Goldman Sachs Exchanges: The Markets

Why markets are in a period of 'normalization, not nirvana'

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Sam Grobart: A credit downgrade of the US Fed Government caused markets to swoon this week. But what's the longer-term forecast? This is The Markets.

Hi, I'm Sam Grobart. Today I'm talking to Alexandra Wilson-Elizondo, Deputy Chief Investment Officer of Multi Asset Solutions in Asset & Wealth Management. Alexandra, thanks so much for joining us today.

Alexandra Wilson-Elizondo: Thank you so much for having me.

Sam Grobart: So, let's get into some of the big news of the week. We're seeing a downturn in markets right around now. On Wednesday, the S&P had its worst day since April.

This, of course, has been spurred on by the downgrading of US credit by Fitch, one of the big ratings agencies. What do you see happening so far? And what's your take on, ultimately, where it goes?

Alexandra Wilson-Elizondo: I think right now you're seeing a little bit of a convergence of different things happening. And it's not necessarily started by the downgrade itself. We don't see significant long-term effects of the downgrade. But the underlying cause of it is worth mentioning.

And that is that elevated US debt burden at a time of high interest rates can crowd out other fiscal spending and public investments. And that's really not good for the long-term benefits of the US economy. Right now, it's the middle of August, you are seeing liquidity impacts. And in particular in the US treasury market, you're seeing the debt downgrade as well as the BOJ impact hitting at the same time, also meaning a lack of liquidity. And that's causing yields to back up. We do think that some of that should resolve in the near term.

Sam Grobart: Let's take a step back for a minute here.

There's been increasing sentiment we're due for a soft landing, that we may have threaded the needle in fighting inflation and avoiding a recession. You're a bit more cautious on that front though. Tell us why.

Alexandra Wilson-Elizondo: We're describing this window as a period of normalization and not nirvana. And by that we mean, yes, inflation has come down, but the core is still just shy of 5 percent. And year o' year, wage growth is around 4. And these numbers are really inconsistent with the Fed's 2 percent target.

So, we believe that we need to see evidence of durable disinflation, especially with financial conditions loosening up. And so, the bottom line for us is still there's a really long ways to go.

Sam Grobart: In fact, we had the Fed make some public comments about a week ago. What were you seeing in those comments?

Alexandra Wilson-Elizondo: So, when you look at what happened with the presser last week, so what the Fed came out and said after their meeting, it leaned dovish. And that was to be expected. But there were some really deep undertones of disinflationary resolve, which is critical. And that means that they still view the worst outcome to be not dealing with inflation now. And so, the bar to hike is still low. And the bar to cut is still materially high.

Sam Grobart: Let's take a look at another data point from earlier in the week. We saw the latest JOLTS numbers which measures the demand for labor. The results showed a continuingly tight labor market. How do you factor that into your plans going forward?

Alexandra Wilson-Elizondo: The number of job openings are still quite elevated compared to pre-COVID levels. And by that, I mean when you look at openings to seekers ratio, we're currently standing at about a 1.6 ratio. Prior to COVID, that number was around 1.1, 1.2. And so, even though we've seen the number of job openings decline from about 12 million at its peak to closer to 9.6 million right now, that level still remains very high. And that is one of the main reasons that we are thinking the Fed will stay higher for longer, because that's going to determine that unstickiness from getting from 3 to 2.

Sam Grobart: Of course, JOLTS is but one input the Fed looks at as it continues to fight inflation. What do you think is next for the Fed?

Alexandra Wilson-Elizondo: The Fed, in particular, Chair Powell, left options very open in the July FOMC commentaries. And our base case remains that they will be on hold throughout the end of the year. We think that there is a bit of, you know, Atlanta Fed Chair Bostic's thought process deeply rooted in what they're saying. And that is we're currently at restrictive rates. We're going to stay higher for longer. And us not doing something right now is doing something.

Sam Grobart: I want to ask you about something that's coming up later this month. Of course, it'll be the Fed's annual meeting in Jackson Hole. What are you expecting from that gathering?

Alexandra Wilson-Elizondo: There is a lot of pressure on this gathering. And I say that because it's focused on structural shifts in the global economy. There's a real question here as to whether we're entering a regime in which supply shocks have become more frequent and bigger in size than they used to be. And as a result, will they have to change and adjust the way that they think about how to deal with this and longer-term inflation targeting?

Sam Grobart: Alexandra, what are you going to be paying attention to next week?

Alexandra Wilson-Elizondo: So, we're going to continue to be watching developments in Q2 earnings, both in the US and outside the US. Something that we're hyper focused on is the consumer. We believe if you get the consumer right, you're going to get the recession call right. And ultimately, we have seen a very resilient consumer. But there are signs of fatigue. And in particular, you're seeing, you know, really at the expense of volume price staying higher. And you are seeing some trade down effects. And this is both in the US and outside the US, but in particular in Europe we're seeing that dynamic play out. And so, that's one thing that we're hyper focused on.

And you'll get to see consumer sentiment next week, as well as consumer credit outstanding. And then away from that, we continue to be hyper focused on liquidity conditions. And by that, I mean liquidity is ephemeral. And when you really need it, it's not there. And in particular in OTC markets that's the case. And so, you know, where we've seen credit spreads really tighten in, we're focused on are we in the right part of the capital structure? Are we in the right ratings spectrum? And if you're not the first to move, you are often the last to experience the price drawdown. And so, that is something we're spending an increasing amount of time and focus on.

Sam Grobart: Alexandra, thanks so much for joining us.

Alexandra Wilson-Elizondo: Thank you so much for having me.

Sam Grobart: That does it for another episode of The Markets. Subscribe to our feed on Apple Podcasts, Spotify, or wherever you get your podcasts.

I'm Sam Grobart. Thanks so much for listening.