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Research Spotlight on What's Next

Quarterly Macro Themes

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About Quarterly Macro Themes

Quarterly Macro Themes, a quarterly publication from our Macroeconomic and Investment Research Group, spotlights critical and timely areas of research and updates our baseline views on the economy. Themes are selected from the broad range of issues we are currently analyzing, and demonstrate the type of market and economic topics we address in developing our outlook on the U.S. and global business cycle, market forecasts, and policy views. Our Macroeconomic and Investment Research Group's research is a key input in Guggenheim's investment process, which typically results in asset allocations that differ from broadly followed benchmarks.

Macroeconomic Outlook

Downside Risks Decreasing, Not Disappearing

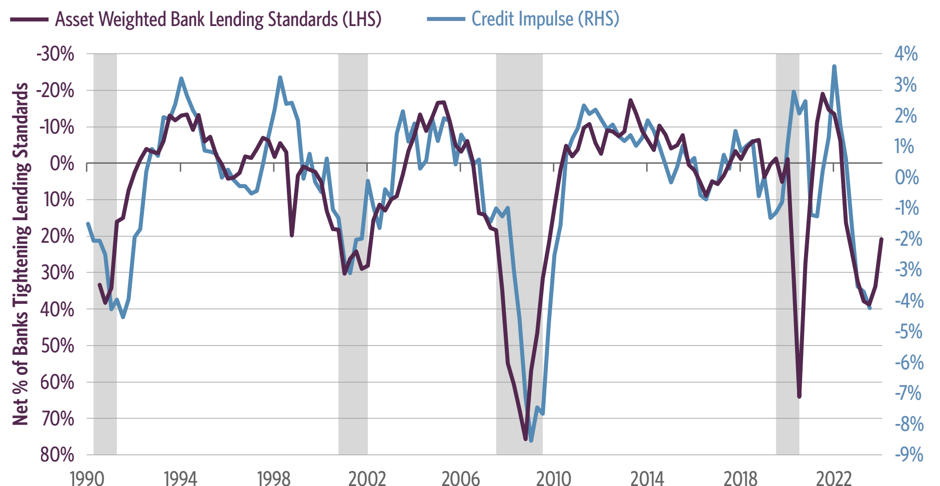
While recession risk has been reduced, it is far from eliminated.

The U.S. economy has been through a sizable adjustment over the last two years as a result of the Federal Reserve's (Fed) aggressive monetary policy tightening. Many of the usual consequences of a tightening cycle unfolded: the yield curve inverted, interest rate-sensitive sectors contracted, credit growth slowed, and the labor market softened. However, the economy has so far avoided a recession that was widely predicted to begin sometime in 2023, even by the Fed.

A combination of unique features in this cycle are the likely cause of this economic resilience. Strong private sector balance sheets with low-cost borrowing locked in during 2020 and 2021 blunted the transmission of higher borrowing costs. Uncomfortable memories of the pandemic labor shortage have prevented layoffs ("labor hoarding"). The asynchronous nature of the recovery from the COVID shock led to rolling recessions in different sectors at different times, preventing any one quarter from being particularly bad. Immigration surged last year, helping to boost fiscal capacity and reduce price pressures. And fiscal policy unexpectedly became expansionary last year as the deficit exceeded 7 percent of gross domestic product (GDP), cushioning the blow from monetary policy.

With recession avoided thus far and Fed rate cuts in sight, financial conditions have eased meaningfully in recent months, helping bring down near-term recession risk. Based on our outlook for inflation, the Fed delivering on easing should help credit conditions recover further.

Recession Has Been Avoided So Far and Peak Credit Drag Is Now Behind Us



Source: Guggenheim Investments, Haver Analytics. Data as of 9.30.2023 for credit impulse, 2.5.2024 for lending standards. Lending standards are weighted by bank assets. Credit impulse measures the change in growth rate of total credit outstanding to the private sector as a percent of GDP. Gray areas represent recession.

With recession avoided thus far and Fed rate cuts widely anticipated, financial conditions have eased meaningfully in recent months, helping bring down near-term recession risk. Based on our outlook for inflation (see Theme 1), the Fed delivering on easing should help credit conditions recover further and default activity to stabilize. But while recession risk has been reduced, it is far from eliminated. The pockets of stress that remain, such as commercial real estate, carry potential spillover risks to small banks that could transmit the stress to the broader economy. More fundamentally, history shows that maintaining low unemployment rates for extended periods is a difficult task. The 1995 rate cut cycle—and subsequent multiyear expansion—is a frequent comparison made to today, but that cycle started with more economic slack on which to draw down. Additionally, the late 1990s experienced a multiyear productivity boom and it is too soon to tell if all of the investment in artificial intelligence will be a similar catalyst in this cycle.

Therefore, while the economic backdrop has gotten more positive, our investment strategy remains largely unchanged. More progress on inflation should lead to Fed rate cuts around midyear, and as the economy slows further in the second half, the Fed should ultimately cut more than current market pricing suggests. On the credit side, very tight spreads have priced in too much economic optimism given that the balance of risks still points to a weaker economy. With all-in yields still attractive, we continue to have a bias toward higher quality fixed income, generally focusing on borrowers better able to withstand the increasingly bifurcated economy.

Theme 1

What's Holding Up Inflation, and Why It Will Fall Further (Even If the Economy Doesn't)

Despite some recent bumps in the road, inflation is heading lower.

