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The Fed is likely finished hiking rates as the US avoids recession

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Allison Nathan: With the Federal Reservoir's key Jackson Hole symposium in the rearview mirror and the September Fed meeting around the corner, what's next for the Fed and for the US economy more broadly?

David Mericle: We cut our recession probability for the next 12 months just a couple of days ago down to 15%, which is about the historical unconditional average, because we felt like at this point the risk of aggressive monetary policy tightening causing a recession seems pretty minor. And we're back to a world where, sure, something can go wrong but something can always go wrong.

Allison Nathan: I'm Allison Nathan and this is Goldman Sachs Exchanges.

To discuss the state of the US economy and what consumers and investors should expect in the coming months, I'm sitting down with my colleague in Goldman Sachs Research, David Mericle, our chief US economist. David, always great to have you here.

David Mericle: Very nice to be here, thank you.

Allison Nathan: David, you and I have discussed in recent podcasts the number of challenges that the US economy is facing this year between inflation. We've seen this recent surge again in interest rates. The Fed gathering of global central bankers at Jackson Hole just took place. What did it reveal to you about the Fed's next move at the September meeting?

David Mericle: My main takeaway was that Chair Powell brought back the word "carefully" in talking about the pace of further tightening. Now, when he introduced that word in June, we and most people took it to mean that they would hike every other meeting. He deliberately avoided it in July, I suspect because some of his colleagues thought that it was premature to commit to not hiking at the September meeting. But he felt comfortable bringing it

back at Jackson Hole. And that means to me that they're very unlikely to hike in September.

Beyond September, different people still have different views, but I don't think he would have brought back that word unless he had largely decided that they were not going to be going at that meeting.

Allison Nathan: But some people did perceive some of his comments at Jackson Hole to be a bit more hawkish than they were in July. Correct me if I'm wrong, but we at this point expect them to not hike again. What gives you confidence in that view?

David Mericle: That's right. We still think that the July hike will turn out to be the last hike of the cycle. Big picture, the way that we've been viewing the world for the last year and a half has been through the lens of our framework that we developed for thinking about what's necessary to achieve a soft landing.

First, you need to keep policy tight enough to keep demand growth below potential so that supply can catch up. That will hopefully yield a further normalization of labor market

tightness with the falling jobs workers gap. And that will flow through to softer wage growth and softer inflation.

Now, the big risk that we were worried about in 2023 was that, with the fiscal and monetary policy tightening fading, with the impact on GDP fading, we might see a reacceleration of demand growth that would threaten to stall that labor market rebalancing. The puzzle of 2023 has been that we have indeed seen demand re-accelerate this year, but, nevertheless, labor market rebalancing has continued in exactly the way you would have hoped. Our jobs workers gap is now pretty close to where we think it needs to be compatible with sustainable wage pressures and at-target inflation. So that's been a bit of a stroke of good luck.

If all you knew were that the economy were this strong when inflation is still well above 2%, you might very well say, as Chair Powell alluded to, that further hikes might be necessary in order to slow demand growth and ensure that labor market rebalancing continues. But I don't think that's really necessary because I don't think strong GDP growth is necessarily that big of a problem if we're moving back toward 2% anyway and we're moving back toward a

more balanced labor market anyway.

Allison Nathan: But how can we explain the fact that we are seeing inflation moving towards a more comfortable level, lots of rebalancing in the right direction as you just said, but ultimately growth is holding up? What explains that resilience?

David Mericle: Part of it is the strength on the supply side. We continued to see last month a further increase in labor force participation. We've also seen above-trend immigration levels in the US. That means that maybe very near-term potential growth. There's a little bit higher than medium-term potential growth. Some of the decline in job openings, which has also contributed to that labor market rebalancing, even as final demand growth for goods and services has proven quite robust. Some of that decline might just come from post pandemic normalization. Companies realizing that they had overestimated their needs for labor as the economy was booming during the reopening phase.

Whatever it is, though, it's good new for the FOMC. It means that strong demand growth that we worried about at

the start of the year actually hasn't been particularly costly because rebalancing has continued anyway. And I think there are a lot of signs that inflation will fall quite a bit further.

Allison Nathan: And talk to us a little bit more about that because, to a lot of people, inflation doesn't feel like it's falling very quickly. So what are you looking at that gives you confidence that we have been seeing inflation decline and we're going to see it decline further?

David Mericle: Sure. I break this into fundamental drivers of influx. The sort of overheating issues. Things like an excessively tight labor market and evaluated inflation expectations. And then the kind of quirky pandemic factors that we just had to wait out. And at this point, I would say on both sides things are going quite well. The labor market has substantially rebalanced, we think basically enough at this point. Measures of labor market tightness don't look that much different from 2019. And if they look a little bit tighter, that's probably fine because back then we had a low rather than a high inflation problem. So we don't need to go all the way back there.

