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Portfolio Strategy | May 13, 2024

The Economic Cycle Isn't Dead, Merely Delayed… And That's Good for Bonds

Commentary by Anne Walsh, CIO for Guggenheim Partners Investment Management

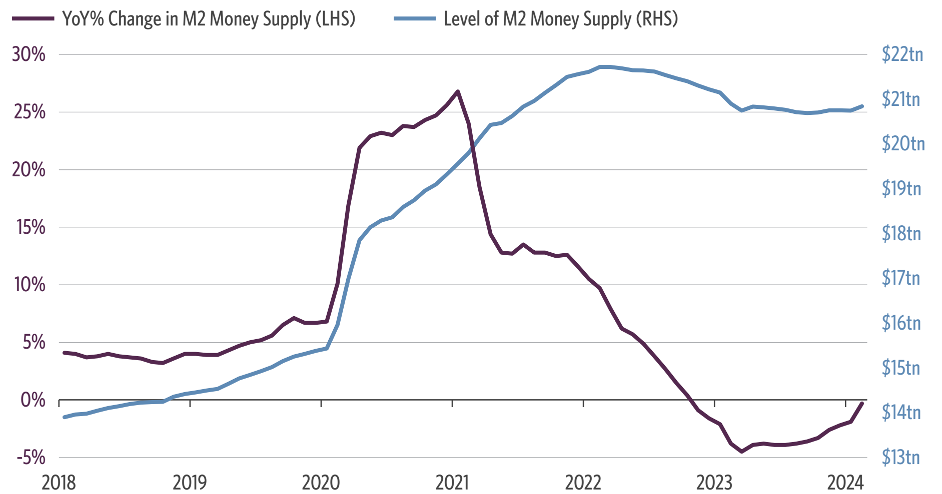
We find ourselves at a point in the economic cycle where old patterns don't seem to apply. The 2s/10s Treasury yield curve has been inverted for 22 months, exceeding the old record of 20 months set in the Volcker era. Historically, the average time span between curve inversion and a recession has been 16 months. The Leading Economic Index has been on a declining trend for two years and conventional wisdom had been that a recession would follow after just four consecutive down months. Finally, it's now been 26 months since the Federal Reserve started its hiking cycle and historically a recession would have started by now.

Economic forecasting relies heavily on analyzing patterns and outcomes from historical data. That faith in precedent provides the rationale for Sir John Templeton's famous quote, "The four most dangerous words in investing are 'this time it's different.'" It also suggests a warning against recency bias that assumes the current situation not only differs from the past but that it will also persist into the future. This time last year, as inflation raged and rates climbed, market consensus held that zombie companies would go begging for credit, recession loomed and the Fed would ride to the rescue. But here we are a year later, and we seem to be in the exact same place. We have seen neither a full-blown recession nor a credit purge beyond the margin. We continue to watch a bifurcated economy in which lower income consumers and smaller companies are struggling, but higher income households and larger companies are doing just fine. The Fed's expected rate cuts keep getting pushed back.

So is it different this time? Two critical developments have been making new and underappreciated contributions to the current situation. First, we are still deeply rooted in a post-COVID global economy contending with staggering amounts of stimulus: $12 trillion was added to global central bank balance sheets between 2020 and 2022, and even with quantitative tightening, only $5 trillion has been taken out. In the United States, M2 money supply growth—the flow—may have turned negative since jumping 41 percent from February 2020 to March 2022, but the stock of money supply is still near all-time highs.

> "The Fed isn't fighting inflation, it is fighting the echo effects of all this stimulus.

M2 Money Supply Growth Turned Negative, But Remains Near All-Time Highs

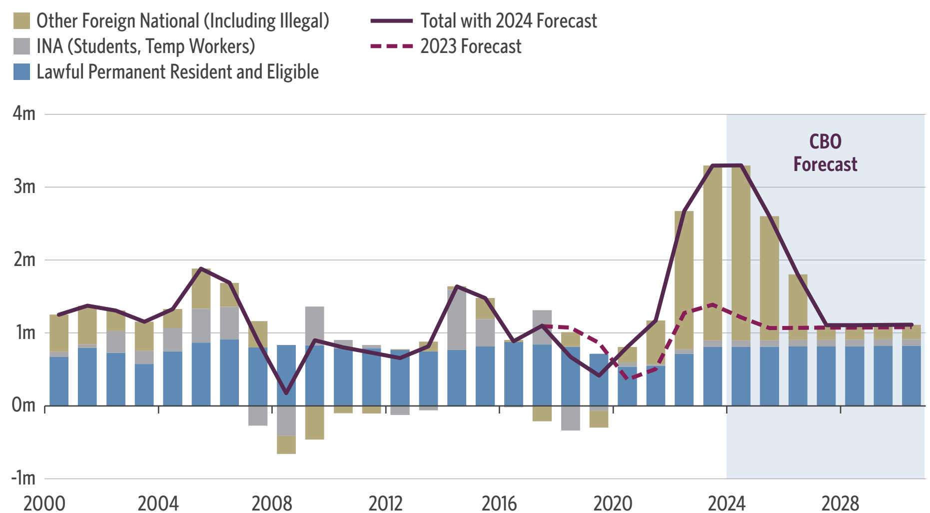


Source: Guggenheim Investments, Bloomberg. Data as of 3.31.2024.

