Goldman Sachs Exchanges: The Markets

Normalizing inflation: are 'hard yards' ahead?

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Sam Grobart: The big question everyone's trying to answer, what's cyclical and what's structural? This is The Markets.

Hi, I'm Sam Grobart. Today I'm joined by Ashok Varadhan, co-head of Global Banking and Markets here at Goldman Sachs. And we're going to be talking about interest rates and how that final push to a target rate might be a game of inches.

Ashok, so great to have you join us today. Let's get right to it. Markets are still trying to figure out which way interest rates are going. Where do you see them headed?

Ashok Varadhan: I think when you look at interest rates and you look at how much normalization has taken place over the course of the last two years, you've had 525 basis points of rate hikes. And that's a pretty dramatic thing. And so, obviously, that's a policy that's been undertaken in an attempt to bring inflation back down to 2 percent. They've made a lot of progress. Inflation has basically gone from 8 percent at this time last year to now tracking at about 3 percent currently with some contemporaneous readings which show us at, like, in the low twos at the margin.

And so, I think what the market is saying is, okay, that is somewhat cyclical as opposed to structural. We think that over the course of the next couple years when the Fed does ultimately succeed and bring inflation down into the twos, they'll be able to lower rates back to a more neutral, long-term rate, which the market approximate as being somewhere around 3.5 percent.

Sam Grobart: On the macro front, markets seem to be pricing in a soft landing, or even maybe no landing at all. If that's the case, why do you think the yield curve is still so inverted?

Ashok Varadhan: The yield curve is less inverted than it has been. So, I'd say over the course of the last two months as the market has basically taken down its probability of a recession. And again, Jan Hatzius, our chief economist, came out over the weekend and basically now puts odds at a reaction to 15 percent, which is basically a long run average. It's essentially statistically insignificant. So, you've seen long-term yields come up.

Long-term yields now are, again, they're still below the policy yield of 5.25 to 5.5. But they've come up a fair bit. You know, the ten-year note trades at around 4.25 percent. And that's the highest point that it's basically been in this cycle subsequent to normalization after the pandemic.

And what I would say is it's inverted because people still feel on a long run basis the policy rate is restrictive. We're in a restrictive place. And one way in which bond market participants think about that is if inflation even is in the threes with the policy rate between 5.25 and 5.5, you would say, you know, short-term real rates are around 2 percent. That's in the arena of being restrictive.

And so, people believe that will mean revert over time back to what I said before, you know, sort of a long-term neutral rate of, call it, 3.5 percent. So, therefore, that's what's driving the inversion.

Sam Grobart: Let's talk a little bit more about those rates. Rising rates are good for savers, obviously. But what does it mean for the corporate credit markets? We have a lot of refinancing on the horizon. Is the corporate bond market already priced for that?

Ashok Varadhan: I'd say it depends. There are different parts of the corporate bond market you obviously have. I'd say for the higher quality companies, call it the investment-grade universe, I actually don't think these higher rates are that burdensome. I would say, one, there was a lot of fixing out that took place at lower yields, certainly during the pandemic. And when those policy yields got to zero percent and long-term yields were at very low levels, we saw record amounts of issuance. So, certainly, corporations turned out their liabilities and are not as subject to the rise in floating rates that we've seen.

And what I would say is the maturity walls, when you look at, you know, that consistency of issuers in the bond market, isn't something that causes alarm bells. In other words, I think when you look at debt service costs for these companies, it doesn't stand out to me that something, obviously, is more onerous. But it doesn't stand out to me as something that's burdensome.

I think it's where you get down to the lower quality part of the credit consistency in which refinancings will come up and the combination of higher floating rates and higher borrowing spreads will lead to, obviously, debt service, which will be onerous. I think that will be a little bit more episodic in nature. And I think we will undoubtedly see realized defaults tick up. The question is how much? And are there externalities associated with that?

But my base case is that you'll see a rise in realized defaults, but they'll be somewhat isolated in nature.

