Macroeconomic Outlook

Normalizing Today, Overshooting Tomorrow

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A strong economy is likely to embolden the Fed to raise rates at a faster pace than the market is expecting.

The U.S. economy continues to expand at an above-trend pace. Real gross domestic product (GDP) grew at an annualized rate of 3.0 percent in the third quarter, similar to the 3.1 percent pace seen in the second quarter, despite a roughly 1 percentage point drag from several major hurricanes. We also expect fourth-quarter growth to be near 3 percent, supported by strong momentum in the United States and abroad, favorable financial conditions, and rebuilding activity in the wake of recent storms. We see potential upside risks to 2018 growth in the event that tax cuts pass in Washington.

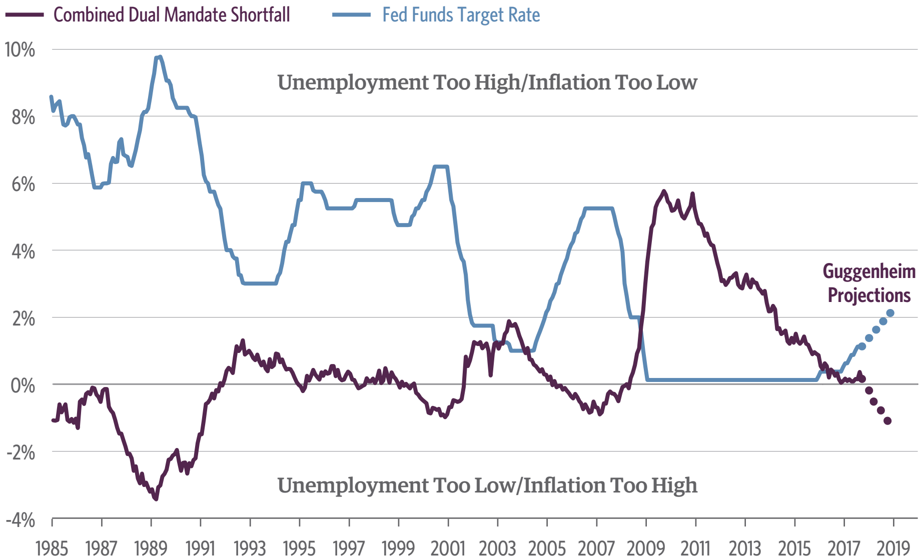
Meanwhile, the labor market is steadily tightening and is in the early stages of overheating. This is evidenced by the fall in the unemployment rate to a cycle low of 4.1 percent in October. Hurricane activity distorted payroll employment in September and October, but job growth has averaged 169,000 per month in the year through October, underscoring the robust—and unsustainable—underlying trend in hiring. Although average hourly earnings data have been noisy, other indicators of wage growth, such as the employment cost index, continue to trend higher, confirming that the wage Phillips Curve is not defunct. Leading indicators, including hiring intentions surveys, point to further declines in the unemployment rate.

Inflation continues to be well below the Fed's 2 percent target, with core personal consumption expenditure (PCE) inflation coming in at 1.3 percent in September. However, inflation lags GDP growth by about six quarters; because growth has accelerated over the past year, and the dollar has depreciated, inflation will likely move closer to 2 percent later in 2018.

We expect the Fed to resume a quarterly pattern of rate increases in December, continuing until late-2019, as unemployment and inflation are likely to overshoot on a net basis the Fed's dual mandate objectives (see chart, top right). Four hikes in 2018 would be a much faster pace than the market is currently pricing in, and we expect the result to be a bear flattening of the Treasury yield curve. The rise in shorter-maturity yields should outweigh any steepening pressure coming from the decline in net demand for long-duration bonds as the Fed balance-sheet runoff ramps up and European Central Bank (ECB) tapering takes effect (see chart, bottom right). The appointment of Jerome Powell as Fed Chair does not change our bear flattening view, as he is likely to continue the policy direction that is currently in place.

GUGGENHEIM

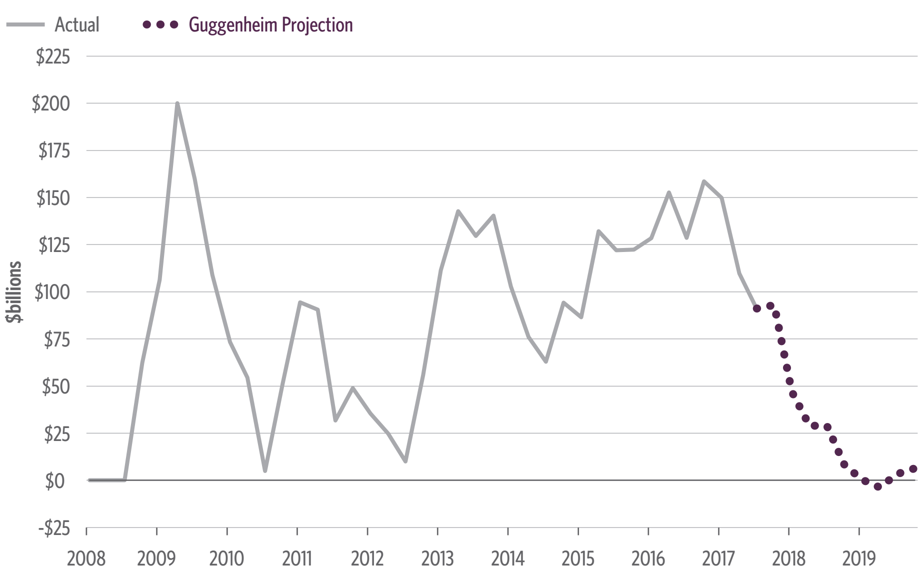
Fed Rate Hikes Are Set to Continue as the Fed Overshoots Its Dual Mandate Goals



Source: Haver Analytics, Congressional Budget Office (CBO), Guggenheim Investments. Data as of 10.11.2017. Combined dual mandate shortfall adds the deviation of core PCE inflation from the Fed's 2 percent objective and the deviation of the unemployment rate from the CBO's estimate of the natural rate of unemployment.

We expect the Fed to resume a quarterly pattern of rate increases in December, hiking four more times in 2018 as unemployment and inflation overshoot on a net basis the Fed's dual mandate objectives.

Net Central Bank QE Purchases Are Likely to Fall Sharply Over the Coming Year



Source: Haver Analytics, Guggenheim Investments. Data as of 10.30.2017. Note: Monthly rate of net bond purchases by the Federal Reserve, European Central Bank, Bank of Japan, and Bank of England at current exchange rates. QE = quantitative easing.

The rise in shorter-maturity yields should outweigh any steepening pressure coming from the decline in net demand for bonds as the Fed balance-sheet runoff ramps up and ECB tapering takes effect.