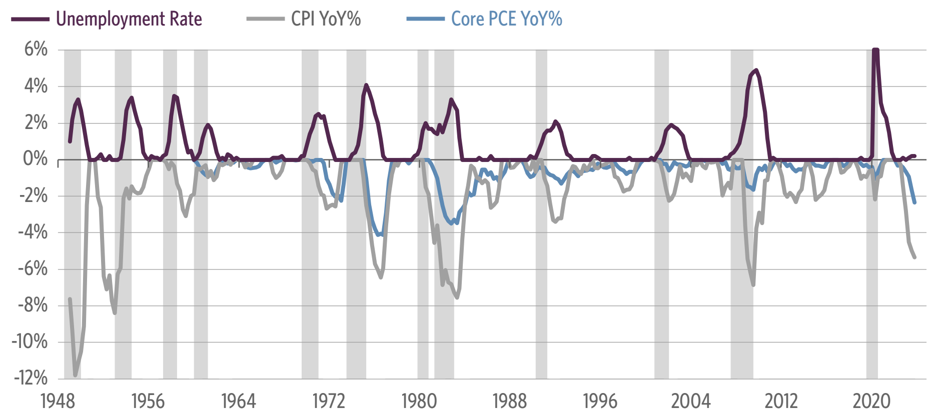
Higher than expected inflation figures to start the year have shaken market and Fed confidence that inflation will continue its steady progress toward the central bank's 2 percent target. These fears have been bolstered by resilient economic growth, with certain sectors even showing signs of accelerating growth. Understandably, these factors have led to concerns about inflation staying sticky at 3–4 percent, or worse, a second wave of inflation on the way.

To understand the outlook for inflation, though, it's important to examine why typical inflation drivers, such as robust economic growth and low unemployment, have not stopped inflation from falling over the last year. This not only clarifies the absence of inflationary pressures but even highlights the mechanisms supporting disinflationary progress, which are largely related to post-pandemic normalization. With respect to growth, the supply side of the economy has been increasing faster than demand over the past several quarters. Supply chains have healed, and increased labor force participation and immigration have expanded the workforce. Meanwhile, worker productivity is recovering at a fast pace after subdued readings during the pandemic years. The net result of expanding economic capacity is strong output growth and falling price growth.

Labor market tightness has not disrupted the disinflationary progress because a loosening of labor market dynamics has materialized in other ways. Specifically, the improvement in labor supply was met by a decline in job openings, and reduced job-hopping helped ease upward pressure on wages.

Labor Market Tightness Has Not Disrupted Disinflationary Progress

Unemployment Rate Increasing from Two-Year Trailing Low and Inflation Drawdown from Two-Year Trailing High



Source: Guggenheim Investments, Haver Analytics. Data as of 12.31.2023. Gray areas represent recession.

The other arguably inflationary factor is the low unemployment rate, which has remained in an unusually tight and low range of 3.4–3.9 percent since February 2022. Labor market tightness has not disrupted the disinflationary progress because a loosening of labor market dynamics has materialized in other ways. Specifically, the improvement in labor supply was met by a decline in job openings, and reduced job-hopping helped ease upward pressure on wages. Given these unique dynamics that have allowed for an "immaculate disinflation," a continuation of current economic growth rates and unemployment would not necessarily prevent further declines in inflation.

Instead, we see several positive developments that point to lower inflation ahead. The first is wage growth: Labor costs are the biggest cost for most businesses, especially in the service sector. After peaking at 5.7 percent growth in mid-2022, nominal wage growth as measured by the Employment Cost Index has moderated to 4.3 percent growth as of the fourth quarter. If we also factor in improved productivity growth, the moderation in wage costs looks even better, dropping from an 8.3 percent peak to 1.5 percent, a rate fully compatible with 2 percent inflation.

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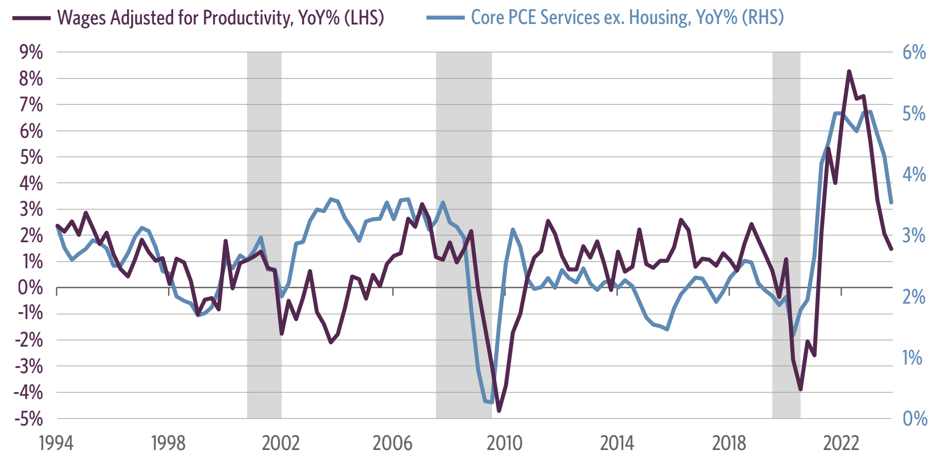
Drop in Wage Growth Bodes Well for Decline in Services Inflation



Source: Guggenheim Investments, Haver Analytics. Data as of 12.31.2023. Wages are private sector wages and salaries from the Employment Cost Index. Gray areas represent recession.

Dynamics in the rental market, a category that makes up over 40 percent of the core Consumer Price Index (CPI) basket and about 18 percent of core personal consumption expenditures (CPE), will also play a critical role. Rental inflation, including owners' equivalent rents (imputed rents that homeowners are paying themselves) is currently responsible for 2.5 percentage points of the year-over-year 3.8 percent inflation in core CPI. But a multitude of sources indicate that this will fall significantly over the next several months. The official inflation data measures

rents paid by all tenants, but the market for newly signed leases has shown a dramatic slowdown over the past year and a half, and these newly signed leases are a reliable leading signal for overall rent growth. Additionally, a massive wave of new apartment supply hitting the market this year, amid already rising vacancy rates, will help keep rent growth subdued. As the CPI and PCE data catch up to real world developments, overall inflation rates should come down given that housing costs are the biggest current driver of inflation.

