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Guggenheim Investments

10 Macro Themes for 2018

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10 Macro Themes for 2018

This collection of charts presents 10 of the macroeconomic trends we believe are most likely to shape the investment environment in 2018.

1. Tax Reform Will Boost Growth But May Not Save the GOP Majority
2. The Unemployment Rate Will Fall to 3.5% or Lower
3. Wage Growth Will Accelerate as the Labor Market Overheats
4. Core Inflation Will Rise Modestly as the Economy Strengthens
5. The Fed Will Hike Four Times as it Overshoots its Employment Mandate
6. Central Banks Will Steadily Turn Off the Liquidity Taps
7. Recession Risk Will Grow as Fed Policy Becomes Restrictive
8. The Yield Curve Will Flatten as the Fed Keeps Hiking
9. Stocks Will Rise Despite an Aging Business Cycle
10. Record Corporate Debt Levels Will Come into Focus

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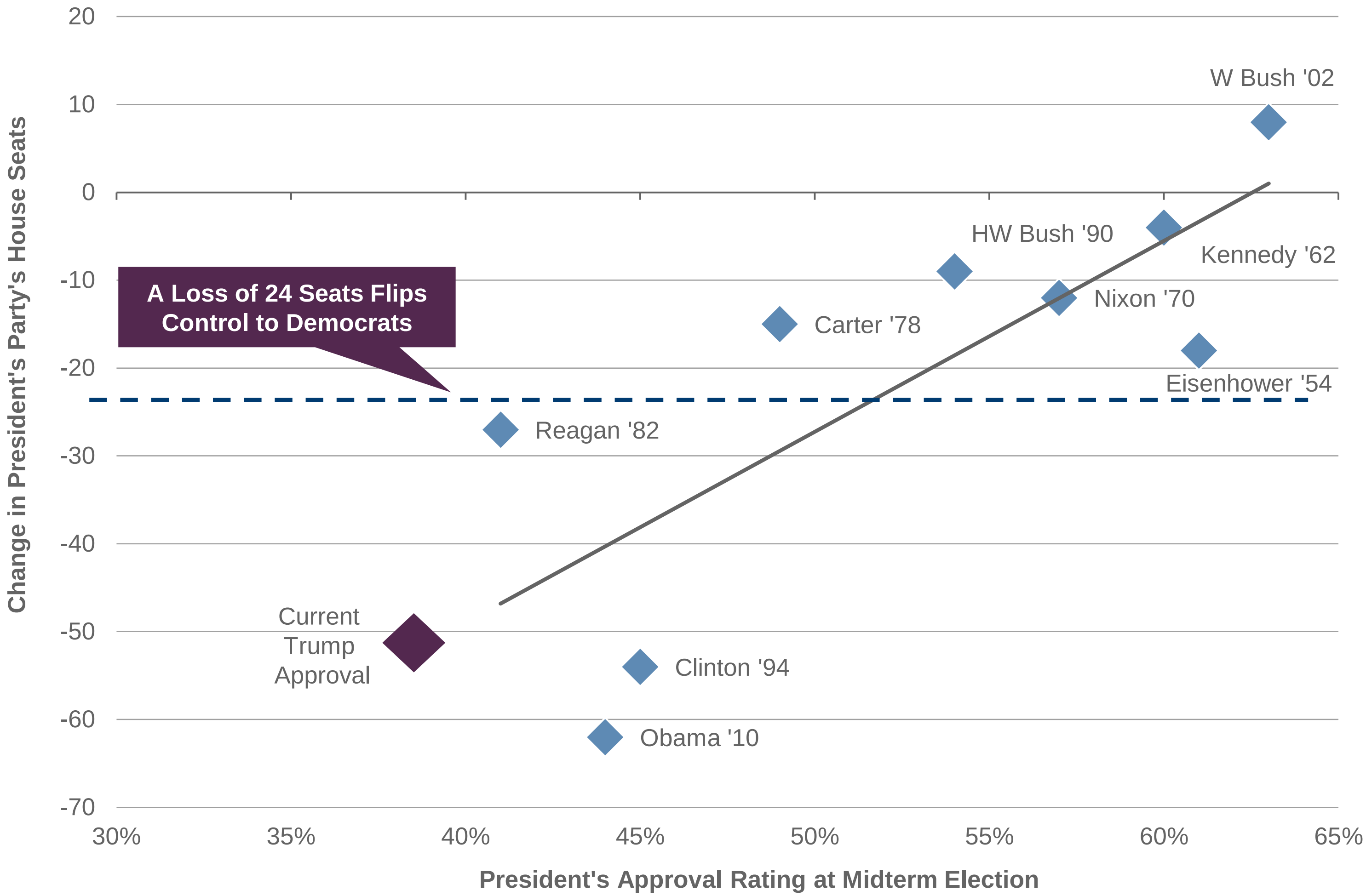
Tax Reform Will Boost Growth But May Not Save the GOP Majority

Presidential Approval vs. Party's Change in House Seats During First Term Midterms

