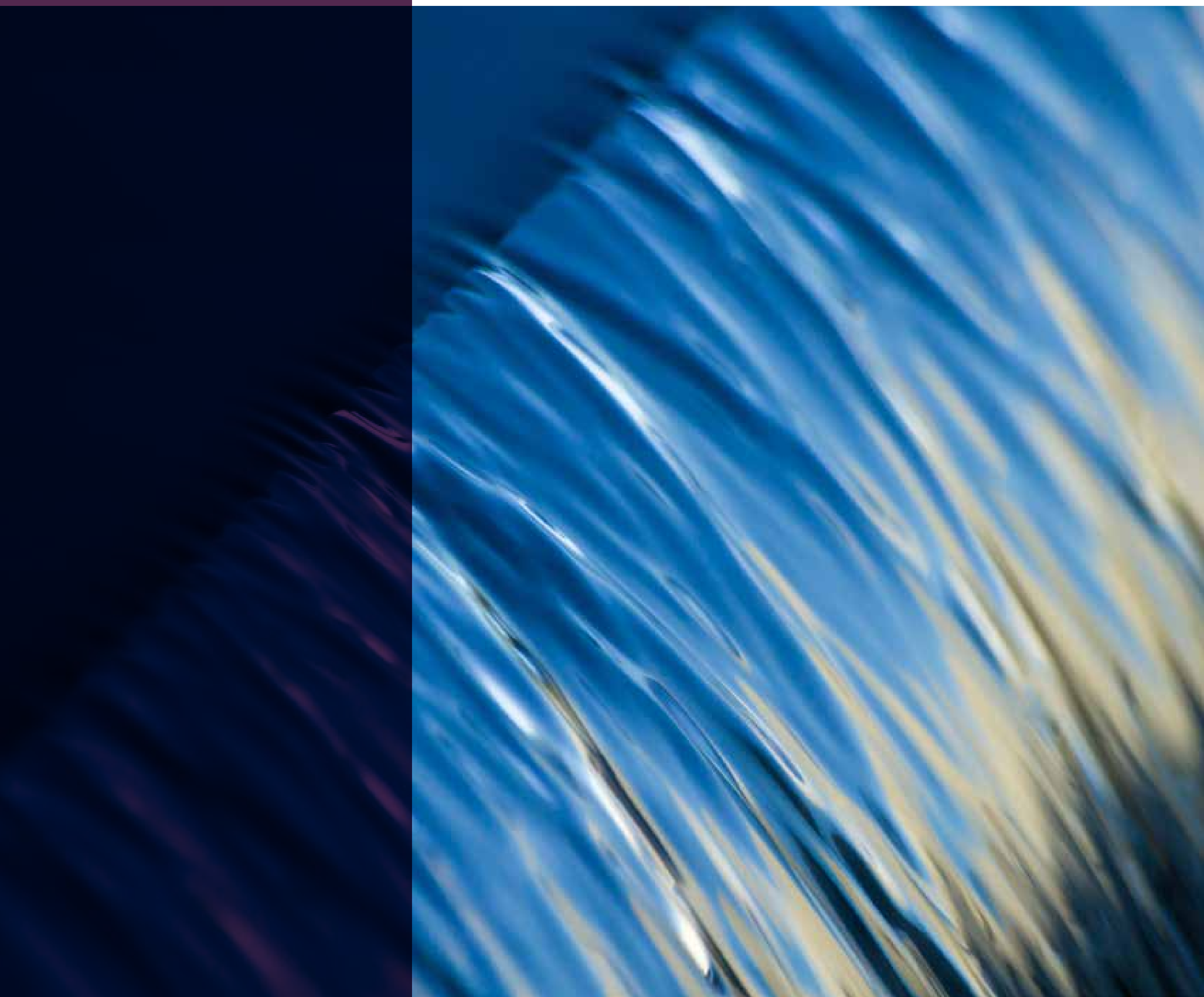
GUGGENHEIM

Second Quarter 2024

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 Research and Market Strategy 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 Research and Market Strategy 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

Improved Economic Expectations Set the Stage for More Downside Surprises

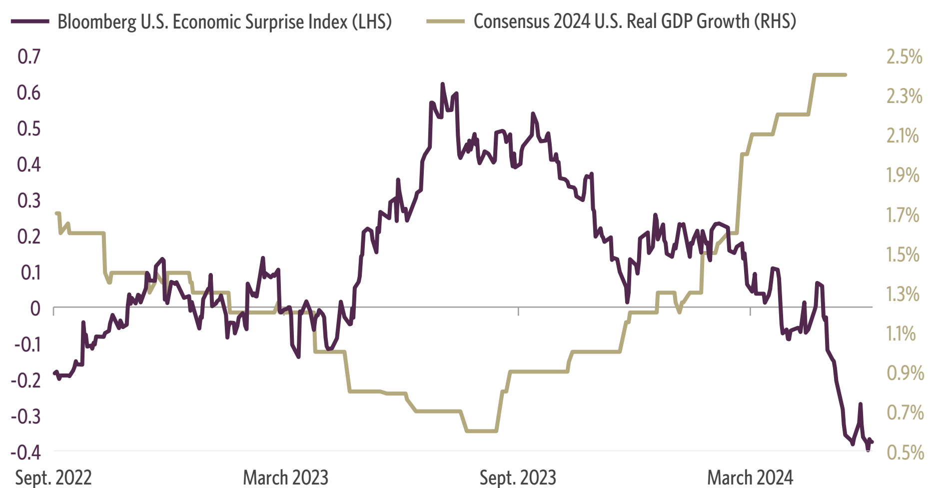
Optimistic economic expectations baked into market pricing may be overlooking downside risks.

