Global Views: The Home Stretch

Jan Hatzius
+1(212)902-0394 | jan.hatzius@gs.com
Goldman Sachs & Co. LLC

Q: Where do you see the probability of a US recession?

A: Our judgmental 12-month probability remains at 35%, above our 25% estimate prior to SVB weekend but far below the 65% Bloomberg consensus as well as the view of the Fed staff.

The risk of an outright banking crisis has declined sharply, as no additional institutions have failed since SVB weekend, Fed lending to banks has come off the highs, and deposit flight has subsided. While loans and securities on bank balance sheets have contracted substantially in seasonally adjusted terms, most of the weakness reflects sales of assets to nonbanks as well as residual seasonality introduced by the extreme volatility in March/April 2020.

This has reduced the uncertainty around our estimate that tighter lending conditions will subtract 0.4pp from GDP growth over the next year, which is similar to that of the IMF. It also looks broadly consistent with the meaningful, but not dramatic, increase in the share of small businesses reporting that "credit was harder to get" in the March NFIB survey. Given the rest of our forecast, a 0.4pp growth drag would be helpful in keeping growth below potential at a time when other growth drivers—including stabilization in housing, an upturn in real disposable income growth, and stronger growth in China—are pointing to acceleration. However, it would be premature to sound the all-clear on the banking stress as significant uncertainty remains.

Q: Even if the banking stress does not push the economy into recession in the near term, does the Fed *need* to create a recession to bring down inflation sufficiently?

A: We don't think so. Although the March CPI was only slightly below consensus expectations, it confirmed that inflation is still slowing gradually. This is a reassuring development following the upside surprises of early Q1.

But it is the labor market where the recent news has been particularly encouraging. The combination of higher labor force participation and stronger immigration has kept the unemployment rate at 3½% for a full year despite continued strong payroll growth. Our jobs-workers gap has fallen at least halfway back to its pre-pandemic level, depending on whether we use the official JOLTS data or the softer private sector measures. The quits rate has fallen more than halfway back to its pre-pandemic level. And sequential wage growth has fallen two-thirds back to the

3½% pace that we think is consistent with the Fed's inflation target.

Q: Has the FOMC now reached the "sufficiently restrictive" level for the funds rate at which it wants to wait for the remaining adjustment to play out?

A: Probably not quite. At the March 21-22 FOMC meeting, 17 out of 18 participants projected a yearend funds rate of at least 5-5¼%, which is 25bp above the current level. Since then, the news has been slightly hawkish on net, mainly because of the better financial news. This suggests a high probability of a 25bp hike at the May 2-3 FOMC meeting, barring large negative surprises in either the financial news or the economic data.

However, we think the committee is now in the home stretch as we no longer forecast a hike at the June 13-14 meeting. The economic data are likely to be too soft to persuade the committee to both deliver a hike in May and signal an upward revision to the terminal rate implied in the March dot plot. Instead, we expect the committee to keep the funds rate at 5-5¼% until 2024Q2. The risks around this baseline forecast are clearly tilted toward rate cuts but, in our view, not by as much as implied by market pricing.

Q: Is the Euro area also making progress toward disinflation?

A: It's much less obvious than in the US, as neither core inflation nor wage growth have shown clear signs of deceleration so far. With European banking stress abating and the ECB deposit rate still nearly 200bp below the US federal funds rate, we therefore feel more confident that the ECB will deliver at least another 50bp of hikes.

Ultimately, however, we also expect substantial disinflation in the Euro area because the contrast with the US is probably largely a timing issue. First, Euro area inflation took off 3-6 months later and the progress in the US only started to become obvious last fall. Second, the European wage data are both noisier and subject to longer publication lags, so turning points take longer to discern. Third, Euro area wages are often set via collective bargaining agreements, which take longer to respond to new information such as cost-of-living increases and increased labor market tightness. And fourth, wage inflation in other large DM economies that previously saw a large pickup—not just the US but also the UK, Canada, and Australia—has fallen in recent months. We would be surprised if the Euro area proved to be a persistent outlier.

Q: So is the world economy set for a soft landing?

A: Not across the board. On the one hand, Russia's war against Ukraine has pushed both countries, as well as some of their neighbors, into a slump. On the other hand, China is in a different stage of the cycle altogether and our 6.0% GDP growth forecast for 2023 remains well above consensus.

But most other major economies need a landing from the post-covid inflation surge, and we expect it to be mostly soft. As we noted late last year, this cycle is different from prior high-inflation periods in ways that should continue to make it much easier to bring down inflation without a recession. Inflation expectations remain much more anchored; temporary factors account for much more of the earlier price inflation runup; and labor markets should prove much easier to rebalance via reduced job openings and without a large—or perhaps, any—hit to employment.

Q: What are the implications for asset market returns?

A: Not as stellar as one might expect. From a tactical perspective, the equity market already seems to discount quite a rosy scenario, while the rates market looks downbeat. But more lasting headwinds are also at play. The flip side of sustained high employment levels is that the room for both rate cuts and profit margin expansion is fundamentally limited, at a time when the continued risk of geopolitical conflict may require a higher risk premium than what is currently priced. Consistent with these observations, our rates strategists expect higher yields and our equity strategists see little or no upside from current levels. However, our credit strategists see further room for spreads to normalize in the near term as banking stresses abate, and our commodity strategists expect the rebound in oil prices on the back of the OPEC+ production cut to continue.

Jan Hatzius

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