Macroeconomic Outlook
Factoring in Late-Cycle Fiscal Stimulus

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The Fed will likely need to hike rates at a faster pace than the markets are pricing in.

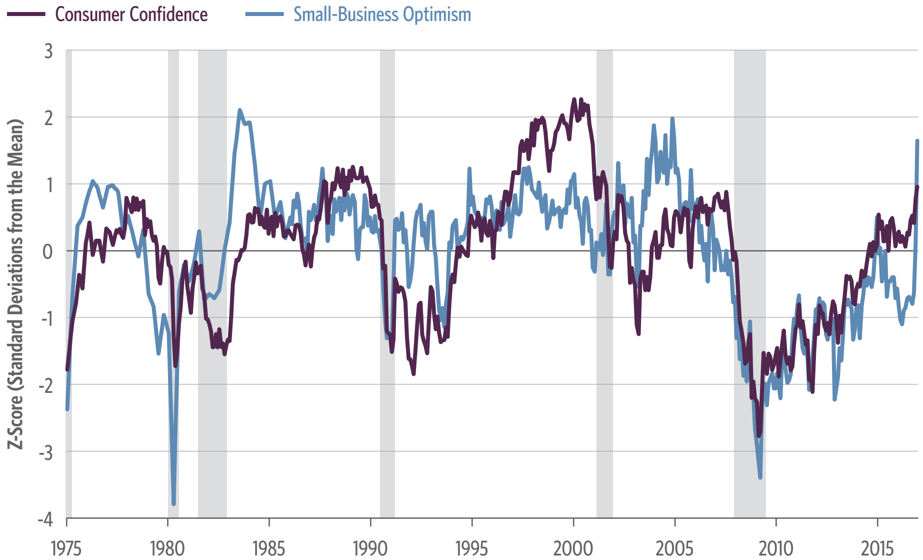
U.S. real gross domestic product (GDP) growth in the fourth quarter was solid but unspectacular, like most of the post-crisis period. The initial estimate came in at 1.9 percent, slightly below expectations and down from 3.5 percent in the third quarter. The quarterly volatility seen in the second half of 2016 resulted mainly from large swings in the contribution of net exports. Smoothing through the quarterly noise reveals a trend-like pace of 1.9 percent real GDP growth over the past year.

Fiscal stimulus and deregulation are about to give the U.S. economy a shot in the arm. We expect the combination of corporate and individual tax cuts plus infrastructure spending to lift growth into the 2.5–3.0 percent range over the next couple of years, with the largest impact likely to be seen in 2018. In the meantime, growth should benefit from recent gains in consumer and business confidence, which will support consumption and investment spending as precautionary savings are reduced (see chart, top right).

We forecast the unemployment rate to fall below 4 percent before the end of the expansion as faster GDP growth boosts employment while demographic constraints limit gains in the size of the labor force. This would be well below the Fed's estimate of the natural rate of unemployment; however, we believe the Trump administration's fiscal agenda will not push up inflation materially because the Fed will respond by tightening monetary policy faster. While CPI inflation will rise in the first quarter due to the receding effects of low oil prices, we forecast a subsequent decline as base effects fade and a stronger dollar helps to contain import prices. These forces, combined with our forecast that crude oil prices will average less than $60 per barrel in 2017, should help keep inflation near the Fed's target this year.

Nevertheless, Fed policymakers will raise the fed funds rate at a faster pace than the market is currently pricing in. This should cause the yield curve to flatten as rates in the short end rise while the long end is stabilized by confidence in the Fed's willingness to contain inflation. Our research indicates that the terminal rate at the end of this hiking cycle will be near 3 percent. We expect three Fed rate increases in 2017, amid upside risks to growth and downside risks to unemployment (see chart, bottom right). The next hike will most likely occur in June, but action at the March FOMC meeting is still plausible. We do not think the Fed will begin to shrink its balance sheet until well into 2018, and we expect any such shift to be telegraphed well in advance as Fed officials seek to avoid another "taper tantrum."

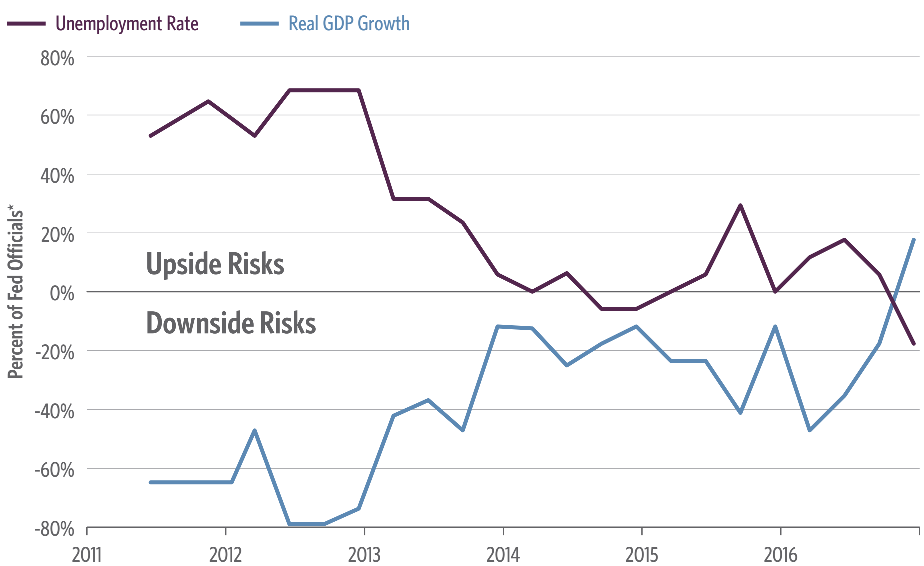
Surge in Consumer and Business Confidence Will Support GDP Growth



Source: Guggenheim Investments, Haver Analytics, Conference Board, NFIB. Data as of 1.31.2017. Shaded areas represent periods of recession.

Consumer and business confidence indicators have surged in the wake of a contentious election cycle. Optimism about the potential impact of pro-growth fiscal and regulatory policies should spur increased spending, boosting real GDP growth.

Fed Officials Now See Upside Risks to the Economic Outlook



Source: Guggenheim Investments, Federal Reserve Board. Data as of 1.31.2017. *Equal to the number of FOMC participants who see upside risks to their baseline projections minus the number who see downside risks, divided by the total of FOMC participants.

Based on the Summary of Economic Projections, more Fed officials see upside risks to growth—and downside risks to the unemployment rate—than those who see downside risks to the economy. This optimism should translate into a faster pace of policy tightening.