Macroeconomic Outlook

Fiscal Policy Giveth, Monetary Policy Taketh Away

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Investors should focus on credit quality amid further spread tightening as tax cuts take effect.

The performance of the global economy exceeded expectations in 2017, with growth accelerating and the expansion becoming more synchronized across countries. U.S. real gross domestic product (GDP) growth came in at 2.5 percent in 2017 (Q4/Q4). We forecast an even faster pace for 2018, girded by strong global momentum, supportive financial conditions, and an additional boost from tax cuts and federal spending increases. Corporate profit growth will also get a jolt from the tax cut, though some highly leveraged companies will be hurt by the new limits on interest expense deductibility.

While GDP growth has been tepid during this expansion, there is a growing risk of the economy running too hot, thanks in part to fiscal easing. The labor market is already in the early stages of overheating, with the unemployment rate at a cycle low of 4.1 percent in December. We see the unemployment rate ultimately falling to 3.5 percent, and expect that a tight labor market will nudge wage growth higher.

The fly in the ointment is core inflation, which remains below the Fed's 2 percent goal on a year-over-year basis. Recent data have been firmer, however, with core consumer price index (CPI) inflation having accelerated to a 2.6 percent annual rate in the six months ending in January (see chart, top right).

Notwithstanding this uptick, some Fed officials remain concerned about the persistence of below-target inflation in recent years. Their caution can be seen in the Fed's interest rate projections, which as of December showed a decline in the average number of rate hikes forecast for 2018 (see chart, bottom right) as some officials shifted their rate hike expectations into 2019. Curiously, this occurred despite a 0.8 percentage point cumulative increase in the median GDP growth forecast and a 0.2 percentage point drop in the median unemployment rate forecast. We still see four hikes in 2018 as opposed to the Fed's baseline of three, reflecting our expectation for a steeper drop in unemployment this year, financial conditions that have eased in spite of Fed tightening, and a more hawkish Federal Open Market Committee composition.

The yield curve should continue to bear flatten as a result, driven by an outsized increase in shorter-term yields. With our work indicating that the next recession is about two years away, and with credit having richened further since the passage of tax cuts, we believe this is an opportune time to upgrade portfolio credit quality.

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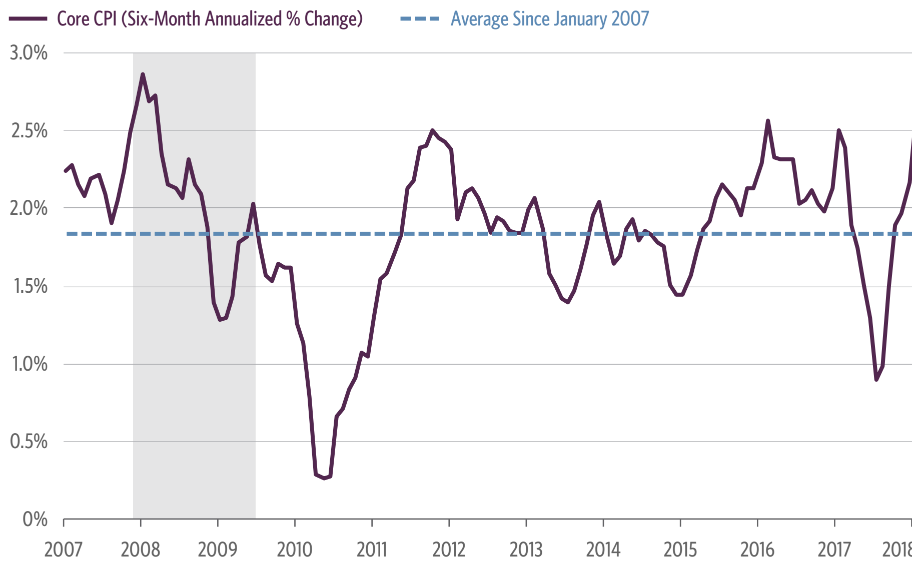
Core Inflation Has Recovered from the Abrupt Slowdown in Early 2017



Source: Haver Analytics, Bureau of Labor Statistics, Guggenheim Investments. Data as of 2.15.2018. Shaded area represents recession. CPI = consumer price index.

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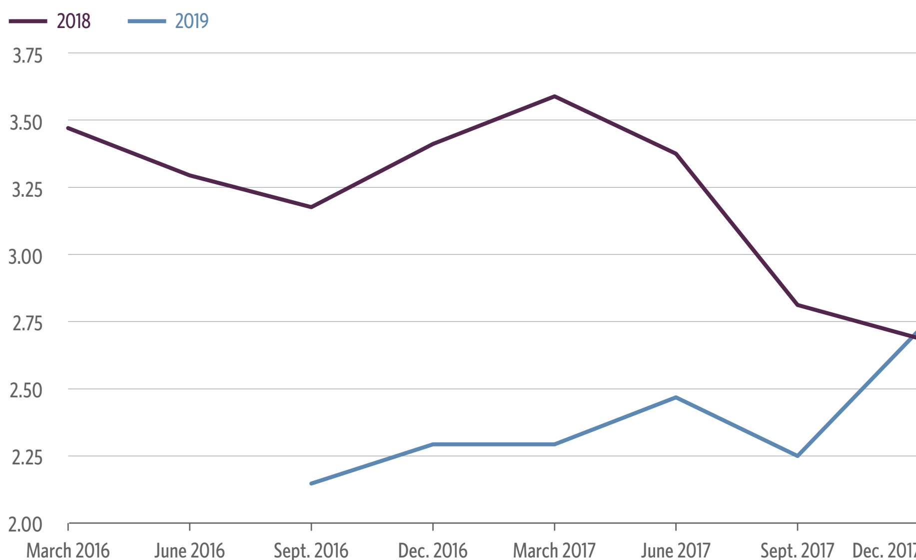
With Inflation Low, Some Fed Officials Want to Postpone 2018 Hikes

Average Number of 25 Basis-Point Rate Hikes Projected by Fed Officials, by Calendar Year



Source: Federal Reserve Board, Guggenheim Investments. Data as of 1.17.2018.

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