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On this week's program, Guggenheim Partners' Scott Minerd explains why he is getting defensive in all six of his five-star rated bond funds.

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CONSUELO MACK: This week on WEALTHTRACK, Guggenheim's Scott Minerd oversees six five-star rated bond funds. He'll tell us how and why he is getting defensive in all of them. That's next on Consuelo Mack WEALTHTRACK.

Hello and welcome to this edition of WEALTHTRACK, I'm Consuelo Mack.
Is the great expansion soon to become the great unwinding? The recent unanimous decision by Federal Reserve officials to start reducing the size of its bond holdings would indicate it.
This chart illustrates the staggering expansion of the Fed's balance sheet. Up an estimated 500% to $4.5 trillion since the financial crisis. The Fed's massive purchases of Treasury bonds and mortgage-backed securities were designed to lower interest rates and thus borrowing costs for businesses, homeowners and consumers alike.

The chart also shows the Fed's estimated unwinding of those purchases. They are expected to be very gradual, initially allowing only $10 billion dollars a month of the bonds to mature without replacing them. A pace to be accelerated later.

The Fed is the first among the major central banks of developed countries to start withdrawing from this unprecedented monetary experiment. The European Central Bank and the Bank of Japan continue to buy bonds to keep their interest rates low in an effort to encourage economic growth.

This week's guest is a successful fixed income manager who is tracking these developments with interest and concern. He is Scott Minerd, Co-Founder of Guggenheim Partners, its Global Chief Investment Officer and Chairman of Guggenheim Investments where he oversees $290 billion dollars of assets, two-thirds of which are in fixed income securities. Included in that mix are six taxable bond funds. All are rated 5-star by *Morningstar*. He is a Portfolio Manager on all but one. All carry the Guggenheim name. They are the flagship, Total Return, Macro Opportunities, Floating Rate Strategies, Limited Duration, High Yield And Investment Grade Bond.

Guggenheim has been in the news lately about alleged management discord, which the firm vehemently denies and what it calls a routine sec examination for a registered investment advisor which it says is in the final stages.

For Minerd it appears to be business as usual. In a recent report on the outlook for fixed income he told clients "We have to remind ourselves that we are living in a highly unusual time."
I asked him to describe how unusual it is.

SCOTT MINERD: Well, we're living in an unprecedented age. I mean never in the history of the world have we had a series of central banks around the world essentially propping up global economies by printing money. And so, we don't have an analog to look at. It's not like we can talk about our traditional business cycle. And so how does this all play out? And as I like to tell people, the history of money is checkered. Kings were known for shaving the edges of coins and building palaces or fighting wars and debasing their currency. And that

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ultimately was inflationary. The history of paper money is abysmal. There's never been a paper money regime that ultimately doesn't fall into a period of hyper-inflation.
Now, today I'm not predicting hyperinflation. But policy makers are going to be really challenged to figure out how are they going to play this out at the end. And I think what they want to do is they want to follow the traditional path, which is let employment rise, let wages rise, let inflation start to take off a little bit, and then clamp down on money growth. And that will ultimately lead to a recession. But when you look at where we are today with interest rates as low as they are, the average recession has ended with the Fed ultimately having to reduce rates by five percentage points. It's unlikely that given how low inflation is now that rates are going to get that high. And so, we're likely to find ourselves beginning a recession when rates are maybe two and a half or three percent, and then the Fed will have to do what it traditionally does, which is inject money in the system and lower interest rates.
And we've never had to do this before with rates this low. So, it's going to be an interesting and challenging road ahead, but the key right now for investors is trying to figure out what does that road ahead look like between where we are today and when the Fed has to clamp down on money growth and probably induce a recession? And that's where I've been really focused.

CONSUELO MACK: That's what, two years out, I don't know, 18 months out?

SCOTT MINERD: History would tell us that it's probably about two years away, unless the Fed finds itself in the mode of having to abort its current tightening cycle of raising rates. We had that in 1987 and then of course we got the stock market crash and what followed. And then we had it again in the Asian crisis in the late 90s, and of course that led to the internet bubble. So, if we stay the course, I think we will have a recession by late 2019, maybe early 2020. But if the Fed has to abort, and that could be for any number of reasons, it could be because of what's going on in Korea. But I'm acting as if we're going to have a recession in another two or two and a half years, and then trying to plan accordingly.

CONSUELO MACK: Now, you're on a committee that advises the New York Fed. So, what's your advice to the New York Fed? What are you telling them that they should be doing?

