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Guggenheim Investments

10 Macro Themes for 2019

January 2019

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10 Macro Themes for 2019

This collection of charts presents 10 of the macroeconomic trends we believe are most likely to shape the investment environment in 2019.

1. The Fed Will Pause to Start 2019
2. Stocks Will Rebound in Response to a Fed Pause and Surpass Their Highs
3. A Fed Pause Will Allow Excesses to Become More Pronounced
4. A Historically Tight Labor Market Will Ultimately Call for More Fed Hikes
5. 10-Year Treasury Yields Will Rebound as the Outlook Improves
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7. Recession Will Be Avoided in 2019, but Watch Out for 2020
8. Credit Spreads Will Widen as Recession Fears Mount
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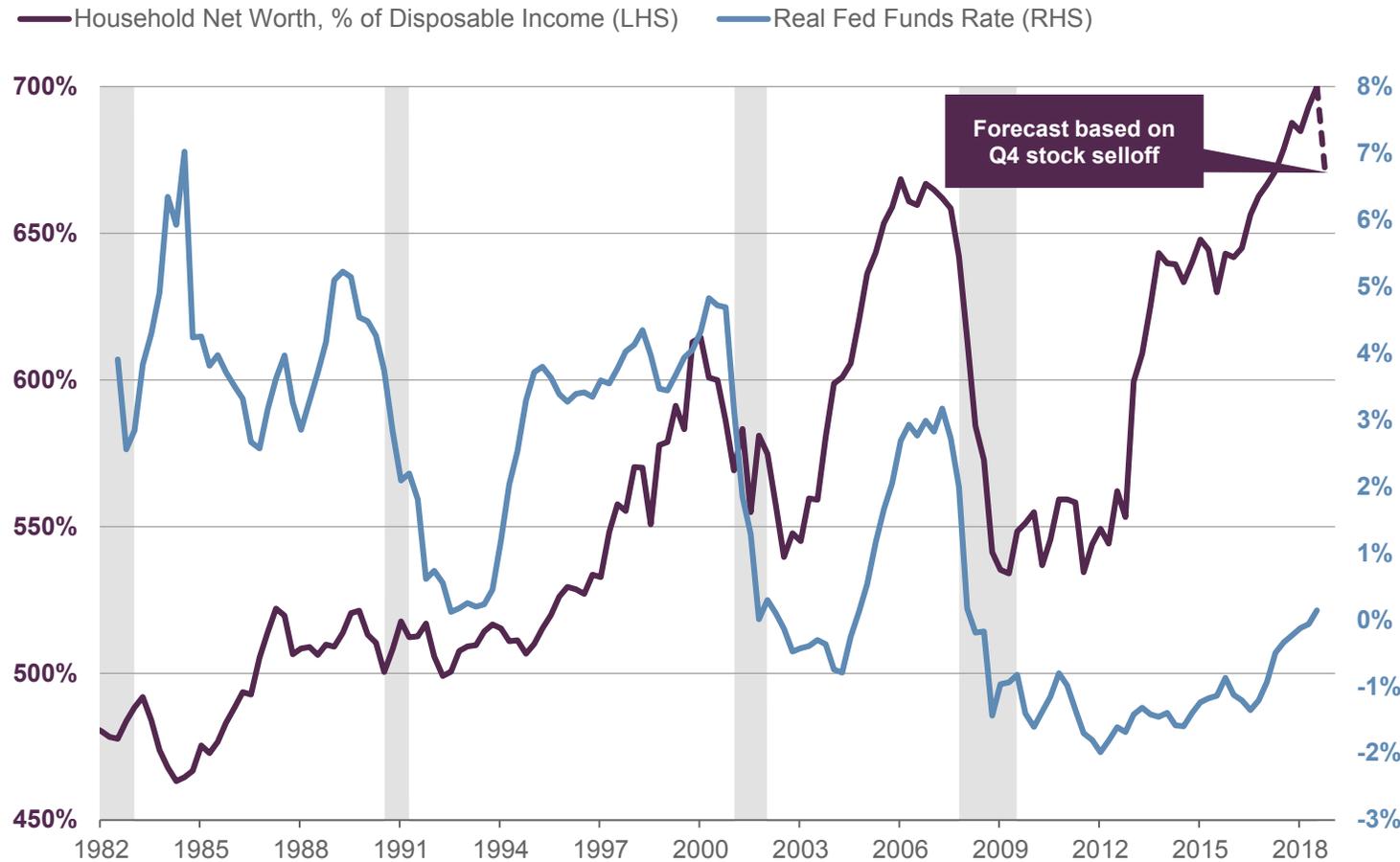
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The Fed Will Pause to Start 2019

Household Net Worth as a Percent of Disposable Personal Income and the Real Fed Funds Rate

