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Guggenheim Investments

10 Macro Themes for 2023

February 2023

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10 Macro Themes for 2023

This collection of charts presents 10 of the macroeconomic trends we believe are most likely to shape the investment environment in 2023.

1. Inflation Will Fall More than the Fed Expects
2. The Unemployment Rate Will Rise from Historically Low Levels
3. A Recession Will Start Around the Middle of 2023
4. Strong Credit Fundamentals Will Limit Spread Widening
5. Attractive Yields Will Drive Fixed-Income Returns
6. High-Quality Fixed Income Will Outperform Equities
7. Bonds Will Again Provide Diversification as Fed Wins the Inflation Battle
8. Structural Housing Supply Shortage Will Limit Downside to Home Prices
9. China Reopening Will Boost Energy Demand
10. Divided Government and Narrow Majorities Will Spur Debt Limit Drama

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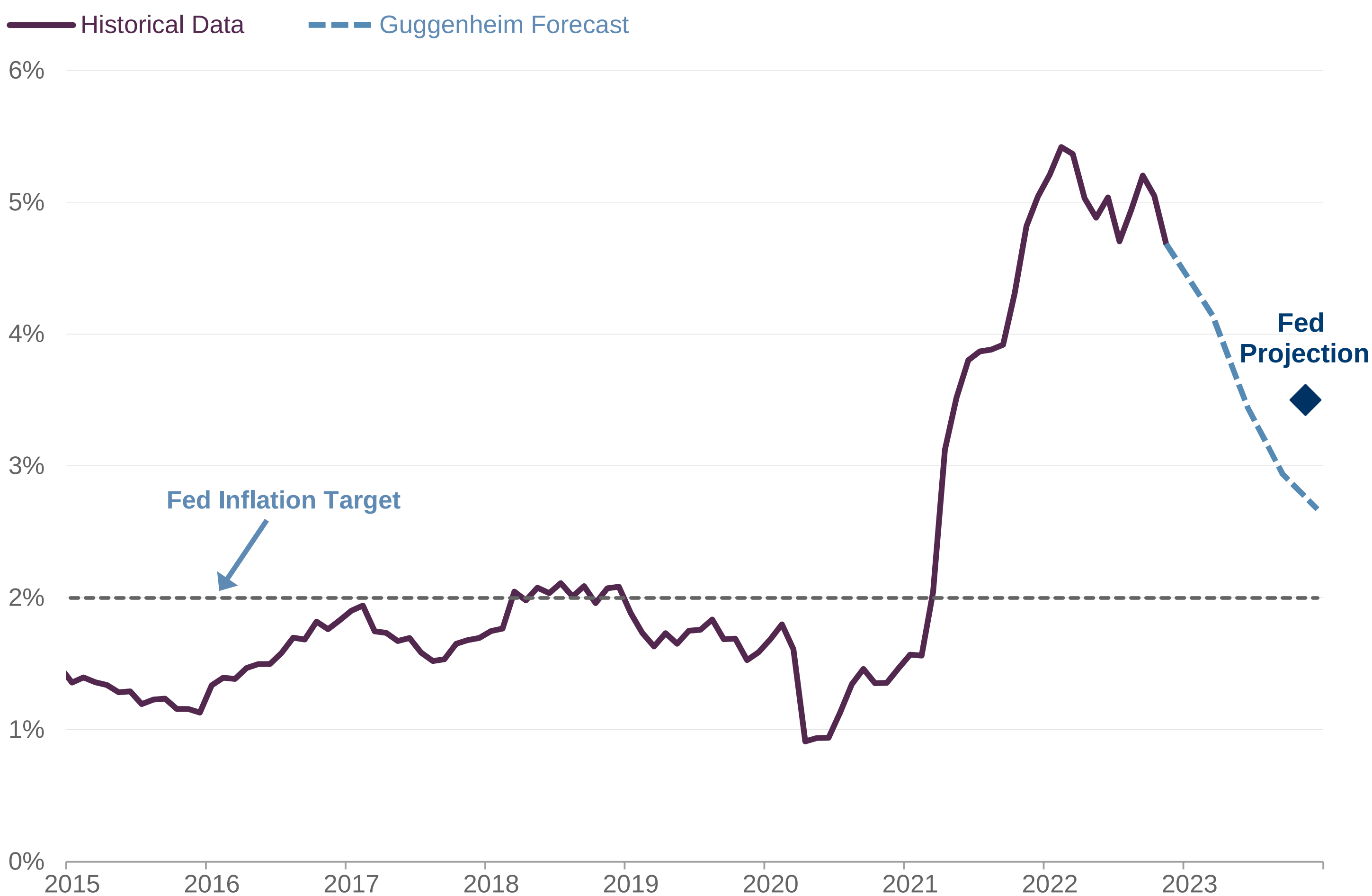
Inflation Will Fall More Than the Fed Expects