SCOTT MINERD: Well, I think that they need to let the economy run hot, that we need to see inflation above two percent for some period of time. They have to do that so that we can move far enough away from what we've euphemistically called the zero bound to get rates high enough so that when we get to the next recession, we don't find ourselves back at the zero bound and again in the exercise of printing money and quantitative easing.
I think the political dynamic in Washington right now isn't very favorable for another monetary experiment, and so I think just from the standpoint of their own long-term credibility, that they would probably be better off to allow the economy to run hot and let inflation rise a little bit further than they think they should so that we can avoid having to go through some of this more unorthodox policy that we've had to live with for the last decade.

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CONSUELO MACK: You're always looking ahead, but of course I'm looking at what's happening right now in front of my nose. So, let me quote you again, and you said that … and again, this is in a report to clients, a big report that you wrote about fixed income to clients, that your "worry is that 18 months from now if not sooner, we will look back at this period and be amazed at how obvious it was that we were not being compensated enough to take on the risk that we are being offered at today's prices." So how risky is the fixed income markets right now?

SCOTT MINERD: Well, it's interesting, the perspective I think is to say … take high-yield bonds. It's a good example. Given where high-yield bonds are currently trading and the yields that are being offered, if you take the historical default experience over a decade and adjust those returns or those yields for the expected defaults, you would actually get a return that is about the same as the 10-year Treasury note …

CONSUELO MACK: Really?

SCOTT MINERD: … if you just bought it and held it. Right.

CONSUELO MACK: Wow, that's stunning.

SCOTT MINERD: It is stunning. And you think about that …

CONSUELO MACK: That low.

SCOTT MINERD: That low. And if you think about that and you're a long-term investor and you say, "I want to invest my money for the next 10 years," would you say that you would want to live through all the volatility and noise of holding high-yield bonds for the next decade and getting something like a two percent return when you can just go buy a 10-year Treasury and get a two percent return. And I'm not arguing that a two percent return is that attractive, but it's these kind of crazy tradeoffs that investors are being asked to make because when you look at high-yield bond issuance or you look at leveraged loan issuance, we're running at records. And you look at corporate bonds and we're going to have another record year in corporate bonds. And so, all this credit risk that's getting created by all the new issuance of these bonds on a risk-adjusted basis doesn't really make a lot of rational sense because you're not being paid a premium to take on the risk relative to taking on a risk-free asset like a U.S. Treasury security.

CONSUELO MACK: When you were on Wealth Track last, which was in April of 2016, you actually … the investments that you were recommending at that time were higher-risk, were high-yield bonds and I think bank loans, long exposure asset-backed security. You've really changed your tune. Your funds did extremely well investing that way. But now you've gotten much more defensive. So, tell us what you're doing.

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SCOTT MINERD: Well, I mean clearly, we've moved a lot more toward U.S. Treasuries. And we're doing a lot of U.S. agency-backed securities. Commercial mortgage backed securities that are guaranteed or wrapped by the agencies are exceptionally attractive.

CONSUELO MACK: So I'm hearing safety, higher quality …

SCOTT MINERD: Right, higher quality. I often joke that … and use the Baron von Rothchild line which is when asked the secret of his great wealth, he said he sold early.

CONSUELO MACK: Which is such an interesting … it's don't let your profits run, don't be afraid to sell early in anticipation of whatever you think is going to happen.

SCOTT MINERD: That's right. And the problem with this strategy is valuation. Valuation is a great thing for long-term investors, but as a short-term timing tool, it's very bad. I often joke that markets that get over-valued and become more over-valued are called bull markets. And so, investors get frustrated when they say, "Well, I sold my equity portfolio or I sold my high-yield bonds," and then they read the next quarter how much they could have made if they had just stayed in one more quarter. So, that is a common behavioral thing in investors that they feel that they missed out on the opportunity. But disciplined investors have to understand that valuation in the long run is what drives returns. And you just have to be willing to say, "Yeah, I might miss the next five percent or ten percent of upside, but am I worried about next quarter's returns or am I worried about what my returns look like for the next decade?"

CONSUELO MACK: In this short-term oriented environment, and I know you worked with Daniel Kahneman, the Nobel Prize winner, the behavioral psychologist and you've applied a lot of his disciplines, behavioral finance to your disciplines at Guggenheim. In the short-term oriented environment, should you be adjusting your time frames more to the current time frames that we're seeing among investors in the markets?

