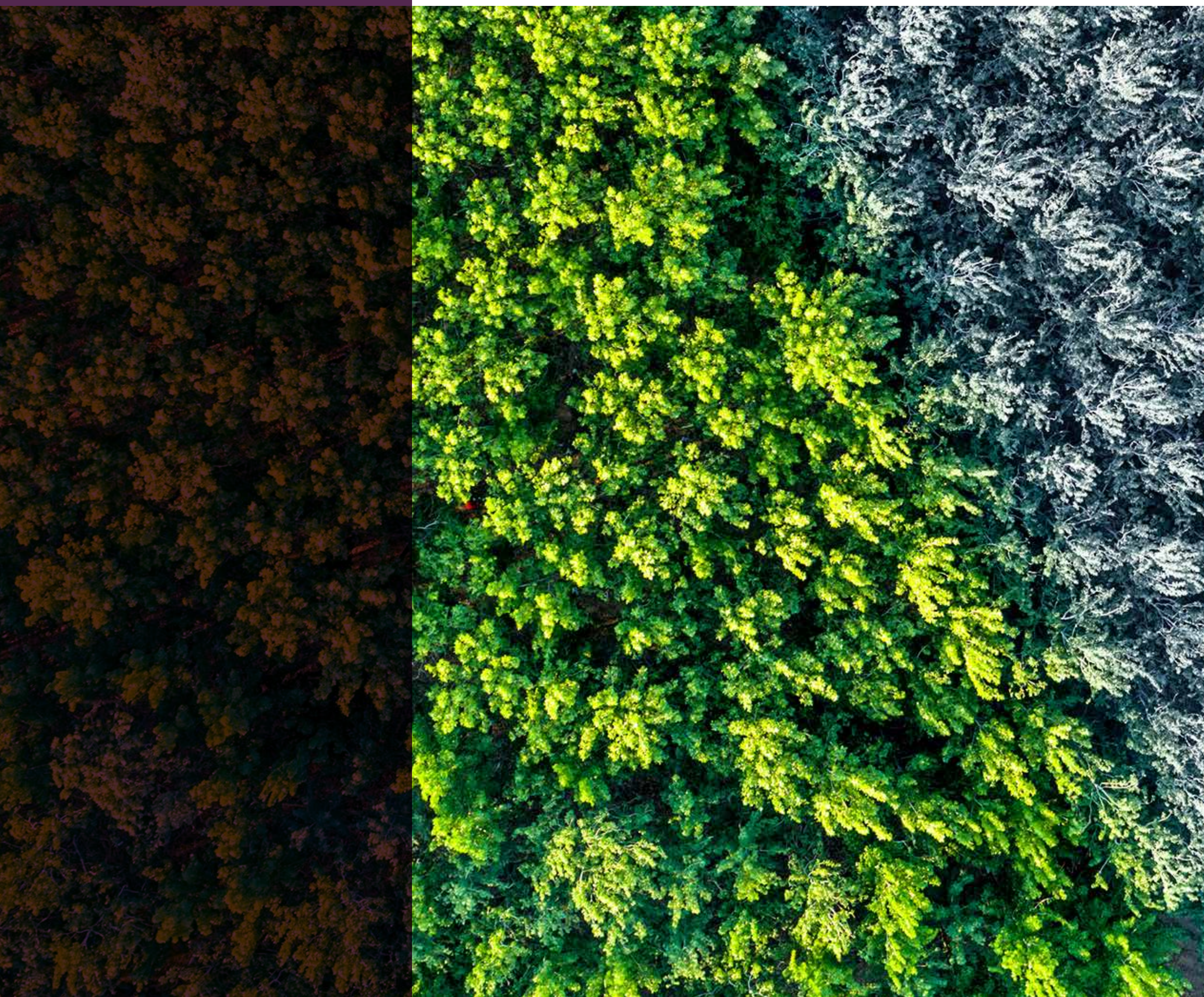
GUGGENHEIM

Third Quarter 2023

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

Reaccelerating U.S. Economy Is Not a Sustainable Outcome

Any pickup in economic momentum is incompatible with the Fed's inflation fight.

Driven by a string of strong economic data, the latest market narrative to take hold is that a recession has been avoided and the U.S. economy is out of the woods. This belief has helped support risk assets while pressuring bond yields because such a "no landing" scenario for the economy would mean interest rates stay higher for longer. While markets remain focused on metrics such as solid first half gross domestic product (GDP) growth and over 5 percent third quarter GDP tracking from the Atlanta Fed, we see signs of a slowdown beneath the surface.

This slowdown is apparent in the labor market, where job gains have steadily cooled to below 200,000 per month, with every month this year revised lower than the initial estimate and more downward revisions on the way, according to the Bureau of Labor Statistics' preliminary benchmark revision. Total hours worked are even weaker, with no growth between January and August. Historically, such an extended flatline in labor utilization has been a reliable (though not perfect) signal of impending economic downturn. (See Theme 1 for a deeper dive into this topic.)

