the stage to do so again. It will take a few years to get there, and we should enjoy the time in between, when risk assets will likely produce healthy returns.

TAYLOR RULE ESTIMATE VS. THE FEDERAL FUNDS TARGET RATE

The Taylor Rule, a model used to suggest an appropriate Fed funds rate, is signaling that the Fed should raise interest rates this year given prevailing levels of inflation and unemployment. With the Fed pledging to maintain its zero-bound policy until at least late-2014, the Taylor Rule is suggesting that rates will stay too low for too long.

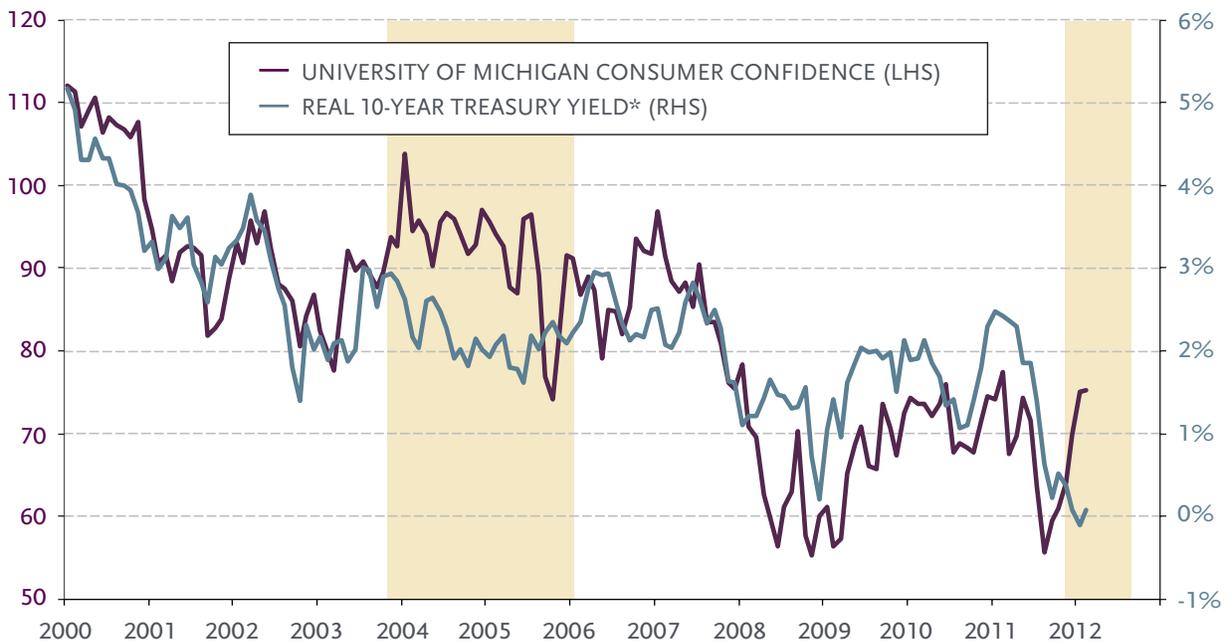


Source: Federal Reserve, Bloomberg, and Guggenheim Investments. Data as of 2/29/2012.

In the U.S. fixed income markets, the credit trade has worked very well. As concerns about the recession dissipate, riskier asset classes are rallying. However, while below investment-grade credits continue to look attractive, Treasury yields remain unsustainably low. I think the Fed's policy actions will keep rates lower than they normally would be, but I believe the improving U.S. economy will put upward pressure on rates over the next six to twelve months. Essentially, what we have right now in the Treasury market is a Ponzi scheme. If the market had its way, Treasury rates would be at least 100 basis points higher than they are today. But because there is a buyer out there who is willing to keep purchasing these securities, even though it doesn't make any economic sense as a prudent investment, the market has reached levels that wouldn't be sustainable if free market forces were allowed to prevail.

CONSUMER CONFIDENCE SUGGESTS REAL TREASURY YIELDS SHOULD RISE

Treasury yields remain unsustainably low. Although Fed policy actions should keep rates lower than they normally would be, an improving U.S. economy will likely put upward pressure on rates over the next six to twelve months. Historically, the real yield on the 10-year Treasury bond has tracked well with the University of Michigan Consumer Confidence Index, which is showing an upward trend.



Source: Bloomberg, Guggenheim Investments. Data as of 2/29/2012. *Note: The real 10-year treasury yield is calculated by subtracting the core PCE deflator rate from the nominal 10-year yield.

The bottom line is Treasuries at current levels are exceptionally overvalued. As the U.S. economy continues to heat up, I think we will likely see a negative total return for Treasury securities this year. To put that in perspective, Treasuries have gone negative only three times in the past 38 years: 1994, 1999 and 2009. It doesn't happen very often, but given the low current yield, the likelihood for price depreciation is high. It is time to short long-dated Treasury securities, something many of my colleagues in the fixed-income world are loathe to recommend given the huge losses taken over the past 12 months by those who failed to recognize the determination and ability of the Fed to lower the term structure of interest rates.

As for my outlook on Europe, I have been saying for a while now that the euro area has fallen into recession. We saw negative GDP growth in the fourth quarter, so one more bad quarter will officially put us there. And I think all of this turmoil in Europe will put pressure on the emerging markets and China, as export markets suffer. The only way out involves a significant debasement of the euro, and I believe that is on the horizon.

While I think the overall environment remains supportive for risk assets, especially in the United States, the uncertainty of the European debt crisis will continue to cloud the global financial outlook, and the looming question will remain: how long until we finally resolve it? To put that question in perspective, consider that Germany did eventually pay all of its remaining reparations from World War I. The final payment of \$94 million was made on October 3, 2010 – 92 years after the last shot was fired. Perhaps that gives us some sense of how long it can take to restructure the debts of Europe.

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