SCOTT MINERD: Right. Well, it's an interesting challenge from where I sit because when you underperform for a quarter or two, investors have gotten themselves conditioned by watching the news media like CNBC, and not to criticize them, they're a great network, but they're seeing all these headlines and news stories. And so, the idea that they're missing out, it's a very difficult behavioral issue to deal with. So, what my approach typically is, is to say we're turning a big ship. If we think things are overvalued or getting overvalued, it's probably time to start reducing the position and then do it over a series of months or quarters and not make a lot of short-term kneejerk trades. And I think that would line up with Danny Kahneman's view of the world, is that investors tend to be too reactive. And so, you can't time all these things perfectly, and that's the way we manage our portfolios, is we just say … it's funny, you just mentioned a year and a half ago how bullish I was on high-yield. We started to get more conservative toward the end of last year, early this year. And so, it's a slow evolution and you hope you get the pacing of it right. But it's hard for an investor to stay disciplined like that because there's the old adage which your viewers are going to know,

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there are bulls, bears and pigs. Bulls make money, bears make money, but pigs get slaughtered. And people who are just trying to hold on for another quarter's returns often come up and regret that kind of investment philosophy.

CONSUELO MACK: Another interesting prediction that you've made is that you expect that the 10-year Treasury will be under two percent? I'm not sure if you put a time frame on it or not.

SCOTT MINERD: A lot of investors inherently have this basis from where we've come from that somehow, we think normal interest rates are five percent. And the reality is that as we talked about earlier, that wasn't normal for the 1950s or even in the early 1960s. And so, a lot of people think that we're suddenly going to see rates much higher or this or that. And the reality is that now we're going to … two percent where we are today, two and a quarter percent in the 10-year note is pretty much a fulcrum point. And if things get heated up, we should move closer to three. When the economy slows down, we'll go under two. And so, the idea that a one percent 10-year note is something that we aren't going to experience again I think is a very unlikely outcome for investors. And investors should protect themselves. One of the themes that you see playing out in our portfolios is even though we believe the Federal Reserve is committed to increasing rates, history shows us that as they raise short-term rates, long-term rates tend to lag. And you actually have at the end of a cycle when the yield curve is flat, that is the short-term rate and the 10-year note is the same yield, that after that period, long-term rates tend to fall in anticipation of short-term rates coming down. And so, it's I think imprudent for investors to say, "Okay, let me sell all my long-dated bonds." They should have something in their portfolio. But they should also construct the portfolio in a way that takes advantage of short-term rates coming up by having less significant amount of floating rate assets in their portfolio, but not to abandon the long end of the yield curve.

CONSUELO MACK: And so, in 18 or 19 months, you think we are going to have a recession. And therefore, you're adjusting your portfolios gradually towards that end. Talk to us about how you are adjusting them now, and if we should as individual investors, should be doing the same thing?

SCOTT MINERD: I mean as I mentioned earlier, one of the things that we've done because we do think we're in the late stages of the business cycle as I call it, the seventh inning, and so it's time to start moving toward the exits. If you go to Dodger Stadium, usually around the eighth inning you want to start leaving because it gets awfully crowded leaving in the parking lot. So, I think that the first thing is to start considering upgrading the credit quality of your portfolio, which we've discussed. The second thing is to have a significant portion of the portfolio in very short dated or floating rate assets. And that would include things like collateralized loan obligations, CLOs, which are floating rate in nature reset on a monthly or a quarterly basis, those are very attractive. There are also floating rate mortgage products that offer you incremental yield. Like for instance today you can find a high grade, high quality floating rate asset for around three percent. So, you're not really giving up any current yield

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relative to being, owning a long-term Treasury security. And then at the other end of the yield curve or at the longer end, we're focused on buying things like U.S. Treasury strips, very high quality muni products. Municipal bonds are very cheap relative to history. So, they make sense even if you can't take advantage of the tax exemption. So, a balanced portfolio needs to have a mix of both short-term assets and long duration assets to protect you in the event that the one percent 10-year note or the one percent Treasury rate is closer than I would anticipate today.

CONSUELO MACK: You've got six five-star rated bond funds. And you never want to pick your favorite child, but if you were to look at a time horizon over the next 12 months, for instance, which one do you think is going to perform the best?

SCOTT MINERD: I think the Limited Duration fund is the place to be. The Total Return Bond fund has done very well, has outperformed the limited duration fund. But as rates do continue to rise, the Limited Duration fund will protect you from that and preserve capital overweight at this point.

CONSUELO MACK: You have a background in risk management. Let me ask you about some of the risks that you are seeing.