In recent quarters, the U.S. economy has demonstrated continued strength as fiscal spending helped defy predictions of a Federal Reserve (Fed) induced recession. Inflation continues to gradually recede, albeit in fits and starts, leaving the Fed on hold to preserve its policy optionality for now. Our economic outlook has continued to improve as the aggregate economy has not responded to rate hikes in the usual ways, even as higher rates weighed on some sectors and reinforced our outlook for increasing bifurcation across the economy and markets. While factors like fiscal stimulus and immigration have helped prop up the economy, we don't believe they will support the economic cycle indefinitely. Our base case is for a benign slowdown in real gross domestic product (GDP) growth from 3 percent in 2023 to about 2 percent in 2024, and 1.5–2 percent in 2025, although we view risks to this forecast as tilted to the downside, particularly relative to the improved expectations of the market.

U.S. real GDP growth expectations for 2024 have risen from just 0.6 percent last July to 2.4 percent currently. Forecasts for one year ahead recession probability have fallen by more than half, from 65 percent last July to 30 percent currently. This resetting of

Resilient economic growth has created better economic data, but that means a higher bar for the data to clear going forward to support market pricing.

Resetting of Real GDP Growth Expectations Has Meant Higher Bar for Incoming Data to Clear



Source: Guggenheim Investments, Bloomberg. Data as of 6.7.2024. The Bloomberg Economic Surprise Index tracks how the economic data are faring compared with expectations. The index rises when economic data exceed economists' consensus estimates and falls when data are below estimates.

growth expectations helps explain why, despite the economic data remaining solid in recent months, the Bloomberg Economic Surprise Index has turned negative. Resilient economic growth has created better economic data, but that means a higher bar for the data to clear going forward to support market pricing.

Optimistic expectations baked into market pricing are the driving force behind the recent easing financial conditions, which we detail in our first theme in this report. Optimism can also be seen in forecasts of accelerating corporate earnings growth that our second theme explores. While our baseline view is also relatively constructive on the economy, and Fed easing later this year should help support the growth outlook, we still view risks as skewed to the downside. Signs of economic bifurcation and more cautious consumers may weigh on growth more than currently anticipated, particularly if the softening in labor market indicators that we explore in the third theme continues. Still, with the Fed on hold for now, and easing in sight, it is a good time to be an active fixed-income investor, especially given attractive all-in yields across higher quality segments of the fixed-income market, which we detail in our fourth theme.

Theme 1

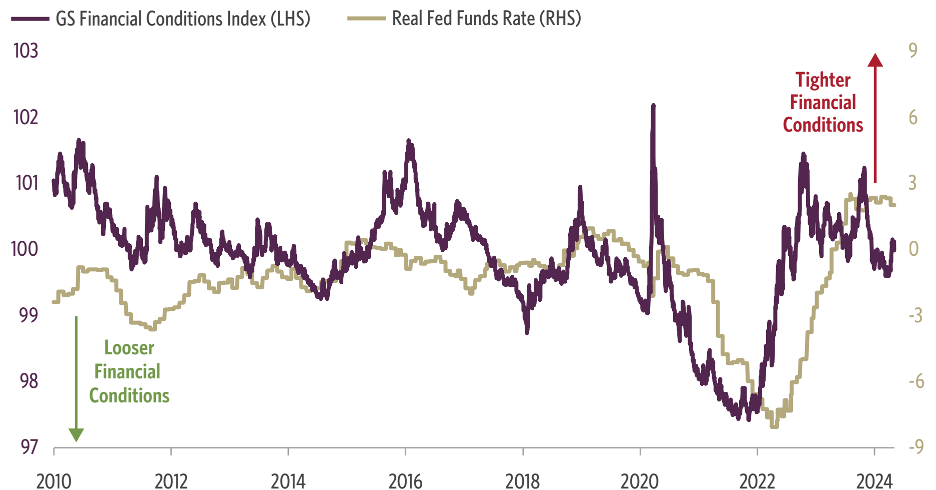
Looser Financial Conditions Improve the Growth Outlook, but Some Sectors Are Still Straining Under High Rates

Easing financial conditions may make assets more susceptible to sudden shifts in risk premiums.