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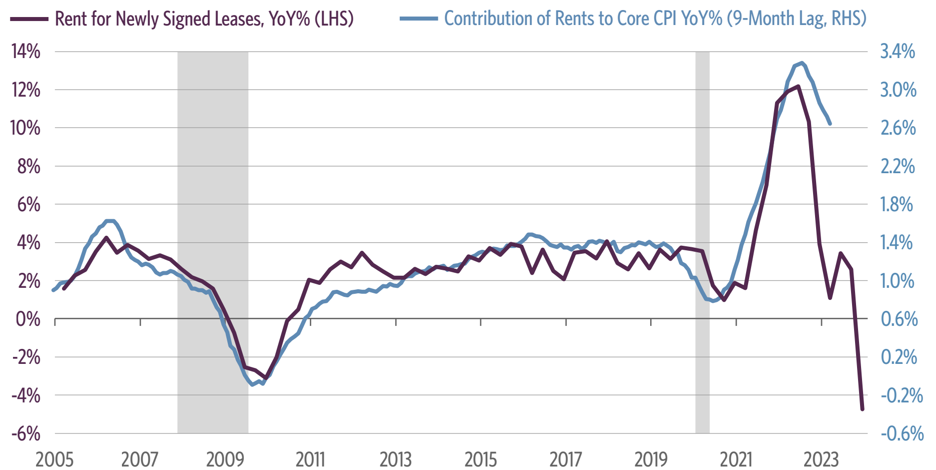
Housing Costs, the Biggest Current Driver of Inflation, Are Poised to Fall

New Tenants Inflation and CPI Rent Inflation (YoY% Change)



Source: Guggenheim Investments, Haver, Bloomberg. Data as of 1.31.2024 for CPI, 12.31.2023 for new tenants rent. Gray areas represent recession.

Finally, there has been a large drop in inflation expectations by both consumers and businesses back to pre-pandemic ranges. Normalized expectations are an important sign that the Fed's inflation fighting effort has credibility, and lessens the likelihood of inflation picking back up. For instance, in the 1970s, inflation expectations became unanchored and prompted consumers to adjust their spending habits in anticipation of rising prices. This behavior, in turn, fueled inflation, turning it into a self-fulfilling prophecy.

All told, we expect year-over-year core PCE inflation, the Fed's preferred measure, will moderate further in the coming months, dropping below 2.5 percent. Despite some recent bumps in the road, inflation is heading lower, opening up the door for the Fed to start cutting rates back toward neutral levels.

Theme 2

Corporate Default Outlook: A Peak in Sight But Increased Dispersion

Large and small companies face divergent challenges this year.

Recession-like conditions at the start of 2023 set the stage for the speculative-grade default rate to climb from 1 percent to 4 percent, but a blend of continued challenges and some easing conditions today signals the potential for a modestly better outcome in 2024. Credit spreads have tightened across the board, and the Fed's Senior Loan Officer Opinion Survey (SLOOS) reveals an important shift: while more banks are tightening than easing loan standards for commercial and industrial (C&I) borrowers, the net share of banks doing so has peaked. At the current rate of the survey's improvements, the net share of banks tightening standards for C&I loans could be zero by the end of the year.

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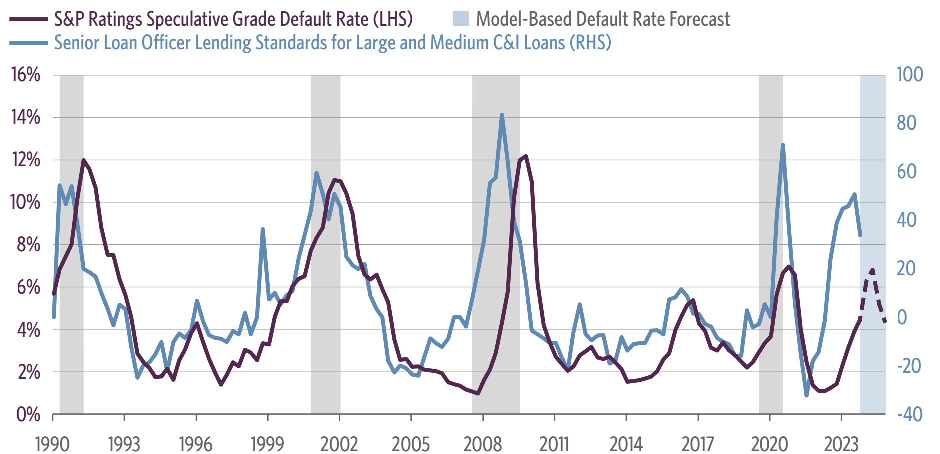
Lending Standards and Corporate Fundamentals Indicate a Near-Term Peak in Corporate Defaults