Core PCE Price Index, YoY% Change

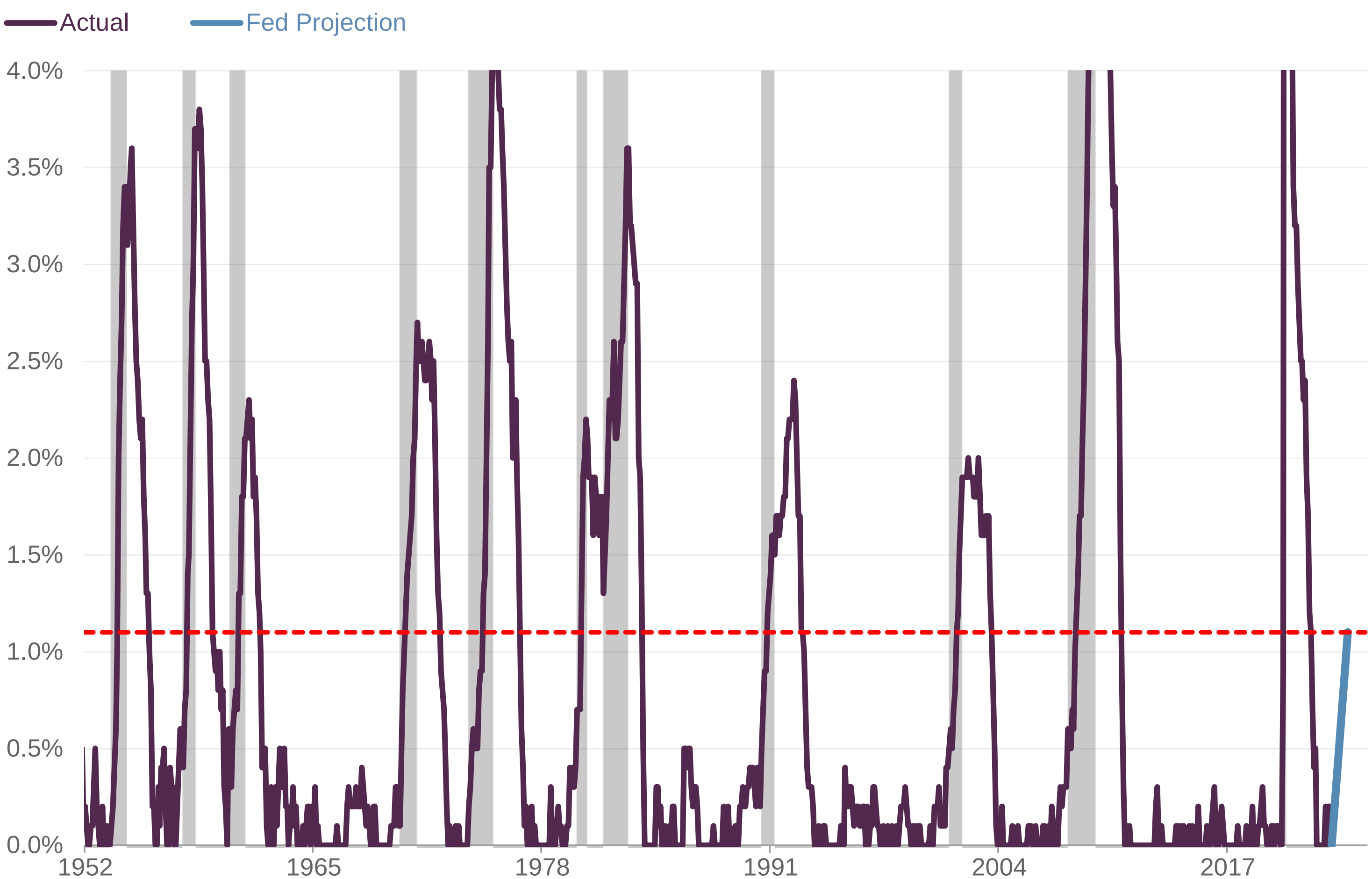


- U.S. inflation is set to fall sharply in 2023, with many of the factors that drove inflation higher now reversing.
- Goods prices are already falling, and supply chain improvements suggest more declines are ahead. Timely alternative measures of rent, the largest contributor to current inflation, suggest the official data will slow substantially later this year.
- Services inflation ex-housing will come down as pent-up demand from the pandemic fades and wage growth normalizes in a cooling labor market.
- We expect core PCE inflation will come in under 3 percent, well below the 3.5 percent the Fed expects.

Source: Guggenheim Investments, Haver Analytics. Data as of 11.30.2022.

