Macroeconomic Outlook
Fed Likely to Stay the Course

Brian Smedley
Head of Macroeconomic and Investment Research

Maria Giraldo, CFA
Director

A tightening labor market and near-target inflation will keep the Fed on track even as fiscal policy sputters.

Tracking estimates for first-quarter real gross domestic product (GDP) growth gradually fell throughout the quarter despite strong gains in consumer and business sentiment since the election. On April 28, the advance release of first quarter GDP came in at a tepid 0.7 percent. We attribute a large portion of the apparent weakness to seasonal factors that have depressed as-reported first-quarter GDP growth over the past several years. In keeping with this pattern, we would expect the final first-quarter GDP number to be revised higher once benchmark GDP revisions are released in July. More importantly, the prospects for quarterly U.S. GDP growth are better going forward, and we expect a strong bounce back in the second quarter.

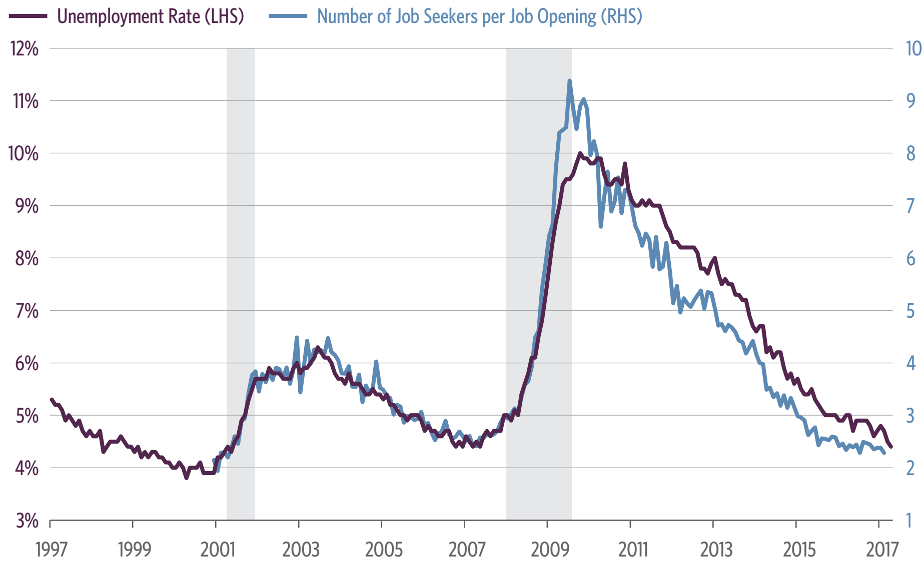
Our medium-term growth outlook has dimmed marginally as a result of the minimal progress seen to date on the Trump administration's fiscal policy initiatives. The ongoing struggle to create a healthcare bill has sapped early legislative momentum, and tax reform will be a politically fraught process. Nevertheless, financial conditions have eased since the election, despite Fed rate hikes in December and March, and we continue to expect the economy to expand faster than its potential growth rate. This should push the unemployment rate to under 4.1 percent by the end of 2018, well below its natural rate of 4.7 percent (see chart, top right), and support a continued gradual rise in underlying inflation, which is nearing the Fed's 2 percent goal (see chart, bottom right).

In light of these trends, we believe that the market is underpricing the likely pace of rate hikes by the Fed in 2017 and 2018. Importantly, Fed Chair Janet Yellen noted in March that the FOMC's baseline forecast of two additional rate increases in 2017 and three more in 2018 was not conditioned on expectations for fiscal stimulus. Rather, it reflected a need to gradually remove accommodation due to the fact that the Fed has essentially achieved its dual mandate objectives for employment and inflation. Fiscal easing, if it materializes, could result in a faster pace of tightening, she explained, as could a further overshooting of the Fed's labor market objectives.

Markets are skeptical and are pricing in 1.5 more rate hikes in 2017 and fewer than 1.5 rate hikes in 2018, according to fed funds futures contracts. We expect that the Fed will deliver two more rate hikes in 2017 and another four in 2018. Fed policymakers also appear set to formally announce a change in their balance sheet policy later this year, likely in September. In the coming months we are likely to learn further details on how the Fed intends to begin to shrink its portfolio.