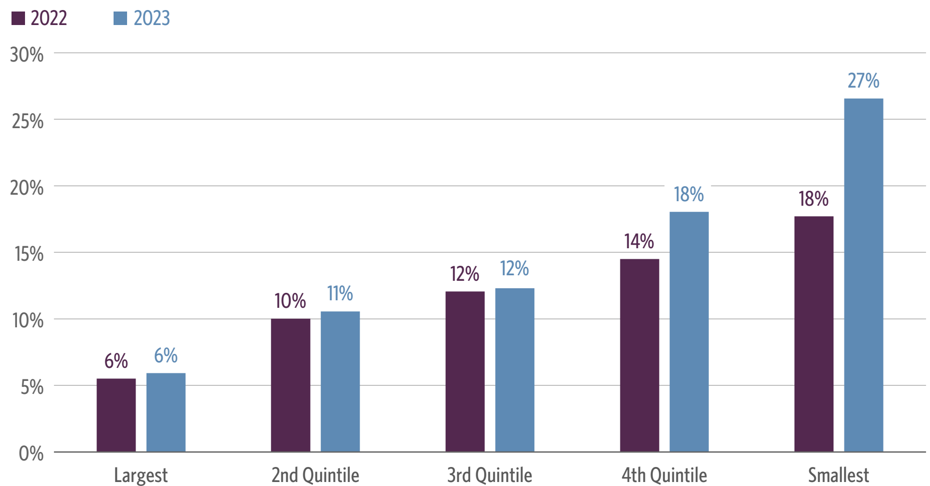
Source: Guggenheim Investments. Bloomberg, Board of Governors of the Federal Reserve System, S&P CreditPro Data as of 1.31.2024. Includes Guggenheim assumptions for Q4 2023–Q3 2024 nonfinancial corporate fundamental data. Gray areas represent recession.

A look at U.S. nonfinancial corporate fundamentals reveals a relatively stable picture. Corporate leverage has been rangebound since the third quarter of 2021. Aggregate net interest expense continues to decline despite rising interest rates because elevated cash holdings are enjoying attractive interest income. As inputs into our macro corporate default model, the Fed's SLOOS and corporate fundamentals suggest some ongoing stress but a peak in default rates later this year.

Annual interest expense increased as a ratio to earnings for the smallest group of a list of 700 nonfinancial publicly traded companies, from 18 percent in 2022 to 27 percent in 2023.

The Ratio of Interest Cost to Earnings Increased for the Smallest Companies

By Revenue Quintile



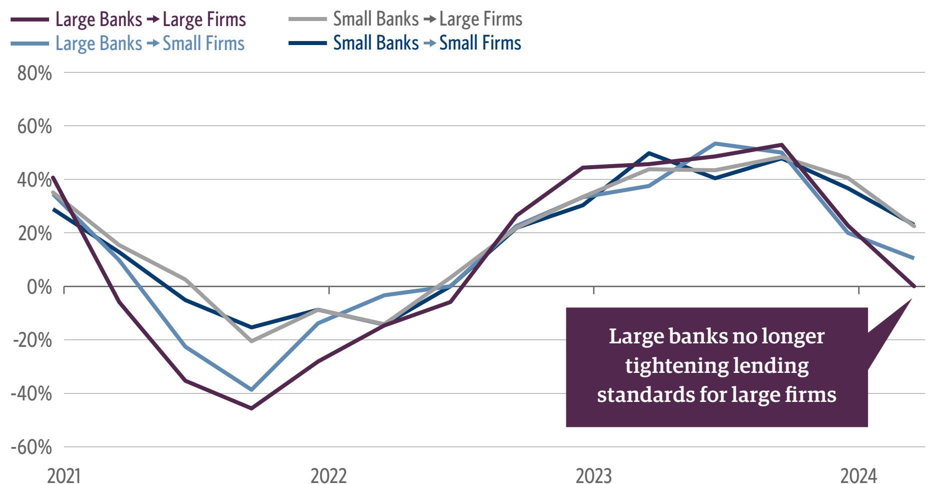
Source: Guggenheim Investments, Bloomberg. Data as of 12.31.2023. Based on nonfinancial companies with outstanding long-term debt in the S&P 500 and S&P 600. Bars depict the ratio of annual interest expense to earnings before interest, tax, depreciation, and amortization.

However, this broader conclusion masks the underlying nuances and potential for increased market bifurcation. For example, the aggregate fundamental data could be skewed by large investment-grade companies with little leverage and robust cash holdings. In contrast, we found that annual interest expense increased as a ratio to earnings for the smallest group of a list of 700 nonfinancial publicly traded companies with debt, from 18 percent in 2022 to 27 percent in 2023.

An important distinction in the Fed's SLOOS is that large banks have ceased tightening credit standards for large firms, and yet continue to impose tight standards on small firms.

Trends in Loan Underwriting Standards Highlight Bifurcations

Net Percent of Banks Tightening Standards for Large and Small Firms



Source: Guggenheim Investments, Federal Reserve. Data as of 12.31.2023.

An important distinction in the Fed's SLOOS is that large banks have ceased tightening credit standards for large firms, and yet continue to impose tight standards on small firms. Small banks continue to tighten standards for all firms, possibly reflecting the need to balance existing loan book challenges. These dynamics point towards a more fragmented credit landscape, with differing trajectories for large and small firms and for sectors that historically relied on credit from small banks.

The persistence of high interest rates poses more direct challenges for borrowers with floating rate liabilities. Data from Moody's already indicates a higher default rate among loan borrowers compared to bond issuers. As the full impact of the current level of interest rates materializes, especially for these borrowers, we expect continued efforts by individual companies to restructure corporate leverage to a level that is more manageable in a higher-for-longer rate environment. Over the last few years this caused an increased share of distressed exchanges as a form of default rather than missed payments or bankruptcies, which we expect will continue.