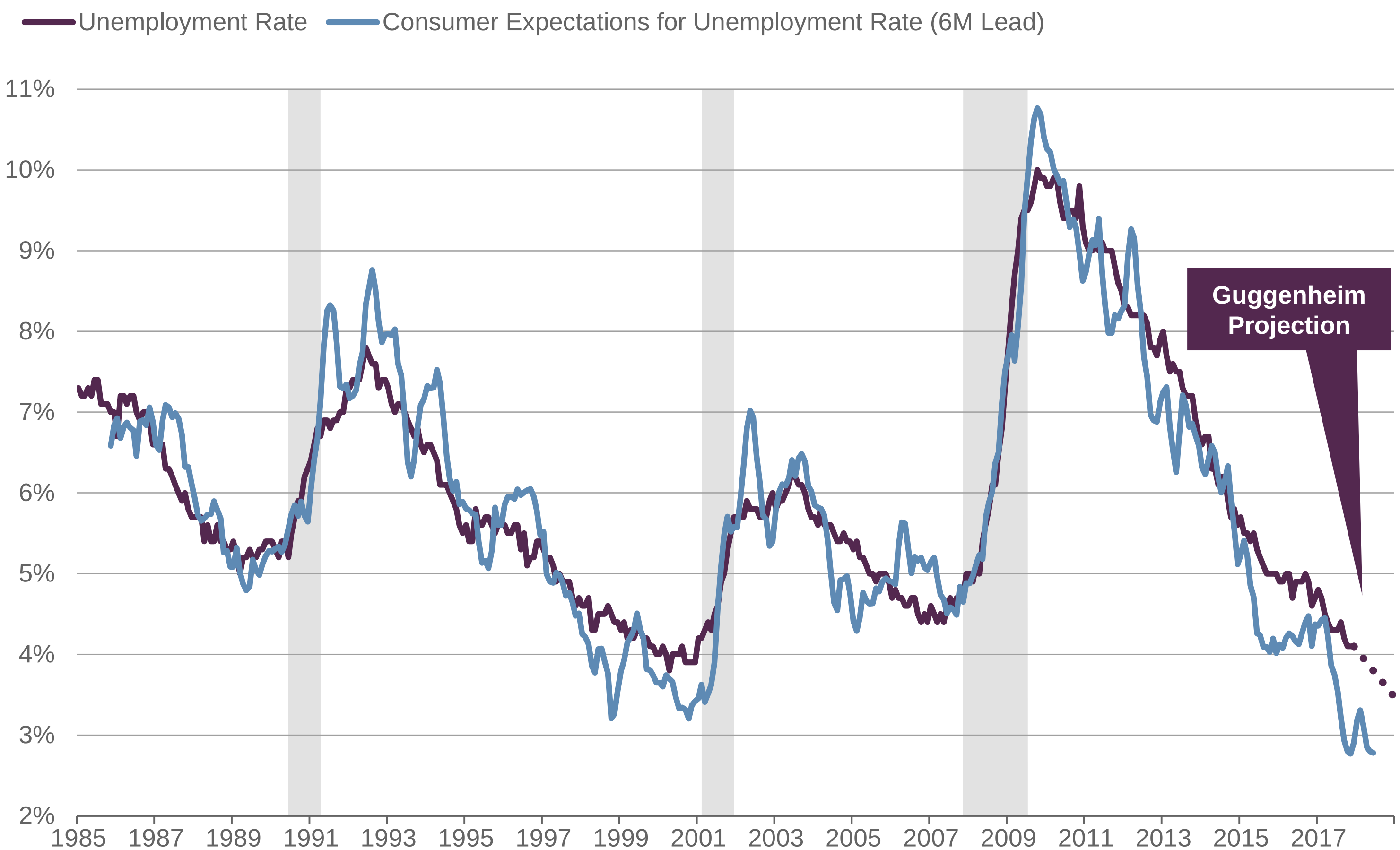


- Midterm elections tend to be challenging for first-term presidents, with the number of seats lost (or won) closely tied to the president's approval rating.
- Based on President Trump's current approval rating, the 2018 midterms do not look promising for House Republicans, who can only afford to lose 23 seats to retain their majority.
- Knowing these dynamics, Republicans passed tax reform to try to boost incomes before the election. Whether the passage of the tax reform bill will be sufficient to save the GOP's House majority is in doubt.
- Tax reform will be a modest net positive for the economy, boosting real GDP growth by between 0.2 and 0.5 percentage point in the near term, but it comes as the labor market is already on track to overheat.

Source: The American Presidency Project, U.S. House of Representatives, Office of the Clerk, Guggenheim Investments. Trump approval rating as of 12.22.2017.

The Unemployment Rate Will Fall to 3.5% or Lower

Unemployment Rate and University of Michigan Survey Derived Unemployment Forecast