The Unemployment Rate Will Rise from Historically Low Levels

Unemployment Rate: Increase from Trailing 2-Year Low

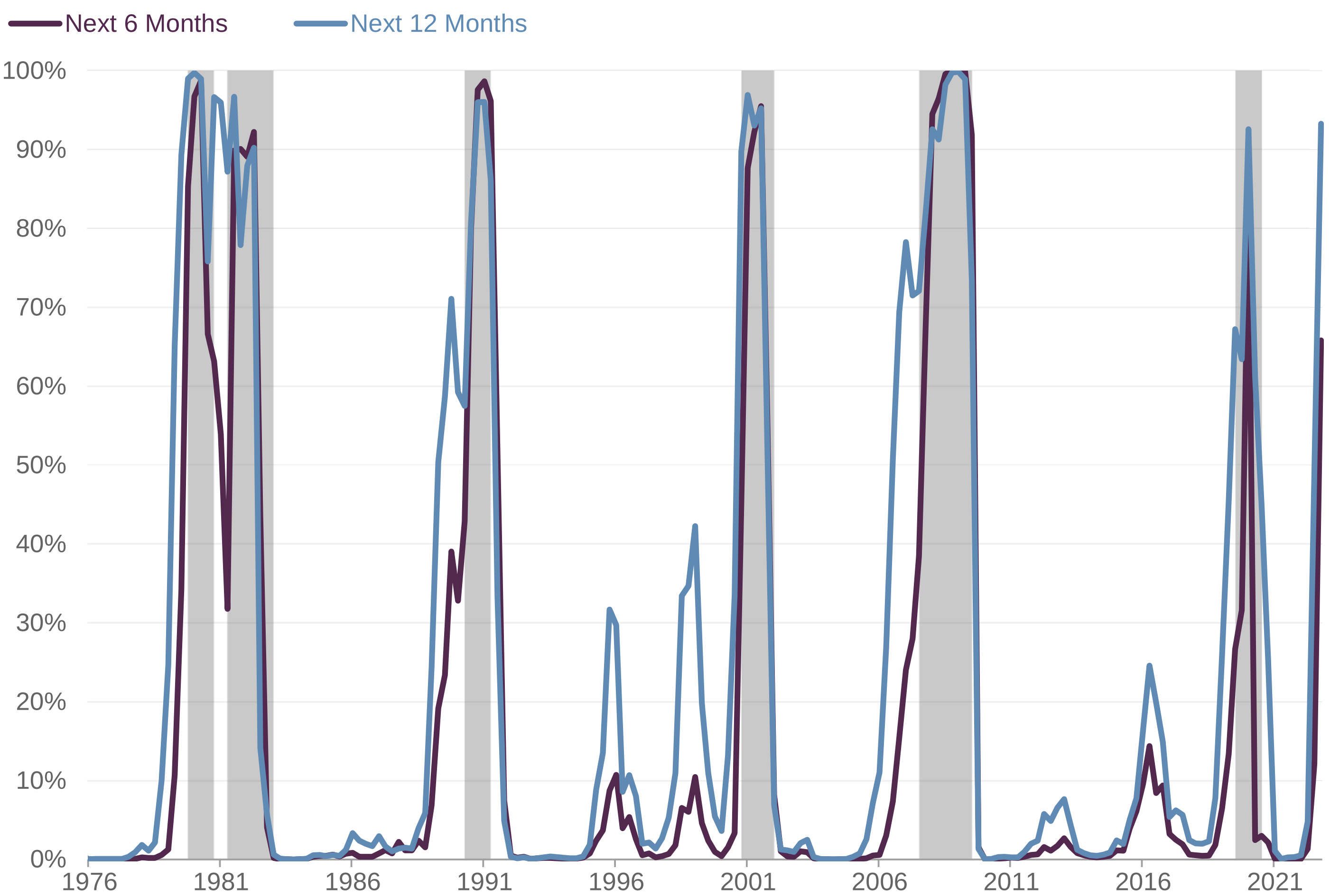


- Fed communication has made it clear that reported inflation must not only come down, but it must stay contained over the medium term. To be confident that will happen, the Fed needs to see a weaker labor market to keep wage pressures in check.
- The Fed's unemployment projections have been steadily rising, and officials now expect to see more than a 1 percentage point rise in the unemployment rate.
- The lagged effect of recent Fed tightening may be enough to cause higher unemployment (several leading indicators that we track support this view), but if not the Fed will continue to hike until it sees a weaker labor market.

Source: Guggenheim Investments, Haver Analytics, Federal Reserve. Data as of 12.31.2022. Shaded areas represent recession. Red line shows the magnitude of the unemployment rate increase the Fed is projecting this year, which historically has only occurred in recessionary periods.

A Recession Will Start Around the Middle of 2023

Guggenheim Model-Based U.S. Recession Probability

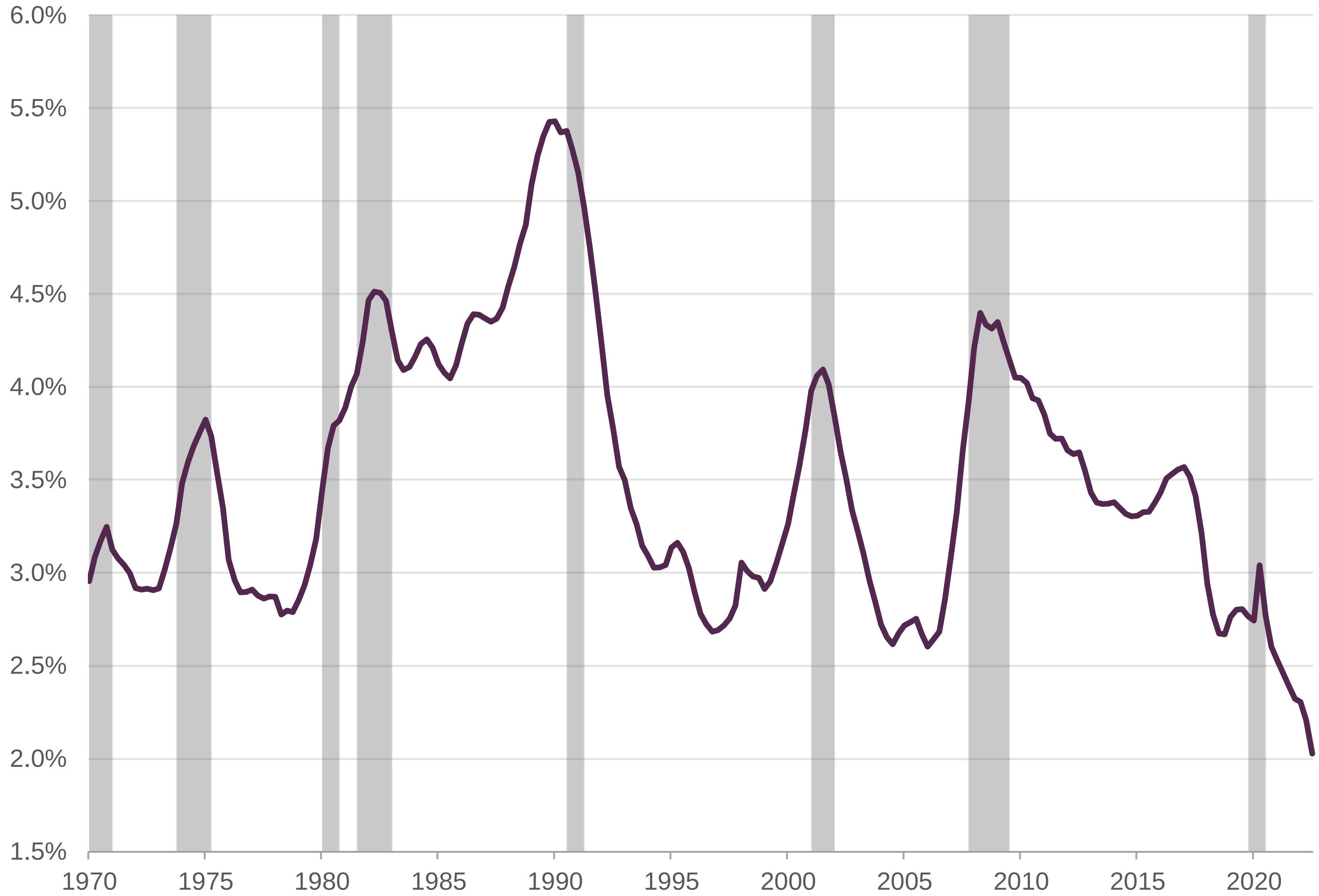


- Our recession forecasting tools suggest that a recession will likely start around the middle of 2023.
- An increase in the unemployment rate of the size the Fed is envisioning has always been associated with a recession.
- Among other signs, an inverted yield curve and a falling Leading Economic Index are clear warnings of an impending economic downturn.
- We do not expect an overly severe recession. The economy does not appear to have major imbalances that would amplify a recession, and household and corporate balance sheets are in good shape in aggregate, which should help cushion the downturn.

