

Macroeconomic Outlook

The Fed Is Leaning into the Fiscal Boost



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Above-potential growth, a tight labor market, and rising inflation mean Fed policy is heading into restrictive territory.

The U.S. economy had a stellar second quarter, with real GDP growth accelerating to 4.1 percent annualized (see chart, top right). As we expected, fiscal easing is boosting growth further above potential, which we estimate to be just 1.5 percent. While growth should moderate in the third quarter, government spending will support the economy in the quarters ahead. Nevertheless, our research still indicates that a recession is likely to begin around early 2020.

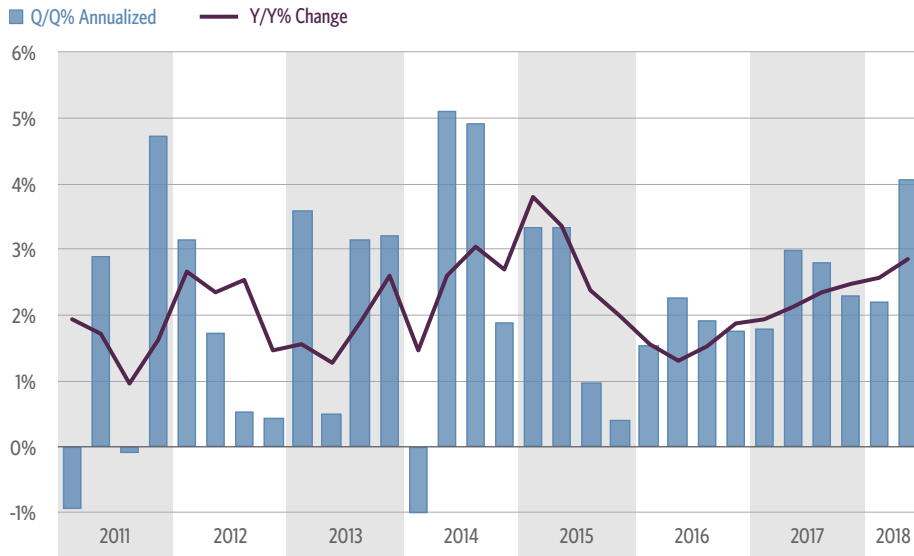
With growth above potential, the labor market is on track to overheat. Trend payroll growth remains roughly two times its sustainable rate, consumer and business surveys point to increasingly tight labor conditions, and job openings exceed the number of unemployed workers to fill them. This has driven an acceleration in wage growth, with private-sector employee compensation costs rising 2.9 percent in the second quarter of 2018, up from an average of 2.0 percent from 2012–2015.

Inflation stands at the Fed's target, with core personal consumption expenditures (PCE) running at 1.9 percent year over year. Given the 18-month lag between GDP growth and core inflation, strong growth should nudge up inflation through 2019, particularly given recently enacted import tariffs. Given the U.S. administration's threats of much broader tariffs, near-term inflation risks are skewed to the upside.

We have long argued that the Fed's policy stance will turn restrictive in 2019 in order to slow economic growth and job creation to more sustainable rates. Fed policymakers now agree, with nearly all Federal Open Market Committee (FOMC) members projecting in June that rates at end-2019 will be above their respective estimates of neutral. On average, policymakers expect rates to be 0.5 percent above neutral by end-2020 (see chart, bottom right). The market either believes that the neutral rate is lower or it is skeptical that the Fed will get restrictive, with just three hikes priced in for the rest of the hiking cycle. We expect six hikes, like the Fed, but we see them all happening before the end of 2019. Restrictive Fed policy is coming.

With economic growth unsustainably high, the labor market tight, and Fed policy heading into restrictive territory, it is natural for the Treasury yield curve to flatten. We are positioned for further bear flattening toward our 3.25–3.5 percent terminal fed funds rate projection over the next year, implying a roughly 50 basis point increase in 10-year yields from here. We maintain low credit exposure as we see an unfavorable risk/reward tradeoff given tight spreads, escalating trade tensions, and a recession approaching in 2020.

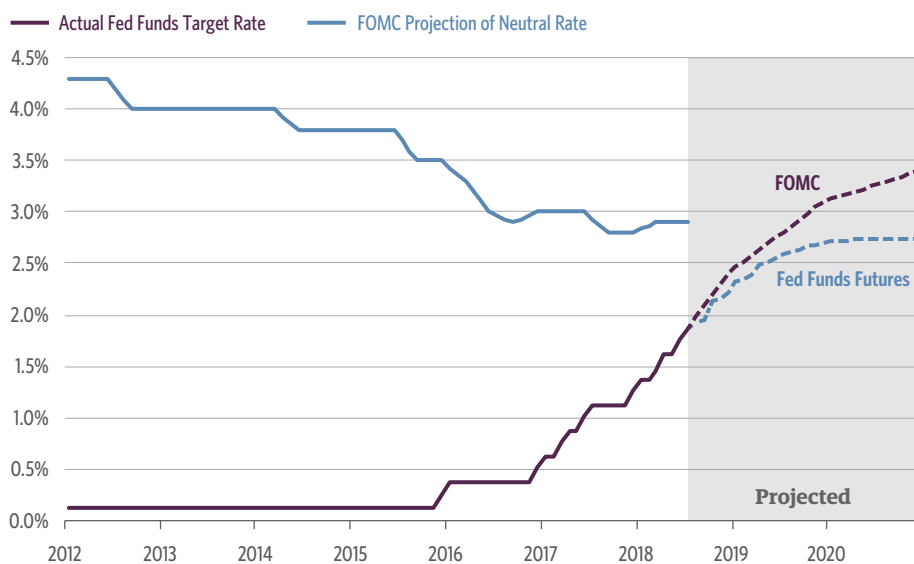
U.S. Economic Growth Accelerated in Q2 as Fiscal Easing Kicked in
Real Gross Domestic Product



Source: Haver Analytics, Bureau of Economic Analysis, Guggenheim Investments. Data as of 6.30.2018.

Real GDP growth accelerated to 4.1 percent annualized. As we expected, fiscal easing is boosting growth further above potential, which we estimate to be just 1.5 percent.

FOMC Sees Rates in Restrictive Territory by End-2019



Source: Federal Reserve Board, Haver Analytics, Guggenheim Investments. Monthly data as of 7.25.2018.
Note: FOMC projections are interpolated based on yearly forecasts in the June 2018 Summary of Economic Projections.

On average, the FOMC expects rates to be 0.5 percent above neutral by end-2020, implying six more hikes. The market either has a lower estimate of neutral or it is skeptical that the Fed will get restrictive, with just three hikes priced in for the rest of the hiking cycle. We expect six hikes before end-2019.

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