Guggenheim Investments

10 Macro Themes for 2017

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This collection of charts presents 10 of the global macroeconomic trends we believe are most likely to shape the investment environment in 2017.

1. Fiscal Stimulus Will Boost GDP Growth Above the FOMC’s Baseline
2. The Unemployment Rate Will Fall Below 4%
3. Oil Prices Will Rise, but Average Less than $60 Per Barrel in 2017
4. Inflation Will Rise Through Q1, but Remain Contained
5. The Market Will Reprice the Fed Path, Causing the Yield Curve to Flatten
6. The FOMC’s Natural Rate Projection Will Rise After Years of Declines
7. Monetary Policy Divergence Will Drive Further Dollar Appreciation
8. Floating-Rate Securities Will Outperform as the Fed Hike Pace Accelerates
9. The High-Yield Corporate Default Rate Will Fall to 4%
10. The Trade Slowdown Will Continue to Hurt Global Growth

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Fiscal Stimulus Will Boost GDP Growth Above the FOMC’s Baseline

We have modeled the effects of the Trump campaign’s fiscal stimulus proposal, as well as that of the House Republicans (GOP), and added a more moderate stimulus scenario.

In all scenarios, the combination of corporate and individual tax cuts plus infrastructure spending should boost real gross domestic product (GDP) growth compared to the Federal Open Market Committee’s (FOMC) baseline forecast.

Most of the effects will be felt in 2018 and 2019.

Questions remain as to the final size, scope, and timing of any fiscal stimulus, as well as how it will affect monetary policy and the size of the deficit.

Source: Federal Reserve, Haver Analytics, CBO, Tax Policy Center, Tax Foundation, Guggenheim Investments. Actual data as of 2015. Note: assumes that the median FOMC growth projection from the December 2016 Summary of Economic Projections does not include fiscal stimulus impacts.
The Unemployment Rate Will Fall Below 4%

Since 2010, the Federal Reserve (Fed) has consistently underestimated the pace of decline in the unemployment rate. We think 2017 will prove to be no different.

We expect the unemployment rate to fall below 4 percent as faster GDP growth boosts employment while demographic constraints limit gains in the size of the labor force.

This would be well below the Fed's estimate of the natural rate of unemployment, and would add to the case for a faster pace of rate hikes in 2017.

We expect the Fed to raise the fed funds rate three, possibly four, times in 2017.

Source: Haver Analytics, Guggenheim Investments. Data as of December 2016.
The agreement between OPEC and non-OPEC oil producers to cut production by 1.8 million barrels per day is effective January 2017. The news has supported a $7 oil price rally since late November.

The rise in oil prices will incentivize a faster recovery in U.S. shale production, which will limit further price gains. At $60, for example, we would expect the U.S. rig count to double by the end of 2017, with production surpassing its all-time high in the second half.

Oil producing nations’ history of complying with production cuts is spotty, however, and a failure to comply with the recent OPEC agreement would lead to a pullback in oil prices.

*Model results are back-tested, with the benefit of hindsight, based on historical data. It is not an indication of the success of past model estimates or projections. Sources: Bloomberg, IHS, Guggenheim Investments. Actual Data as of 12.31.2016.
Inflation Will Rise Through Q1, but Remain Contained

Expectations that the Trump administration’s fiscal agenda will push up inflation will prove to be unfounded.

CPI inflation should rise in the first quarter due to the receding effect of low oil prices, and then decline as base effects fade and a stronger dollar contains import prices.

This should help keep inflation near the Fed’s inflation target.

Nonetheless, Fed policymakers will likely be spurred to raise rates at a faster pace due to stronger real GDP growth and falling unemployment.

We expect the Fed to raise the fed funds rate three, possibly four times in 2017.

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*Model results are back-tested, with the benefit of hindsight, based on historical data. It is not an indication of the success of past model estimates or projections. Source: Haver Analytics, Guggenheim Investments. Data as of 1.18.2017.*
The Market Will Reprice the Fed Path, Causing the Yield Curve to Flatten

OIS Forward Rates* vs. FOMC Participant Projections for the Appropriate Path of the Federal Funds Rate as of December 2016

- In December the median FOMC participant projected three rate hikes in 2017. The median forecast also sees three hikes in 2018 and 2019.

- The market is skeptical that this pace of hikes will materialize, with forward overnight index swap (OIS) rates still well below the Fed’s projections.

- We expect the Fed to deliver three, possibly four, rate hikes in 2017, which should jolt rates higher in the front end and flatten the yield curve.