Even if we are wrong about these signs of a slowing economy, any reacceleration for the economy is likely to be short-lived, as it risks stoking inflation pressures and prompting a response from the Federal Reserve (Fed). Fed Chair Jerome Powell's widely anticipated Jackson Hole speech made it clear that seeing a few months of lower inflation was not enough for the Fed: It is also seeking economic growth below its longer run potential rate, and a continued easing of labor market tightness. Powell's speech also acknowledged that the Fed is watching signs the economy is not cooling as expected, which would warrant further monetary policy tightening.

These upside risks to the data will keep the Fed from signaling any easing in the near term as it looks to preserve its optionality. We think risks of another hike are underpriced in the market, with technical factors related to seasonal adjustments and health insurance measures likely to meaningfully push up inflation readings this fall. Economic reacceleration is not a sustainable outcome, as the Fed remains deeply wary of inflation turning back up like the 1970s and will act more aggressively if signs of this dynamic emerge. However, the dominant factor is that the Fed is near the end of its aggressive hiking campaign and the next move in fed funds is eventually lower.

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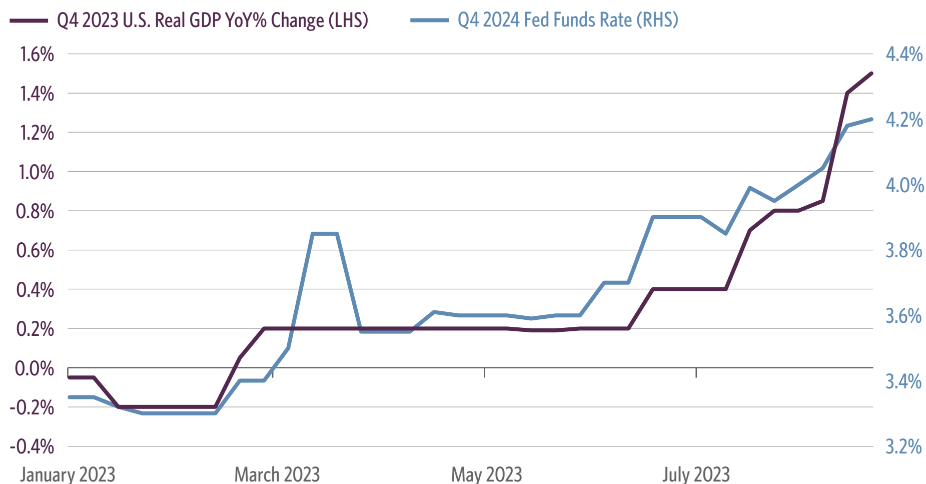

Source: Guggenheim Investments, Haver Analytics. Data as of 8.25.2023.

This macroeconomic backdrop continues to argue for a cautious approach in the markets, given fading economic tailwinds, rising corporate distress, and problems overseas, most notably in China. Fortunately, we continue to find attractive areas of opportunity, such as corporate bonds with strong balance sheets weathering the rate hike storm, and as we draw closer to the end of the Fed's hiking campaign our research suggests it is a good time to rotate defensively and into bonds.

Theme 1

Factors Supporting U.S. Economy's Resilience Are Set to Fade

With less support from disinflation, fiscal policy, and the labor market, the economy should slow by the end of the year.

A striking feature of the U.S. economic data over the last several months has been the resilience—if not reacceleration—of many indicators, despite widespread recession fears earlier this year and 525 basis points of rate hikes from the Fed. Second quarter real GDP growth beat expectations at a solid 2.1 percent, and the third quarter is likely to be even stronger. Bloomberg's U.S. Economic Surprise Index, which measures a wide array of data releases relative to consensus expectations, is near its highest level in over five years, with the exception of the pandemic reopening period.

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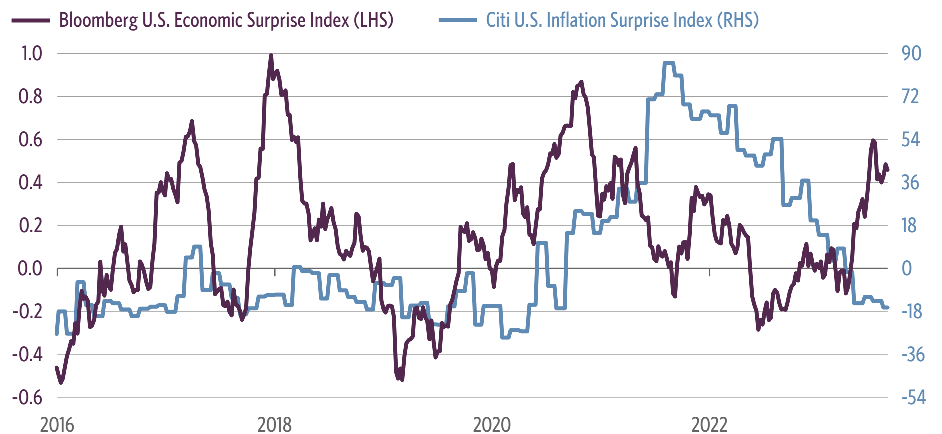
U.S. Economic Data Is Stronger than Expected Even as Inflation Cools



Source: Guggenheim Investments, Bloomberg. Data as of 8.25.2023. The Bloomberg U.S. Economic Surprise Index measures a wide array of data releases relative to consensus expectations. The Citi U.S. Inflation Surprise Index measures price surprises in the United States relative to market expectations.

