Macroeconomic Outlook

Fed Cuts Rates as Downside Risks Build

Brian Smedley
Head of Macroeconomic and Investment Research

Maria Giraldo, CFA
Managing Director

Matt Bush, CFA, CBE
Director

The U.S. economy is strong, but soft inflation and downside risks to growth prompted the first Fed rate cut since 2008.

U.S. economic growth slowed to 2.1 percent annualized in the second quarter from 3.1 percent in the first quarter. Personal consumption expenditures (PCE) rebounded sharply, as expected, while government spending contributed an outsized 0.9 percentage point to growth, the most since mid-2009. However, negative contributions were seen from housing, business capital expenditure, inventory investment, and net exports. Looking ahead, we expect the economy to grow at a 1.5–2.0 percent pace in the third quarter.

The second-quarter gross domestic product (GDP) release also featured annual revisions to the five prior years of data, which showed that growth peaked in year-over-year terms in the second quarter of 2018, earlier than previously thought (see chart, top right). An upwardly revised personal saving rate gives consumption room to run, but downwardly revised and shrinking corporate profits will continue to pressure investment spending and could begin to weigh more heavily on hiring.

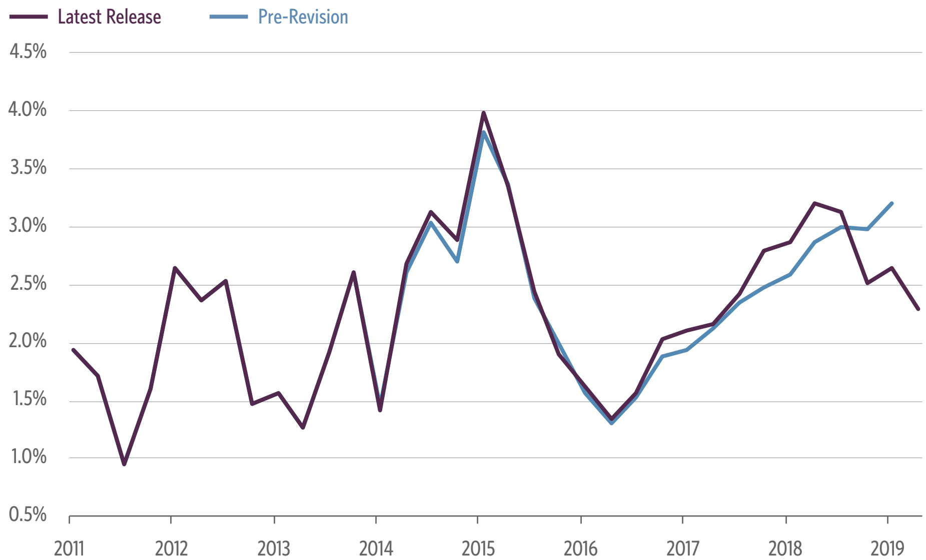
With growth in the first half of the year coming in somewhat above potential, the labor market continued to strengthen, albeit at a slower pace than the year before. Net monthly payroll gains averaged 141,000 in the six months through July, down from 236,000 during the same period in 2018. This was enough to push the unemployment rate down by 0.2 percentage point to 3.7 percent. While the labor market remains strong, we believe the sharp slowdown in aggregate hours worked—a component of our U.S. Recession Dashboard—foreshadows a deterioration in labor market conditions in 2020.

After a weak start to the year, core inflation picked up in the second quarter but remained below the Fed's 2 percent target at 1.8 percent annualized. We expect inflation to firm a bit further in the second half of 2019.

Although the U.S. economy is in good shape overall, on July 31 the Fed announced its first rate cut since 2008 amid growing downside risks to policymakers' baseline growth and inflation forecasts (see chart, bottom right). Key among these are slowing global growth, the threat of additional U.S.-China tariffs, and a possible hard Brexit, the odds of which have increased with the ascendance of Boris Johnson as prime minister of the United Kingdom. While a possible U.S. fiscal contraction in 2020 was averted by the recently signed budget deal, we expect two more Fed rate cuts in 2019 as Chair Jay Powell seeks to sustain the expansion. In our view, this could serve to embolden the White House to impose new tariffs on China and Europe later this year, which would in turn further cloud the outlook for global growth.

GUGGENHEIM

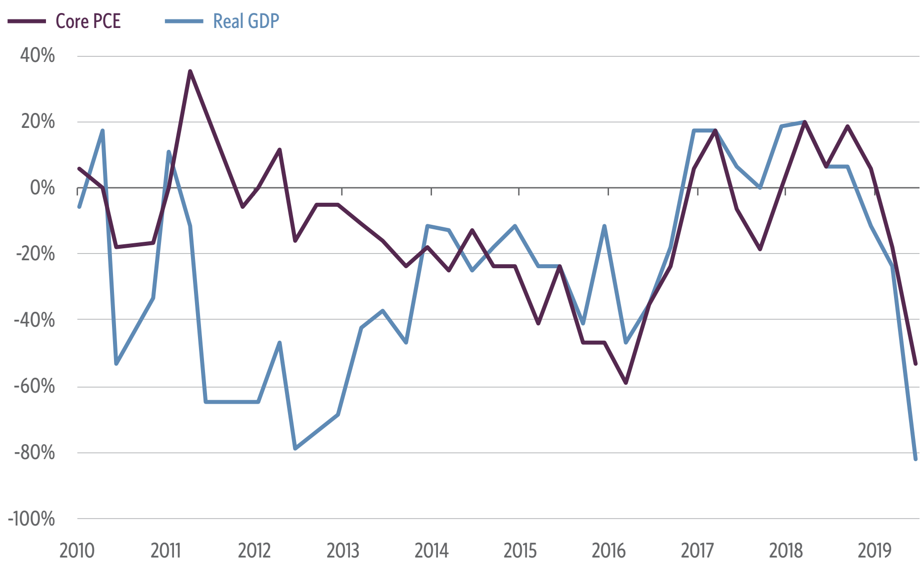
Latest GDP Data Shows Growth Peaked Earlier Than Thought
Real GDP, YoY% Change



Source: Guggenheim Investments, Haver Analytics. Data as of 6.30.2019.

The second-quarter GDP release featured annual revisions to the five prior years of data, which showed that growth peaked in year-over-year terms in the second quarter of 2018, earlier than previously thought.

Mounting Downside Risks Drive the Fed into Easing Mode
Net Upside/Down Risk to SEP Projections: % of FOMC Participants



Source: Guggenheim Investments, Federal Reserve. Data as of 6.19.2019.

Although the U.S. economy is in good shape overall, on July 31 the Fed announced its first rate cut since 2008 amid growing downside risks to policymakers' baseline growth and inflation forecasts.