The seismic impact of monetary and fiscal stimulus was like a giant meteor crashing into the Pacific Ocean. The stimulus meteor created initial waves of liquidity that were strong enough to overcome the complete shutdown of the global economy in the depths of the pandemic. Subsequent waves helped pull the economy out of the depths, but in the United States the waves are still coming and there is still unspent stimulus in the system. The Fed isn't fighting inflation, it is fighting the echo effects of all this stimulus. Counterfactual evidence supporting this concept is that other developed economies, which did not receive as much stimulus, have slowed down considerably while U.S. growth continues apace. This is unprecedented: It is different this time.

Immigration Unexpectedly Surged in 2023, Driven by Illegal Entries

CBO Estimates of Annual Net Immigration by Category



Source: Guggenheim Investments, Congressional Budget Office. Estimates as of 1.18.2024.

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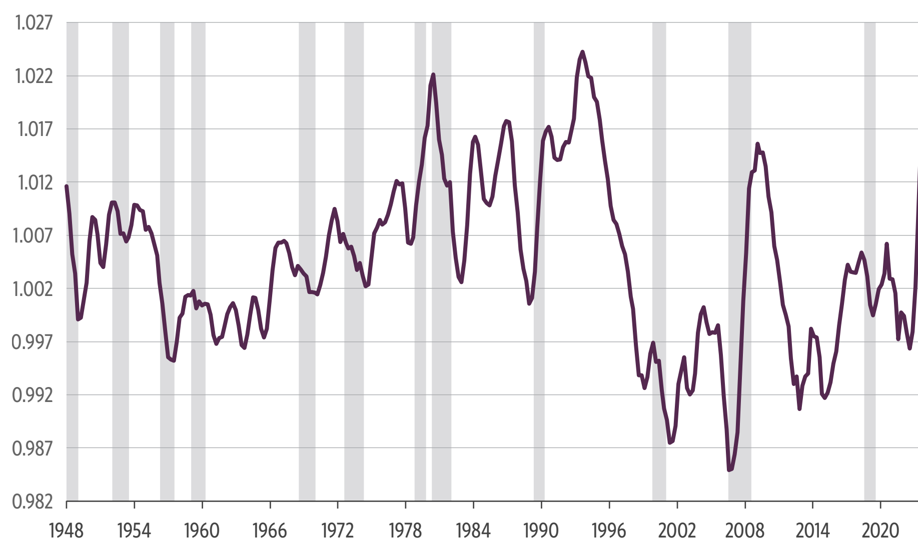
The other unusual factor in this cycle is the surge in immigration that has helped keep the labor market humming, but in the process has also skewed the economic data and made it less reliable. Recently updated demographic estimates from the Congressional Budget Office show a sharply higher estimate of net immigration, almost entirely due to illegal immigration. This immigration likely helped to meet excess labor demand in 2023, which created a positive supply shock that helped the economy expand even as inflation came down. One possible explanation for this dynamic is that immigrants have higher labor force participation rates, boosting supply more than demand, at least in the short term. The demand for rental housing by the influx of immigrants may also be distorting rental rates, which are the largest contributor to CPI inflation data.

Immigration may also explain the recent disparity between gross domestic product (GDP) and gross domestic income (GDI)—the income generated from producing GDP. A potential reason for this discrepancy is that many immigrants have come to the United States to work, but they do not earn income in the traditional—i.e. trackable—sense because many are employed off the books. Immigrants are also being subsidized in many cases, so while they may not initially derive officially recorded income from work, they are also getting spending money directly received from state, city, and federal dollars. This combination of difficult to track income and easier to record spending likely contributed to this divergence between GDI and GDP. Real GDP is trending stronger than it otherwise would relative to real GDI, suggesting that undocumented workers’ consumption is supporting GDP, but the income they are receiving to support that spending is not picked up in GDI.

Illegal Immigrants’ Income Likely Caused GDP/GDI Divergence
Ratio of Real GDP to Real GDI



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

> "Higher-for-longer may fuel market volatility in the months ahead, but investors would be wise to remember that fixed income generally does well when the Fed is on pause.