It is important to understand what has been driving this economic resilience to determine if it can continue. Our analysis suggests the past year or so has seen a confluence of positive tailwinds that have helped blunt the impact of tighter monetary policy, but that these tailwinds are unlikely to persist. One important tailwind has been falling inflation. In summer 2022, headline Consumer Price Index (CPI) inflation was running at 9.1 percent and gasoline prices had spiked. Since then, inflation has dropped as low as 3 percent, with outright declines in energy prices earlier this year. While 3 percent is still an elevated rate of inflation—the Fed's target is 2 percent—the slowdown from 9 percent inflation has had an important positive impact on consumer sentiment and spending.

Another significant economic tailwind has been fiscal policy. The federal fiscal deficit has widened by a remarkable degree over the past year, growing from 3.9 percent of GDP in August 2022 to 8.3 percent as of June 2023. That expansion is larger than we have experienced in most prior recessions, let alone an economic expansion. While not all of the widening is from stimulus, instead representing factors like higher interest costs and lower tax payments, an expansion of that magnitude undoubtedly has benefited economic growth.

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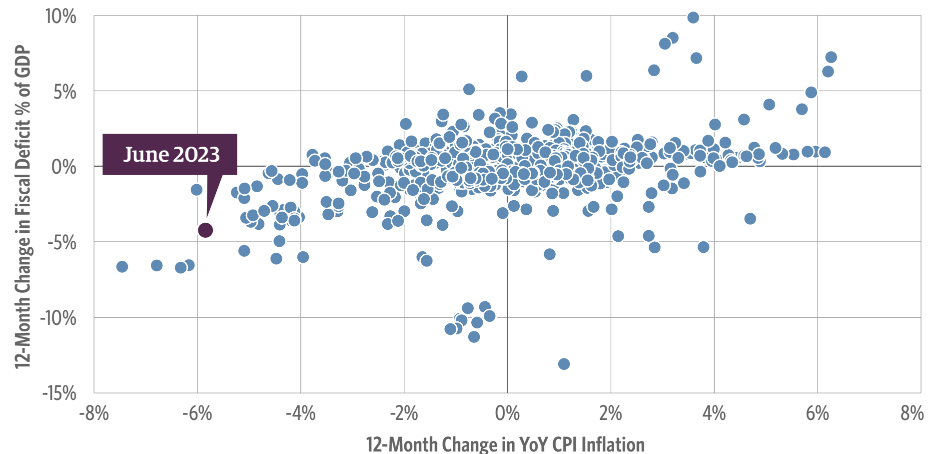
Slower Inflation and Growing Fiscal Deficit Have Supported U.S. Economy
1961–2023



Source: Guggenheim Investments, Haver Analytics. Data as of 6.30.2023.

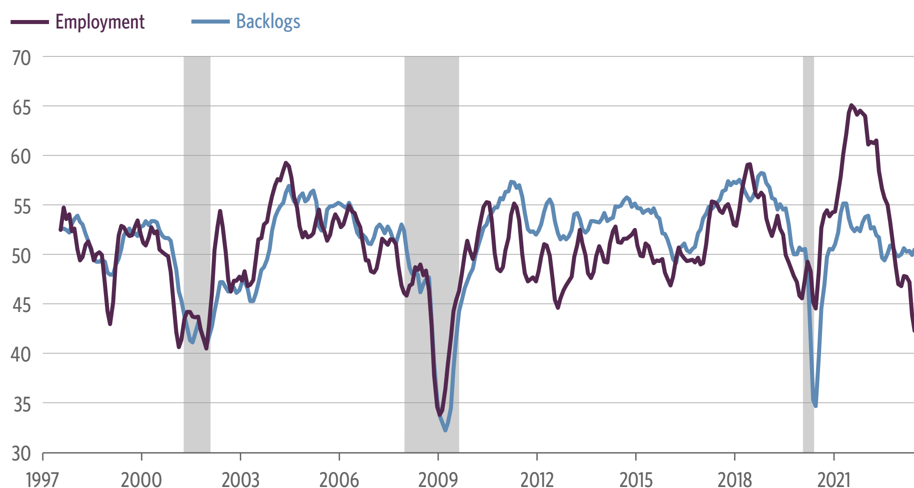
Neither of these factors is likely to be sustained going forward. Inflation can continue to fall, but not by another 6 percentage points, and a cooling led by imputed rental costs for homeowners will feel different than one led by deflation in food and energy costs. The widening of the fiscal deficit should also slow substantially in the coming months as delayed tax payments come in and student loan payments restart, and because the one-time boost from large cost of living adjustments for government benefits at the start of the year is likely behind us.

While the labor market has cooled off more than economic activity, we also see evidence that temporary factors have helped support employment. One factor is an aggressive reduction in average hours worked, which was elevated by pandemic-era labor shortages and is now near the lows of the last cycle. Cutting hours instead of headcount has been an important reason why the unemployment rate has not risen more, but with hours now substantially reduced there will be more pressure for layoffs. On a similar note, job growth has been supported by the working down of backlogs built up over 2020–2022. Even as new business has slowed, these backlogs have meant that employment levels could be maintained. But eventually these backlogs will be worked down, creating more pressure for layoffs.