Source: Guggenheim Partners, Haver Analytics, Bloomberg. Data as of 12.31.2022. Hypothetical Illustration. Actual results may vary significantly from the results shown.
Shaded areas represent recession.

Strong Credit Fundamentals Will Limit Spread Widening

U.S. Nonfinancial Corporate Net Interest Payments as a Share of Corporate Output

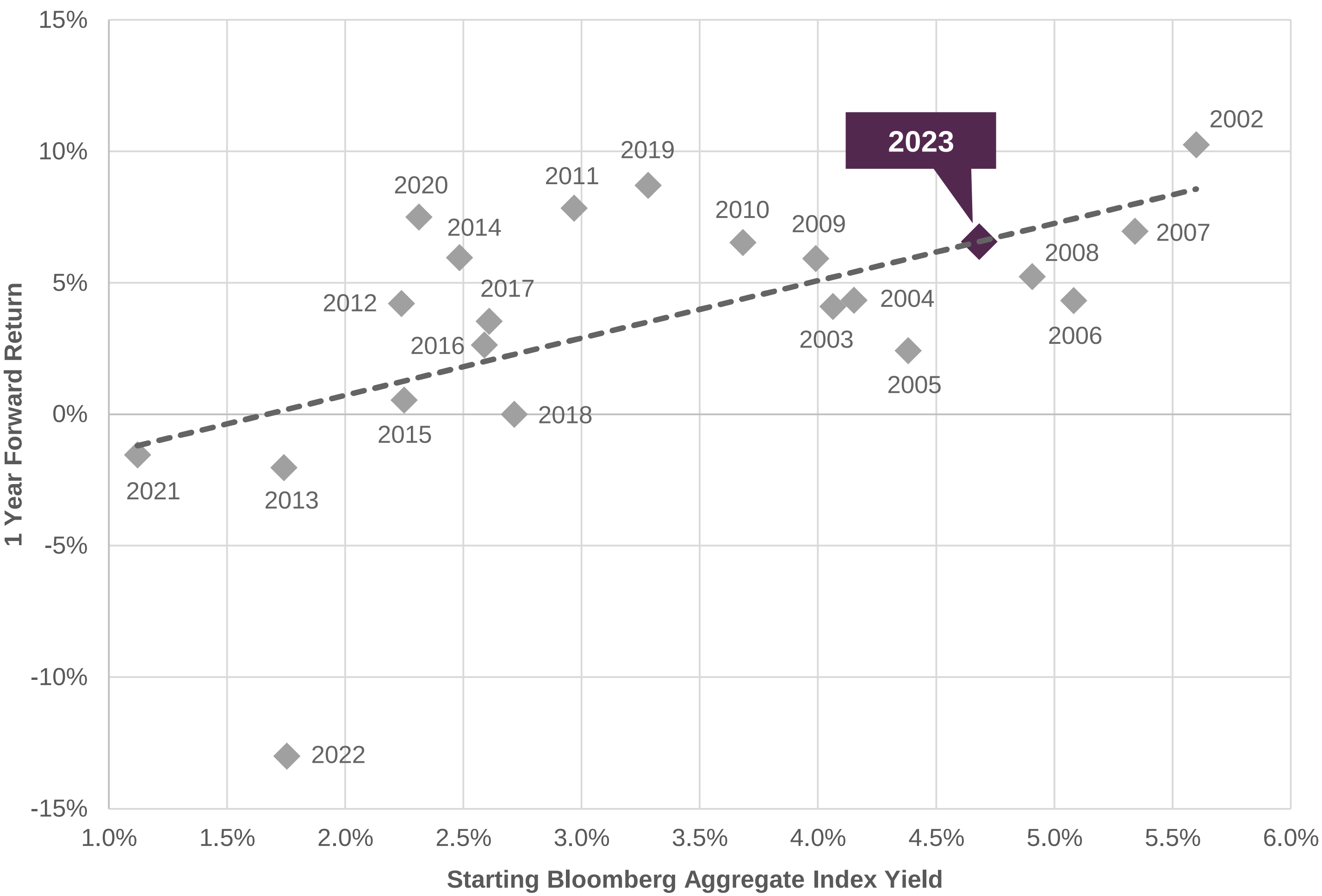


- In 2020 and 2021, U.S companies issued record volumes of debt in an effort to improve balance sheet liquidity and lock in extremely low borrowing rates for years to come.
- Subsequently, the strong pace of nominal economic growth drove robust corporate output and revenue growth.
- As a result, interest expense for U.S. nonfinancial corporates stands at just 2.0 percent of output, the lowest since the 1960s.
- These dynamics should result in more manageable interest expense levels even in a possible earnings recession, which should limit spread widening relative to prior cycles.

Source: Guggenheim Investments, Haver Analytics. Data as of 9.30.2022. Note: Gross Value Added (GVA) used to measure corporate output. Shaded areas represent recession.