SCOTT MINERD: I'm very concerned about the policy risks in terms of tax reform, immigration. These are highly charged issues in our country. For instance, in the long run, even in the short run, the immigration question is going to be one of the defining issues for us in terms of our growth potential. Our work force is not growing fast enough to accommodate three or even four percent growth as the administration has … its objective.
And so, if you go to a country like Australia, which has a very rational immigration policy that qualifies immigrants to come into the country, they've been able to grow the size of their work force in such a way that it's kept them from having a recession for over 24 years. And they qualify the people based on needs.

CONSUELO MACK: On job needs.

SCOTT MINERD: On job needs and the credentials of the people coming in.

CONSUELO MACK: So as far as tax reform is concerned, would it be business tax reform or personal tax reform? What would be the priority?

SCOTT MINERD: I think the highest priority should be business tax reform. We have one of the highest corporate tax rates in the world. There's a need for us to be more competitive as a place to manufacture and for business to be located in general. I think we also need to figure out a way to come up with a rational tax system which encourages the repatriation of capital into the United States. If the over a trillion dollars' worth of cash which is sitting on balance sheets in corporations around the world came home, that in and of itself would give a big lift

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to equity prices. It would be an interesting source of funds for infrastructure and other things that we desperately need to remain competitive in the world.

CONSUELO MACK: Geopolitical risk with North Korea lobbing rockets over Japan for instance, how much attention are you paying to those and what difference does it make in how you're managing portfolios?

SCOTT MINERD: Well, the Korean tensions are a frightening thing for me. And it really does make me pause and say do I need to de-risk further? Should I be reducing the size of our equity portfolios and allocations there? And I think the likelihood that we're going to have some sort of a military conflict, possibly nuclear is rising. I would say prospects are at least 20 percent at this point.

CONSUELO MACK: Wow, that's real.

SCOTT MINERD: That's real. And it's not the likely outcome but it's a very, very real outcome. And it's probably time for people to factor that into their risk calculation as we're trying to. Probably should start increasing their allocation to things like gold and precious metals if they don't have any. I think that at this point an allocation of about five percent of a portfolio to precious metals makes sense.

CONSUELO MACK: Your normal range you told me at one point was two to five percent.

SCOTT MINERD: That's right.

CONSUELO MACK:So, you're at the high end of your normal allocation to precious metals and gold.

SCOTT MINERD: Exactly. And I think that we are … in times of uncertainty, that does well and hopefully it doesn't lead to something worse that would be a global bear market.

CONSUELO MACK: What would be your one investment for a long-term diversified portfolio, and I will add that in April of 2016 that you recommended an ETF investing in Brazilian stocks and it was up almost 50 percent. What's your view now of that ETF and what would your new one be?

SCOTT MINERD: Right. Well, I would continue to be long Brazil.

CONSUELO MACK: You would?

SCOTT MINERD:And I would add its sister, Chile, next door, which probably will perform even better, which is ECH. But to get out of the emerging markets, Bank of America, as interest rates rise, Bank of America has a very large fixed rate deposit base. And so, as

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interest rates go up, the earnings will go up. It's still trading well below the value of what it was at back in 2007 and pays a pretty handsome dividend and is growing earnings. So, if you don't have the stomach for the emerging markets, the Bank of America probably is a great pick.

CONSUELO MACK: We'll leave it there. Scott Minerd, thank you very much for being with us on Wealth Track once again.

SCOTT MINERD: Thank you, Consuelo.

CONSUELO MACK: At the close of every WEALTHTRACK we try to give you one suggestion to help you build and protect your wealth over the long term.
This week's action point is one we have recommended many times before but it bears repeating. It is: Make sure you have a safe haven asset in your portfolio.
Minerd mentioned gold. It is a logical choice since it is universally recognized and traded as one. His recommended limit is 5% of a portfolio. Other WEALTHTRACK guests such as First Eagle's Jean-Marie Eveillard traditionally hold up to 10%.

Buying the precious metal itself is a hassle. A good alternative is buying a Gold ETF. The oldest and largest Gold ETF is SPDR Gold Shares (symbol GLD), or it's close relative, iShares Gold Trust, (symbol IAU). They give you tradeable ownership shares of gold bullion without having to take possession.

Next week we will sit down with retirement experts Kimberly Lankford and Christopher Blunt to discuss managing the increasing costs of retirement, especially health care expenses.

On our website's EXTRA feature this week, Scott Minerd discusses his early retirement from Wall Street years ago and what brought him back.

Please feel free to reach out to us on Facebook and Twitter about this week's program or any other topic you care about.

Thank you so much for watching. Have a great weekend and make the week ahead a profitable and a productive one.

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