Sam Grobart: Alongside those public debt markets, we've seen tremendous growth in private credit. What does that mean for your business and for Goldman Sachs overall?

Ashok Varadhan: I think it's a healthy development. I think certainly as it relates to the business of credit extension in this country, you wouldn't want that to necessarily be constrained to a handful of banks. Certainly, one of the things when you look at what happened with regional banks at the onset of the second quarter and certainly the prospect for credit creation and credit extension from that community to be somewhat constrained on a go-forward basis, thank God for private credit as another supply channel in which society can access credit.

Sam Grobart: I want to shift gears for a moment to a slightly more global view.

Ashok Varadhan: Sure.

Sam Grobart: The US economy, for all intents and purposes is showing some good signs. But--

Ashok Varadhan: Unbelievably resilient is the way I would characterize the US economy.

Sam Grobart: It has been pretty extraordinary.

Ashok Varadhan: I would say shockingly resilient.

Sam Grobart: Yeah. Meanwhile, economic growth in China and Europe looks a lot shakier. What do you think that means for the dollar and for currency markets?

Ashok Varadhan: Well, the dollar is a tricky one. I would say obviously what you're seeing recently in the near-term is dollar strength. And that makes all the sense in the world, especially if you say, wow, our growth rates are hanging in there. We're growing at trend. Inflation is coming down. Real rates here are actually higher than they've been in a long time. If you look at basically the nominal curve and you subtract out market base measures for break even inflation, the real rate curve in the US is at about 2 percent. And we've come through a decade plus after the global financial crisis and after the pandemic in which real rates were negative.

US fixed income relative to what it's offered you before on a real basis is quite attractive. And so, that's accruing to the dollar.

I'd say over the longer run, who knows? Because one of the things that's certainly happening is our debt levels continue to grow. and so, in the end, I think one of the things, you don't want to be complacent, even though the US is performing right now economically better than Europe and China, I think as a policymaker, you want to be careful about the amount of debt that you subsume because that ultimately could end up being negative for the dollar on a go-forward basis. But I think that's tomorrow's problem.

Today, the US looks in the near-term, relatively attractive. And I think that's manifesting itself in currencies.

Sam Grobart: Ashok, last question. What are you going to be paying attention to next week?

Ashok Varadhan: I'd like to think, I think, with a little bit more of a longer time horizon than next week. But obviously, I think one of the things I want to pay a lot of attention to is what is the path of inflation going to be through, call it, the fourth quarter? Are we going to continue to make progress on inflation and get down into the twos? Or are these last 100 basis points, are they going to be really hard yards? And in particular, are they going to be hard yards because the US economy is growing at or above trend?

And so, it's one thing to go from eight to three because you have a lot of these supply side imbalances from the pandemic that ultimately--

Sam Grobart: And we've worked those out. Right.

Ashok Varadhan: Yeah. Worked it's way out. And autos are being produced again.

Sam Grobart: Getting through canals and--

Ashok Varadhan: Ships are getting through canals. And workers are getting back to hotels. And all of that sort of stuff. So, once you get past that, now if you sit here, call it at 3 percent inflation, what is it going to take to get to 2 percent? Is gravity just going to take care of that? Or do you need to do some unpopular things and things that may inflict some collateral damage in other places to get that last 100 basis points? I'd say that's what me and my colleagues, and by the way, our clients and investors are very focused on, because you have two very different polarizing outcomes. If it happens by virtue of gravity, which is where the market is right now, that's great. You stay in your strategies, and they should continue to work because the thing's on autopilot and should get to the destination that you want to go.

If instead it's not going to get there and it's going to require draconian policy measures, then all of a sudden now you've got to rethink and there's going to be some turbulence. And so, that's really what I'm paying attention to. And it's not really a next week question. It's much more of a Q4 question.

Sam Grobart: Sounds good to me. Ashok, thank you so much.

Ashok Varadhan: Thank you.

Sam Grobart: That does it for another episode of The Markets. Be sure to find us on Apple Podcasts, Spotify, or wherever you find your podcasts.

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