Attractive Yields Will Drive Fixed-Income Returns

Bloomberg U.S. Aggregate Bond Index Yield and 1-year Forward Return



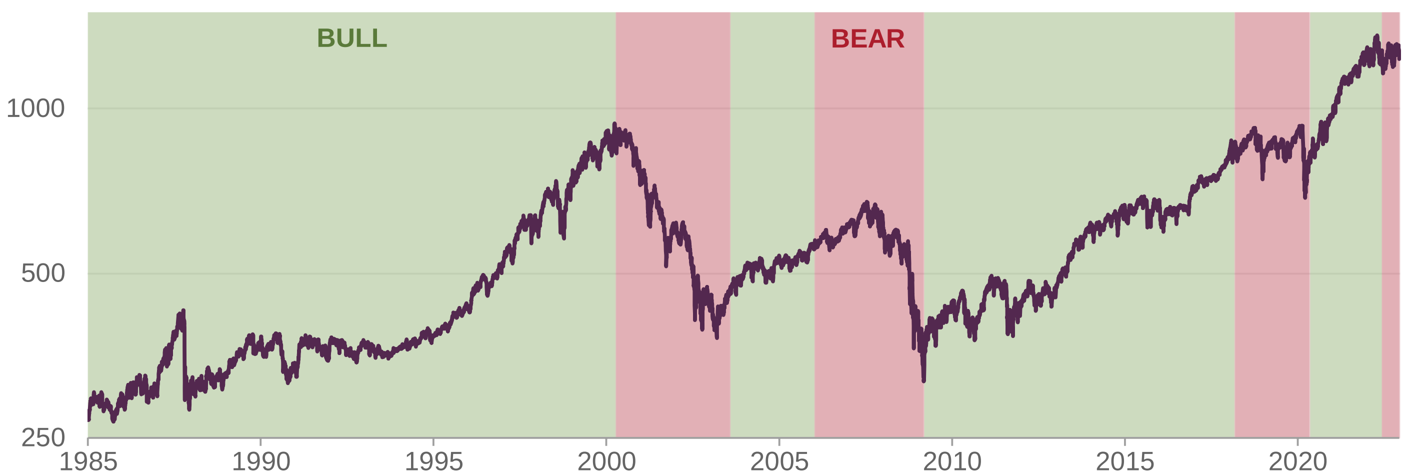
- The Fed's aggressive tightening cycle drove a painful resetting of bond yields in 2022, but the upshot is that the central bank has put "income" back in fixed-income, thereby improving its return prospects.
- Based on the yield of the Bloomberg U.S. Aggregate Bond Index (the Agg) at the start of 2023, history would suggest that this year's total return profile for bonds is at its most attractive since 2008.
- The historical relationship between annual returns and starting yields on the Agg would suggest a total return of nearly 6 percent for 2023 in our view.
- A recession could boost returns further if an investor flight to safety drives bond yields lower.

Source: Guggenheim Investments, Bloomberg. Data as of 12.31.2022. Past performance does not guarantee future returns.

High-Quality Fixed Income Will Outperform Equities

Guggenheim Bull/Bear Market Indicator

S&P 500 Relative to Bloomberg U.S. Investment-Grade Corporate Bond Index (Log Scale)

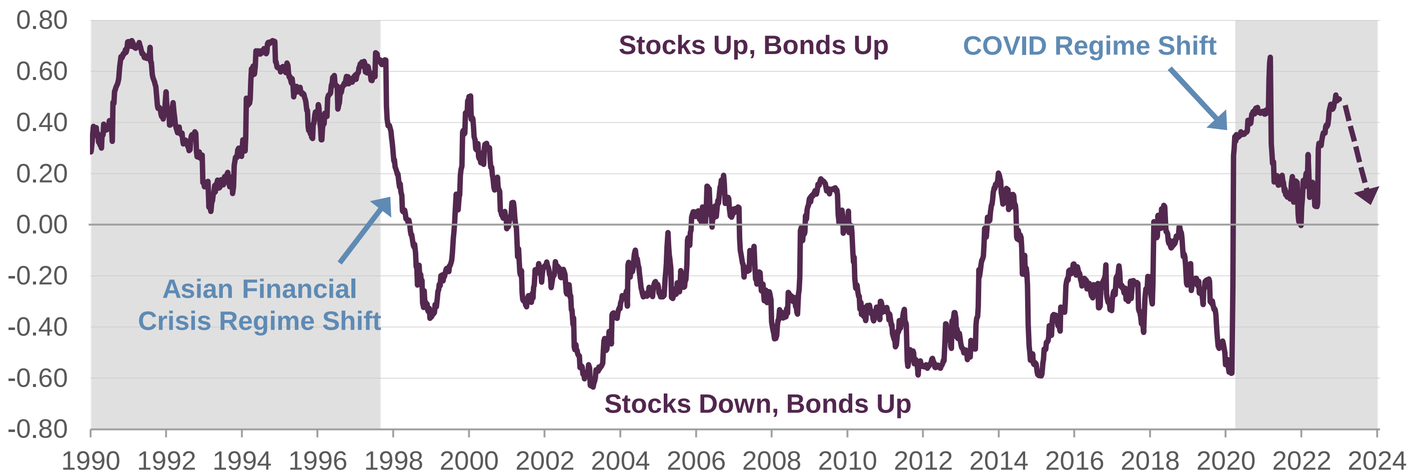


- Our internal models based on economic and market indicators have flipped to a risk-off asset allocation regime, where safer assets such as high-quality corporate bonds are expected to outperform riskier assets such as equities.
- Past “bear” regimes have seen outperformance of bonds relative to stocks.
- Our analysis suggests we should remain in this bond-favorable environment throughout 2023.

