Macroeconomic Outlook

Market Yawns as Fed Tees Up Balance Sheet Runoff

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Easy financial conditions keep the Fed on course despite a string of weak inflation readings.

Second-quarter U.S. real gross domestic product (GDP) growth was solid at 2.6 percent annualized, rebounding from a soft 1.2 percent reading in the first quarter. We anticipate that personal spending will continue to propel above-trend real GDP growth in coming quarters, supported by strong gains in household income and net worth (see chart, top right).

The U.S. labor market has strengthened further, with robust payroll gains of 209,000 in July. The 12-month moving average stands at 180,000, roughly double the amount needed to keep the unemployment rate steady. Indeed, the unemployment rate has fallen by 0.6 percentage point over the past year to 4.3 percent, and we expect further declines going forward. Inflation and wage gains have disappointed in recent months, however, with core personal consumption expenditure (PCE) inflation slowing from 1.9 percent to 1.5 percent year over year between February and June. While transitory factors account for some of the weakness, inflation should be accelerating, not slowing. Nevertheless, the Fed pressed forward with a quarter-point rate increase at its June meeting, and projected another hike in 2017, plus three more in both 2018 and 2019. The Fed's forecasts show that it expects inflation weakness will not persist beyond 2017.

A key reason the Fed is shrugging off soft inflation data is that measures of broad U.S. financial conditions—which incorporate factors such as short- and long-term interest rates, credit spreads, equity prices and the exchange value of the dollar—have eased even as the Fed has raised rates (see chart, bottom right). There has also been a benign market reaction to the Fed's pre-announcement of its balance sheet normalization strategy, which we expect to be implemented starting in October. The fact that growth-friendly financial conditions still prevail despite Fed tightening—and diminished odds of fiscal easing—has given the Fed confidence that it can stick to its plans to gradually raise rates and shrink its balance sheet without damaging the economy. We see the next Fed hike in December.

The ECB's path is arguably more treacherous than the Fed's because markets are more uncertain about the future of the ECB's asset purchase program. Purchases are currently scheduled to continue at a pace of €60 billion per month through 2017. We expect the ECB will announce a reduction in the purchase pace to €40 billion through at least mid-2018, effective in January, later this fall. With the tide of central bank liquidity receding, markets are due for an increase in volatility.

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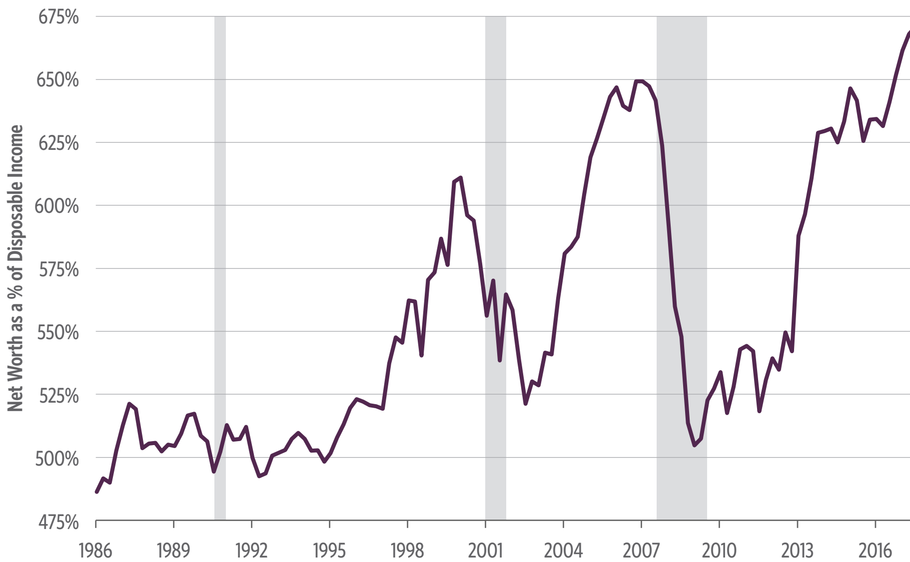
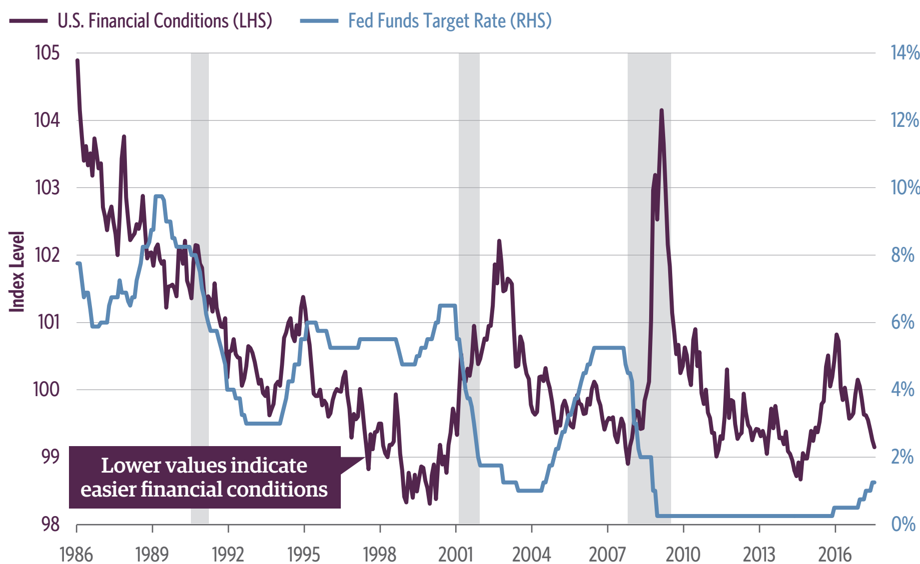
Booming Markets Have Lifted U.S. Household Net Worth to an All-Time High



Source: Haver Analytics, Federal Reserve Board, Guggenheim Investments. Official data through 3.31.2017. Guggenheim estimates through 7.15.2017. Shaded areas indicate recession.

Extraordinary monetary accommodation has boosted asset valuations and lifted household net worth to an all-time high, which should help support consumer spending.

Financial Conditions Have Eased Despite Fed Tightening



Source: Bloomberg, Goldman Sachs, Guggenheim Investments. Data as of 7.15.2017. Shaded areas indicate recession.

Market indifference to Fed tightening has given policymakers confidence to continue normalizing policy.

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