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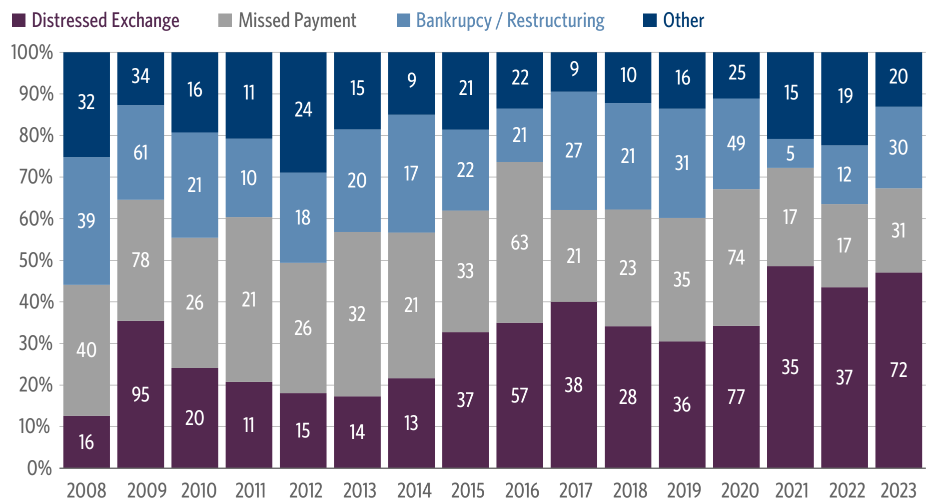
Distressed Exchanges Are Becoming a More Prevalent Form of Default

S&P Global Rating Count and Share of Corporate Defaults by Type



Year	Distressed Exchange	Missed Payment	Bankrupcy / Restructuring	Other
2008	16	40	39	32
2009	95	78	61	34
2010	20	26	21	16
2011	11	21	10	11
2012	15	26	18	24
2013	14	32	20	15
2014	13	21	17	9
2015	37	33	22	21
2016	57	63	21	22
2017	38	21	27	9
2018	28	23	21	10
2019	36	35	31	16
2020	77	74	49	25
2021	35	17	5	15
2022	37	17	12	19
2023	72	31	30	20

Source: Guggenheim Investments, S&P Global. Data as of 12.31.2023.

While we anticipate a peak in corporate default rates this year, the landscape is marked by increasing dispersion, underscoring a fragmented credit environment. This divergence, accentuated by the distinct challenges faced by large versus small firms and sector-specific dynamics, necessitates a nuanced approach to risk assessment and a need for active credit selection. While we continue to see very interesting opportunities in credit, we approach them with additional scrutiny given tighter risk premiums.

Theme 3

Rising Commercial Real Estate-Related Stress in Banks’ Loan Books

We expect office CRE-related stress to get worse.

Office-related commercial real estate loans continue to exhibit rising stress. We have been monitoring this closely, and while some risks are contained within commercial mortgage-backed securities, the exposure by U.S. banks could have spillovers that create broader risks for the economy.

The Federal Deposit Insurance Corporation’s (FDIC) Quarterly Banking Profile reveals increasing delinquency and non-accrual rates in nonresidential nonfarm loans, which captures commercial real estate (CRE) lending for spaces like office buildings, retail centers, industrial facilities, and hotels. This category has seen a notable rise in stressed loans for four consecutive quarters, totaling $23 billion as of the third quarter of 2023, the highest in a decade.

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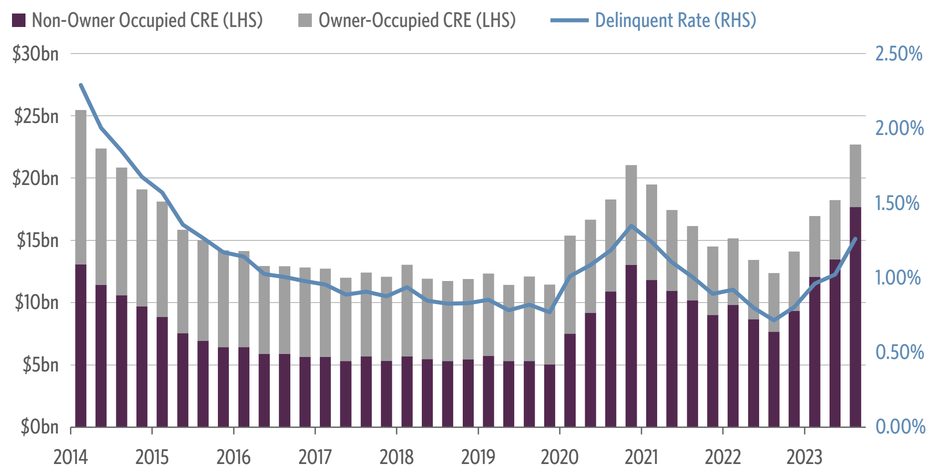
Commercial Real Estate Stress Among Insured Depository Banks Is Rising

All Delinquencies + Nonaccrual Loans by Category



Source: Guggenheim Investments, FDIC. Data as of Q3 2023. CRE = commercial real estate. Based on the nonresidential nonfarm properties categories in the FDIC’s quarterly banking profile data.

For some banks, especially those with assets exceeding $100 billion, CRE loans constitute a small fraction of their total loan book, representing an average of 8 percent. This diversification reduces their risk exposure. However, for banks with assets between $300 million and $100 billion, CRE loans account for almost a third of total loans, where even a 1 or 2 percent charge-off rate could significantly impact their capital.

Bank provisions for expected losses, recorded as losses on income statements, contribute to a cumulative allowance for loan losses on the balance sheet. Should anticipated losses not materialize, these provisions can be reversed, as was the case in 2020, when banks increased their allowances in anticipation of loan losses that were ultimately mitigated by monetary and fiscal policy interventions.