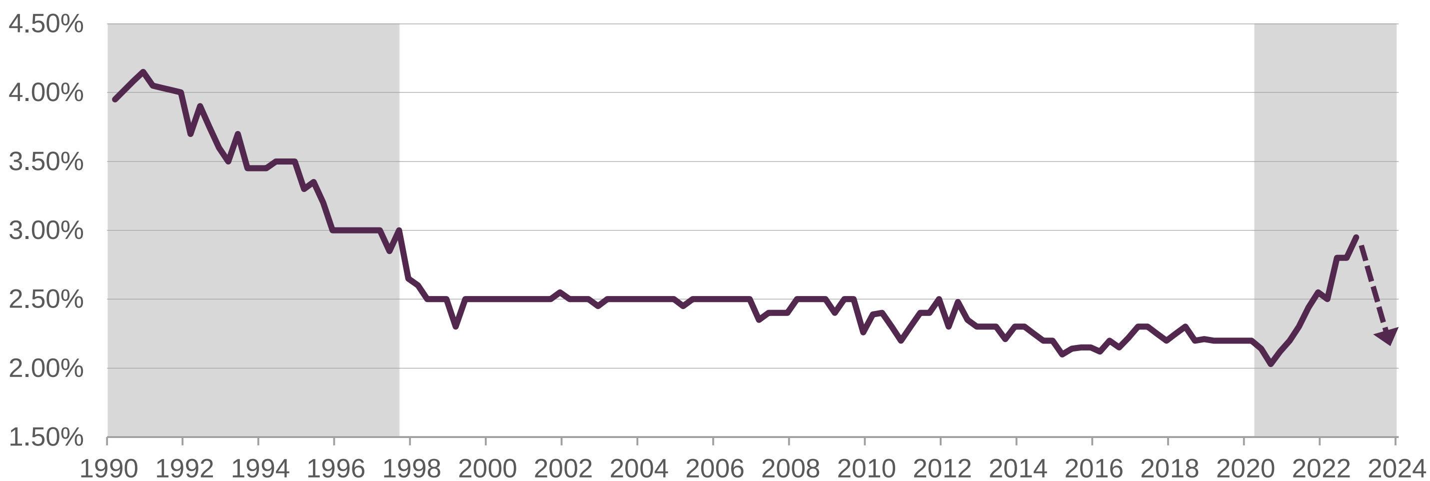
Source: Guggenheim Investments, Haver Analytics, Bloomberg. Data as of 12.7.2022. Past performance does not guarantee future returns.

Bonds Will Again Provide Diversification as Fed Wins the Inflation Battle

Rolling 52-Week Correlation Between the S&P 500 and the Bloomberg U.S. Aggregate Bond Index



Median Economist Forecast of Consumer Price Index Inflation Over the Next 10 Years

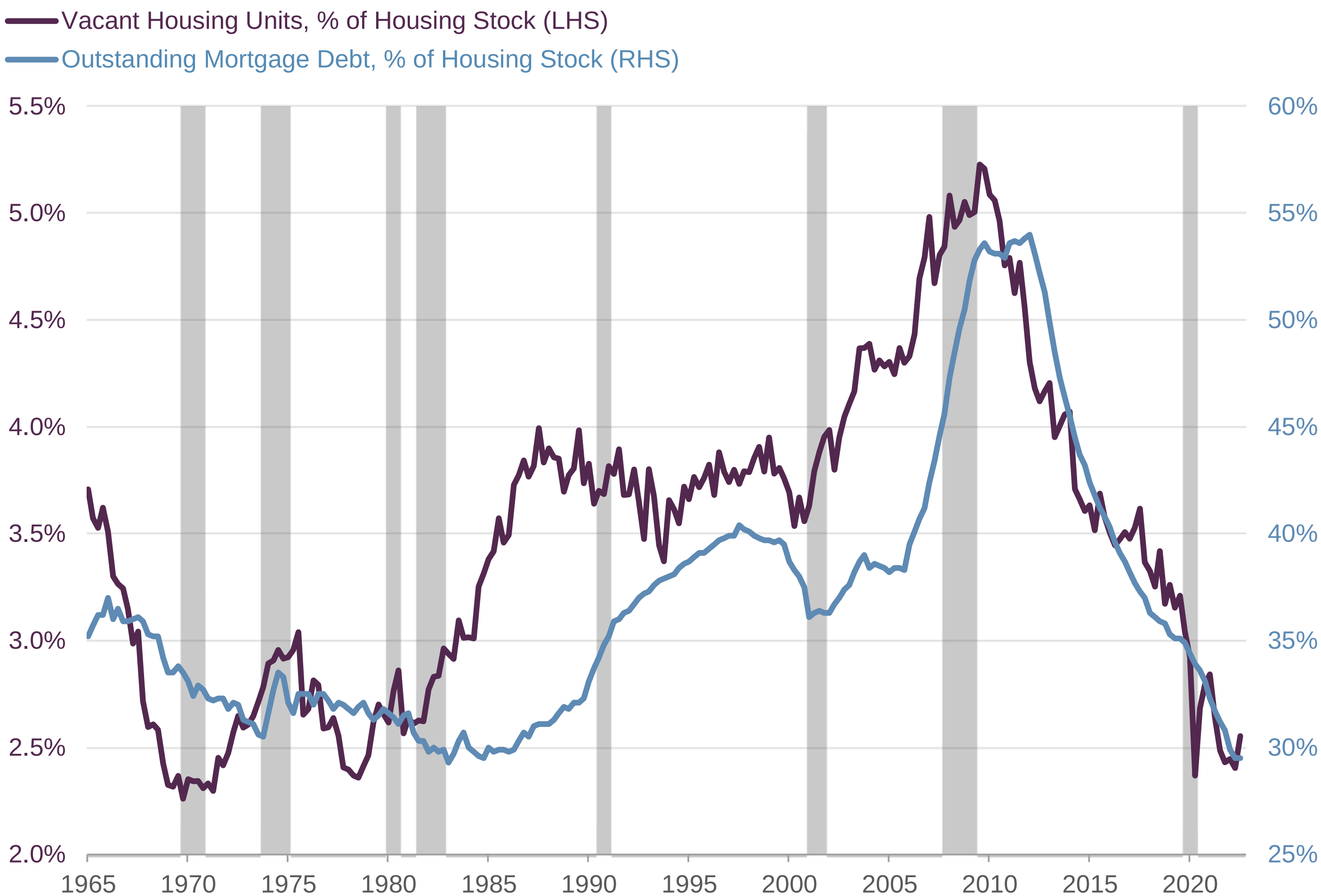


- Fixed-income assets are often used to provide income and diversification within a multi-asset portfolio. The lower the correlation with equities, the greater the potential diversification benefits.
- Prior to the late-1990s, stocks and bonds were positively correlated, in part due to high expected inflation and inflation uncertainty.
- After more than 20 years in which low inflation supported a negative correlation, the return of high inflation following the COVID pandemic flipped the correlation positive again.
- With inflation, as well as inflation expectations, likely to fall as a recession begins, we expect the correlation to once again turn negative.
- Negative correlation will add to the appeal of core fixed income.

