Macroeconomic Outlook

The Best and Worst of Times


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Pandemic deaths continue to mount, but vaccine deployment and massive policy support will lift growth in 2021.

The U.S. economic recovery continued in the fourth quarter even as new COVID-19 cases surged, with real gross domestic product (GDP) increasing at an annual rate of 4.1 percent. As of January 2021, U.S. real GDP had retraced 85 percent of the decline that occurred in March and April of 2020, while employment had retraced 67 percent of its decline through February. Nevertheless, output and employment remained 3.6 percent and 5.4 percent below their February peaks, respectively, much worse than during the first year of past downturns (see chart, top right).

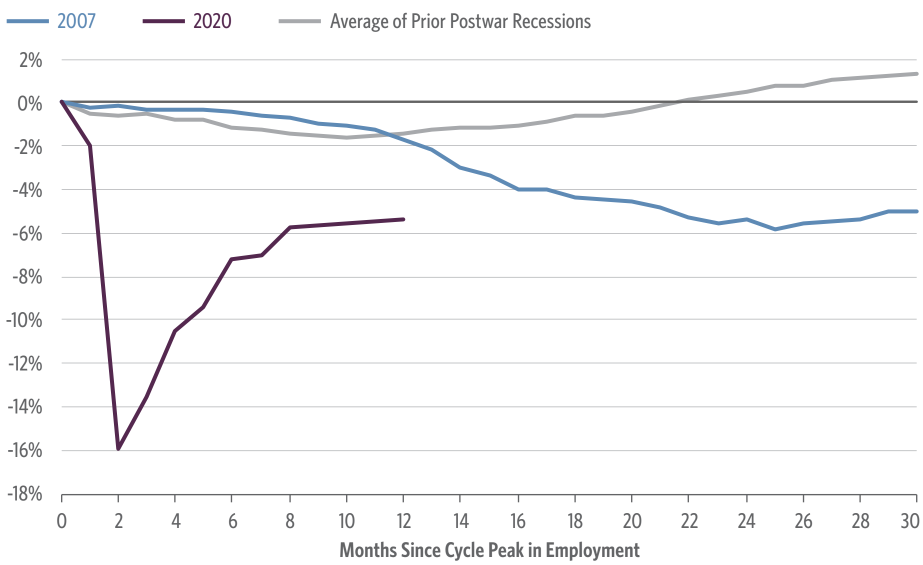
The good news is that several highly effective COVID-19 vaccines have begun to be distributed in the United States and elsewhere. With herd immunity likely attainable this summer, we expect the beleaguered service sector to experience a strong recovery in 2021 as the need for social distancing gradually diminishes. In addition, consumers—already holding excess savings of roughly $1.8 trillion—are seeing a further boost to disposable income as the $900 billion stimulus bill passed in December shows up in the data. Nearly $1.9 trillion in additional stimulus is set to be passed imminently. The combination of progress in the fight against COVID-19, massive fiscal stimulus, and extremely easy financial conditions should boost real GDP growth to 6–7 percent in 2021, the strongest since 1984.

We expect the Fed to do its part to support the recovery, guided by a new and more dovish policy framework. The Fed will no longer aim to cool an overheated labor market but will instead strive to overshoot the 2 percent inflation target in order to compensate for past periods of below-target inflation. While headline inflation is certain to rise in coming months due to sizable base effects, policymakers' focus is on the much weaker underlying inflation trend in place. As core inflation lags real GDP by about 18 months, more sequential downside is ahead over the next several quarters, and the experience of the last expansion suggests the Fed will struggle to achieve its 2 percent inflation target, let alone exceed it on a sustained basis, based on globalization, demographics, and technological trends (see chart, bottom right).

These conditions virtually ensure that the Fed will keep its policy rate at zero for at least the next several years while maintaining an aggressive pace of Treasury and Agency MBS purchases well into 2022. Our expectations for the path of Fed policy in coming years translate into a fair value estimate for 10-year Treasury yields of 0.85 percent, indicating that yields have risen too far too fast, aided by bearish seasonals. We see a constructive near-term backdrop for credit markets as deeply negative real interest rates and low FX hedging costs will spur a reach for yield. A key risk to our bullish view on credit is the emergence of several new strains of COVID-19, which raises the prospect of a much longer and deadlier battle against the coronavirus.

Employment Remains Considerably Below Pre-Covid Levels

U.S. Employment During Recessions, Cumulative Change From Cycle Peak



Source: Guggenheim Investments, Haver Analytics, BLS. Data as of 2.28.2021.

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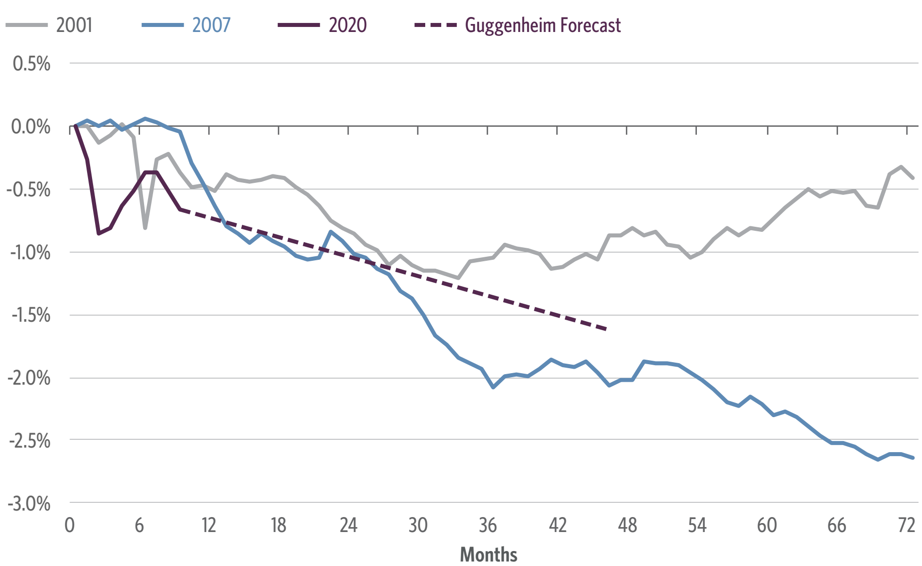
Fed Is Likely to Maintain Maximum Accommodation as Inflation Falls Short

Cumulative Core PCE Inflation Shortfall From 2 Percent Target Since Business Cycle Peak



Source: Guggenheim Investments, Haver Analytics. Data as of 11.30.2020. Note: Dotted purple line shows Guggenheim forecast for cumulative core PCE shortfall at the end of 2023 rather than the precise forecast path.

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