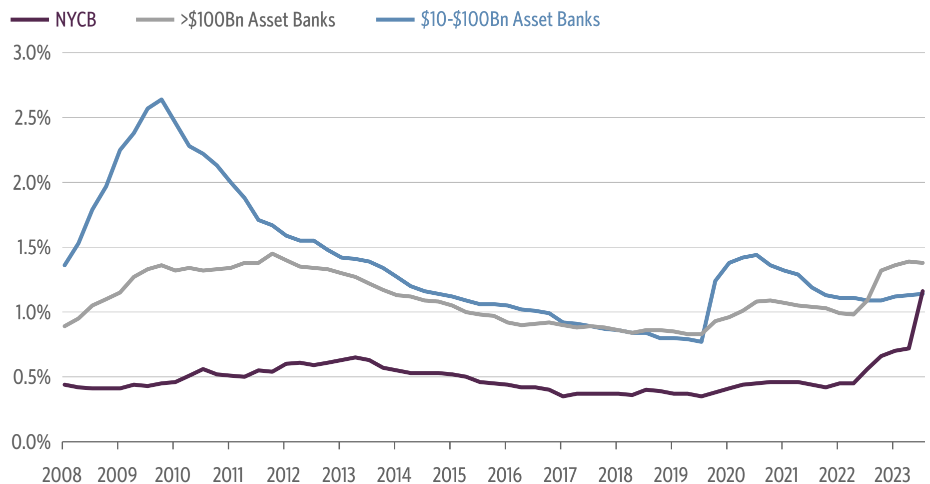
Publicly traded banks strive to manage shareholder and research analyst expectations regarding the need to bolster allowances for loan losses, aiming to avoid market surprises. The experience of New York Community Bank (NYCB) during its announcement of fourth quarter 2023 earnings, when it made an unexpectedly large provision for losses, underscores the importance of accurately anticipating these stresses. NYCB's rapid growth to a $100 billion bank, plus loan quality issues from acquiring Signature Bank's loans, necessitated a large increase in its allowance for credit losses (ACL, or the ratio of total allowances to total loans) to align with peers. Despite distinct challenges, the situation NYCB encountered—adjusting allowances in response to evolving credit conditions—reflects a broader issue that we think extends to other banks with continued spillover risk.

Assessing the adequacy of bank loan loss provisions is more aptly done at the individual credit level but also crucial at a macro level. Over the last four quarters, banks with over $100 billion in assets have raised their ACL ratio by an average of 50 basis points, while those in the $10 billion to $100 billion range remained stagnant. Typically, smaller banks maintain higher ACL ratios, yet currently, the largest banks exceed their smaller counterparts. Our view is that smaller banks will have to increase their ACL ratios further, and this adjustment could trigger renewed market concerns about the breadth and severity of office CRE problems within the banking sector.

Over the last four quarters, banks with over $100 billion in assets have raised their ACL ratio by an average of 50 basis points, while those in the $10 billion to $100 billion range remained stagnant.

Large Banks Average Allowance Ratio Is Higher Than Their Smaller Peers

Lease and Loan Allowance / Total Loans & Leases (ACL Ratio)



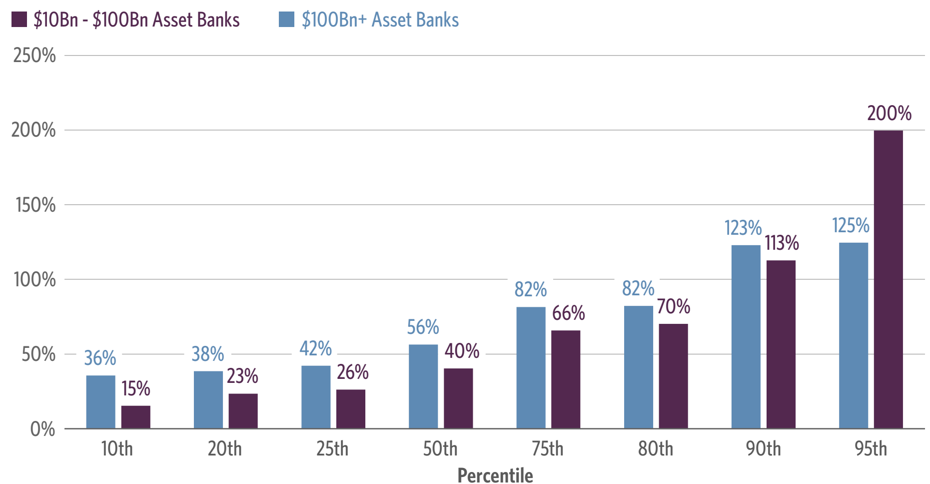
Source: Guggenheim Investments, FDIC. Data as of 12.31.2023.

In addition to running a comparison of ACL ratios, we also compared the volume of noncurrent loans to total allowances among the bank peer groups. This comparison assesses whether existing provisions are sufficient to cover the unlikely event where all noncurrent loans require write off. Banks traditionally maintain a noncurrent loans to total allowance ratio below 100 percent, and this is true on average for all peer groups. But the FDIC also maintains a distribution report that shows the smallest and highest ratio within each peer group, which showed that at the 90th percentile, there are banks with more noncurrent loans than total provisions, similar to NYCB.

Banks traditionally aim to maintain a noncurrent loans to total allowance ratio below 100 percent, and this is true on average for all peer groups. But there are banks with more noncurrent loans than total provisions, similar to NYCB.

There's Likely More Outliers Out There

Noncurrent Loans as a Percent of Allowance, Percentile Distribution by Bank Category



Source: Guggenheim Investments, FDIC. Data as of 12.31.2023.