While the real federal funds rate remains elevated relative to history, various financial conditions indexes (FCIs) indicate that conditions have eased since late last year and now suggest minimal headwinds to economic growth over the coming year. Goldman Sachs' widely followed Financial Conditions Index (GS FCI) has eased notably since the fourth quarter of last year. Similarly, the Fed's own gauge, Financial Conditions Impulse on Growth (FCI-G) has shifted from indicating that financial conditions will be a drag on real GDP growth to now suggesting only a minimal hindrance to aggregate economic activity over the coming year.

Goldman Sachs' widely followed Financial Conditions Index has eased notably since the fourth quarter of last year.

After the Rapid Tightening in 2022, Financial Conditions Have Eased Since Q4 2023



Source: Guggenheim Investments, Bloomberg. Data as of 5.28.2024.

Looking at FCI-G components reveals that the ongoing rally in the equity market has offset the continued headwind of higher interest rates and driven much of the recent easing in financial conditions. In fact, the recent easing has occurred during a period in which expectations for Fed rate cuts have been substantially pared, suggesting optimism about growth and reduced risk premiums are driving the move. In the GS FCI measure, equities have accounted for 75 percent of the easing since October 2023.

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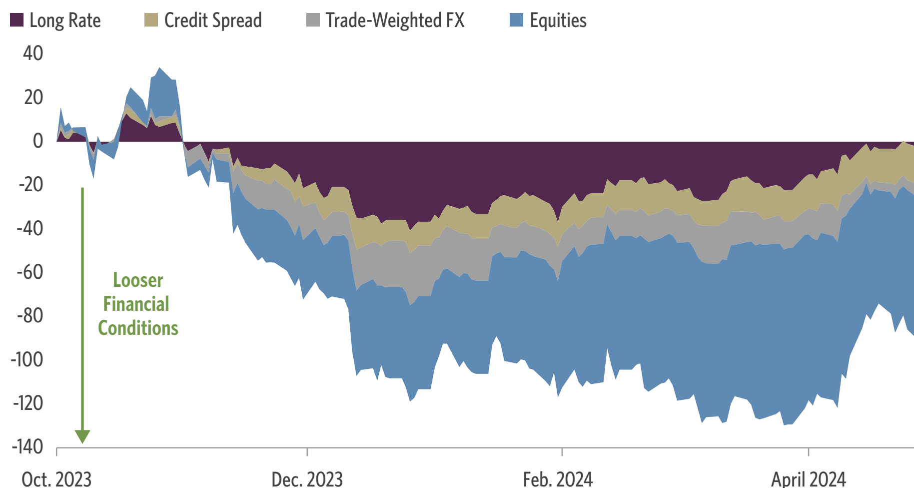
Equities Have Played a Pivotal Role in the Recent Easing of FCIs

Contribution to GS FCI since October 2023



Source: Guggenheim Investments, Goldman Sachs. Data as of 5.31.2024.

Similarly, in the Fed's FCI-G measure, equities have played a pivotal role, nearly offsetting the negative impulse from high BBB-rated corporate bond yields, mortgage rates, and the fed funds rate.

Circumstances unique to this cycle may also be mitigating the impact of higher rates for sectors such as large corporations and wealthier consumers. In the household sector, the effect of increased mortgage rates on debt servicing has been modest, since an unprecedented number of homeowners refinanced and secured lower rates during the pandemic, contributing to the so-called mortgage rate "lock in" effect. In the corporate sector, Fed rate hikes came after a surge in deposits resulting from fiscal and monetary stimulus. The result has been a significant boost to interest income that limited the increase in net interest expenses for the corporate sector in aggregate. Notably, these factors may not be fully captured in financial conditions measures, suggesting less restraint for the economy as a whole.

All of the above is good news for growth, supporting a base case of moderate growth in 2024 even as the boost to growth from fiscal stimulus wanes. Nonetheless, we continue to observe the impact of tight monetary policy in some areas of the economy and see downside risks to our base case.

First, for small businesses and lower income consumers, financial conditions are tighter than buoyant stock prices and tight credit spreads would suggest, highlighting the ongoing bifurcation in the economy. Since both the GS FCI and the FCI-G are constructed based on financial indexes such as the S&P 500 and BBB yields, they do not capture the financial conditions faced by smaller firms without access to capital markets. There has also been recent evidence of rising stress from credit card

delinquencies and personal bankruptcies for lower-income consumers. Should strain in these sectors of the economy spill over into a broad weakening in the labor market, growth could be slower over time than we currently expect.

Second, elevated asset prices themselves may present a risk to growth. Since the rally in equities has driven much of the recent easing in financial conditions, we remain concerned that they are susceptible to sudden shifts in risk premiums. Notably, the majority of S&P 500 returns have been driven by multiple expansion for a select few companies, rather than broad based earnings growth, highlighting the precarious nature of recent easing. An abrupt pullback in risk assets could quickly reverse the narrative, putting real GDP growth at risk.

Theme 2

Consumer Caution Belies Solid Corporate Earnings Season

Strong first quarter corporate earnings reflected recent economic strength, but companies noted that consumers have become more selective.