Source: Guggenheim Investments, Bloomberg, Federal Reserve Bank of Philadelphia. Data as of 1.6.2023. Shading denotes positive-correlation regimes. Past performance does not guarantee future returns.

Structural Housing Supply Shortage Will Limit Downside to Home Prices

Housing Vacancy Rate vs. Aggregate Loan-to-Value Ratio

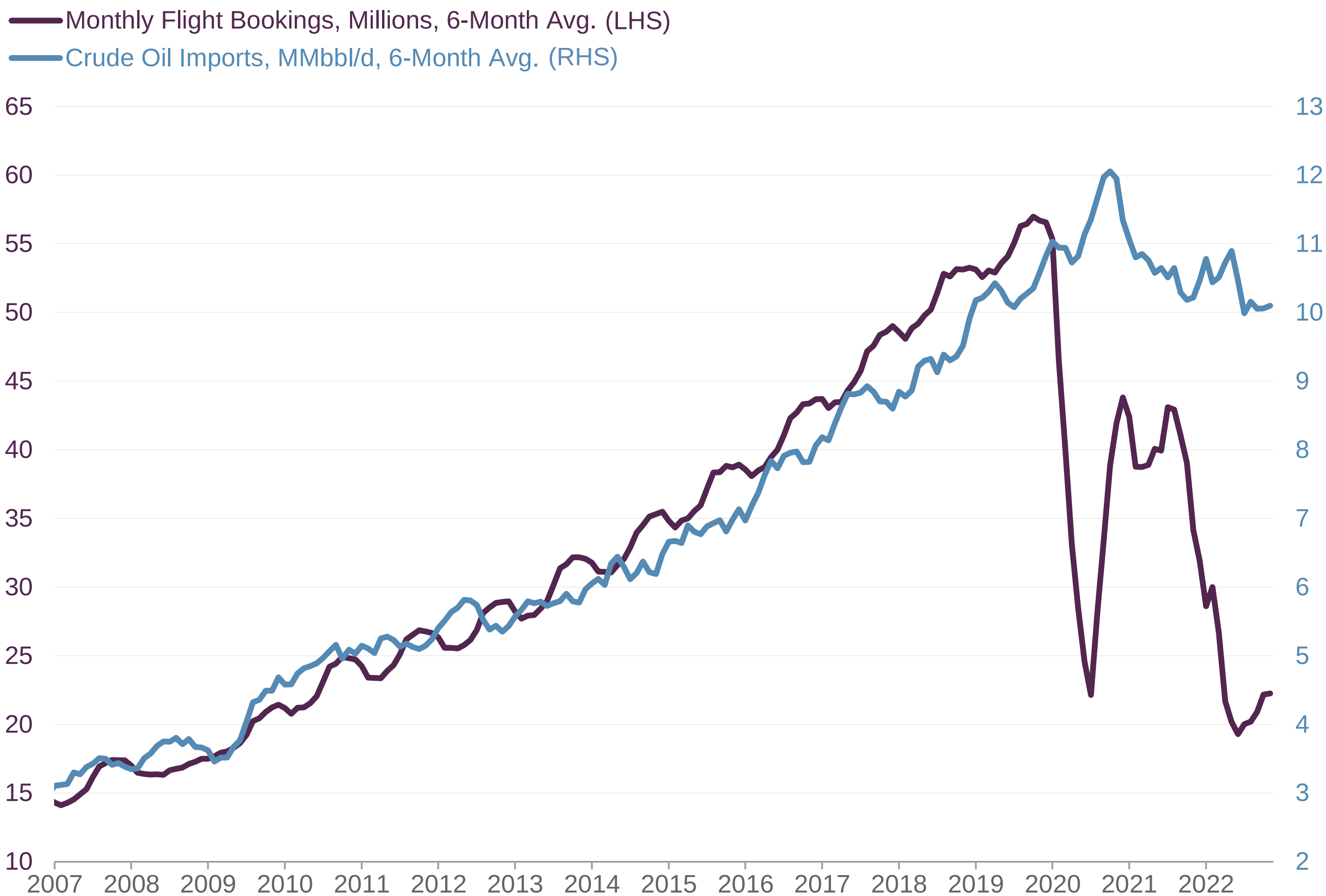


- After surging in 2020 and 2021, home prices have been declining in recent months as the jump in mortgage rates has weighed heavily on demand.
- These declines have sparked fears of a deep downturn in home prices, reminiscent of the 2007–2012 experience.
- We see these fears as overblown, as housing market fundamentals are very different than the last time home prices fell.
- Most importantly, housing supply remains near decades-low levels due to a long period of underbuilding, with high mortgage rates also deterring would-be sellers.
- In addition, deleveraging over the past decade will prevent any significant forced selling. This tight supply environment should keep home price declines contained in 2023.

Source: Guggenheim Investments, Haver Analytics. Data as of 9.30.2022. Note: vacancy rate includes homes for rent and for sale. Excludes seasonal rental properties. Shaded areas represent recession.