It is important to consider why smaller banks may be delaying a necessary increase in the ACL ratio. A key reason driving this delay is the nature of this credit stress, which is a classic "crisis at maturity" challenge. Until now, covering interest payments hasn't posed a widespread issue for office CRE loan borrowers, as tenants are bound by lease agreements regardless of office return. However, as office CRE loans mature, the usual strategy involves extending or refinancing them for another seven to 10 years. This necessitates a property revaluation which, given recent appraisals and sales, has significantly decreased. In the current environment, marking a property to market can turn a low loan-to-value (LTV) loan into a high LTV loan upon extension, making it prohibitively expensive for the borrower. In some cases, the anticipated hit to collateral values has been so substantial that the borrowers surrender the assets to the lenders and walk away.

Maturities have been ramping up gradually and are due to accelerate over the next few years. The Mortgage Bankers Association recently revised its estimate of 2024 CRE maturities up to almost $1 trillion, driven by delays in 2023 maturities due to modifications and extensions. This includes loans held by other lender groups such as CMBS and insurance companies, but they may also be forced to realize the true value of property prices upon those maturities, which will have a spillover effect on other lenders. Until banks face a cascade of maturities where they must revalue the assets in short order, we believe they are inclined to maintain some cognitive dissonance around this issue.

The anticipation of a Fed easing cycle may also be prompting some executives to delay addressing these issues, hoping that lower rates will cure their borrowers' credit pressures. With the anticipation of lower rates later this year, it may seem more strategic for the bank to avoid capital losses that might be recouped later, similar to what happened in 2020. This is especially true for smaller banks in an environment characterized by an inverted yield curve and low demand for credit. But we think the banking system is due for additional adjustments to office CRE-related credit stresses, which are likely to get worse over the next several years.

Theme 4

Fiscal Policy: Near-Term Headwind, Long-Term Calamity

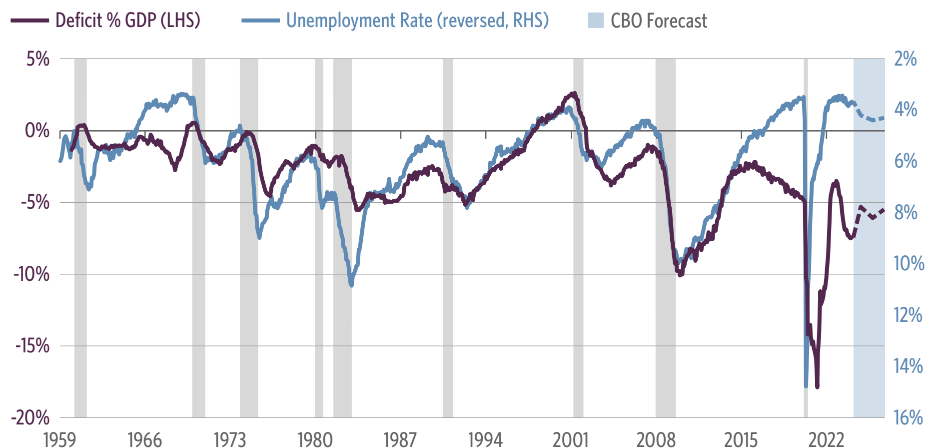
The unsustainable trend in government spending will continue to exert upward pressure on rates.

One of the biggest macroeconomic surprises last year was the magnitude of fiscal policy expansion, a factor that helped cushion the economy from the impact of tight monetary policy. After adjusting for the accounting treatment of the student loan forgiveness program, the deficit rose from 4.0 percent of GDP in 2022 to 7.5 percent in 2023. For context on how much of a surprise this was, the Congressional Budget Office (CBO) forecast a deficit of 3.8 percent of GDP for 2023 in its May 2022 forecast.

While much of the deficit expansion was not traditional stimulus, we believe it had a meaningful impact in supporting the economy and preventing a recession as credit sensitive sectors were hit by Fed tightening. We expect a reverse dynamic in 2024—less tight credit conditions as the Fed begins to ease, while fiscal policy becomes less supportive to growth. According to the latest CBO forecasts, the deficit should shrink to 5.3 percent in 2024. While still large by historical standards, what matters for the growth rate of the economy is the change in the deficit. Some of that deficit contraction could get watered down by tax cuts under consideration and foreign aid for Ukraine, Israel, and Taiwan, but the net result remains that the fiscal impulse to economic growth is flipping from being a big positive contributor in 2023 to a modest drag in 2024, supporting the view that economic growth and inflation should cool.

Despite an unemployment rate near the lowest level in decades, the fiscal deficit has risen significantly from already elevated levels.

Fiscal Deficits Are Huge Despite Strong Economy



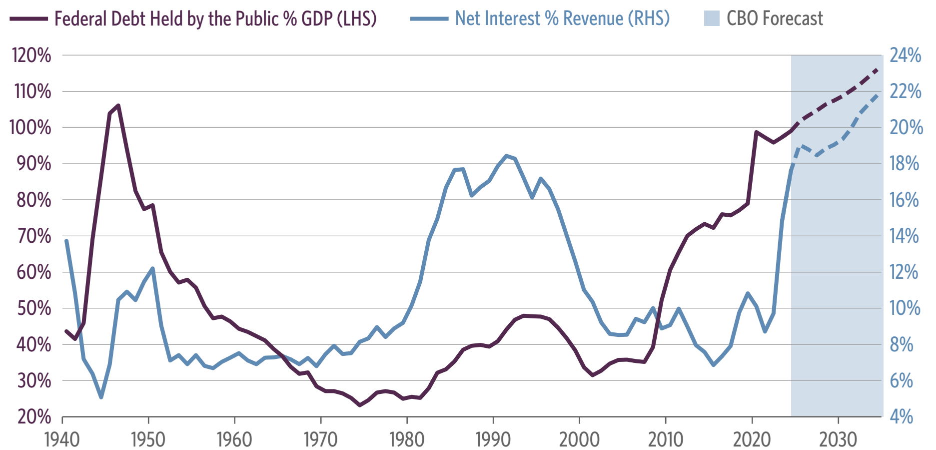
Source: Guggenheim Investments, Haver Analytics. Data as of 1.31.2024, CBO forecast as of 2.7.2024. Gray areas represent recession.