Even measures of short-term inflation expectations are now pretty close to where you would want them to be. So from that underlying trend or fundamental perspective, I don't think there's a whole lot to worry about at this point. I think we're in a situation where, with a lag, we should expect inflation to largely normalize.

And then the pandemic-related factors continue to normalize as well, and that's proven to be helpful, most obviously in the auto sector where I think we all knew that, if shortages had driven prices up, fixing production, rebuilding inventories, restoring competition, would push prices back down. It took a lot longer than anybody thought, but that process is still very much ongoing and I think has more to offer in terms of its deflationary impulse.

Allison Nathan: Energy prices are rebounding again. Is that a concern at all?

David Mericle: I think it's a mild annoyance rather than a game changer at this point. In 2021 and 2022, booming energy prices, as the economy reopened and then as the war in Ukraine broke out, certainly made an out-of-control inflation situation feel a lot worse.

Back then, it was a little bit concerning. It was the case that, between the reopening of the global economy that pushed up commodity prices across the board and the shortages related to supply-demand imbalances that caused price spikes in other areas like autos, there was really a feeling that many prices across the economy were spiking. There was a little bit of a danger, a sense in the corporate sector that, if all these other prices are going up so quickly, why shouldn't I raise my prices more than normally as well? And we saw as a result of that I think a greater impact on core inflation from energy price spikes than you would see in normal times.

Now, the good news is we're past that reopening phase where commodity prices are booming across the board. We're past that phase where shortages give companies more pricing power. So, yes, when energy costs go up, the cost of things like transportation services where a large part of the final consumer price consists of the cost of energy, are going to feel that. But those effects are moderate. So I think we're back to pre-pandemic world of moderate oil price pass through to the core. Maybe it pushes things up by a couple tenths relative to what would

happen if energy prices had stayed flat, but it's not worrisome in the way that it was in the summer of 2022 when we saw rising near-term inflation expectations and a bit of a sense of out-of-control inflation psychology.

Allison Nathan: But even though you see core inflation declining, you still expect it to remain well above the Fed's 2% target. Talk to us about where you think they can get to and when they can actually get to a point where the Fed would be comfortable.

David Mericle: Yeah, absolutely. I think there is still something to be proven on both wage growth and core inflation. Wage growth by our estimates, our wage tracker is running in the mid-fours. That's about one percentage point too high. On core inflation, we're also still running well above target, and we don't have core inflation coming down to a kind of 2.5% level that I think would be close enough to two to be acceptable until the very end of 2024.

So to be sure, it's too soon to say “mission accomplished.” I think the things that you would worry drive a persistent inflation overshoot -- high inflation expectations and an imbalanced labor market -- it does look like we've solved

those problems. And so the best guess is that we'll get back to 2%, but by no means are we definitively there or even close enough. So too soon to say that we've beaten this problem.

Allison Nathan: But close enough that the Fed's not going to hike again.

David Mericle: I think probably close enough that they'll say we can wait for those lags from rebalancing supply and demand to inflation coming down to play out a little bit more. We're not going to take further hikes off the table by any means, but I think they'll feel that it doesn't seem urgent at the moment. That if the labor market's still rebalancing, if we know that we have a number of sources of further disinflationary pressure from alleviating shortages, from rent inflation coming down with the lag, from that high inflation psychology and its second-round effects fading away, that we can afford at this point to see just how close to 2% those factors get us before deciding if we need to go further.

Part of the reason for that is that Fed officials are very focused on the level of the Fed's Fund Rate relative to its

estimated neutral rate, more so than we are. We tend to view the world more through the lens of our Financial Conditions Index framework.

But for Fed officials, that means that the Funds Rate is about three percentage points in nominal terms above what they think of as normal in the longer run. And I think for many of them, that feels like quite a lot already, especially given the improvement in inflation that we've seen and the further improvements that we know that we have coming.

Allison Nathan: And as we mentioned, interest rates have risen pretty dramatically here in the last few months. How much is that weighing on the Fed's decision making? And how much is that weighing on your view that the consumer can still hold up even with mortgage rates and interest rates more broadly, as high as they are?

David Mericle: Yeah, I think it's another reason that there is less pressure to do more with rate hikes at the moment. The purpose of hiking interest rates further would be to tighten financial conditions by more, slow down demand growth and make sure that the inflation fight stays on track. To the extent that the market, for

whatever reason, is pushing up the medium- to longer-term interest rates that matter more for economic activity than the Fed Funds Rate on its own, that reduces the need for the Fed to tighten.