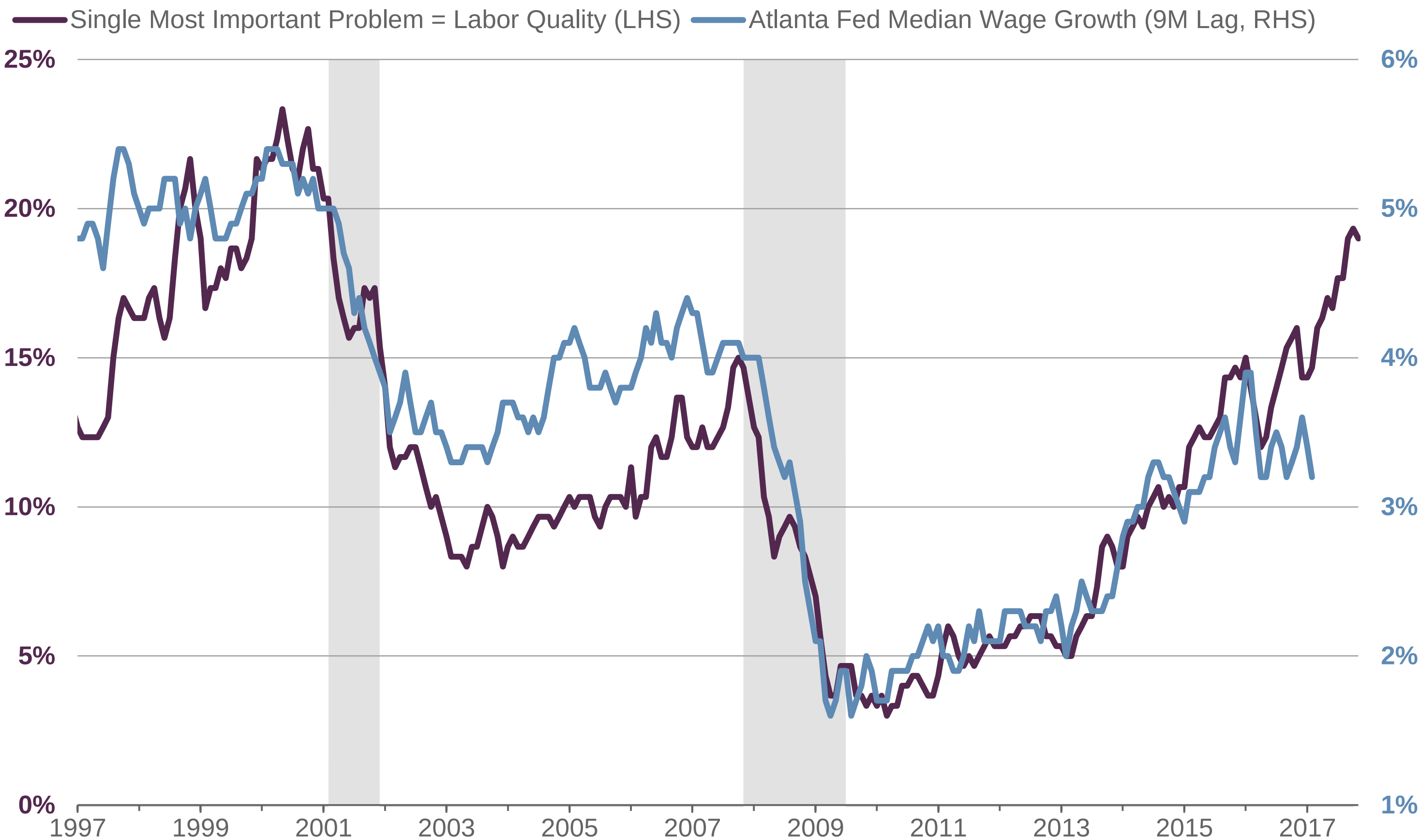


- The unemployment rate has fallen by 0.7 percentage point over the past year,
  and now stands at 4.1 percent, well below its estimated natural rate.
- Historically, consumers have done a fairly good job of predicting future changes in the unemployment rate, and recent readings point to further declines.
- With job growth likely to continue to run above the sustainable rate of labor force growth (75,000–100,000 per month),
  we expect unemployment to fall to 3.5 percent by the end of 2018, meaningfully below the Fed's forecast of 3.9 percent.
- In response, the Fed will deliver four rate hikes to cool a labor market that will have overshot the Fed's "maximum sustainable employment" mandate.

Source: Haver Analytics, Guggenheim Investments. Data as of 11.30.2017 for unemployment, 12.8.2017 for Consumer Expectations.

Wage Growth Will Accelerate as the Labor Market Overheats

NFIB Small Business Survey: Single Most Important Problem* and Atlanta Fed Median Wage Growth Tracker

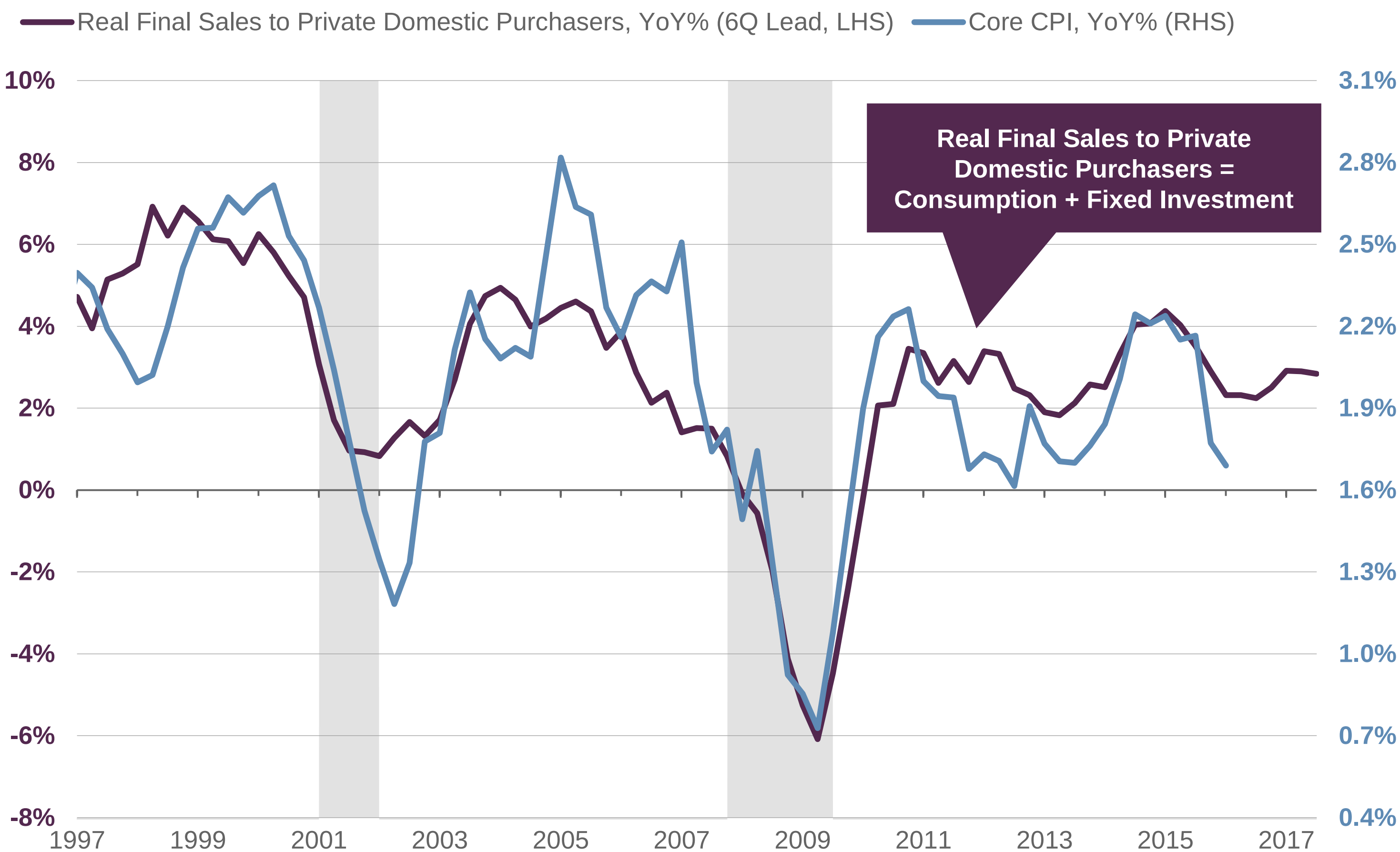


- With the unemployment rate at a 17-year low, a variety of other indicators also point to a tight labor market.
- One such indicator comes from the NFIB Small Business Optimism Survey, where respondents increasingly report that their "single most important problem" is a lack of qualified workers.
- Wage growth has been sluggish, but with labor shortages becoming more widespread, wage growth will accelerate in 2018 as businesses try to attract and retain workers.