Working down the large backlogs that built up in 2021 and 2022 has helped support employment levels, but eventually these backlogs will be worked through.

Employers Are Aggressively Working Down Backlogs, Keeping Employment Steady (for Now)

Average of ISM Manufacturing and Services



Source: Guggenheim Investments, Haver Analytics. Data as of 8.31.2023. Three-month moving average shown. Shaded areas represent recession.

The fading of these tailwinds will be a gradual process, but the peak of their support to the economy is now behind us. With less support from disinflation, fiscal policy, and the labor market, the economy should slow by the end of the year, and we think a recession is likely by early 2024. That recessionary pressure will occur as these tailwinds fade while headwinds from tight monetary policy and slowing credit growth become an increasing constraint on new economic activity.

Theme 2

Corporate Savers Win Even as Bankruptcies Pick Up

High margin and cash flow industries are generally in a better position to survive in a limited growth environment.

This year has seen a surge in corporate bankruptcies as issues stemming from the 2020 pandemic collide with higher interest rates and a stricter lending environment. According to S&P Global Market Intelligence, there have been 459 corporate bankruptcies year to date through August, which exceeds the annual total for all of 2021 and 2022. At the current pace, we may see the highest annual corporate bankruptcy volume since 2010.

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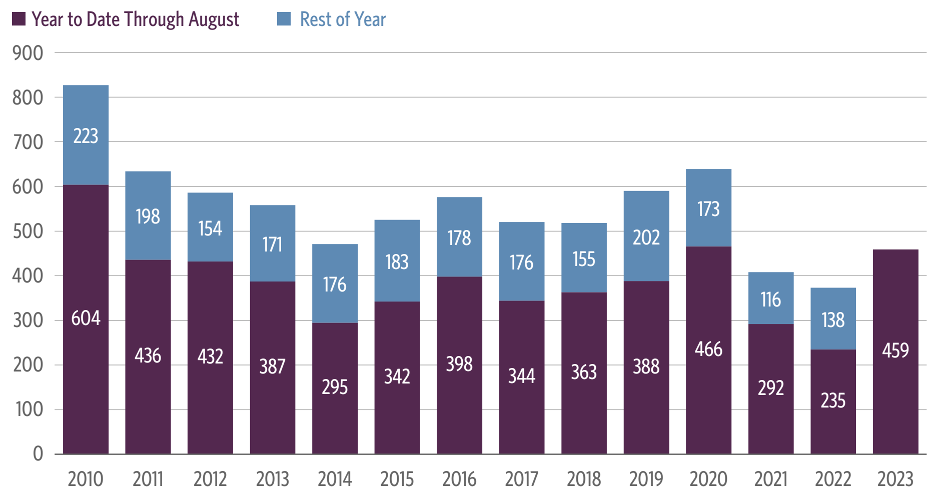
Corporate Bankruptcies Are on the Rise



Source: S&P Global Market Intelligence. Data as of 8.31.2023.

The sectors most in distress are industrials and consumer discretionary, encompassing retail giants like Bed Bath & Beyond and David's Bridal, alongside names unfamiliar to the average household, such as Aztec Plumbing, Unique Freight Lines, and Pacific Panorama. By our count, at least 109 corporations have filed for bankruptcy across these two sectors combined, or 27 percent of the year-to-date total. These sectors have struggled over the past several years, beginning with limited sales due to the economic shutdown in 2020, inventory issues in 2021 due to supply chain constraints, excess inventory in 2022 due to the catch up of product deliveries, and rising costs due to the inflationary environment. The liquidity boost from pandemic-related assistance, such as the Paycheck

Protection Program, is running out while the lending environment has become more challenging, leaving many entities without any financial alternative but to file for bankruptcy.

Healthcare and financials are next on the list of most bankruptcies, but no sector has been spared. Rising bankruptcies cut across energy, real estate, staples, and technology. Equally alarming is the resurgence of repeat filers, informally referred to as "Chapter 22" companies—entities that have had to resort to Chapter 11 bankruptcy more than once. Though an exact number for Chapter 22s is hard to calculate, estimates suggest that the resurgence in repeat filers is reminiscent of the volume last seen in 2009.

Amid this pickup in distress, a paradoxical development has been the Fed's rate hikes boosting corporate interest income so much that net interest expense has actually declined, leaving companies in the aggregate in better shape to cover ongoing debt burdens. According to data from the Bureau of Economic Analysis, net interest expense (interest expense minus interest income) of U.S. nonfinancial corporations declined by $66 billion year over year on an annualized rate as of the second quarter of 2023, largely due to higher interest income. We estimate that U.S. nonfinancial corporates are earning a record $171 billion in interest income from cash, Treasury, and Agency debt holdings, up $102 billion in interest earned from the same assets last year.