S&P 500 index earnings per share (EPS) increased by 6 percent year over year in the first quarter, surpassing the anticipated 3 percent at the start of the earnings season, with 80 percent of companies in the S&P 500 beating expectations. The technology sector led, with 89 percent of companies surprising on EPS, followed by consumer staples and healthcare. This performance marks a significant improvement over last year's first quarter results, which saw a slight earnings decline on a year-over-year basis.

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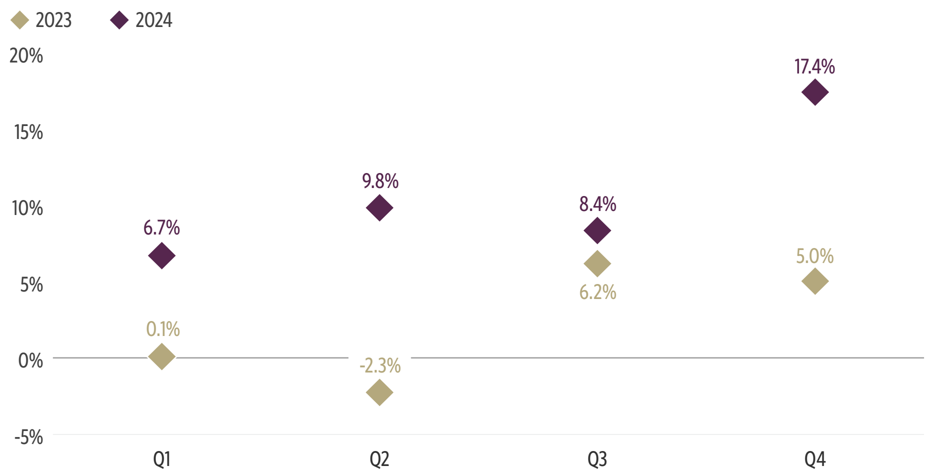
S&P 500 EPS Growth Is Expected to Accelerate

Q1 EPS YoY Tracking and Q2–Q4 Equity Analyst Expectations

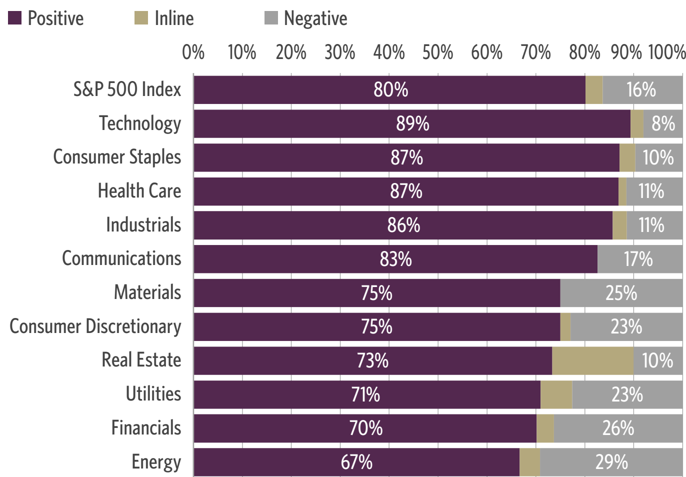


Source: Guggenheim Investments, Factset. Analyst expectations are as of 5.24.2024, and may not actually come to pass. This information is subject to change at any time, based on market and other conditions.

In contrast to accelerating growth in EPS, as the charts on the following page show, sales per share (SPS) growth was softer than last year, suggesting that cost management drove positive earnings outcomes in some sectors. Fewer than 50 percent of industrials, communications, materials, consumer discretionary, and utilities exceeded SPS expectations, despite more than 71 percent surprising to the upside on EPS.

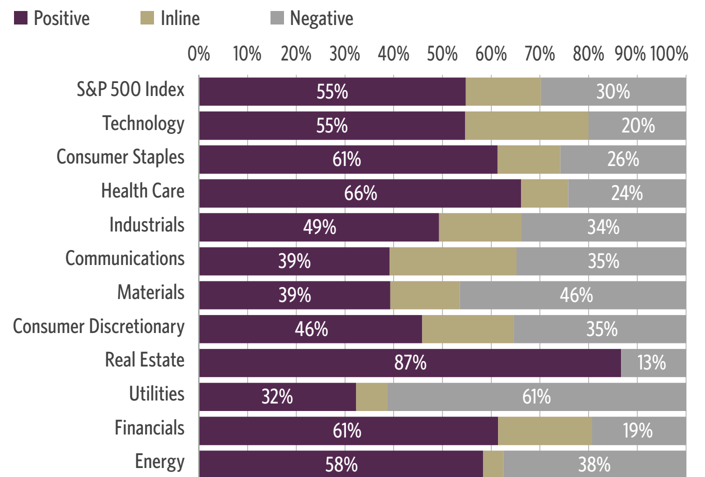
Majority of Companies Delivered a Bottom Line Positive Surprise

S&P 500 EPS Surprise by Sector & Company Count



More Dispersion in Sales Per Share Suggests Margins Played a Big Role

S&P 500 SPS Surprise by Sector & Company Count



Source: Guggenheim Investments, Bloomberg. Data as of 5.24.2024.