Source: Haver Analytics, Guggenheim Investments. Data as of 11.30.2017. *Note: Represents percent of respondents citing labor quality as the single most important problem.

Core Inflation Will Rise Modestly as the Economy Strengthens

Real Final Sales to Private Domestic Purchasers and Core Consumer Price Index (CPI)

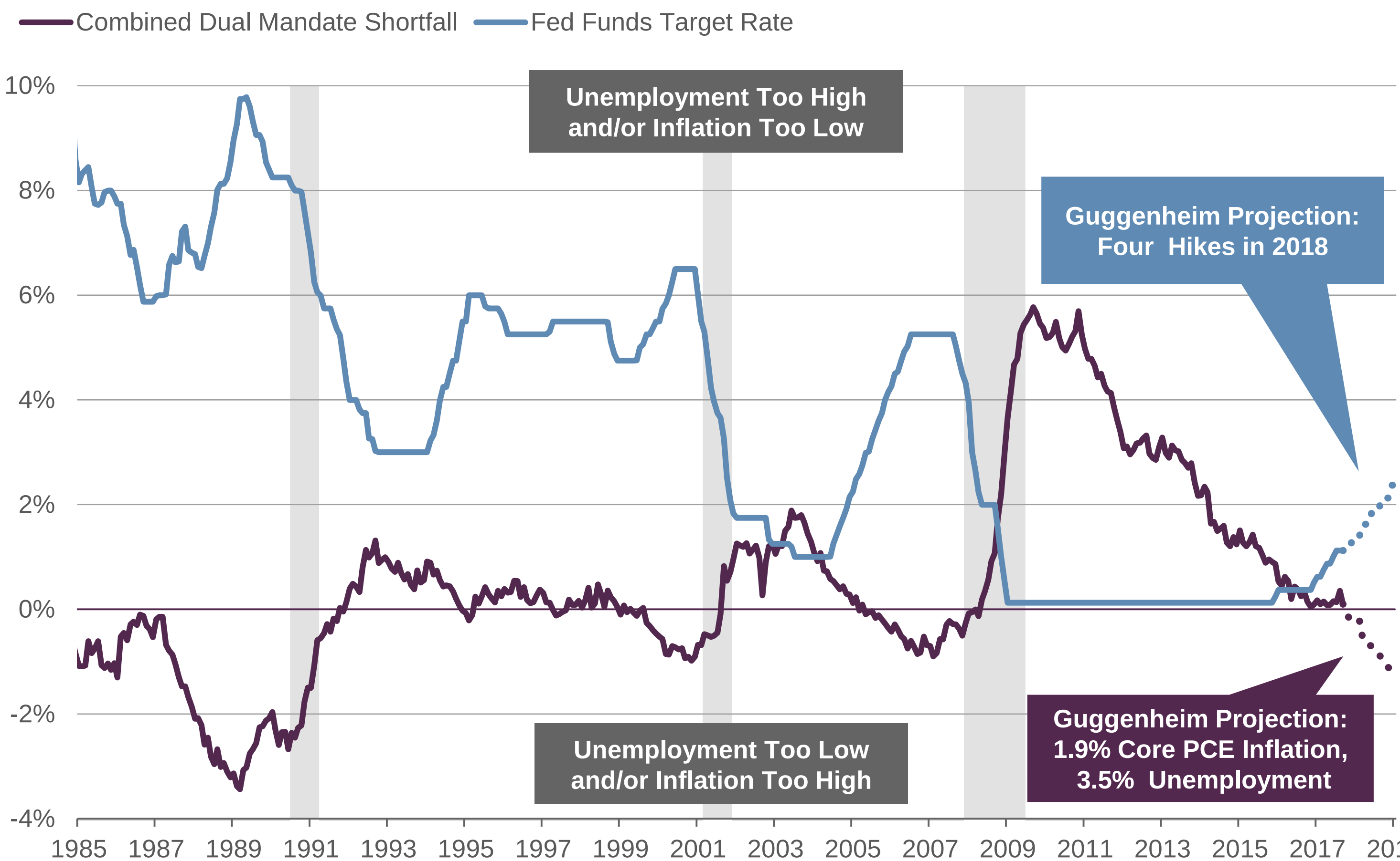


- One of the most surprising macro developments in 2017 was the drop in U.S. core inflation, with core CPI falling from 2.3 percent year-over-year in January to 1.7 percent in November.
- However, inflation is a lagging indicator. The drop in 2017 partly reflects the growth slowdown that occurred in late 2015/early 2016, as core inflation has historically lagged private sector domestic economic activity by six quarters.
- Growth rebounded in 2017, and we expect that it will accelerate further in 2018. As such, core inflation should return close to the Fed's 2 percent target by the end of 2018.

Source: Haver Analytics, Guggenheim Investments. Data as of 9.30.2017.