While the impact on near-term economic growth prospects is shifting, what has not changed is the longer-term fiscal picture. Debt to GDP is expected to rise from 97 percent currently to 116 percent by 2034, according to the CBO, the highest in U.S. history. For context, debt was just 35 percent of GDP in 2007. That 116 percent is almost surely an understatement, as it assumes key provisions of the 2017 Tax Cuts and Jobs Act will expire at the end of 2025, but both parties have expressed interest in keeping at least part of those cuts, which could add up to $3 trillion in deficits over a 10-year horizon.

Why does rising debt matter? For one, growing debt and deficits will put upward pressure on interest rates, which in turn crowds out more productive private investment. Additionally, a growing debt burden means rising interest costs even if interest rates stabilize. Net interest costs accounted for about 10 percent of federal government revenue in 2022. That has risen to 15 percent in 2023 and will eclipse 20 percent by 2031 in the CBO's scenario where 10-year Treasury yields stabilize around 4 percent. Rising debt also makes it more challenging to respond to new shocks, such as a recession or a national emergency related to defense or public health.

A growing debt burden means rising interest costs even if interest rates stabilize. Net interest costs accounted for about 10 percent of federal government revenue in 2022. That has risen to 15 percent in 2023 and will eclipse 20 percent by 2031.

Debt and Interest Cost Burden Set to Reach New Highs



Source: Guggenheim Investments, Haver Analytics. Data as of 12.31.2023, CBO forecast as of 2.7.2024.

Investors have gotten accustomed to closely following fiscal policy in recent years, given the important role pandemic stimulus has played in fueling the economic recovery—and inflation. While cyclical dynamics around the economy and Fed policy will be the main driver of rates in the near term, rising debts, deficits, and Treasury supply are secular dynamics that will exert upward pressure on interest rates over the long term. The political will to address this unsustainable outlook is largely absent now, and the election is unlikely to alter our trajectory regardless of who wins. But somewhere in the not too distant future, fiscal consolidation is likely to be necessitated by economic realities.

Important Notices and Disclosures

Investing involves risk, including the possible loss of principal. Stock markets can be volatile. In general, the value of a fixed-income security falls when interest rates rise and rises when interest rates fall. Longer term bonds are more sensitive to interest rate changes and subject to greater volatility than those with shorter maturities. High yield and unrated debt securities are at a greater risk of default than investment grade bonds and may be less liquid, which may increase volatility.

One basis point is equal to 0.01 percent.

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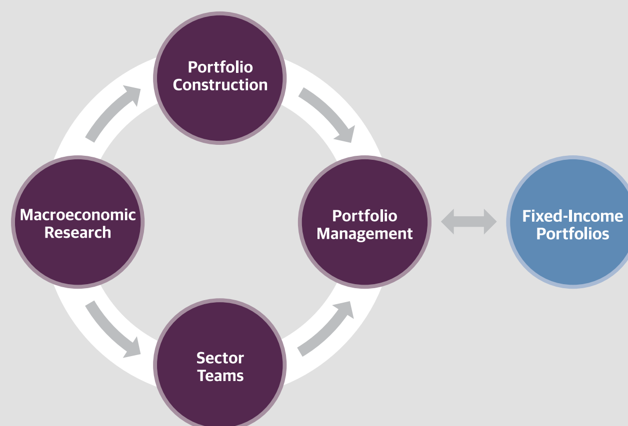
Guggenheim's Investment Process

Guggenheim's fixed-income portfolios are managed by a systematic, disciplined investment process designed to mitigate behavioral biases and lead to better decision-making. Our investment process is structured to allow our best research and ideas across specialized teams to be brought together and expressed in actively managed portfolios. We disaggregated fixed-income investment management into four primary and independent functions—Macroeconomic Research, Sector Teams, Portfolio Construction, and Portfolio Management—that work together to deliver a predictable, scalable, and repeatable process. Our pursuit of compelling risk-adjusted return opportunities typically results in asset allocations that differ significantly from broadly followed benchmarks.



About Guggenheim Investments

Guggenheim Investments is the global asset management and investment advisory division of Guggenheim Partners, with more than $231 billion[1] in total assets across fixed income, equity, and alternative strategies. We focus on the return and risk needs of insurance companies, corporate and public pension funds, sovereign wealth funds, endowments and foundations, consultants, wealth managers, and high-net-worth investors. Our 250+ investment professionals perform rigorous research to understand market trends and identify undervalued opportunities in areas that are often complex and underfollowed. This approach to investment management has enabled us to deliver innovative strategies providing diversification opportunities and attractive long-term results.

About Guggenheim Partners

Guggenheim Partners is a diversified financial services firm that delivers value to its clients through two primary businesses: Guggenheim Investments, a premier global asset manager and investment advisor, and Guggenheim Securities, a leading investment banking and capital markets business. Guggenheim's professionals are based in offices around the world, and our commitment is to deliver long-term results with excellence and integrity while advancing the strategic interests of our clients. Learn more at GuggenheimPartners.com, and follow us on LinkedIn and Twitter @GuggenheimPtnrs.

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