Macroeconomic Outlook

Rising Rates Are Beginning to Bite

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Rising rates are hurting the most rate-sensitive sectors in a preview of the bigger slowdown headed our way.

The U.S. economy registered another quarter of robust growth, with real GDP expanding by 3.5 percent in the third quarter. Consumer spending, which continues to be buoyed by tax cuts, again powered growth. With growth running substantially above our estimate of potential (around 1.5 percent), we expect the unemployment rate to fall further below the 3.7 percent it reached in October. Meanwhile, underlying inflation is in line with the Fed's 2 percent target and trending higher, notwithstanding some recent softening. We see upside inflation risks from tariffs, which we expect to broaden to cover all U.S. imports from China next year.

Strong economic data have led bond investors to realize that the Fed hiking cycle may extend further than previously assumed. The result has been an increase in long-term Treasury yields, which ratcheted closer to our terminal rate forecast over the past quarter. Going forward, we believe 10-year Treasury yields will peak around 3.75 percent, and that the yield curve will flatten further in 2019. The speed at which rates rose in September and early October triggered sharp losses in equities, a widening of credit spreads, and further gains for the trade-weighted dollar. Taken together, financial conditions have become less supportive of growth.

Nevertheless, we continue to forecast a rate hike in December, followed by four more in 2019. As we see it, the Fed has no choice but to try to slow the economy to avoid overshooting the Fed's dual goals of full employment and price stability. Criticism from the White House is unlikely to deter the Fed in this task. If anything, it may embolden policymakers to forge ahead into restrictive territory—as their latest rate projections imply—to avoid being seen as bowing to political pressure.

The desired slowdown will occur as the Fed tightens, the escalating trade war undermines business investment, and fiscal support fades in late 2019. The rise in rates is already hurting housing and autos, two of the most rate-sensitive sectors. Rising rates are dampening consumer appetite for large purchases, which is typical toward the end of an expansion (see chart, top right). Higher mortgage and consumer credit rates are causing household debt service costs to rise faster than disposable income, another late-cycle indicator (see chart, bottom right).

The key question is whether the Fed will manage to slow the economy without tipping it into recession. We wouldn't bet on it. The U.S. economy still appears headed for a recession in the first half of 2020. As such, we are further de-risking client portfolios in anticipation of a bumpier ride for risky assets in 2019.

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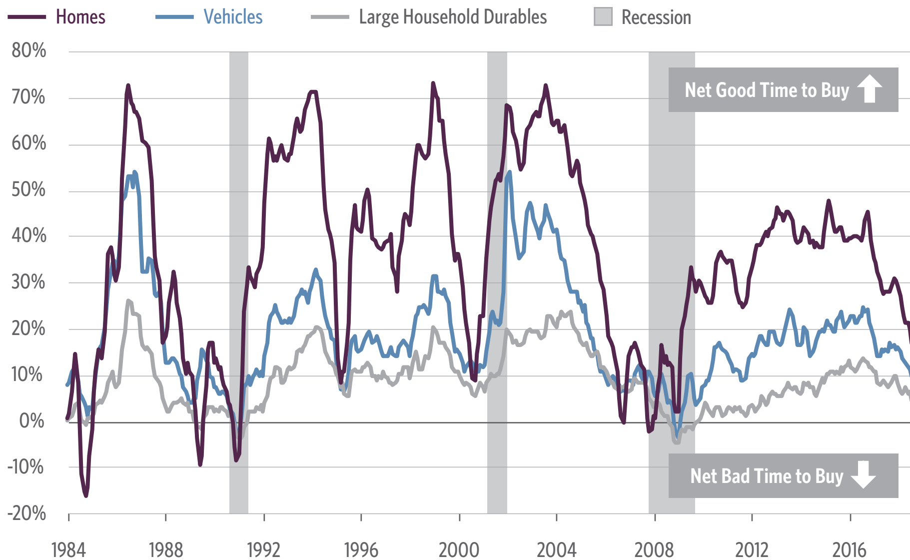
Rising Rates Have Bruised Home, Vehicle, and Durable Goods Perceptions

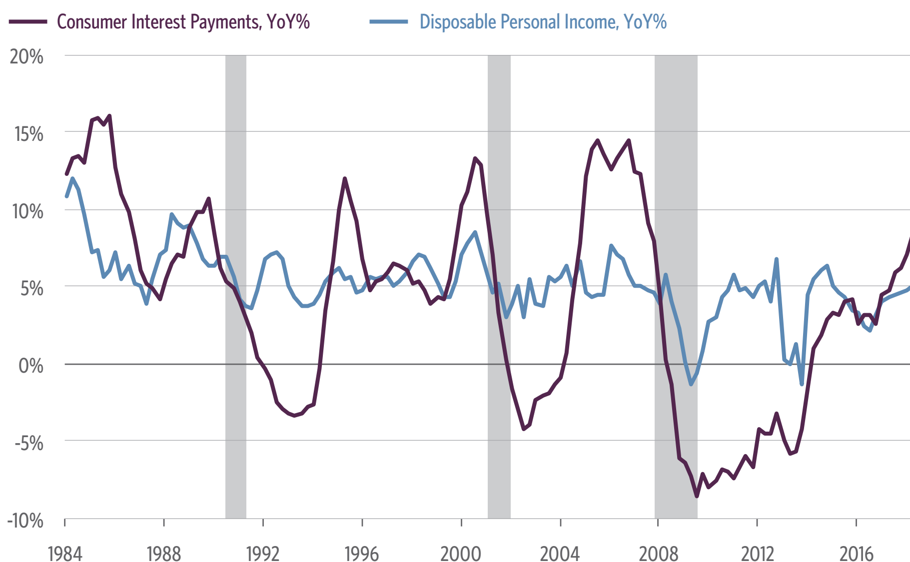
Opinions on Buying Conditions: Net Good Time to Buy Due to Interest Rates (3m Mov. Avg.)



Source: Bloomberg, University of Michigan, Guggenheim Investments. Data as of 10.31.2018.

The rise in rates is already hurting activity in housing and autos, the two most rate-sensitive sectors. Home and auto sales are well off their respective cycle peaks as rising rates dampen consumer sentiment, which is typical toward the end of an expansion.

Consumer Debt Service Costs Are Rising Faster than Disposable Income



Source: Haver Analytics, Guggenheim Investments. Data as of 9.30.2018. Consumer interest payments include mortgage interest payments.

Higher rates on mortgages and consumer credit are causing household debt service costs to rise faster than disposable income, another late-cycle indicator.

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