- A barbell portfolio strategy is appropriate for a flattening yield curve: Short-duration floating-rate assets will benefit from rising rates while the long end will be supported as the Fed demonstrates its willingness to contain inflation.


*OIS forward rates reflect market expectations for the effective federal funds rate in the future. Note: Central tendency is the range of FOMC participant projections excluding the three highest and three lowest. The FOMC defines “longer run” as five to six years into the future.
The FOMC’s Natural Rate Projection Will Rise After Years of Declines

In addition to stronger cyclical growth, the Fed could be spurred to raise rates faster by upgraded views of the natural rate of interest, as seen in FOMC participants’ projections for the appropriate fed funds rate in the longer run.

Expansionary fiscal policies and deregulation will push up the productive capacity of the economy, resulting in higher natural rate estimates.

This dynamic was already evident at the December 2016 FOMC meeting, which saw the longer-run fed funds rate projection raised to 3.0 percent.

The appointment of new, more hawkish Fed governors to fill the two existing vacancies would also pose upside risks to the Fed’s median rate projections.

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Source: Bloomberg, Federal Reserve Board, Guggenheim Investments. Data as of 12.14.2016. Note: projections are taken from the Summary of Economic Projections. *Thus, for the highlighted September 2012 meeting, the number of participants who projected the longer run fed funds rate at each level were as follows: one at 3 percent, one at 3.5 percent, two at 3.75 percent, six at 4 percent, five at 4.25 percent, and four at 4.5 percent.
Monetary Policy Divergence Will Drive Further Dollar Appreciation

The 2-year Treasury yield is sensitive to changes in monetary policy expectations.

As the Fed raises rates, 2-year Treasury yields will rise relative to yields on sovereign bonds of countries whose central banks are more accommodative.

A wider yield differential will attract foreign capital and cause the dollar to appreciate further.

A strong dollar will reduce import prices, which will help contain inflation.

Source: Haver Analytics, Bloomberg, Guggenheim Investments. Data as of 1.17.2017. *Note: uses weighted yield spread of Germany, Canada, Japan, China, and U.K.
Floating-Rate Securities Will Outperform as the Fed Hike Pace Accelerates

Our analysis shows that floating-rate securities tend to outperform fixed-rate securities in periods of rising short-term interest rates.

With the Fed set to raise rates three, possibly four, times in 2017, we expect floating-rate securities such as leveraged loans and floating-rate asset-backed securities to outperform fixed-rate asset classes.

Average Annualized Returns of Select Assets During Periods of Rising Interest Rates*

- Credit Suisse Leveraged Loan Total Return
- BAML ABS Floating Total Return Index
- Barclays U.S. TIPS Total Return Index
- Barclays High Yield Total Return Index
- Barclays U.S. Agg Total Return Index
- Barclays U.S. Treasury Total Return Index
- Barclays U.S. IG Total Return Index

Source: Bank of America Merrill Lynch, Barclays, Credit Suisse, Guggenheim Investments. *Note: Periods of rising interest rates are defined as those from 1985 to present (excluding the 2007-2008 financial crisis) that had a cumulative increase in U.S. 3-month LIBOR in excess of 100 basis points.
The High-Yield Corporate Default Rate Will Fall to 4%

- We expect the 12-month trailing speculative grade default rate to fall to 4 percent by the end of 2017, below the 25-year average.
- The recent spike in corporate defaults was largely caused by the weakened oil sector. Defaults should decline with the sustained recovery of oil prices.
- In addition, we expect bank loan officers to ease lending standards on the margin amid stronger economic growth, which should also improve credit performance.
- With fundamentals improving, investors should maintain exposure to leveraged credit.

*Model results are back-tested, with the benefit of hindsight, based on historical data. It is not an indication of the success of past model estimates or projections.
The Trade Slowdown Will Continue to Hurt Global Growth

Global Exports + Imports, % of Global GDP

- A rise in globalization and new trade agreements helped boost export and import activity from the early 1990s through 2008, thus contributing to strong global economic growth.
- Trade flows have dropped since the financial crisis and are likely to fall further relative to GDP amid a rise in populist sentiment around the world.
- Any efforts to restrict U.S. trade or immigration flows would serve to undermine the Trump administration's stimulative fiscal and regulatory policies.
- Risks to long-term U.S. economic growth and export competitiveness will increase as China and other nations seek to form trading blocs away from U.S. participation.

Source: Haver Analytics, Guggenheim Investments. Annual data as of 2015; 2016 is an estimate based on trade data through Q2.
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