This article is distributed for informational purposes only and should not be considered as investing advice or a recommendation of any particular security, strategy or investment product. It contains opinions of the authors but not necessarily those of Guggenheim Partners or its subsidiaries. The authors' opinions are subject to change without notice. Information contained herein has been obtained from sources believed to be reliable, but are not assured as to accuracy. Past performance is no guarantee of future results.

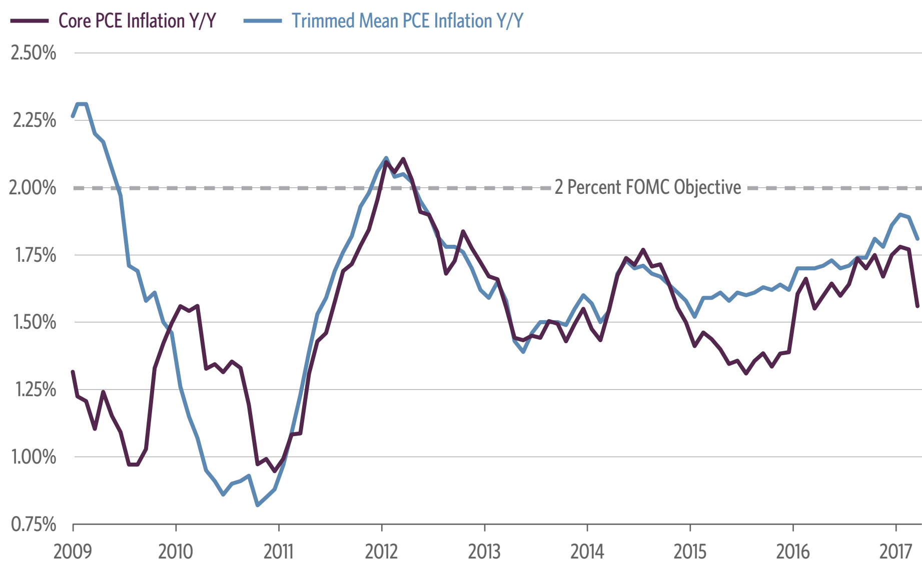
U.S. Labor Market Has Reached Full Employment



Source: Bureau of Labor Statistics, Haver Analytics, Guggenheim Investments. Unemployment data as of 4.30.2017; job openings data as of 2.28.2017.

Financial conditions have eased since the election, despite Fed rate hikes in December and March, and we continue to expect the economy to expand faster than its potential growth rate. This should push the unemployment rate further below its natural rate.

Underlying U.S. Inflation Is Rising Toward the Fed's 2 Percent Goal



Source: Bureau of Economic Analysis, Dallas Fed, Haver Analytics, Guggenheim Investments. Data as of 3.31.2017.

The ongoing tightening of labor and product markets will support a continued gradual rise in underlying inflation measures, which are nearing the Fed's 2 percent goal.

Investing involves risk. In general, the value of fixed-income securities fall when interest rates rise. High-yield securities present more liquidity and credit risk than investment grade bonds and may be subject to greater volatility. Asset-backed securities, including mortgage-backed securities, may have structures that make their reaction to interest rates and other factors difficult to predict, making their prices volatile and they are subject to liquidity risk. Investments in floating rate senior secured syndicated bank loans and other floating rate securities involve special types of risks, including credit risk, interest rate risk, liquidity risk and prepayment risk. Guggenheim Investments represents the following affiliated investment management businesses of Guggenheim Partners, LLC: Guggenheim Partners Investment Management, LLC, Security Investors, LLC, Guggenheim Funds Investment Advisors, LLC, Guggenheim Funds Distributors, LLC, Guggenheim Real Estate, LLC, GS GAMMA Advisors, LLC, Guggenheim Partners Europe Limited, and Guggenheim Partners India Management. ©2017, Guggenheim Partners, LLC. No part of this article may be reproduced in any form, or referred to in any other publication, without express written permission of Guggenheim Partners, LLC.