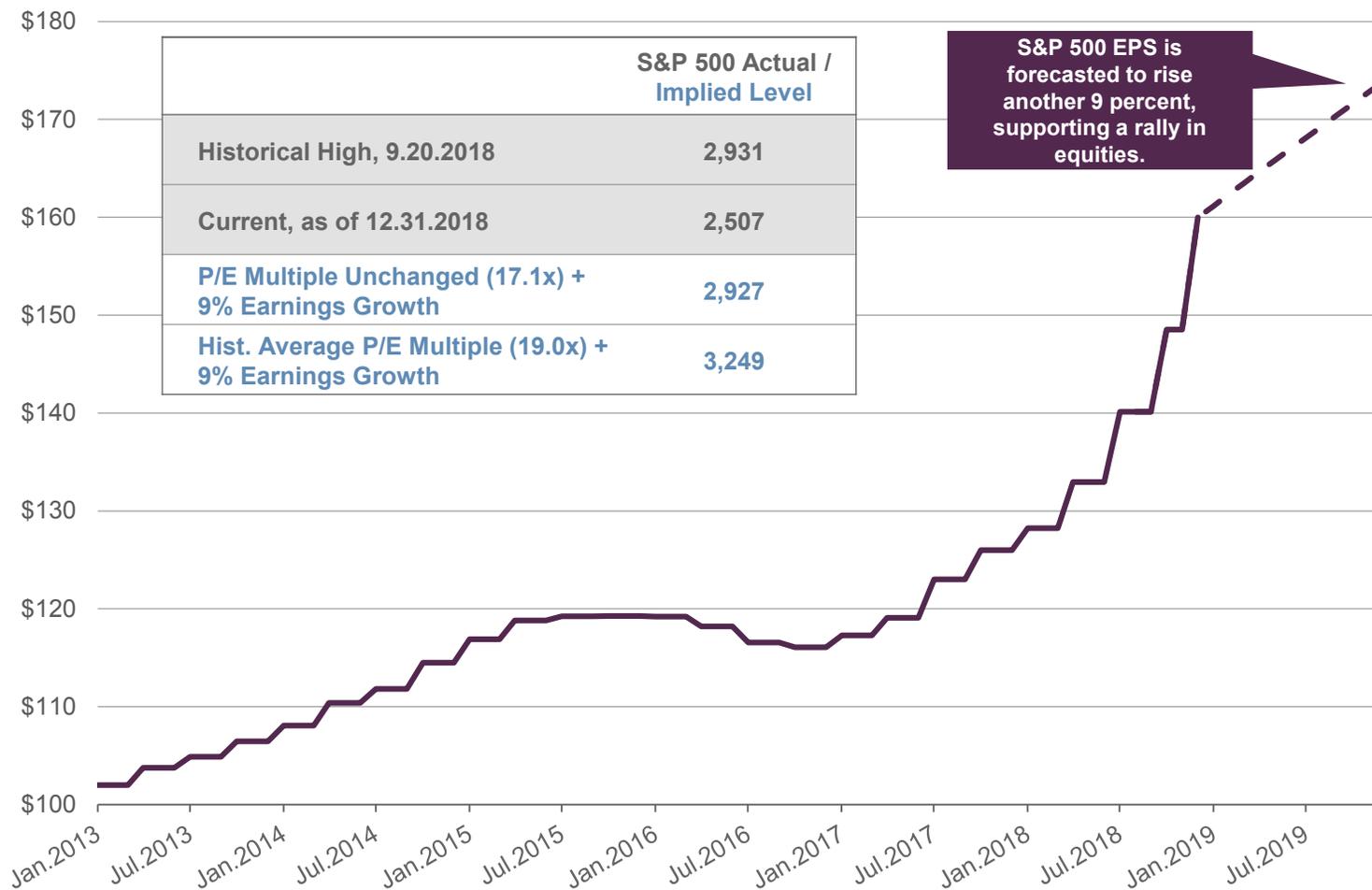


- The stock market selloff represents a negative wealth shock to consumers, who have been the engine of growth for the U.S. economy in this expansion.
- At the same time, tighter credit conditions will also weigh on business investment and hiring activity in 2019.
- With economic growth set to slow and with financial conditions having tightened, the Fed will likely pause its rate hikes to start 2019 in order to stabilize markets.

Source: Guggenheim Investments, Haver Analytics. Actual data as of 9.30.2018, Guggenheim estimate for 4Q18 net worth. Shaded areas represent periods of recession.