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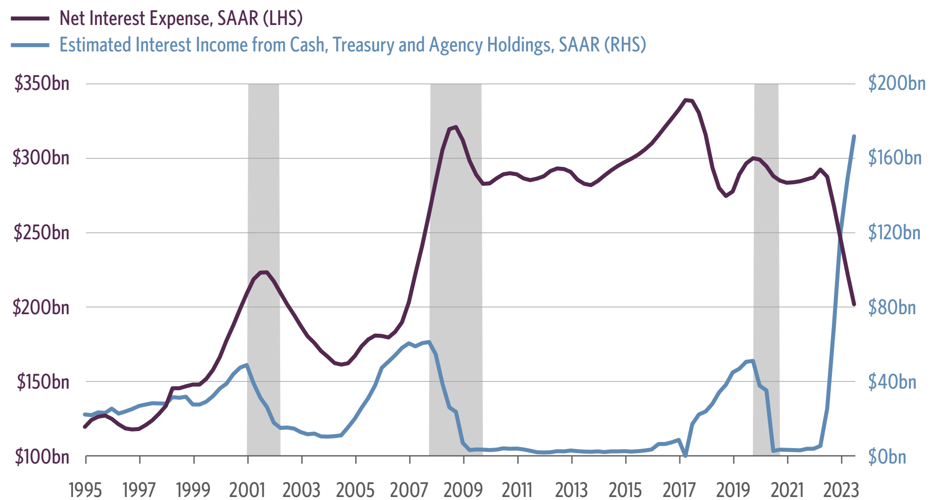
Nonfinancial Corporate Net Interest Expense Falls as Interest Income Rises



Source: Guggenheim Investment, Bureau of Economic Analysis, Federal Reserve Financial Accounts Data. Data as of 6.30.2023. Shaded areas represent recession.

At an aggregate level, even as leverage levels are generally higher, corporations are in the best position to cover interest payments since 1960. For the universe of nonfinancial corporate entities, interest coverage is close to 21 times, according to Fed data, with the trend likely to keep improving.

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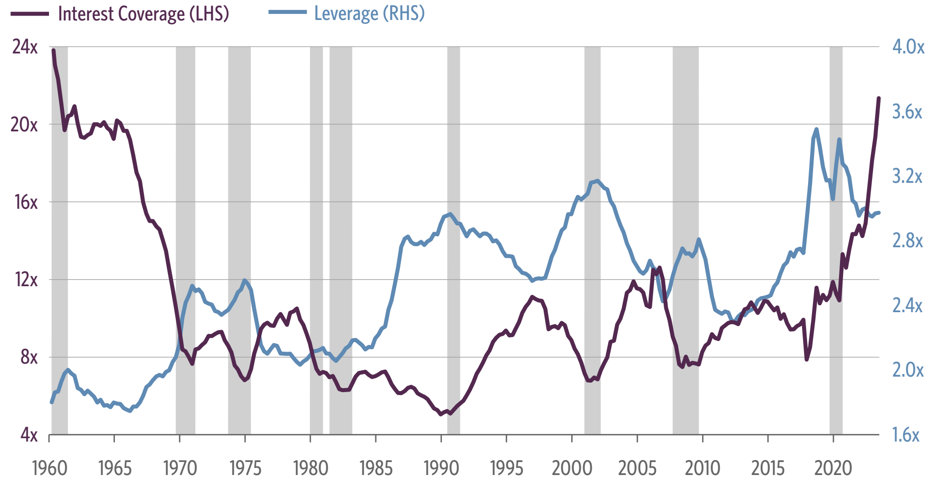
Highest Interest Coverage Ratio for Nonfinancial Corporates Since 1960



Source: Guggenheim Investment, Haver Analytics. Data as of 6.30.2023. Interest coverage and leverage calculated according to Guggenheim's methodology for estimating earnings before interest, tax, depreciation, and amortization using the Federal Reserve's Financial Accounts data. Shaded areas represent recession.

How do we reconcile the surge in bankruptcies against the positive picture presented by aggregate corporate fundamentals? This dichotomy highlights that there are different channels through which the Fed's rate hikes work to slow the economy—higher interest rates not only make borrowing more expensive, but they also benefit and incentivize savings. High margin and cash flow industries that can survive under limited growth conditions are generally in a better position in this environment. Highly indebted companies that are reliant on steady access to new funding and a strong growth outlook are not. For this reason, we think it makes sense to continue being selective around this credit profile and moving up in quality. While corporate bankruptcies may reach the levels last seen in the aftermath of the global financial crisis, we believe there are areas where credit investors can explore without giving up portfolio income.

Theme 3

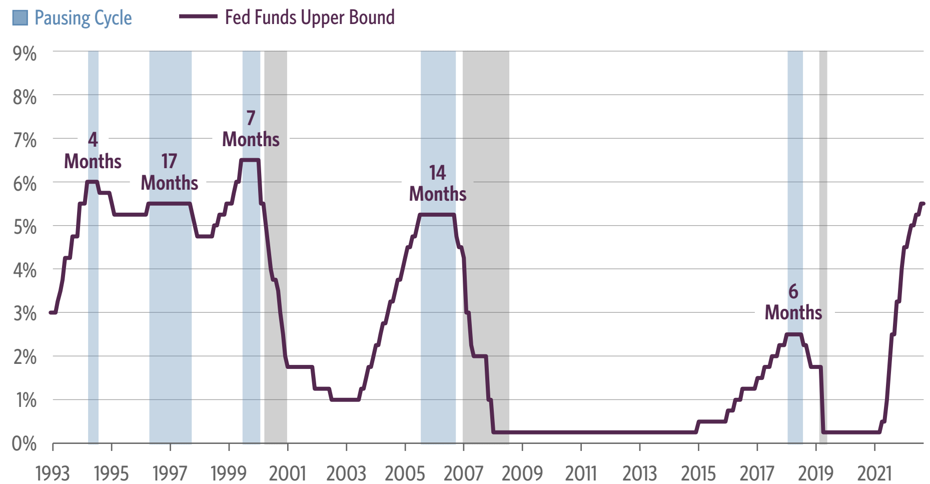
Bonds Meaningfully Outperform Stocks During and After Fed Pausing Cycles