Cost saving efforts were especially notable in consumer staples and discretionary sectors. Consumer sectors generally operate with tighter margins compared to other industries, making them especially sensitive to slowing demand. Quarterly reports from companies such as Target, Starbucks, McDonalds, and Avis Budget Group all suggested that consumers were becoming more selective. Kraft Heinz and Tyson

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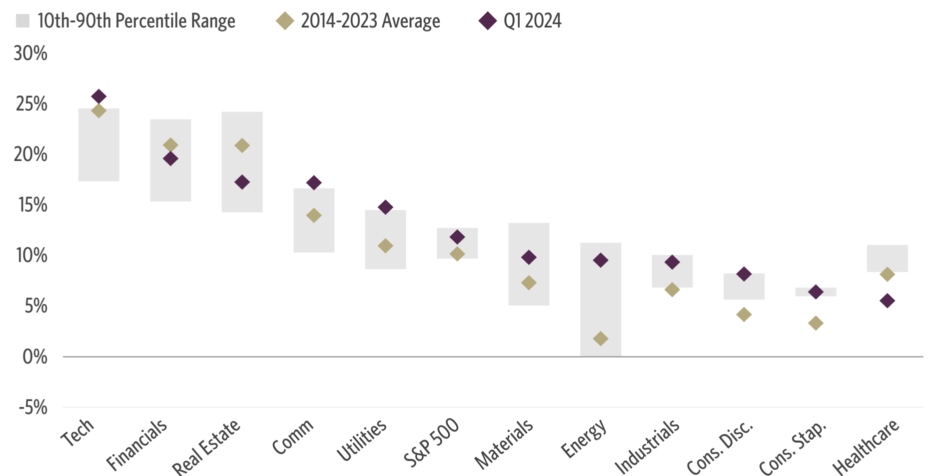
Tight Margins Make Consumer Sectors Sensitive to Mixed Revenue Growth Trends

Net Profit Margins, Q1 2024 versus 2014-2023 Average



Source: Guggenheim Investments, Factset. Data as of 5.24.2024.

Foods specifically noted bifurcated consumer activity, with lower income households struggling. This is a vastly different environment from last year, when robust consumer demand created a broad-based ability to pass through price increases, supporting the notion that inflationary pressures are likely to moderate going forward.

Looking ahead, the consensus forecast for accelerating earnings growth is expected to continue supporting equity prices. Analysts anticipate that the first quarter will be the weakest of the year, with growth expanding to 17 percent year over year by the fourth quarter. But with signs that some consumers are being more cautious, we see risks that earnings growth will not live up to lofty expectations, particularly given the risk that companies may not be able to keep cutting costs to protect the bottom line.

Theme 3

Signs of Cooling Labor Demand Point to Uptick in Unemployment and Slower Wage Growth Going Forward

The Fed has suggested that labor market weakness would factor into rate decisions. Further weakness could be a game changer for the economic trajectory and policy response.

In recent years, U.S. labor market strength has played a central role in supporting robust consumer spending, which accounts for 68 percent of total GDP. The unemployment rate has been low and steady, holding between 3.4 percent and 4.0 percent since February 2022. This stability in unemployment occurred even as excess demand for workers receded and labor supply improved, leading to a relatively painless rebalancing in the labor market. Even with the May payroll report coming in stronger than expected, we expect the labor market to continue to come into better balance but are watchful for any meaningful deterioration.

We may be getting closer to a more meaningful rise in the unemployment rate. Demand for labor over the past few years has declined due to falling job openings, which peaked at 12.2 million and now stand around 8.1 million. But with the job openings rate (openings relative to the size of employment) back near more "normal" levels, we could soon see a typical relationship along the Beveridge curve, where falling job openings coincide with higher unemployment. Fed Governor Christopher Waller, who made an influential argument in favor of a painless rebalancing in 2022, also suggested recently that more normal relationships should soon start to apply given job openings are no longer so abnormally high.

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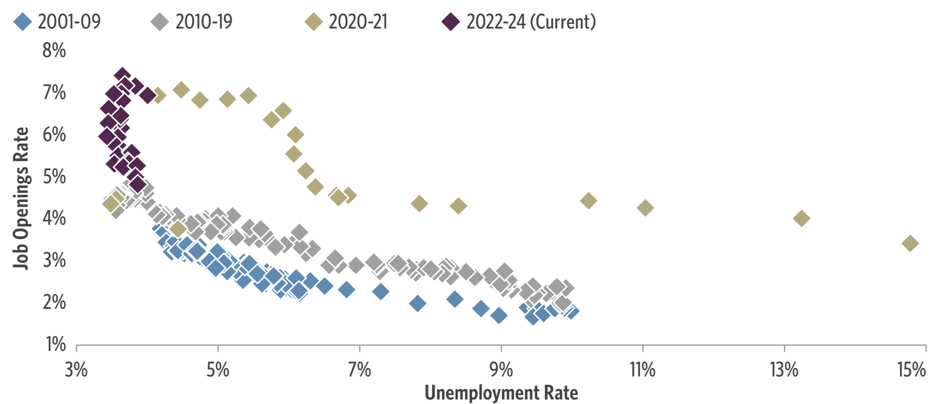
A Further Drop in Labor Demand Could Push Unemployment Higher



Source: Guggenheim Investments, Haver Analytics. Data as of 4.30.2024. The Beveridge curve is a central concept in the macroeconomics of labor markets. Named after the British economist William Beveridge, it captures an inverse relationship between unemployment and job vacancies.