The Fed Will Hike Four Times as it Overshoots its Employment Mandate

Dual Mandate Shortfall and Federal Funds Target Rate

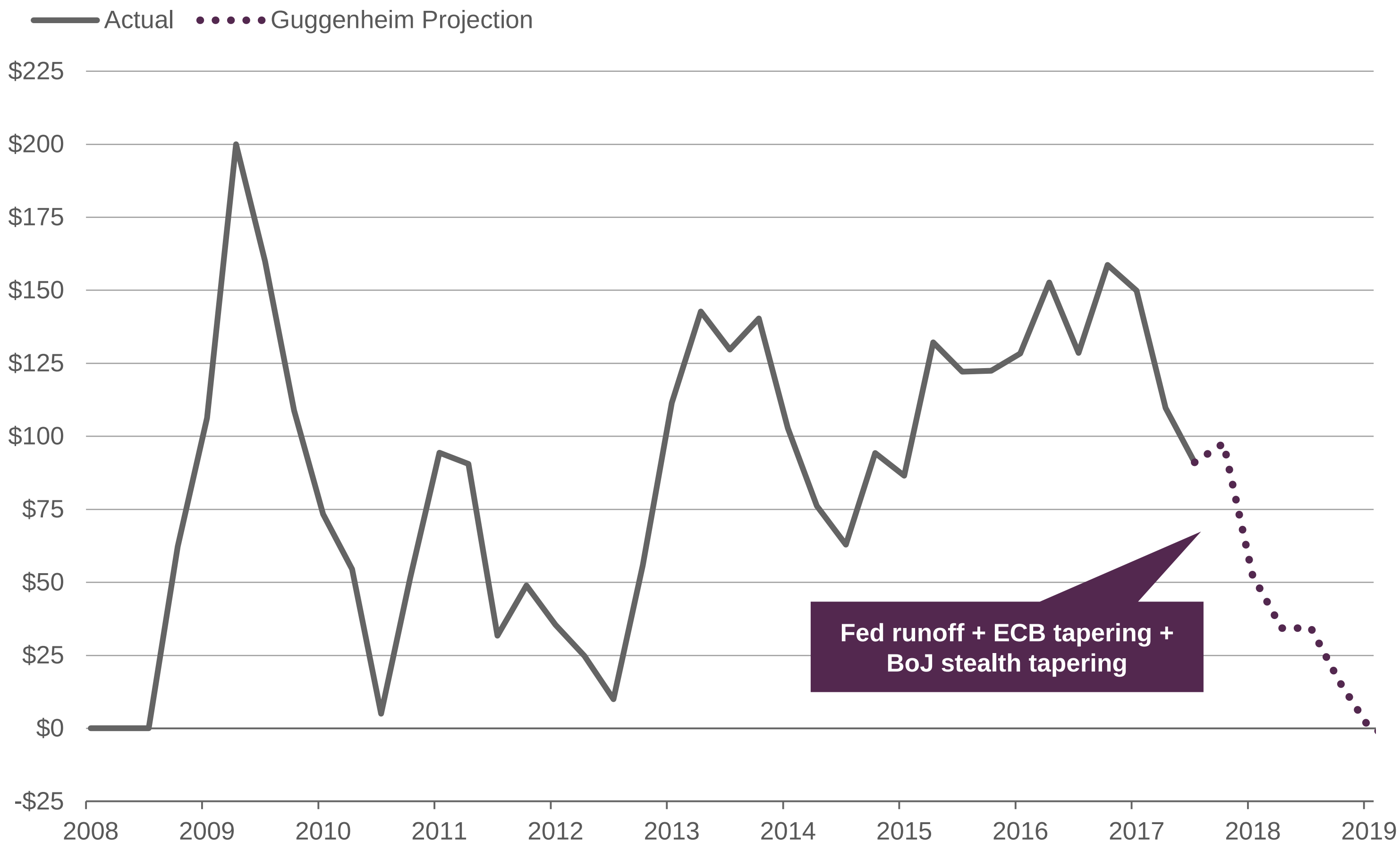


- Markets are pricing in about two Fed rate hikes in 2018, while the FOMC currently projects three.
- We expect four hikes in 2018 as inflation rises toward the Fed's 2 percent goal and the unemployment rate falls further below the Fed's definition of full employment (4.6 percent).
- Moreover, financial conditions remain highly accommodative, giving the Fed further room to raise rates, and fiscal stimulus will likely give the economy an additional boost.
- In keeping with historical precedent, the Fed will steadily tighten in order to cool the overheating economy and avoid a spike in wage or price inflation.

Source: Haver Analytics, Congressional Budget Office, Guggenheim Investments. Data as of 11.30.2017. Combined dual mandate shortfall adds the deviation of core personal consumption expenditures (PCE) inflation from the Fed's 2 percent objective and the deviation of the unemployment rate from the CBO's estimate of the natural rate of unemployment. Positive values indicate that unemployment is too high and/or inflation is too low; negative values indicate that unemployment is too low and/or inflation is too high.

Central Banks Will Steadily Turn Off the Liquidity Taps

Net Monthly Central Bank Purchases of Securities ($billions)
(Includes Fed, European Central Bank, Bank of Japan, and Bank of England)