Risky assets and high-quality fixed income typically perform well during the Fed pause, but bonds usually win the day when easing starts.

As the end of the current hiking cycle draws closer, we turn to history to gauge what the Fed is most likely to do in the coming months and what it means for markets. History suggests that once this hiking cycle is over, the Fed is likely to hold rates steady for several months before cutting rates. This pause occurs for a number of reasons. The economy is usually robust near the end of a hiking cycle when growth is positive and unemployment is low. The Fed will also want to keep rates steady to see how the economy continues to digest the lagged effects of past tightening. In addition to this historical precedent, today the bar is higher for the Fed to cut rates in the near term. Growth is surprising to the upside, the unemployment rate is near historical lows, and inflation remains too far above the Fed's 2 percent target.

History suggests that once this hiking cycle is over, the Fed is likely to hold rates steady for several months before cutting rates. We expect the Fed pause to last from five to eight months before the central bank starts cutting rates.

Pausing Cycles Typically Last Several Months Before the Fed Begins to Cut Rates



Source: Guggenheim Investments, Bloomberg. Data as of 8.31.2023. Gray shaded areas represent recession.

The path of monetary policy has important implications for cross asset performance. For example, we find that risky assets (proxied by the S&P 500), and safe-haven assets (U.S. Treasurys) typically exhibit performance tied to the stance of monetary policy.

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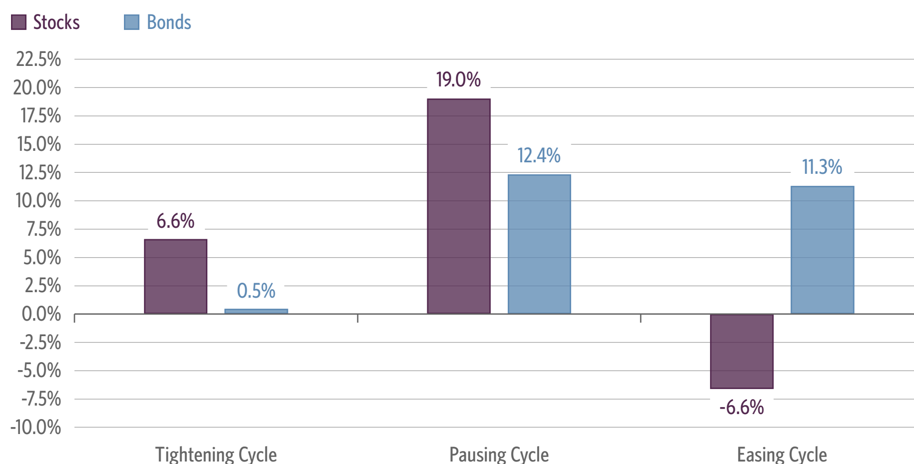
Average Monthly Returns Vary Widely Depending on the Fed's Policy Stance

Annualized monthly returns

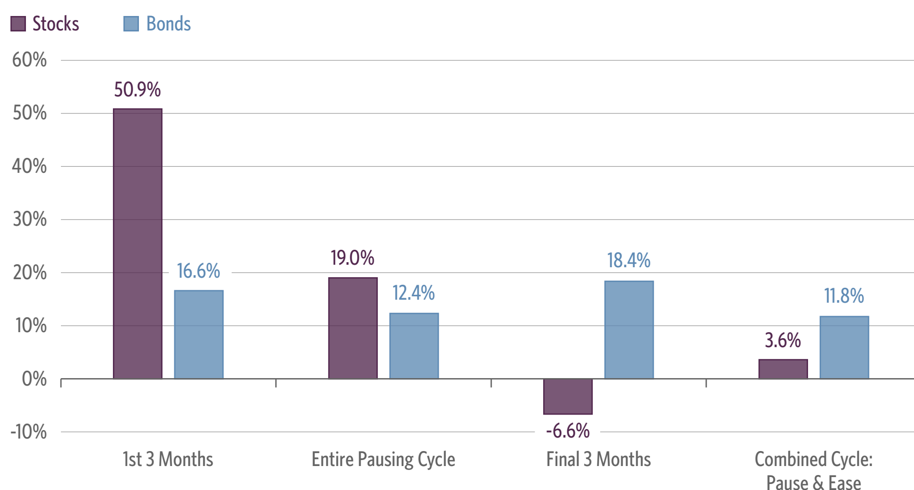


Source: Guggenheim Investments, Bloomberg. Data as of 8.31.2023. Past performance does not guarantee future results.