Another reason why cooler labor demand has not led to higher unemployment is because while hiring has slowed, layoffs are still running at relatively low levels and quits have declined sharply in recent months. While we do not expect any imminent surge in layoff activity, the drop off in the hiring rate means even a modest move higher in layoff activity could mean a sizable downshift in net job growth.

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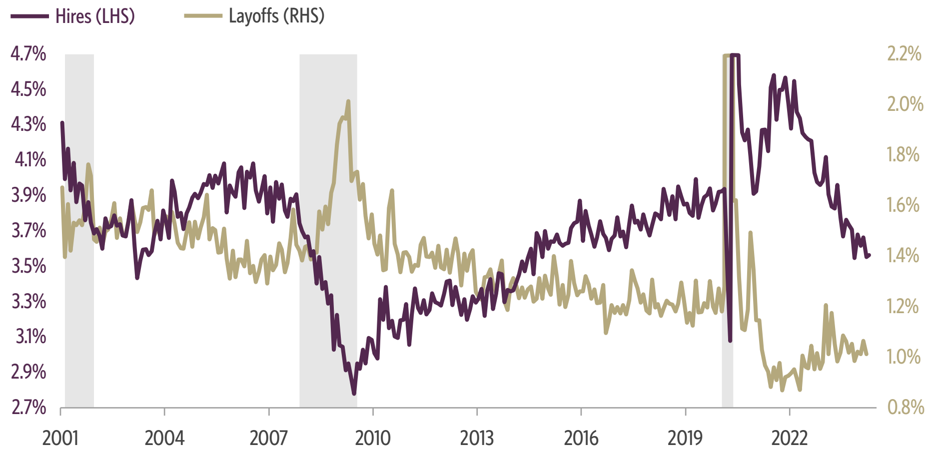
Hiring Has Cooled to 2014 Rates, But Layoffs Remain Very Low

Rates Relative to Total Employment

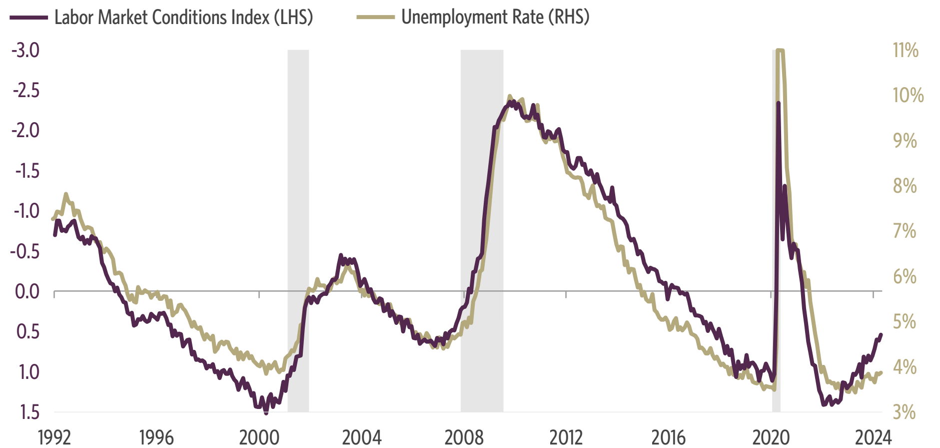


Source: Guggenheim Investments, Haver Analytics. Data as of 4.30.2024.

Broader indicators also show more cooling in the labor market under the surface than the unemployment rate alone. The Kansas City Fed's Labor Market Conditions Index, a composite of 24 variables like hiring plans and consumer perceptions of job availability, has steadily weakened since the end of 2022 to a level that historically would have coincided with a higher unemployment rate.

Broader indicators also show more cooling in the labor market under the surface than the unemployment rate alone.