Stocks Will Rebound in Response to a Fed Pause and Surpass Their Highs

S&P 500 Earnings per Share and Implied S&P 500 Index Level

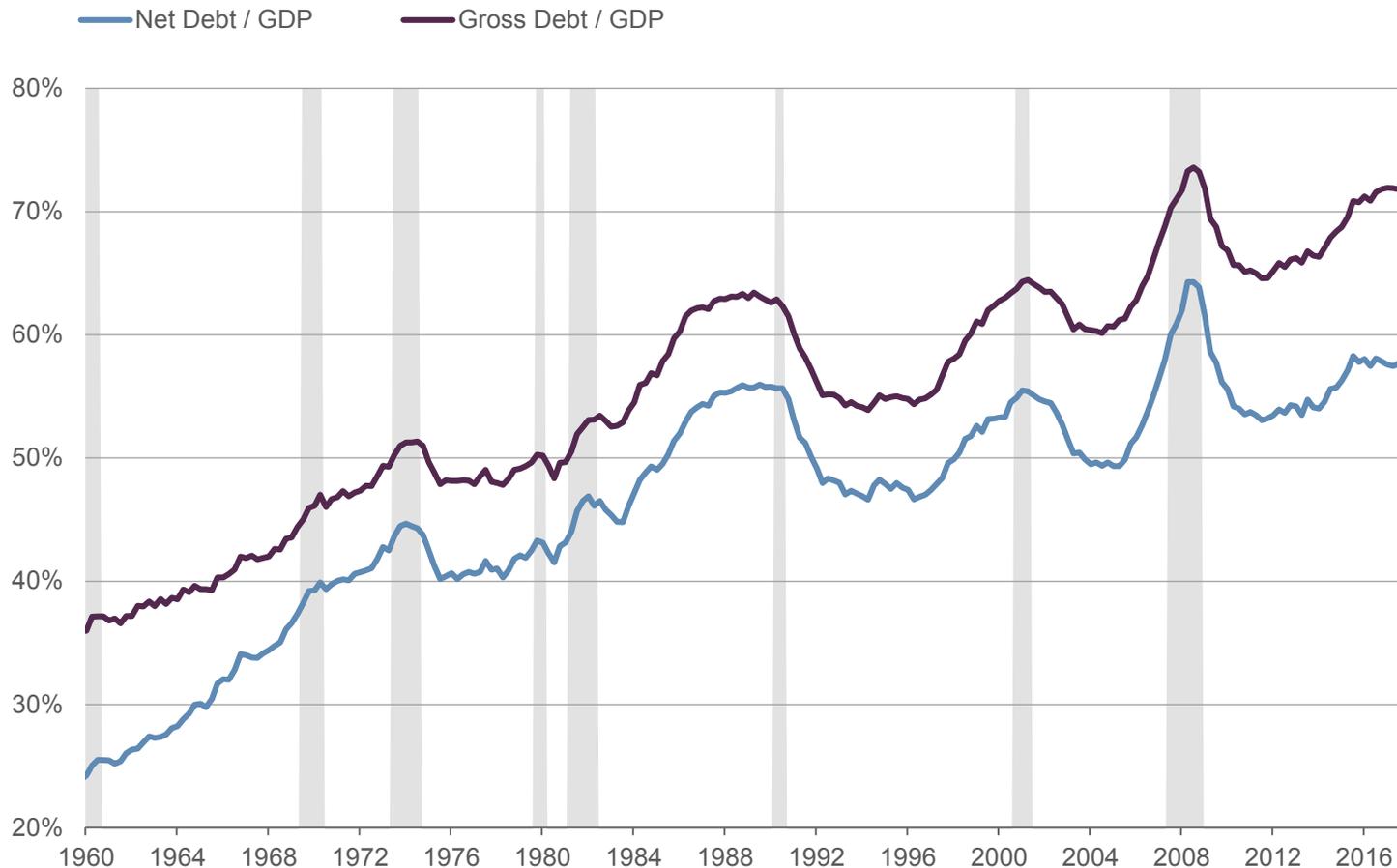


- With a Fed pause helping to alleviate monetary policy concerns, the market will likely turn its focus to fundamentals.
- A relative bright spot following 2018's volatile end will be earnings growth, which is forecasted by analysts to be 9 percent for 2019.
- While this would represent a slowdown from the 27 percent rise in earnings in 2018, it would still be above the historical average.
- The combination of decent earnings growth and a modest recovery in price/earnings multiples will likely push the S&P 500 index to new highs.

Source: Guggenheim Investments, Thomson Reuters, BofA Merrill Lynch Global Research. Data as of 12.31.2018. S&P 500 2018 year-end EPS is based on realized EPS from Q1 2018 – Q3 2018 and consensus estimates for Q4 2018. The P/E multiple, or P/E ratio, is calculated by dividing the current price of a stock by its trailing 12-month earnings per share.

A Fed Pause Will Allow Excesses to Become More Pronounced

Nonfinancial Business Gross and Net Debt as a Share of U.S. Gross Domestic Product

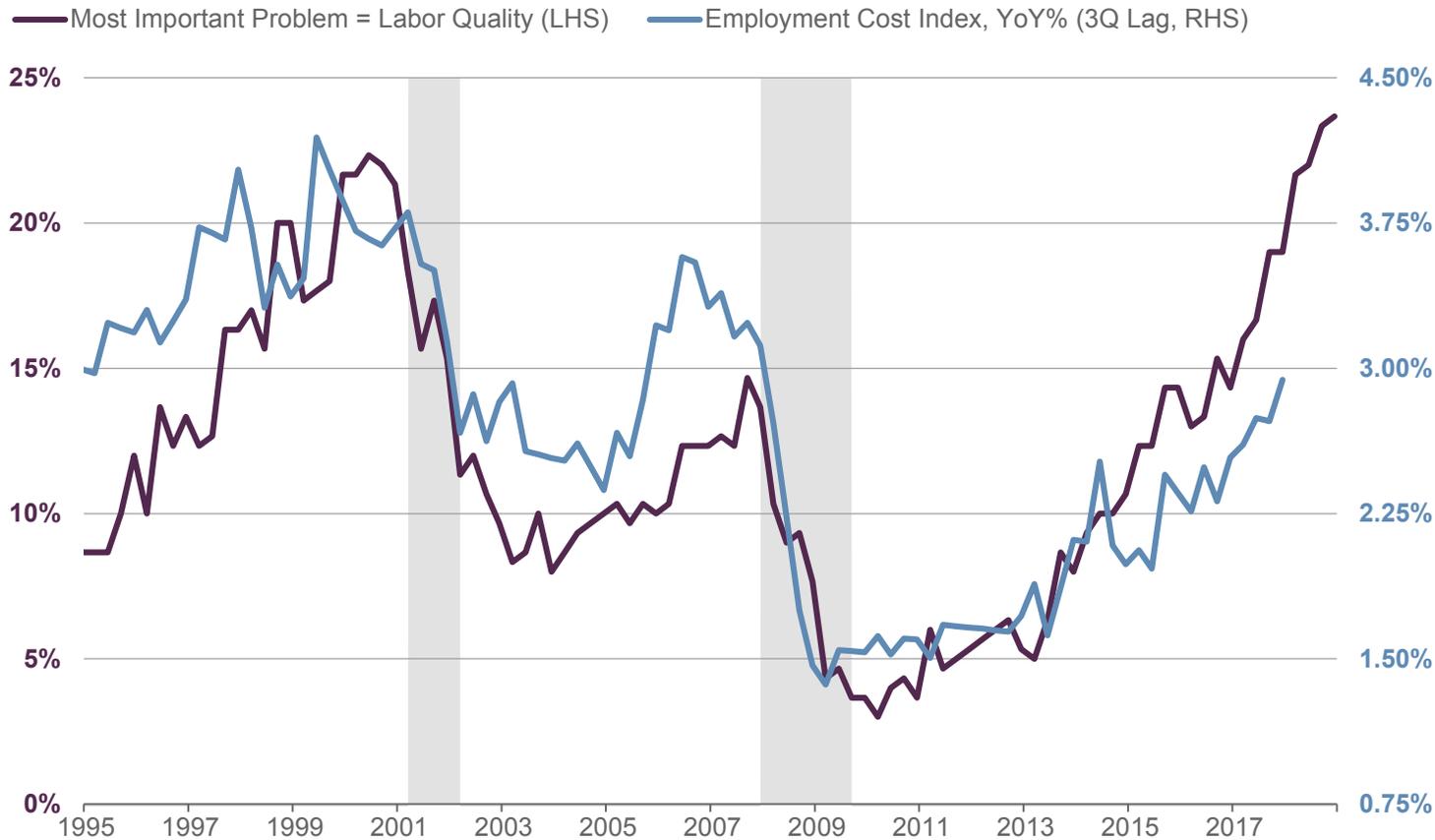


- A pause in monetary policy tightening may grant a short-lived reprieve to debtors facing pressure from rising borrowing costs. This will encourage more debt accumulation in the first half of 2019 as borrowers take advantage of calmer market conditions, particularly in investment-grade corporates.
- The ratio of nonfinancial business debt to gross domestic product (GDP) is already at a level that exceeded the beginning of past recessions, on both a gross and a net basis.
- A more dovish Fed will allow excessive leverage to become more pronounced.

Source: Guggenheim Investments, Haver Analytics. Data as of 9.30.2018. Shaded areas represent periods of recession.