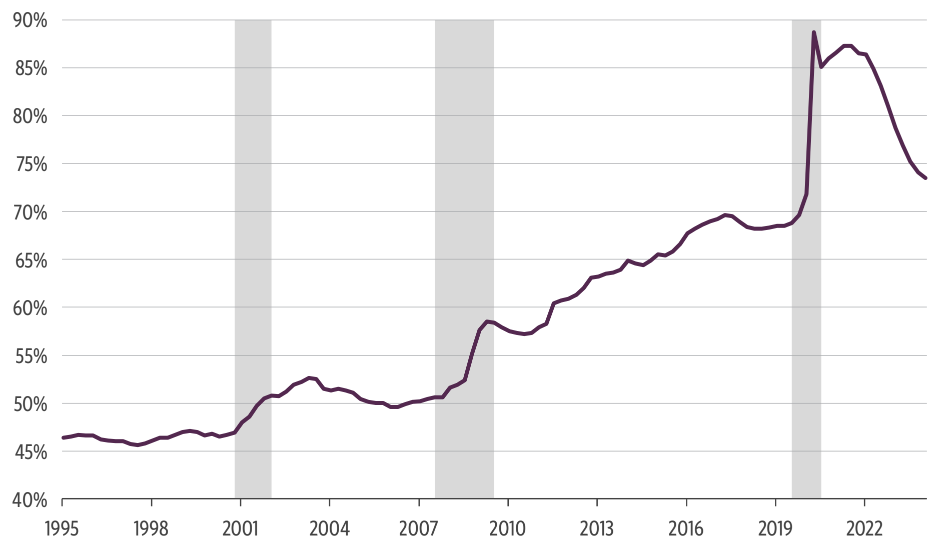
If historical cyclical patterns played out as they had in the past, we would have seen the downturn by now. But the business cycle isn't dead, it has just been extended by the impact of extraordinary monetary and fiscal stimulus and increased immigration. While it may seem as if our economy is no longer sensitive to higher interest rates, the bite of higher rates has simply been delayed because corporate and consumer balance sheets were well-fortified during the multiyear period of ultra-low rates and high liquidity. This is one of the factors that may have delayed the downturn, but we believe it is still coming.

We are starting to see change occur at the margin. Default rates are staying stubbornly high. Credit card delinquency rates for lower income consumers are rising quickly. Stress in commercial real estate persists, particularly in the office sector. More households and companies will succumb to the stress of higher interest rates as the Fed stays higher for longer. Despite recent prints, the balance of evidence continues to support the late-cycle disinflationary trajectory as wage growth trends down and higher frequency measures of rent show signs of softness. The latest Fed Beige Book suggests only limited signs of reheating. Perhaps most importantly, the COVID echo should start to subside as the ratio of total M2 to GDP, while still high, falls towards the historical trend line.

Higher-for-longer may fuel market volatility in the months ahead, but investors would be wise to remember that fixed income generally does well when the Fed is on pause. An extended or delayed economic cycle is not a bad environment for credit, but it makes sense to be somewhat defensive when adding to credit positions. We favor issuers that are at less risk of being unable to service their credit obligations. In addition, as the interest sensitive parts of this bifurcated economy increasingly

While Still High, M2 Money Supply Has Declined Toward Its Historical Range

M2 Money Supply Divided by Nominal GDP



Source: Guggenheim Investments, Haver. Data as of 3.31.2024.

struggle to access credit, less liquid sectors could present opportunities to earn yield at the margin. For example, as banks continue to exit lending to real estate, commercial mortgage loans could emerge as attractive value alternatives. Spreads are likely to remain tight, but nominal yields remain attractive and offer reasonable entry points, including in higher quality high yield.

Active investors have to remain nimble and take advantage of the markets as they find them and not remain fixed on what should be occurring based on historical precedent. Our job isn't to predict the economy, it is to manage within dynamic markets. While it might be different this time—for now—the recessionary pressures are out there. The second half of the year could turn out to be very different from the first, which calls for careful positioning now.

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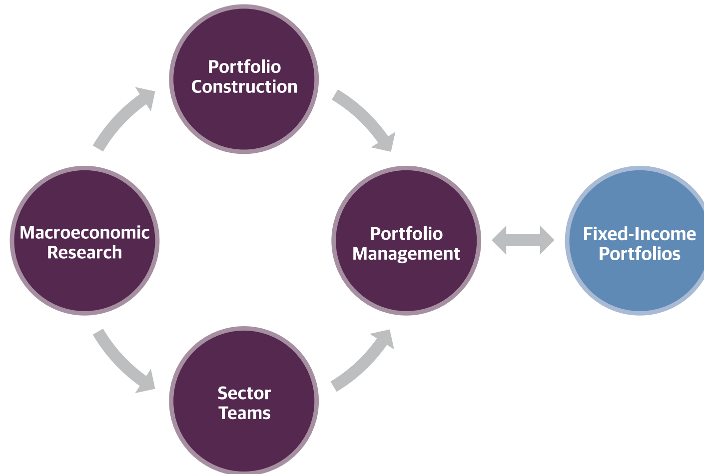

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Guggenheim Partners

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