I think if you're in a situation where growth is above potential and financial conditions have eased a lot, which is where we were before the recent rise in interest rates, then you feel like something is not quite right and it's your fault. And then you're a little bit more obligated to deliver those additional hikes. But if that strong GDP growth is not really translating into a problem in the inflation fight, if it's not knocking the supply-demand rebalancing off course, and if financial conditions are re-tightening a little bit on their own, then I think you feel a lot less pressure because it's not much of a problem and the market's doing something about it. Then perhaps you don't have to.

Allison Nathan: But do you think those high interest rates are going to ultimately pose a problem for growth, just given the hit to consumers?

David Mericle: Our analysis would say that the hit to GDP growth is at this point basically behind us. If you

take a more expansive view to include both market-based financial conditions and the impact of bank credit, then maybe there's a little bit of further drag in the back half of this year yet to come. But by far, the largest effects we think both from fiscal policy tightening and from monetary policy tightening were felt in 2022.

We make those estimates using our Financial Conditions Index Growth Impulse Model where we translate changes in broad financial conditions rather than just the Fed Funds Rate to an impact on GDP growth. Now, the message from that model is that the growth drag is behind us or will be behind us pretty soon. I will say that model is derived from the last several decades of data. It captures a historical average effect of the impact of financial conditions on the economy. It doesn't and isn't designed to capture all of the nuances of the present moment.

One of those nuances in particular I think could be said to justify judgmentally tweaking our model a little bit to say that maybe the impact will be a little bit larger over the course of the next couple of years than the kind of raw historical average impact would say. And that is that many companies in 2020, when the economy was shut down for

at the time who knew how long, when the Fed intervened in the corporate credit market and there's no guarantee that would last forever, they issued an enormous amount of debt, and so their refinancing needs have been pretty muted so far.

Allison Nathan: And we weren't necessarily expecting mortgage rates to be as high as they are today.

David Mericle: Most people don't have adjustable rate mortgages in the US. This is one other reason that I think it's fair to make some judgmental tweaks to the output of our FCI Growth Impulse Model. That model is estimated based on historical averages. In the past, in other countries, adjustable-rate mortgages have been more common. Today, in the US, they're much less common than in other countries and much less common than they were, say, in the 2000s in the United States. And so that means that, as interest rates go up, the hit to the monthly interest payments of people who have mortgages is a lot smaller than it might have been under different conditions.

This is one of the reasons that we thought that higher interest rates would have a little bit less bite than just the

raw historical average would suggest. Now, that does mean for new potential homeowners that they might be a little bit more reluctant to take out a mortgage and build new homes. Although, to me, it looks like most of that impact actually happened in 2022.

Now, we're seeing housing activity kind of stabilize. That's very consistent with the message of our model that says the biggest effects of financial conditions tightening happened last year. And again, the reason for that is that those Fed rate hikes were largely anticipated and priced in advance. And that meant that the transmission to the mortgage rate actually happened pretty early on. And so any homeowners who might have liked to buy a house at lower mortgage rates but decided they weren't going to do it at these rates probably already pulled back in 2022. And so that adjustment of housing demand probably happened. Most of it probably happened quite a while ago.

Allison Nathan: So you don't think the Fed is going to hike again in this cycle. When do you think they'll cut?

David Mericle: We have the first rate cut penciled in for Q2 of 2024. The threshold that we have in mind that's met

at that horizon in our forecast is that core PCE inflation falls below 3% year on year and below 2.5% on a kind of monthly annualized trend basis.

Now, I'll say a couple of things about that. The first is I don't feel terribly strongly about the rate cuts because I don't think it's right to say that the Fed needs to cut. I see it as sort of optional, and I could certainly envision a scenario where we get there and inflation doesn't come down quite enough. Or even if it does, Fed officials say to themselves, "This is a strong economy with a historically tight labor market just coming off of a scary inflation surge. What exactly is the point of cutting? What problem are we trying to solve?" and decide it's just not worth it.

In our Fed Funds scenario analysis, we have for a long time put nearly as much probability weight on a flat no-cut scenario as on our baseline with cuts. Why do I think the right baseline is narrowly for them to cut? Because a 5.5% nominal funds rate or a 3% plus real funds rate will feel high relative to recent history and relative to most estimates of the neutral rate for most Fed officials.