A Historically Tight Labor Market Will Ultimately Call for More Fed Hikes

NFIB Small Business Survey: Single Most Important Problem* and Employment Cost Index (Wages and Salaries)

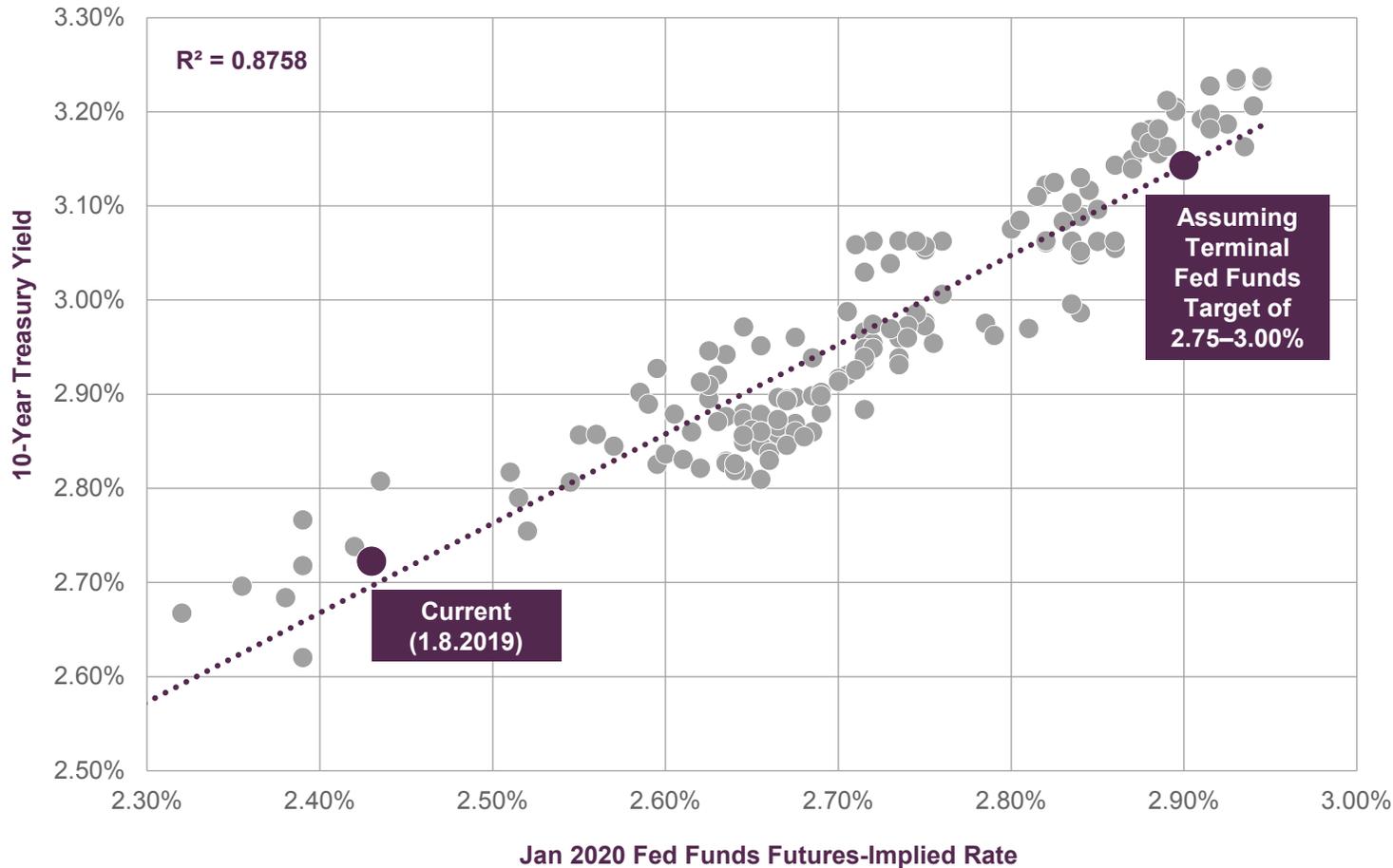


- While the Fed will slow the pace of rate hikes, it will not stop hiking altogether given how strong the labor market continues to be.
- Job openings now exceed the number of unemployed, causing many businesses to complain of shortages of qualified workers, raising labor's bargaining power, and driving up wage growth.
- With above-potential GDP growth likely to cause job gains to run above labor force growth, unemployment will fall further in 2019, leading to an acceleration of wage gains and increasing production bottlenecks from labor constraints.
- We expect the Fed will raise rates two times in 2019 to try to cool the labor market to a more sustainable pace.

Source: Guggenheim Investments, Haver Analytics. Data as of 12.31.2018 for labor quality, 9.30.2018 for employment cost index. *Note: Represents percent of respondents citing labor quality as the single most important problem. Shaded areas represent periods of recession. The employment cost index (ECI) is a quarterly economic series detailing changes in the cost of labor for businesses in the United States. The ECI is prepared by the U.S. Department of Labor's Bureau of Labor Statistics.

10-Year Treasury Yields Will Rebound as the Outlook Improves

10-Year Treasury Yields vs “Terminal Fed Funds” as Proxied by the January 2020 Fed Funds Futures Contract