Stocks tend to do better than bonds in a tightening cycle. This shouldn't be surprising, as the Fed is raising short term rates because the economy is strong, supporting earnings and positive sentiment. Similarly, it is not surprising that bonds underperform, with the effect of rate hikes only barely being covered by coupon income. Looking at the easing cycles, we highlight that the Fed is usually cutting rates because a recession is underway. Given a poor economic backdrop, one would expect risky assets to underperform safe-haven assets like U.S. Treasurys when the Fed is easing policy.

Stocks tend to do better than bonds in a tightening cycle. Both stocks and bonds have historically performed well during pauses. Safe-haven assets like U.S. Treasurys have historically outperformed when the Fed is easing policy.

Risky Assets Typically Perform Best in the Beginning of a Pausing Cycle, Bonds Over the Longer Term



Source: Guggenheim Investments, Bloomberg. Data as of 8.31.2023. Annualized average monthly returns. Past performance does not guarantee future results.

The most interesting, and timely, category is the pausing cycle, where both stocks and bonds have historically performed well. Stocks have produced positive returns because policy is no longer expected to be any more restrictive, and bonds have performed well because short-term rates are not rising. However, the performance of risky assets like stocks varies significantly from the beginning to the end of past pausing cycles. For example, stocks generally produce well above-average returns during the early stages of a pausing cycle. However, in the final months of a pausing cycle, stocks typically produce negative returns and bonds outperform. History would suggest investors should remain allocated to equities during the start of a pausing cycle, but rotate into bonds over the longer term. This aligns with performance during an easing cycle, as investors begin to realize that a recession is becoming increasingly likely. We expect the Fed pause to last from five to eight months before the central bank starts cutting rates.

The investment takeaways from this analysis are straightforward: With the upcoming Fed pause, both risky assets and high-quality fixed income should perform well. However, when we consider the combination of a pausing cycle leading into an easing cycle, we find that bonds have handily outperformed stocks. As we look ahead, keeping in mind our own recession outlook, the upcoming pausing cycle will provide an opportunistic window to further rotate into higher-quality assets at attractive pricing.

Theme 4

Beijing's Competing Priorities Will Exacerbate China's Economic Downturn

An economic slowdown in China will have spillovers to the rest of the world.

President Biden recently slammed China's economic situation as "a ticking time bomb," a characterization that holds some truth. China's economy faces a complex array of growth challenges. July witnessed a continued decline in industrial production, fixed investment, and retail sales. The sluggish consumer spending figures are especially alarming, demonstrating that economic momentum from the post-Covid reopening is diminishing. In housing, the property sector crisis is intensifying. Investment in real estate continues to plummet, with daily home sales in the largest cities plunging to just 30 percent of pre-pandemic levels. Beyond sluggish economic growth, there are worries about deflation, heavily indebted developers stressing shadow banks, local governments struggling to service their debt, and a youth unemployment rate soaring to 23 percent as of July 2023.

China's economic struggles are an inevitable adjustment after years of overinvestment and accumulation of debt. While Beijing recognizes the unsustainability of this growth model and is striving to reduce nonproductive investments, the danger of overcorrection looms large. The preoccupation with de-risking and preparing for possible conflicts with the West has policymakers

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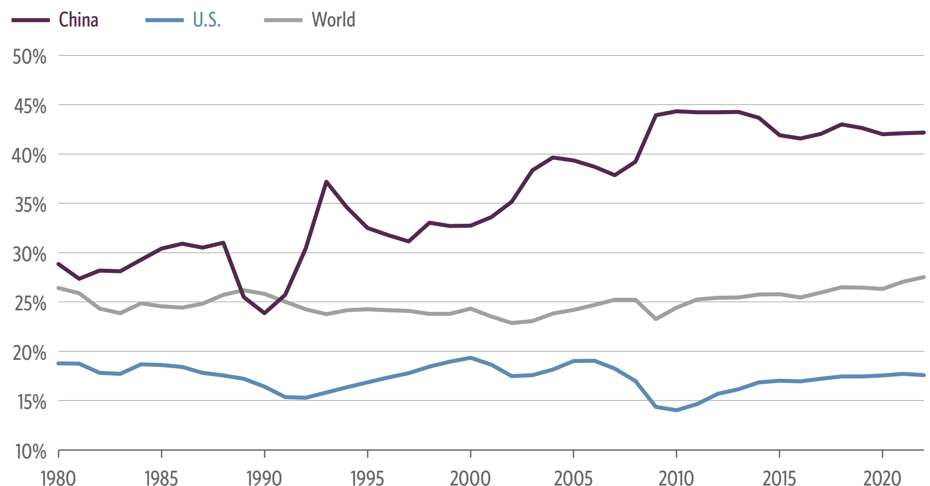
China Needs to Shift to a Less Investment-Driven Growth Model

Investment % of GDP



Source: Guggenheim Investments, Haver Analytics, Wall Street Journal. Data as of 12.31.2022.

leaning toward under-stimulating the economy. The central government is hesitant to rescue debt-laden developers and local governments, wary of the moral hazard involved. It has also shunned U.S.-style stimulus for households, deeming it imprudent when China's priority should be enhancing its industrial capabilities and reducing dependence on foreign technologies. Without forceful policy support, a further decline in growth in the coming quarters seems all but certain.