China Reopening Will Boost Energy Demand

China Flight Bookings and Crude Oil Imports

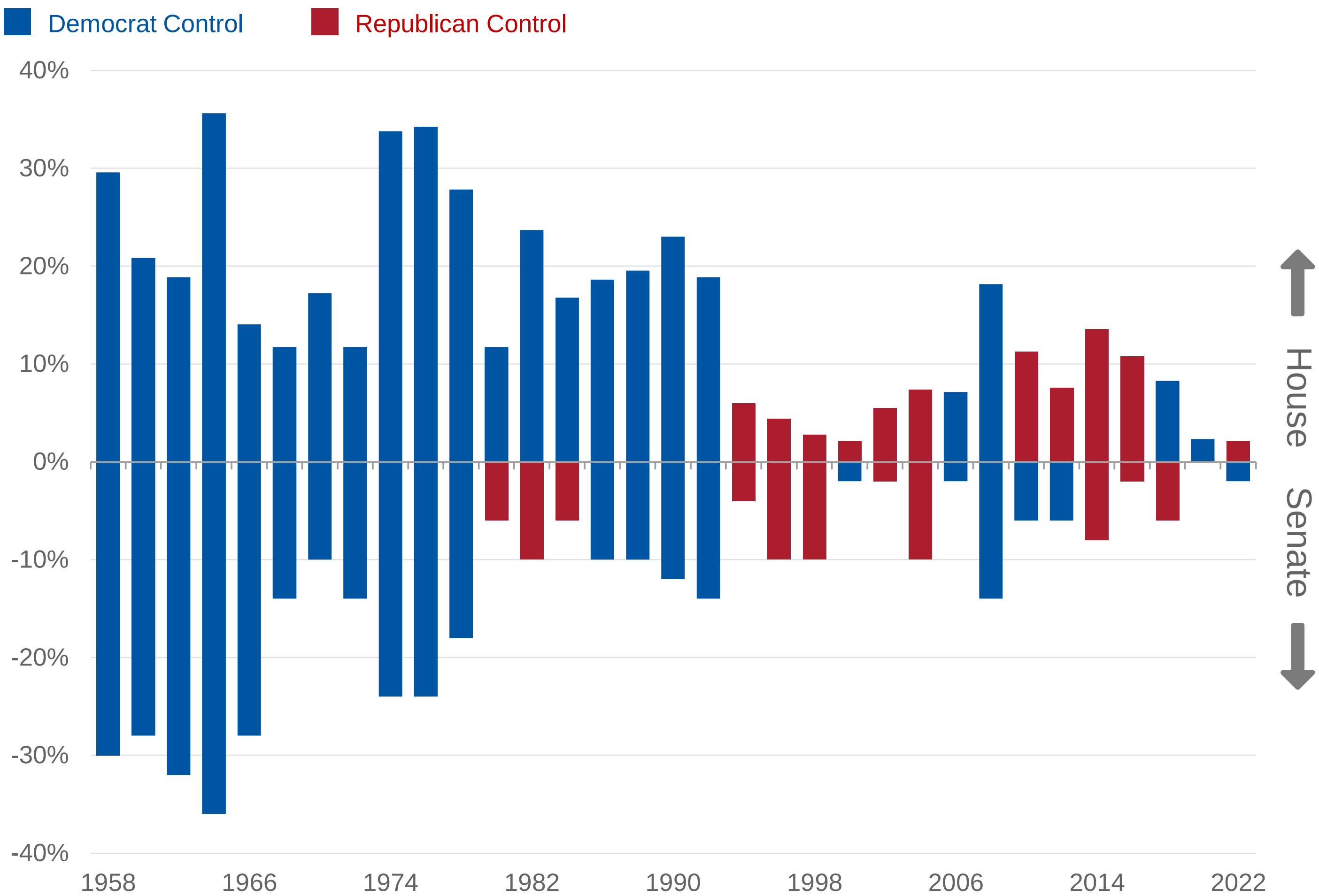


- China's sharp reversal of its zero COVID policy will boost mobility, in turn lifting energy demand in China and across Asia and supporting oil prices amid a U.S. recession.
- The removal of COVID restrictions—plus Beijing's ending the crackdown on real estate and internet platforms—will stabilize China's economy and support global growth.
- The reopening of China will also lift emerging market currencies and weigh on the U.S. dollar.
- However, we do not see meaningful inflationary pressure emanating from China's reopening. Limited government stimulus means the recovery will not be investment-driven, and China's sizable goods-producing capacity will allow it to absorb a surge in consumption, especially when export demand is deteriorating.

Source: Guggenheim Investments, Wind, Haver. Flight bookings data as of 11/30/2022, crude oil imports data as of 12.31.2022.

Divided Government and Narrow Majorities Will Spur Debt Limit Drama

Net Majorities in the House of Representatives & Senate (% of Total Seats of Respective Chamber)



- Narrow majorities in Congress have become more common in recent years, resulting in policy gridlock and dysfunction. Divided government after last year's midterm elections will exacerbate that dynamic.
- An immediate threat from the gridlock is the debate over the debt ceiling, which will need to be raised before extraordinary measures from the Treasury are exhausted, as early as June.
- This year's debt limit debate looks to be contentious, with new House rules complicating matters and with both parties looking to score a win ahead of 2024 elections.
- While we do not expect a default, the standoff is likely to go until the last minute, possibly resulting in a reprise of the 2011 debt limit debate, which led to a U.S. credit rating downgrade and a market selloff. The debate could also result in a government shutdown, which would worsen the market impact.

Source: Guggenheim Investments, House.gov, Senate.gov. *Independents counted as members of party with which they caucus.

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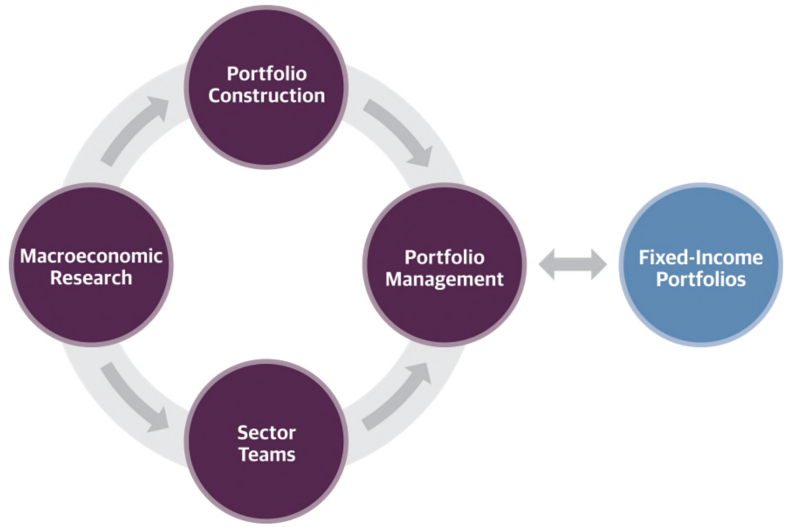

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