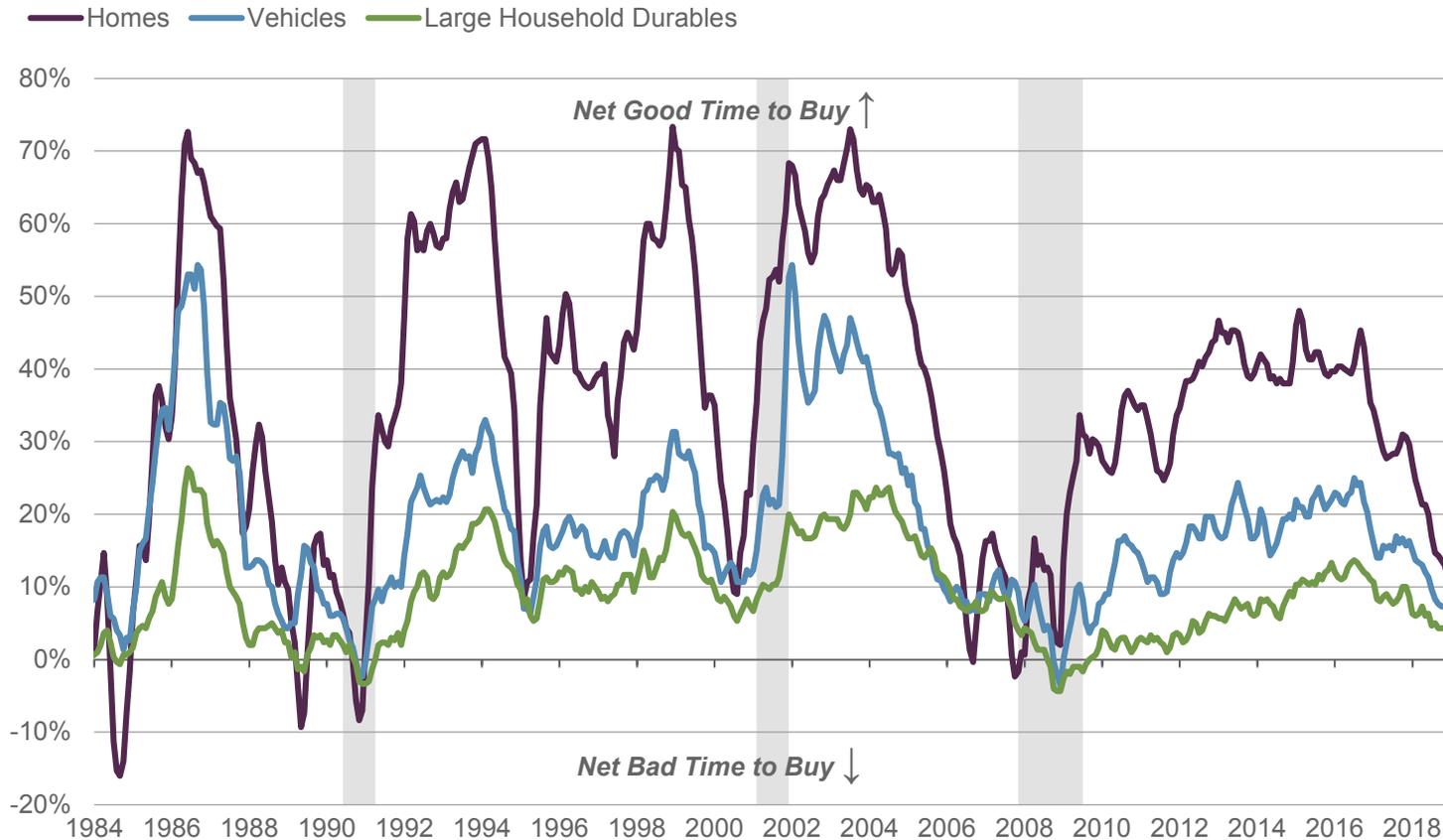


- We observe a strong relationship between the 10-year Treasury yield and market pricing of where the fed funds rate is expected to be at the end of the hiking cycle, also known as the terminal rate.
- In 2007, the 10-year Treasury yield peaked around 5.25 percent, which coincided with the terminal fed funds rate.
- In the current cycle, the 10-year Treasury yield has been highly correlated with the implied rate on January 2020 fed funds futures.
- Our forecast of two Fed rate hikes in 2019 would bring the January 2020 fed funds futures-implies rate to around 2.90 percent, lifting the 10-year Treasury yield to about 3.15 percent.

Source: Guggenheim Investments, Bloomberg. Data as of 1.8.2019.

U.S. Economic Growth Will Cool as Rising Rates Weigh on Consumption

University of Michigan Survey Opinions on Buying Conditions: Net Good Time to Buy Due to Interest Rates (3m Mov. Avg.)