I like to make this analogy with last cycle's hike cycle,

which I think in some ways works a little better than prior historical cutting cycles, in the sense that last cycle they weren't hiking because they had to deal with an urgent inflation problem. Inflation was too low. They were hiking because, once we got back to full employment, keeping the Funds Rate at 0% felt quite inappropriate. And so they decided they would like to slowly gravitate back toward neutral in a as un-disruptive of a way as possible, and they took that to mean 25 basis points every quarter. That's how I think about what they might do this cycle.

Other things equal, if the inflation threat seems like it's been dealt with and they're not worried that rate cuts will reinvigorate the inflation problem, then I think there will be a desire to slowly gravitate back toward something that they see as closer to neutral than the current 5.25-5.5% Funds Rate. But at least from where we are today with growth already quite strong, the labor market already quite tight, and the inflation problem not 100% dealt with, I think they'd likely move pretty cautiously because I think they will want to minimize the probability of regret that inflation progress stalls out or, worse, that the labor market starts re-tightening in a way that brings back some of these inflation fears.

We have penciled in our forecast 25 basis points per quarter, the same pace as last cycle. Last thing I would say about this, it starts in Q2 of next year, proceeds at 25 bps a quarter. We have it ending in the low threes, not at the 2.5% number that the FOMC is writing down in the dot plot as the longer run rate. The main reason for that is that we have been skeptical for about a decade now that neutral was ever really quite as low as was commonly thought last cycle. Specifically, we have long seen the econometric evidence that was cited for that view as open to doubt. And on top of that, I think also because deficits have risen somewhat further from last cycle, there's an argument to be made that neutral -- whatever it was last cycle -- ought to be a little bit higher today.

I think the right baseline is that the FOMC will want to normalize, but I'm doubtful they'll normalize all the way to that 2.5 number they're writing down.

Allison Nathan: And so as we've been discussing, we expect a soft land, we do not expect a recession. In fact, we haven't expected a recession for quite some time, even when that has been more the consensus view. But you

keep lowering your recession outlook. Tell us a little bit about where you are right now, and just is there any risk at all of recession at this point?

David Mericle: Sure. So there's always a risk of recession. In early 2020, I think many of us would have said there's nothing to worry about, and then something unexpected comes along. So you always want to make some allowance for the possibility that some shock will come out of the blue.

We cut our recession probability for the next 12 months just a couple of days ago down to 15%, which is about the historical unconditional average, because we felt like, at this point, the risk of aggressive monetary policy tightening causing a recession seems minor. And we're back to a world where, sure, something can go wrong, but something can always go wrong. And it's not clear to me that the things you might worry about today are any worse than the things that you would always worry about. And so for that reason, the kind of historical unconditional probability seems about right.

Now, most economic forecasters do still have their base

case being a recession, and so relative to other economists we are indeed quite out of consensus. My sense from talking to clients, especially clients who are heavily focused on the macro space, is that we are less out of consensus relative to investors than we are relative to other economists.

Allison Nathan: So it's interesting that you say that the risk of the Fed over tightening leading to a recession has declined substantially. What risks are you watching?

David Mericle: I think there are some things to worry about. We are likely to see some slowdown in growth later this year. These are not in our forecast things that really look recessionary, but labor market is slowing, I think in a good way, but I guess there's some chance that could go too far. Student loan payments are coming back. We think that will slow consumption growth. Again, I would view that as a good thing rather than a bad thing because demand growth has been too strong. But there are always some small things to worry about like that.

One other issue we highlighted recently in our work on the corporate debt maturity wall is that one legacy of last cycle

is that we have this large sector of the corporate space that consists of chronically unprofitable firms. Those firms arguably made a lot more sense when real interest rates were and were expected to be close to zero for the long run than they do in this world of a 3% plus Real Funds Rate. So some worry about those companies as well being forced to pull back a little more aggressively on their hiring or their capital spending. But I don't think of these as serious of a risk as the key risk of the last year and a half, which was that, in order to solve the inflation problem, the Fed might simply be forced to cause a recession. Or that, in its efforts to fight an urgent inflation problem without causing a recession, it might simply miscalibrate.

Now that we're in a phase, though, where we are negotiating whether or not to do an occasional 25 bp hike, rather than doing back-to-back 75 bp hikes, I just don't think that there's that much risk of monetary policy miscalibrating and causing a recession at this phase.

Allison Nathan: David, thanks for joining us again.

David Mericle: Thank you very much.

Allison Nathan: Thanks for listening to another episode of Goldman Sachs Exchanges, recorded on Tuesday, September 5th, 2023. If you enjoyed this show, we hope you follow on your platform of choice and tune in next week for another episode. Make sure to share and leave a comment on Apple Podcasts, Spotify, Google, or wherever you listen to your podcasts.

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