Given the Chinese government's pervasive control over the financial system, China's economic crisis is not likely to unfold in the conventional, textbook manner experienced by Western economies. Rather than being sparked by a single event that has a domino effect, such as the 2008 Lehman Brothers collapse or the 1970s oil embargo, China's economic challenges will be dispersed, initiated from various points, and permeate different sectors. It will likely be a slow, creeping phenomenon, with the Chinese government addressing smaller individual challenges that may inadvertently cultivate larger ones down the road.

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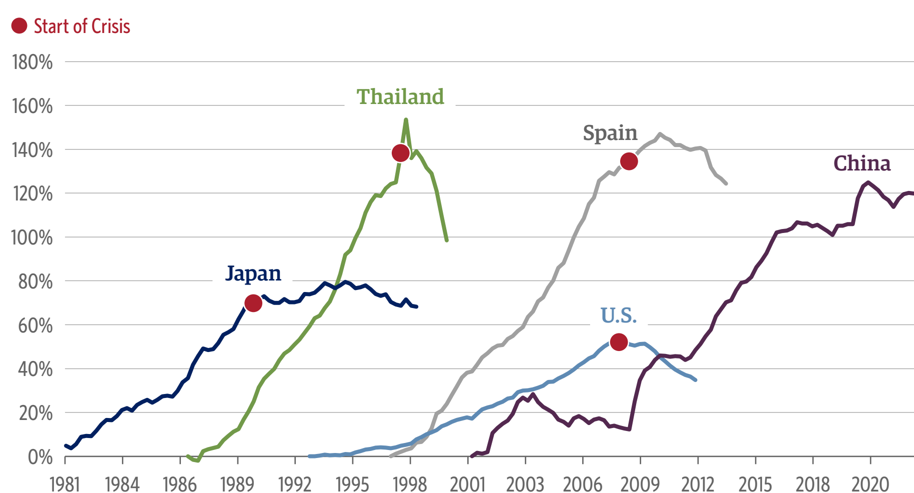
China's Debt Buildup Is Not Sustainable

Credit to the Private Nonfinancial Sector, % GDP, Cumulative Change in the Lead Up to Crisis



Source: Guggenheim Investments, Haver Analytics. Data as of 12.31.2022.

China's crisis is not likely to be confined solely to its domestic economy. Lower commodity and goods prices resulting from China's faltering economy may benefit the United States. However, we are also monitoring the impact via exchange rate channels. With Beijing committed to taking measured steps to support growth, the yuan could easily drop a further 10 percent, bolstering Chinese exports but widening U.S. current account deficits. Rapid depreciation of the yuan and other emerging market currencies could also prompt central banks to intervene, potentially unsettling U.S. financial markets.

Other parts of the world will also feel the impact of China's struggles. To mitigate—and perhaps distract from—internal tensions, Beijing may adopt a more confrontational foreign policy, taking bold moves in contentious areas like Taiwan and the South China Sea. The downturn could also trigger global economic instability, which would weigh heavily on countries reliant on Chinese markets and investments. Commodity exporters and countries deeply intertwined with China's Belt and Road Initiative, predominantly in the Global South, are vulnerable. While first-order impacts of a China slowdown appear manageable from a U.S. perspective, these second-order impacts are more concerning and bear watching.

Important Notices and Disclosures

Investing involves risk, including the possible loss of principal. Stock markets can be volatile. Investments in securities of small and medium capitalization companies may involve greater risk of loss and more abrupt fluctuations in market price than investments in larger companies. Investments in fixed-income instruments are subject to the possibility that interest rates could rise, causing their values to decline. 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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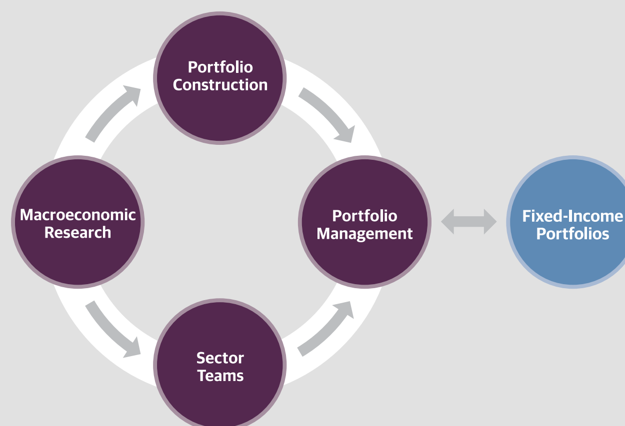
Guggenheim's Investment Process

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.



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About Guggenheim Partners

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1. Assets under management are as of 6.30.2023 and include leverage of $15.9bn. 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 Partners Advisors, LLC, Guggenheim Corporate Funding, LLC, Guggenheim Partners Europe Limited, Guggenheim Partners Japan Limited, GS GAMMA Advisors, LLC, and Guggenheim Partners India Management.

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