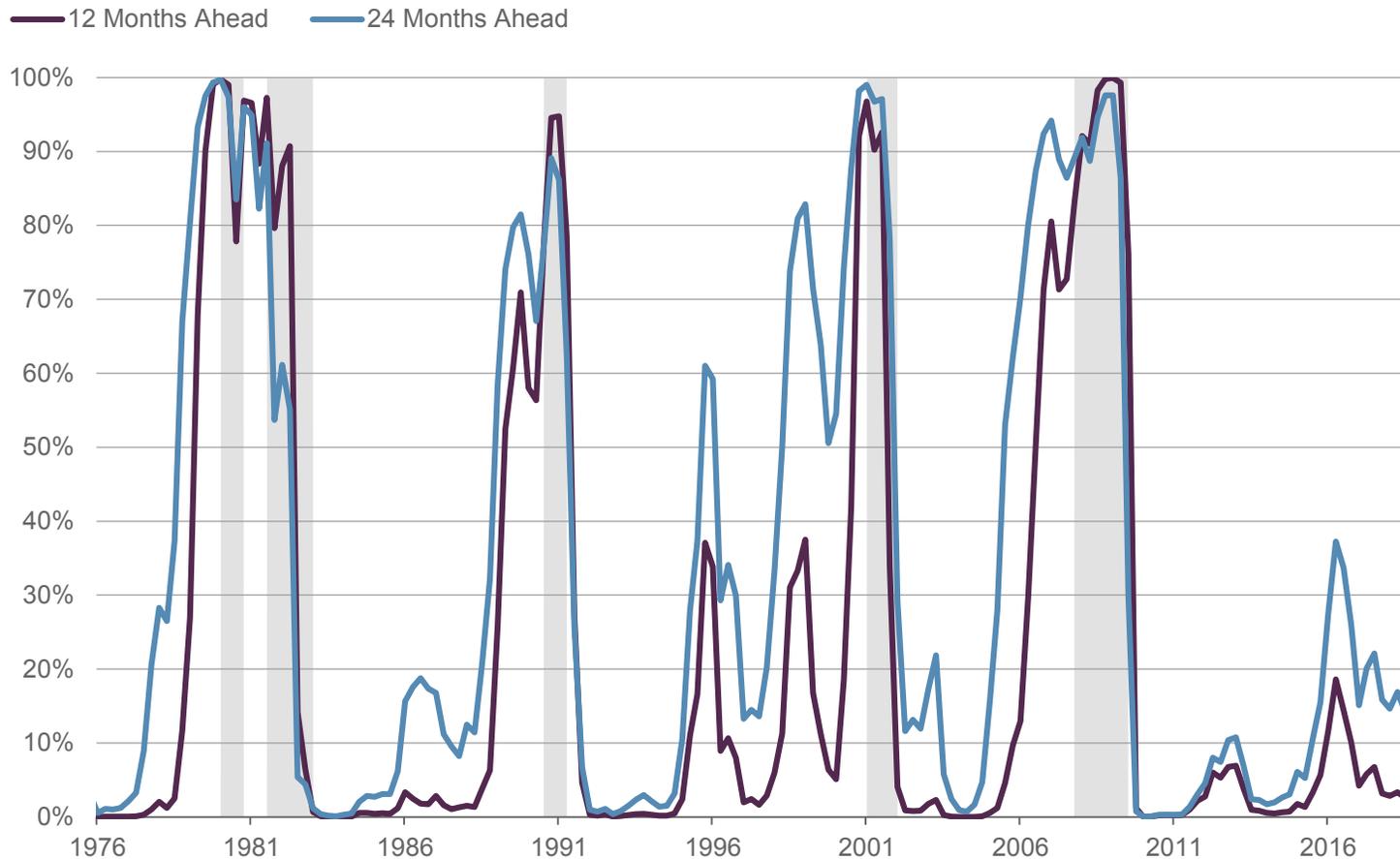


- As the Fed tightens in order to slow economic growth toward potential, interest rate-sensitive sectors have been the first to show signs of a slowdown.
- Consumers are becoming less positive on major purchases of homes, autos, and appliances, citing rising rates as a major reason. These survey measures have historically been a good signal of actual purchases.
- Consumption, housing, and business capital expenditure will all feel the effects of rising rates in 2019. We see a broad-based slowdown in real GDP growth to below 2 percent year over year by the fourth quarter of 2019.

Source: Guggenheim Investments, Bloomberg, University of Michigan. Data as of 10.31.2018. Shaded areas represent periods of recession.

Recession Will Be Avoided in 2019, but Watch Out for 2020

Guggenheim Recession Probability Model

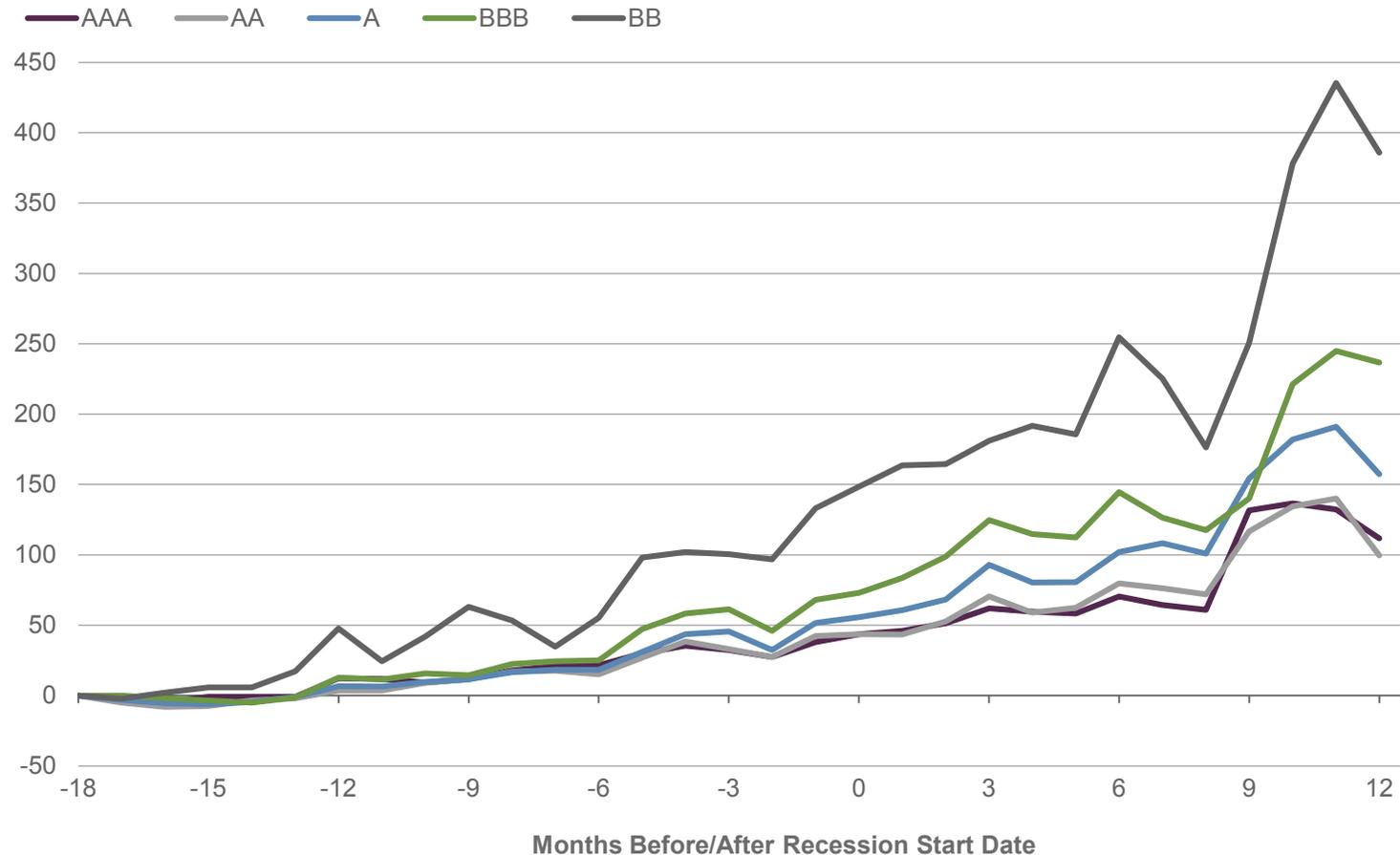


- While GDP growth is set to decelerate meaningfully in 2019, the economy is unlikely to enter a recession this year.
- Our recession model is signaling relatively low recession risk in the next 12 months. The yield curve has not yet inverted, Fed policy is not yet restrictive, and leading indicators, though slowing, are still positive.
- Looking further ahead, we continue to expect a recession will begin in 2020, as a historically tight labor market forces further tightening by the Fed, pushing the overleveraged corporate sector into a downturn.