Broad Labor Market Conditions Have Eased More than the Unemployment Rate

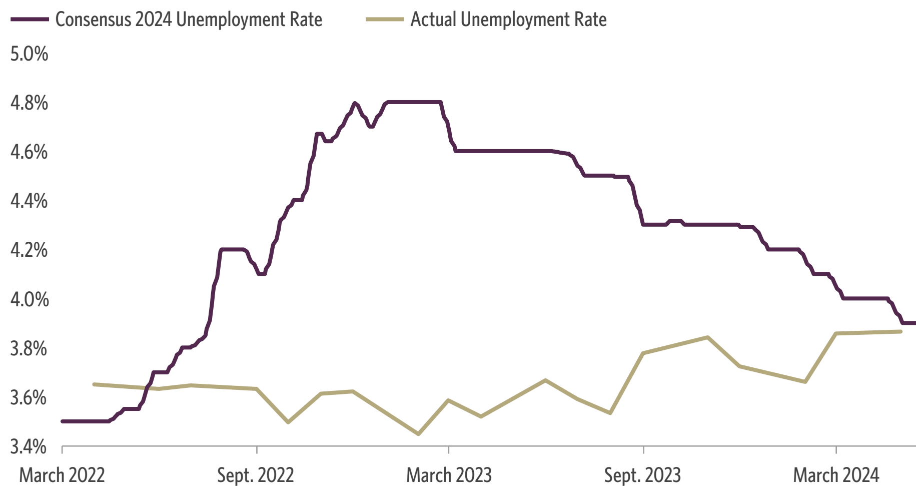


Source: Guggenheim Investments, Haver Analytics. Data as of 4.30.2024 for LMCI, 5.31.2024 for unemployment.

While we do not expect a spike in unemployment given the current momentum in domestic demand and easier financial conditions, job market weakness is a downside risk to consumer spending and broader economic activity. Importantly, these risks do not seem to be broadly shared among market participants or embedded in asset prices. After expecting economic weakening over much of the past year, consensus views have steadily improved to the point where forecasters now see no change in the unemployment rate this year. Additionally, year ahead unemployment forecasts have become clustered in a tight range (tighter than 93 percent of quarterly forecasts since 1968), indicating little uncertainty over the outlook that we think does not reflect current risks to the labor market.

After expecting economic weakening over much of the past year, consensus views have steadily improved to the point where forecasters now see no change in the unemployment rate this year.

Consensus Now Sees No Change in Unemployment This Year



Source: Guggenheim Investments, Bloomberg. Data as of 5.31.2024 for unemployment, 6.7.2024 for consensus.

While forecasters have become less concerned about labor market weakness, the Fed seems to be attuned to the downside risks to employment. At the June press conference, Fed Chair Jerome Powell said potential weakening of the labor market could induce a rate cut. Even a more modest softening, consistent with our baseline forecast, could lead the Fed to ease later this year, as it would help to further reduce wage growth and by extension inflation. That would reinforce an already cooling outlook for wage growth, where leading indicators like listed wages have cooled significantly, while much of the strength in wage inflation is concentrated in lagging sectors like government and union jobs.

Theme 4

Favoring High Grade Credit and Higher Quality High Yield

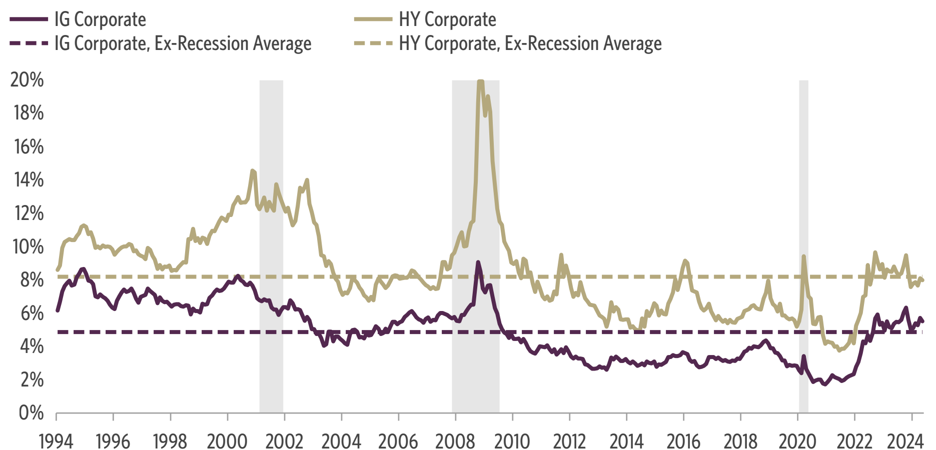
With the Fed on pause until later this year, carry should drive returns, particularly in higher quality sectors.

The onset of the Fed hiking cycle in 2022 initially sparked concerns over the impact of higher rates on credit markets. However, corporate borrowers remain resilient, and their prospects have improved further in 2024. After a period of widening in 2022 and 2023, corporate bond spreads have narrowed to historically tight levels. Nonetheless, with the Fed on pause until later this year, we see all-in yields as attractive, particularly in higher quality sectors. We also see value in structured credit, which we view as broadly undervalued relative to corporates on a spread basis and where we find attractive yield-premiums for comparable ratings.

The average credit spread on the Bloomberg U.S. Corporate Bond Index (representing investment-grade credit) is just 87 basis points, approaching its 2021 tight of 80 basis points. While technical dynamics are a key driver of these levels given strong investor demand and limited net supply, we also believe aggregate credit fundamentals support tight spreads. The median leverage ratio on BBB-rated corporates sits slightly below 2019 average levels of 2.2x while interest coverage is nearly a full turn above the same period, currently 9.6x versus 8.8x in 2019. Corporates conservatively navigated the 2023 earnings slowdown to preserve balance sheet quality, allowing for the investment-grade sector to see more credit rating upgrades than downgrades over the past year.