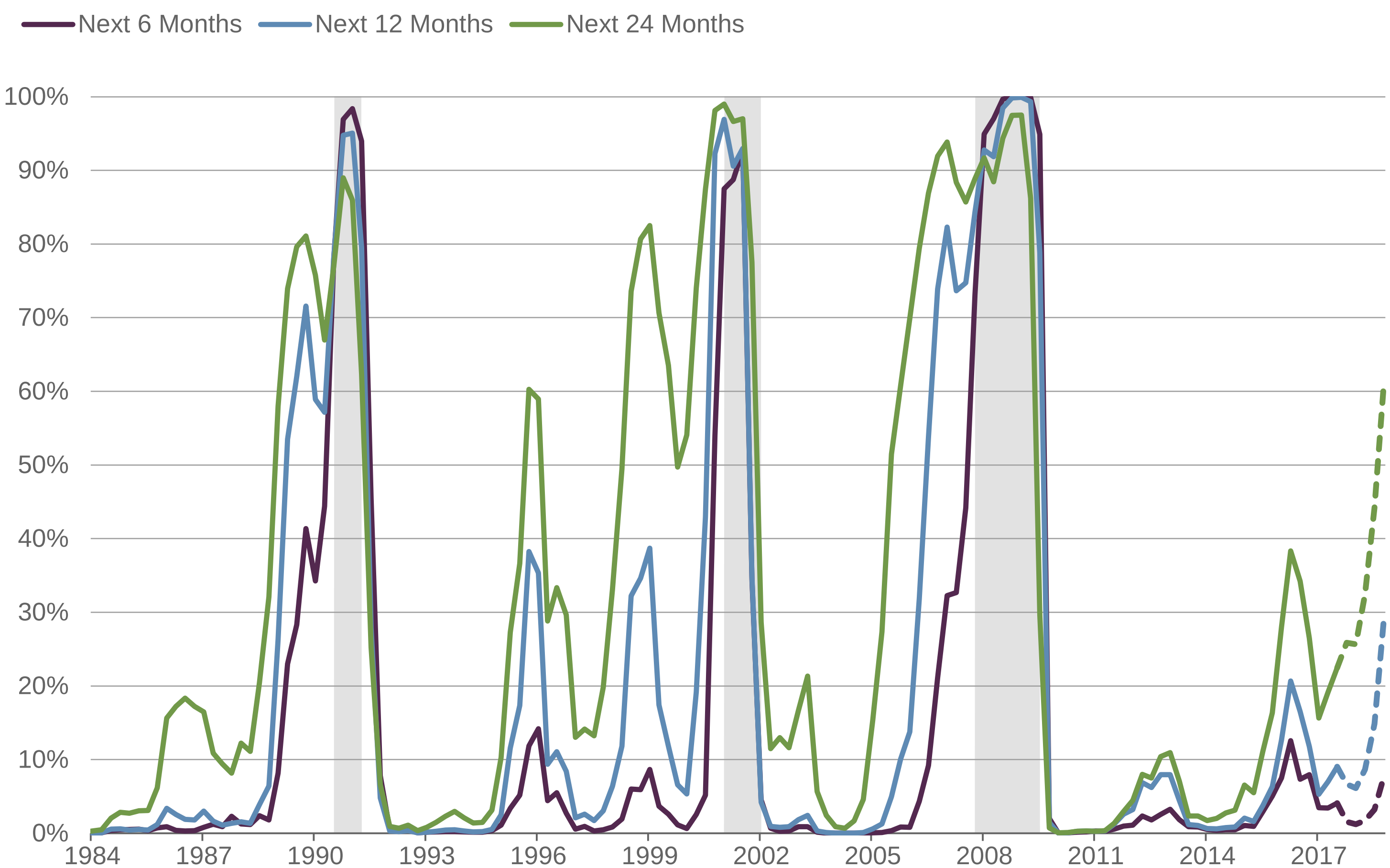


- In 2018, some central banks will ramp down asset purchases while others allow holdings to run off.
- This dynamic will result in the withdrawal of a significant bid in fixed-income markets, with secondary effects spilling over into other asset classes.
- For the Fed, during all of 2018 about $380 billion will run off.
- The ECB will reduce monthly purchases from €60 billion to €30 billion ($74 billion to $34 billion) in January until September 2018, and will probably wind down QE by the end of 2018.
- The BoJ has been “stealth tapering” its target purchases of ¥80 trillion per year, or $60 billion per month, but has recently bought as little as $35 billion per month as it focuses on the 0 percent 10-year yield target.
- The BoE will continue to maintain the size of its holdings.

Source: Guggenheim Investments, Haver Analytics, Federal Reserve Bank of New York. Data as of 9.30.2017. Note: Assumes constant exchange rates. Quarterly averages of monthly figures.

Recession Risk Will Grow as Fed Policy Becomes Restrictive

Model-Based Recession Probability

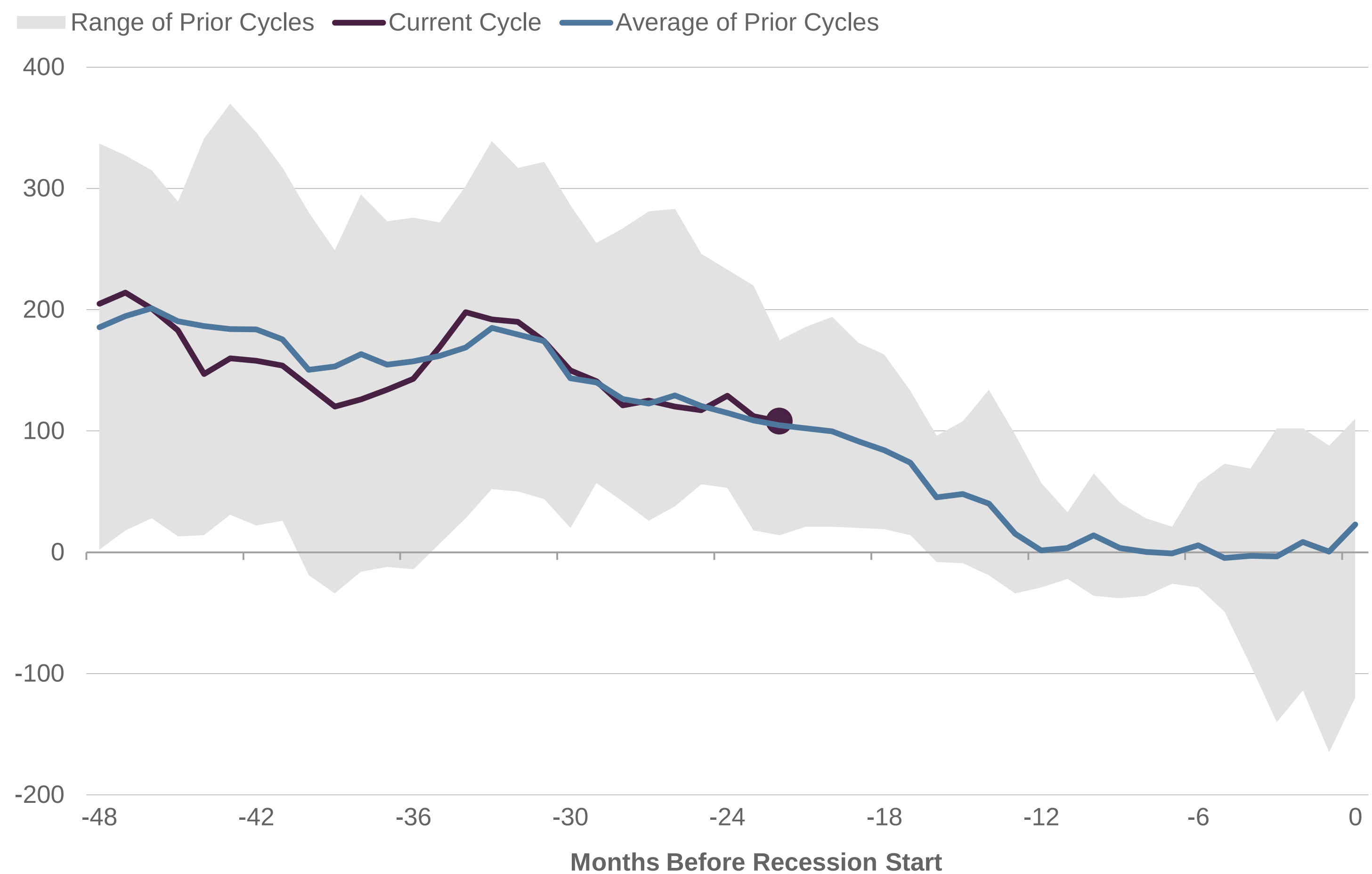


- While our 2018 economic outlook is positive, we are heading into the late stages of the business cycle.
- Seeing an overheating labor market and rising inflation, the Fed will raise rates into restrictive territory, leading to an eventual recession.
- Our Recession Probability Model, which integrates several cyclical indicators, would have successfully signaled each recession going back to 1960.
- We expect that by the end of 2018 our model will signal a 30 percent probability of a recession in the next 12 months and a 60 percent probability within the next 24 months.
- By the end of 2018 investors should be positioned more defensively, as downside risks for equity and credit markets will grow in 2019.

