

## Macroeconomic Outlook

# When Fiscal and Monetary Policy Collide



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Ill-timed fiscal stimulus will require more aggressive Fed policy tightening, ultimately ending in recession.

Seasonal adjustment challenges and winter weather appear to have taken a toll on U.S. economic data in the first quarter, as seen in previous years. Nevertheless, the outlook for near-term economic growth has brightened due to the spending bill that was passed by Congress in February. With significant federal spending increases and tax cuts in the pipeline, the economy will grow well above potential in 2018 and 2019. The good news is that this will support corporate earnings in the near term. The bad news is that this is how business cycles end.

The problem is that above-potential economic growth drives above-potential job creation, which will push the unemployment rate further below its sustainable rate (see chart, top right). Payroll growth has averaged 211,000 over the last six months and 188,000 over the last year, roughly double the rate that would be necessary to maintain a stable unemployment rate given U.S. demographics. We expect the unemployment rate to fall to 3.5 percent or lower—a full percentage point or more below its estimated natural rate—before the cycle ends.

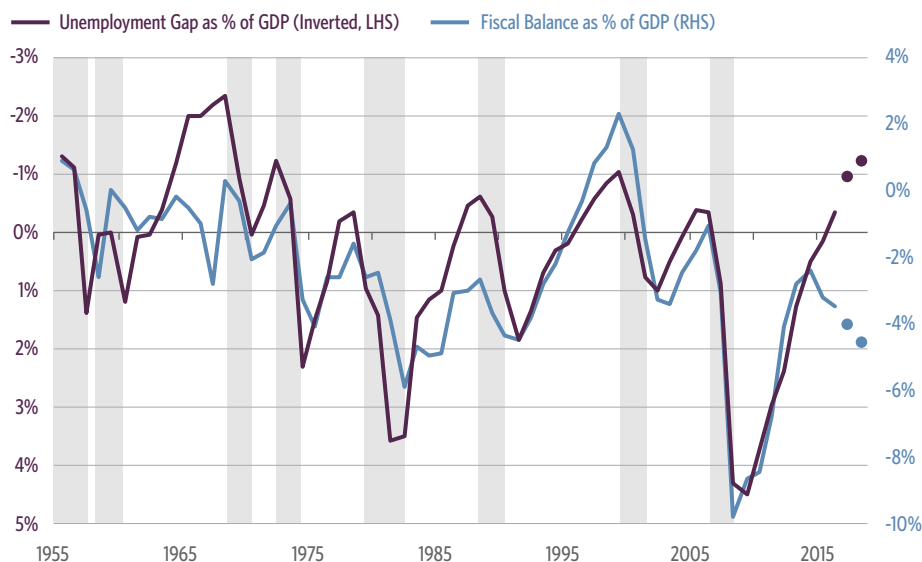
With a tighter labor market comes faster wage and price inflation. Inflation has rebounded from last year's slump, with the Fed's preferred core inflation measure having accelerated from 0.9 percent in August to 2.3 percent in March on a six-month annualized basis. Twelve-month inflation numbers turned higher in March as last year's decline in wireless services prices provided a favorable base effect, bring core inflation to 1.9 percent, essentially at target.

With lawmakers doubling down on fiscal stimulus at a time when the labor market is already beyond full employment, the Fed will need to tighten monetary policy further (see chart, bottom right). We expect the Fed to deliver three more rate hikes in 2018 and another four in 2019 as it attempts to engineer a soft landing. However, history suggests that its odds of success are low. We continue to forecast that a recession will begin around early 2020, when a fading fiscal impulse collides with tight monetary policy and an overextended economy.

The combination of rate hikes and supply congestion in the front end of the yield curve underpins our expectation for further bear flattening. Three-month Libor will bear the brunt of Fed tightening, owing to the combined effect of a higher fed funds rate and declining excess reserves as the Fed's balance sheet shrinks. We maintain an up-in-quality bias, as the Fed's determination to avoid overheating will ultimately spell trouble for credit markets.

## Fiscal Stimulus Will Drive Unemployment Below a Sustainable Level

Unemployment Gap vs. Fiscal Balance, % of GDP



Source: BLS, Haver Analytics, Congressional Budget Office, Guggenheim Investments. Data as of 3.31.2018. Gray areas represent periods of recession. LHS = left hand side, RHS = right hand side.

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## Recession Risks Rise as the Labor Market Moves Beyond Full Employment

U.S. Unemployment Rate, with the Point When Full Employment Was Reached



Source: BLS, CBO, Haver Analytics, Guggenheim Investments. Data as of 3.31.2018. Gray areas represent periods of recession.

With lawmakers doubling down on fiscal stimulus at a time when the labor market is beyond full employment, the Fed will need to tighten monetary policy further. The chart illustrates that recession occurs approximately two to three years after full employment is reached. For example, the last recession began 31 months after full employment was reached.

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