Source: Guggenheim Investments, Bloomberg, Haver Analytics. Data as of 9.30.2018. 4Q18 recession probability is based on Guggenheim forecast of model inputs. Shaded areas represent periods of recession.

Credit Spreads Will Widen as Recession Fears Mount

Corporate Spread to Treasuries by Rating: Cumulative Change in Basis Points Around Recessions, Average of Last Three Cycles*

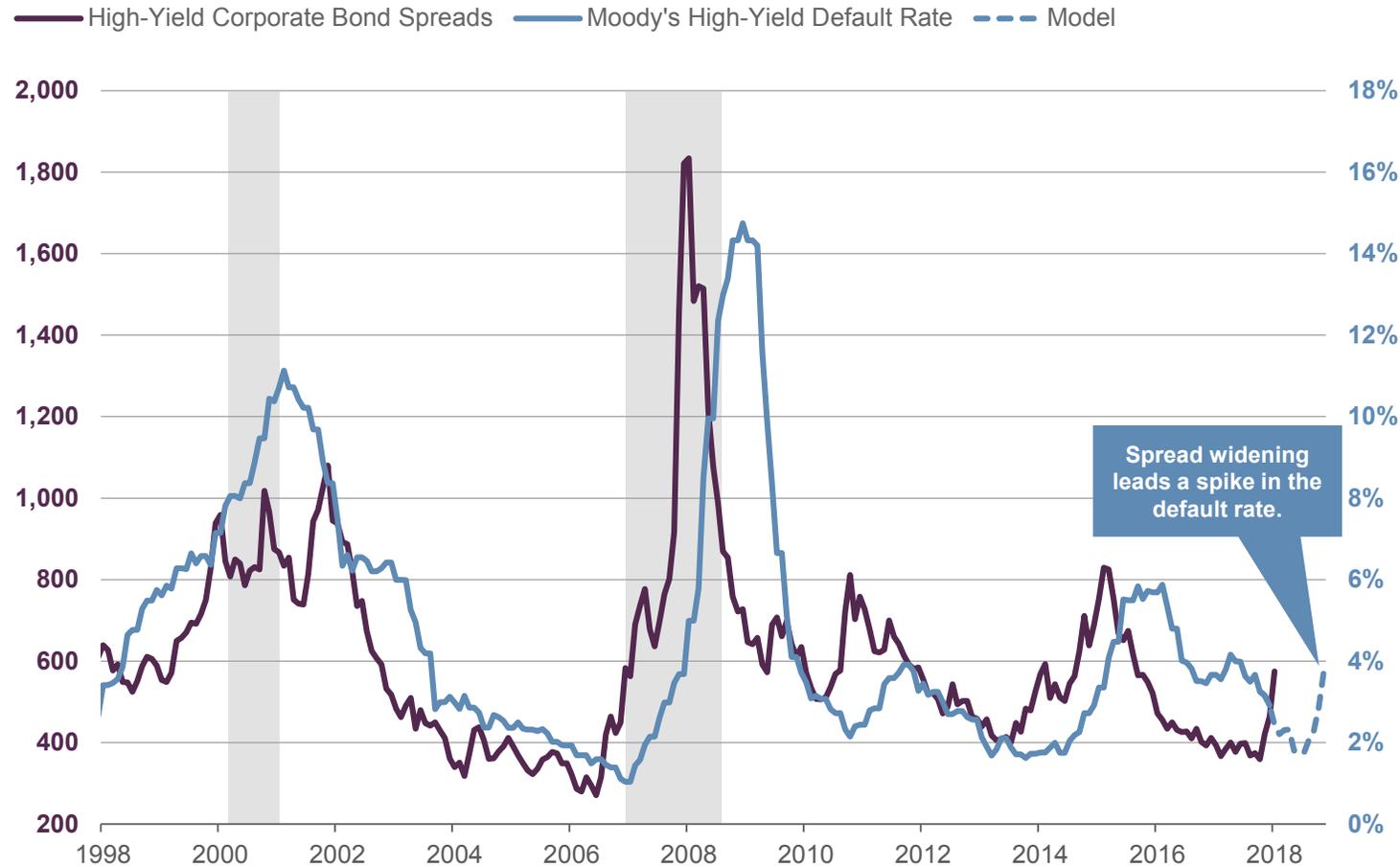


- Corporate bond spreads typically widen about a year ahead of the start of a recession as investors respond to a deteriorating economic environment by seeking higher compensation for credit risk.
- With a recession likely to begin in 2020, we expect that spreads will be wider by the end of 2019. The most pronounced widening would occur in the lower quality, high-yield sector.
- Given a significant duration extension and quality deterioration in the investment-grade corporate bond market compared to past cycles, the negative price impact from spread widening will be more pronounced.
- In anticipation of spread widening and poor credit performance, we have been upgrading the credit quality of our portfolios and shifting to government-backed assets that may benefit from a flight to safety.

Source: Guggenheim Investments, Bloomberg. Data as of 8.2.2018. *Note: includes recessions beginning in 1990, 2001, and 2007. 1990 cycle data begins at -13 months for AAA, AA, A, and BBB due to limited data availability. One basis point is equal to 0.01 percent.