Hypothetical Illustration. The Recession Probability Model is a new model with no prior history of forecasting recessions. Actual results may vary significantly from the results shown.
Source: Haver Analytics, Bloomberg, Guggenheim Investments. Data as of 9.30.2017. Shaded areas represent periods of recession.

The Yield Curve Will Flatten as the Fed Keeps Hiking

3 Month – 10 Year Treasury Yield Curve (basis points) Leading up to a Recession in Five Comparable Prior Cycles

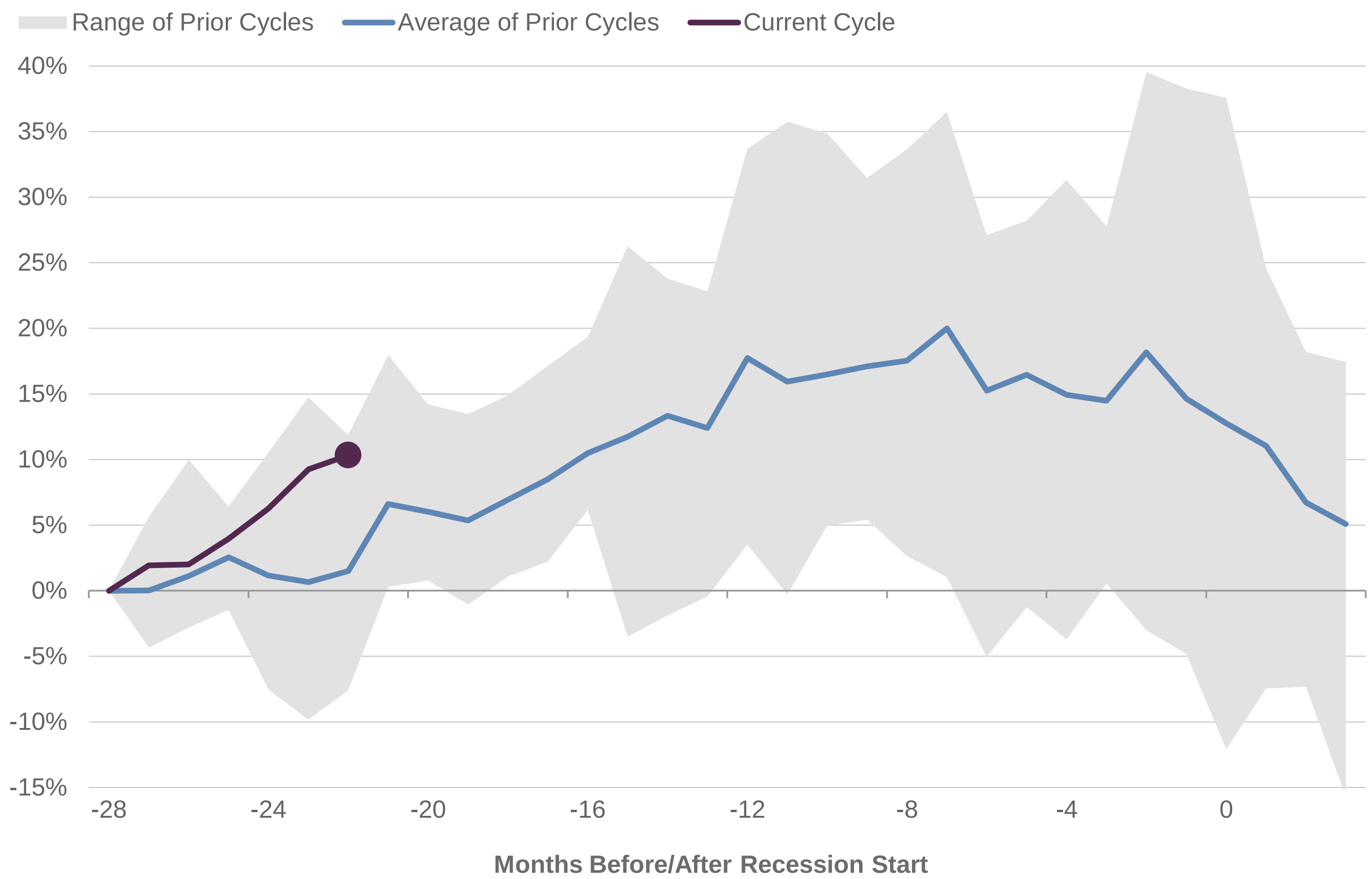


- As the Fed raises interest rates, we expect yields at the short and intermediate sectors of the Treasury curve to rise.
- At the same time, the market will recognize signs of an aging business cycle, which will help to limit increases in 10–30 year yields.
- The result will be a continued flattening of the yield curve, which has historically been a reliable indicator of recession risk.
- Having observed similar yield curve behavior in past tightening cycles, our analysis shows that the current slope of the yield curve is consistent with periods when only 22 months remained until the onset of a recession.

Source: Haver Analytics, Guggenheim Investments. Data as of 12.31.2017. Includes cycles ending in 1970, 1980, 1990, 2001, and 2007. One basis point = 0.01 percent.