With the Fed on pause until later this year, we see all-in yields as attractive, particularly in investment-grade sectors.

Corporate Bond Yields Remain Near Decade Highs



Source: Guggenheim Investments, Bloomberg U.S. Corporate. Bond Index, Bloomberg U.S. Corporate High Yield Bond Index. Data as of 5.24.2024. Gray areas represent recession. Past performance does not guarantee future results.

Spreads are also tight in high yield, but we think they are consistent with a relatively benign default outlook, particularly for higher quality issuers. Default activity has plateaued at a rate that is suggesting a 4–4.5 percent default rate by year-end, consistent with our 2024 forecast. Leverage ratios and interest coverage continue to look healthy at the aggregate level and especially for higher quality high yield, although we see a lot of dispersion underlying these figures. Yield seeking investors with active credit managers are presented with a compelling opportunity to lock in attractive coupon returns.

We remain mindful of the asymmetric risks for credit spreads. Using 30 years of monthly credit spread data from Bloomberg credit indexes, history shows a roughly even chance of investment-grade corporate bond spreads tightening further or widening from here. The same history suggests only a 17 percent chance that high yield spreads will tighten further or stay unchanged. However, under most realistic Treasury yield and spread shock scenarios, the impact to prices would not be enough to offset current yields and drive a negative return. This highlights the cushioning role that attractive yields could play in the current environment.

We favor finding this yield cushion in a diversified manner across various fixed-income sectors, including structured credit, which comprises subsectors like collateralized loan obligations, whole business securitizations, container ABS, and other specialty areas where Guggenheim has dedicated analysts to conduct the underwriting efforts. There is a wide dispersion in pricing in these subsectors but as an example, for single-A rated assets, we have obtained between 50 and 250 basis point spread premiums relative to corporates of comparable maturity profiles. This translates into a higher yield for the portfolio that may cushion performance should economic conditions deteriorate, causing spreads to widen*.

While an improved economic outlook has created opportunities in credit, we maintain a defensive posture as it relates to deeper lower quality credit, given the tight spreads and risks to slower growth. Payment defaults and distressed exchanges are occurring in this cohort with minimal prospects for debt recovery. We see better opportunities in higher grade sectors, including structured credit, and higher quality high yield, which could benefit from positive rating migration and shift them into a cohort with lower spread widening risk.

Even as slower growth or shifts in sentiment create some potential for spread widening, all-in yields remain attractive on a historical basis and are still near decade-plus highs, and with the Fed attentive to downside risks any substantial shift in conditions could be met with expectations of greater monetary policy easing, creating a favorable environment for active fixed-income investors.

*Structured credit, including asset-backed securities (ABS), mortgage-backed securities, and CLOs, are complex investments and not suitable for all investors. Investors in structured credit generally receive payments that are part interest and part return of principal. These payments may vary based on the rate loans are repaid. Some structured credit investments may have structures that make their reaction to interest rates and other factors difficult to predict, making their prices volatile and they are subject to liquidity and valuation risk. CLOs bear similar risks to investing in loans directly, including credit risk, interest rate risk, counterparty risk and prepayment risk. Loans are often below investment grade, may be unrated, and typically offer a fixed or floating interest rate.

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One basis point is equal to 0.01 percent.

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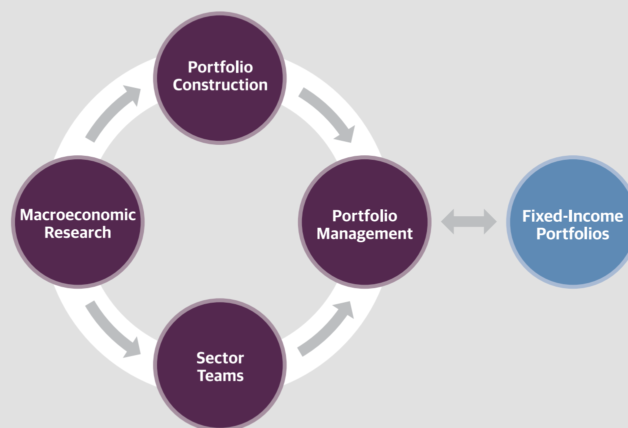
Guggenheim's Investment Process

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.



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Guggenheim Investments is the global asset management and investment advisory division of Guggenheim Partners, with more than $234 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 235+ 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.

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For more information, visit GuggenheimInvestments.com.

1. Guggenheim Investments assets under management as of 3.31.2024 and include leverage of $14.5bn. Guggenheim Investments represents the following affiliated investment management businesses of Guggenheim Partners, LLC: Guggenheim Partners Investment Management, LLC, Security Investors, LLC, Guggenheim Funds Distributors, LLC, Guggenheim Funds Investment Advisors, LLC, Guggenheim Corporate Funding, LLC, Guggenheim Partners Europe Limited, Guggenheim Partners Japan Limited, and GS GAMMA Advisors, LLC.

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