The U.S. Corporate Default Rate Will Rise

Moody's U.S. Speculative-Grade Default Rate and Guggenheim Model Estimate

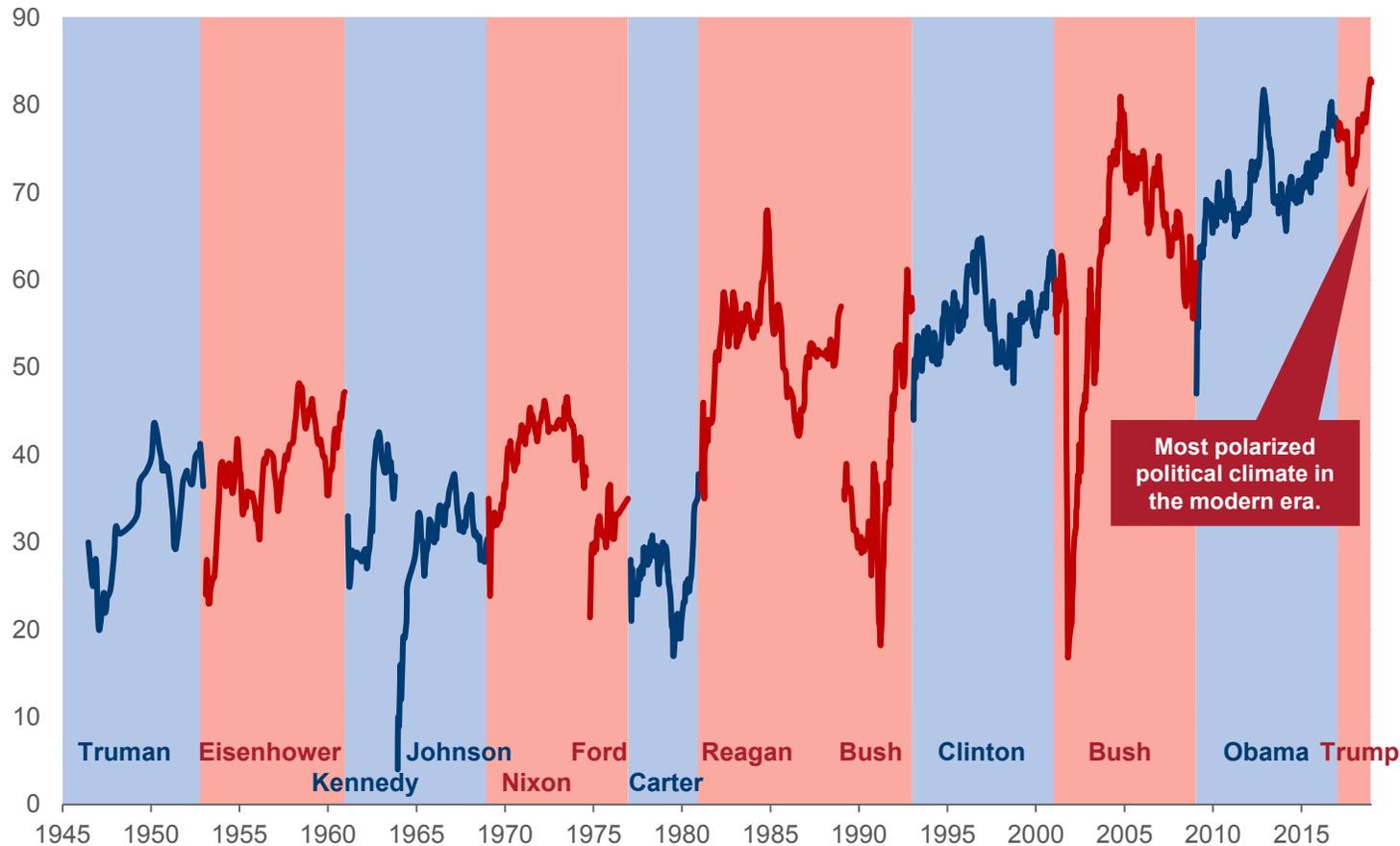


- The significant widening in credit spreads in the fourth quarter of 2018 caused the high-yield corporate bond new issue market to seize up completely in December for the first time on record.
- While spreads may tighten in the short term, we expect the Fed's Senior Loan Officer Survey likely to show more banks tightening lending standards than easing for the first time since January 2017 later in the year.
- Given higher borrowing costs, lack of issuance in high-yield corporates, and a likely tightening of bank lending standards, we expect the high-yield default rate to climb in the second half of 2019.
- We expect this to mark the beginning of a prolonged period of stress in corporate credit similar to the period between 1998 and 2002.

Source: Guggenheim Investments, Moody's, Credit Suisse, Federal Reserve. Data as of 12.31.2018. Guggenheim's high-yield default rate model is based on the U.S. Federal Reserve's Senior Loan Officer Survey and high-yield corporate bond spreads. Shaded areas represent periods of recession.

U.S. Political Battles Will Undermine Confidence and Increase Risk Premia

Presidential Approval Rating: Spread Between President's Party and Opposition Party Voters, in Percentage Points



Source: Guggenheim Investments, Gallup. Data as of 12.22.2018. Blue shading denotes Democrat presidents, red shading denotes Republican presidents.

- The U.S. political climate has become more polarized under President Trump than at any point in the post-war period, continuing a longstanding trend.
- This can be seen in the spread between the president's approval rating with his own party relative to opposition party voters.
- With the 2020 election looming and voters appearing to prefer confrontation over compromise, bi-partisan efforts will be increasingly difficult, resulting in gridlock.
- Partisan conflicts will become more acute with Democrats having recently taken control of the House of Representatives, as they now have subpoena power.
- Legislative battles over the budget, trade issues, the debt ceiling, and investigations into the Trump administration will undermine confidence and weigh on markets.

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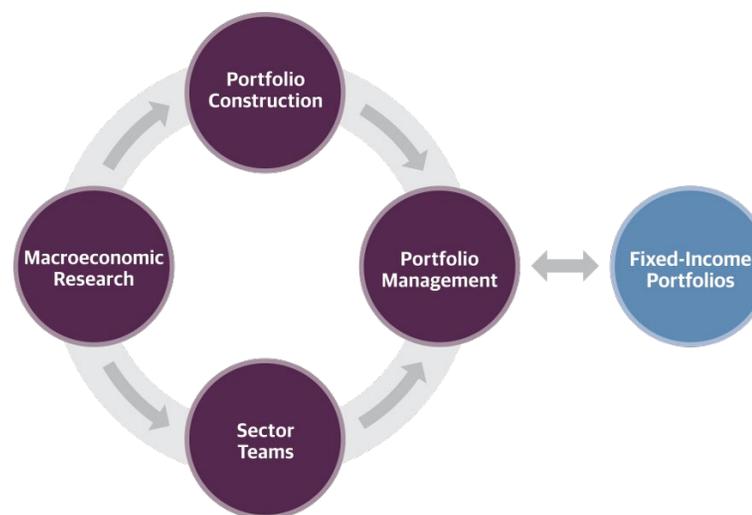
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