Stocks Will Rise Despite an Aging Business Cycle

S&P 500 Index, Cumulative Percentage Change Leading up to a Recession in Five Comparable Prior Cycles

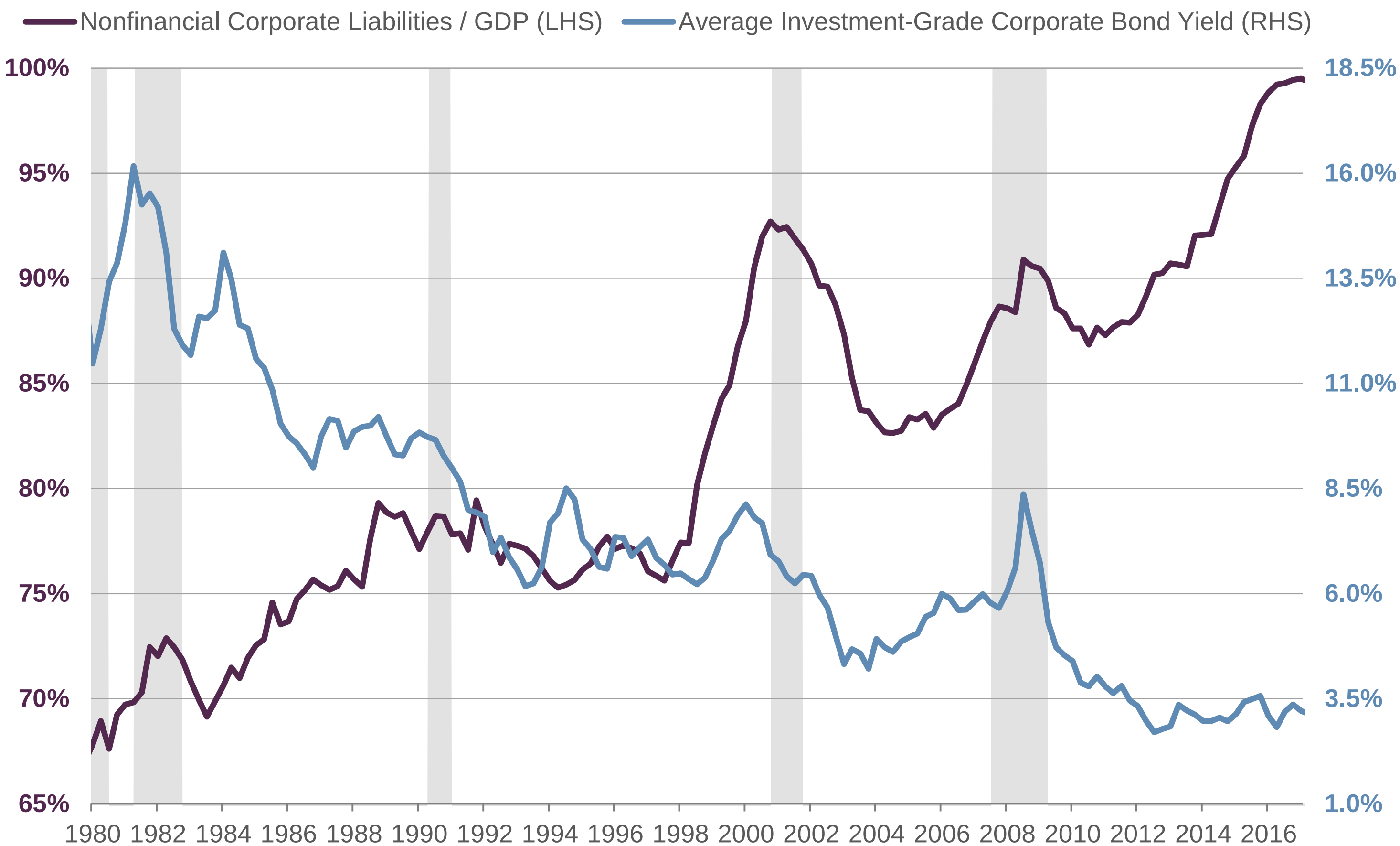


- Our analysis indicates that the next recession will occur around the end of 2019, but history suggests that there is plenty of upside remaining in equities.
- Historically, the S&P 500 has rallied by 16 percent, on average, in the penultimate year before the recession.
- This suggests that the S&P 500 will make new highs in 2018 before turning lower in 2019.

Source: Haver Analytics, Guggenheim Investments. Data as of 12.31.2017. Includes cycles ending in 1970, 1980, 1990, 2001, and 2007. **Past performance does not guarantee future results.**

Record Corporate Debt Levels Will Come into Focus

Ratio of U.S. Nonfinancial Corporate Liabilities to GDP and Average Investment-Grade Corporate Bond Yield



- Although we expect stocks to perform well in 2018, attention will increasingly turn to growing credit risks.
- The ratio of U.S. nonfinancial corporate liabilities to GDP is nearing 100 percent, well above the previous record of 93 percent in 2001.
- This increase in corporate indebtedness has been fueled by a secular decline in corporate borrowing costs.
- Given current tight credit spreads, we believe investors are not being adequately compensated for the buildup in credit risk that will be exposed during the next recession.
- Investors should begin to upgrade the credit quality of their fixed income portfolios now despite the next recession being two years away.

Source: Haver Analytics, Guggenheim Investments. Data as of 9.30.2017. Corporate bond yields are based on Bloomberg Barclays Investment-Grade Corporate Bond Index, and are smoothed based on a three-month average of monthly data before December 1989, and a three-month average of daily data from December 1989 through current.

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[2]Guggenheim Partners' assets under management are as of 9.30.2017 and include consulting services for clients whose assets are valued at approximately $63bn.

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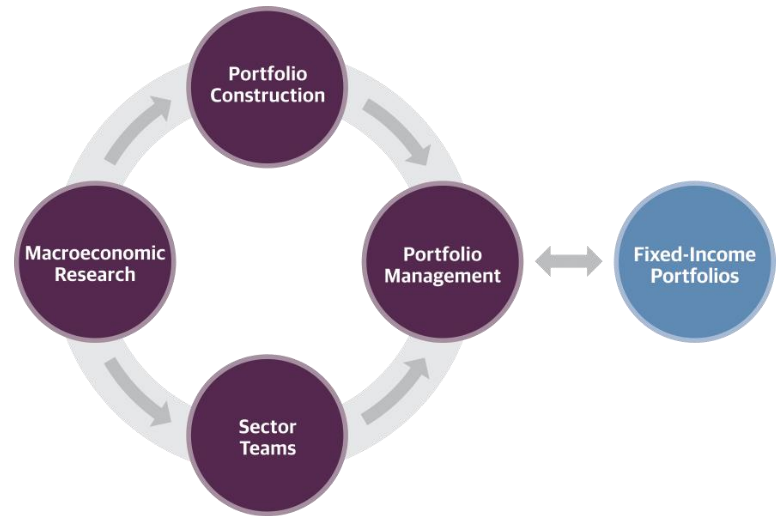

Guggenheim Investments

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Guggenheim Partners

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