Goldman Sachs Exchanges: The Markets
What the Fed's hawkish pause means for markets
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Sam Grobart: Did the Fed hit pause or did it hit skip? And what's the difference? This is The Markets, a new podcast from Goldman Sachs Exchanges.

Hi, I'm Sam Grobart. Today, I'm joined by Jonny Fine, head of our investment grade new issue business in the Americas. And we're going to talk about the latest moves from the Fed and the ECB and how corporate clients are navigating these new economic conditions.

Jonny, thanks so much for joining us today.

Jonny Fine: And thank you for having me on.

Sam Grobart: So, let's talk a little bit about, obviously, the big news of the week. The Fed met. It paused its interest rate hikes. But what do you think the Fed's dot plot, it's projection forward tells us? Is another hike possible later this summer?

Jonny Fine: So, I think the answer to that is absolutely yes. I think the market is calling yesterday's announcement a skip, not a pause. And a hawkish skip at that. Although, I think I kind of need somebody to tell me what's the difference between a skip and a pause.

I think people are confusing when they say pause for the word peak. Although, yesterday, I think it was made pretty clear that every other Fed meeting through year end is now in play. Although, of course, the Fed always has the option to change its mind. I actually think yesterday and the prior FOMC was kind of a hedge your bets type of FOMC announcement and press conference. They want to see how the US economy reacts. They want to see what data looks like.

It's clear that two more hikes for the remainder of the year is favored by the majority from Fed voters. But we'll have to see what the path of theta is from here.

Sam Grobart: Let me ask you how the market is viewing this. How are they thinking about the path of rates versus this dot plot?

Jonny Fine: So, firstly, with respect to the dot plot, there were nine voters who said that there would be two more hikes between now and the end of the year. Three said that there will be more than two hikes. And six said that there would be less than two hikes. So, clearly a pretty hawkish split overall. But the market is barely pricing one hike between now and year end.

Now, of course, throughout this entire hiking cycle, the market has been behind where the Fed has been, both from the dot plot as well as from an actual rate evolution perspective. So, that's not surprising. And in fact, rate cuts were priced in through the end of the year as recently as last week.

And so, finally the no cuts narrative is taking hold in the marketplace. And by the way, one of the other, I think, very interesting things I took away from the press conference yesterday is, I'm going to paraphrase here, that Chair Powell basically said, "I wouldn't put too much weight on our own forecasts. It is so uncertain."

Sam Grobart: As far as the uncertainty that you were just referring to and what Chair Powell was talking about, what do you think that he and the Fed overall will be most closely focused on in the coming days and weeks which will inform those future decisions?

Jonny Fine: So, as we think about the path of inflation and growth, and of course, employment in the US, I think one of the key drivers the Fed's going to be focused on is going to be lending in the real economy. It's been a big focus for the market. And, of course, for the Fed since the regional bank troubles began in March. I think there'll be a lot of focus, for example, on the senior loan officer survey data, which will be in hand before the July Fed.

Now, I will say, economic activity has been remarkable despite this very restrictive monetary policy environment that we're in. We've climbed many walls of worry. And so, I tend to be fairly glass half full as I think about the outcomes from here. But those are the things that I that the Fed will be focused on.

Sam Grobart: Let's shift focus for a moment here to

Europe where it central bank, the ECB, just announced a 25 basis point rate hike. That's going to bring rates in Europe to the highest they've been in 22 years. Obviously, a different economic picture there. What is Europe grappling with that, in this case perhaps the US isn't?

Jonny Fine: So, the ECB, I think broad consensus is that they were behind the curve versus the Fed. They didn't hike until we got to mid 2022. And the Fed simply moved earlier and faster. But there are a couple of other things that Europe's had to contend with as well that the US has not. The energy shock from the war in Ukraine was clearly more painfully for Europe given the dependence on Russian gas in the largest industrial economies, especially Germany. And also, food prices remain stubbornly high in Europe, although even though underlying commodity costs are going down.

The US on the other hand has benefited from a reversion in supply chain driven inflation and a decline in energy prices, particularly oil. Where clearly the economic exposure in the US to European natural gas is much lower. And so, that's actually helping and will continue, we think, to help some of the hotter inflation sectors in the US like travel with airfares coming down with lower oil prices.

Sam Grobart: Jonny, you spend a lot of your time talking with CFOs and treasurers of large corporations around the world. What is top of mind for them right now? And how have you been, and the company overall, helping them navigate the current environment?

Jonny Fine: So, several themes have been playing out. The first of which I think has really been a priority of 2023, which has been balance sheet bolstering. So, if you kind of think about how the year has developed thus far, in January it felt like the coast was clear and everything was great. February delivered a [UNINTEL] of inflationary data. And March delivered a mini regional banking crisis.

So, all of the sudden you had visible risks and walls of worry that we discussed creating a desire for corporates to have somewhat of a more conservative posture. More cash, more liquidity, lower risk investments, reducing near term funding needs. And so, that's been clear and focused, number one.

The second thing has been interest rate experience management. Funding costs have obviously increased significantly since the hiking campaign began last year. And the historical environment over many, many years has been, hey, when long-term funding costs go up, what to corporations do? They genuinely bridge to a better environment by insuring short. They did that commercial paper. Taking out term loans from relationship banks. Finding other sources of long dated liquidity.

That hasn't worked this time around because of the shape of the yield curve being as steeply inverted as it has been. A significant majority of US corporates can issue ten year debt at a lower yield than they can issue three-month commercial paper.

So, if you can't hide out in the front end, you have to be more creative in reducing interest expense. A couple of moves that we've seen: foreign currency markets has been one. So, the Euro market has been very buoyant since the beginning of the year. A lot of companies have been able to issue in euros and swap the proceeds into dollars, for example, and save money versus organically issuing in dollars.

Another beneficiary of this trend has been the convertible bond market. That's where a number of investment grade rate corporates have issued this year. It's been a very effective way of buying down coupon costs. In fact, almost 40 percent of convertible issuance this year has come from investment grade rated corporates. And over the course of the last decade, there's been almost zero from this cohort.

Sam Grobart: So, that's a tremendous increase.

Jonny Fine: Yes. Absolutely.

Sam Grobart: So, Jonny, longer term, how are companies adapting to this higher rate, post quantitative easing environment?

Jonny Fine: I think there are a couple of things. One of them is we've seen a lot of companies revisiting their existing treasury and risk management policies, for example. In fact, really particularly with respect to risk management. We've seen extraordinary growth in corporate risk management activity as the macro vol that we've seen for the last couple of years has ensured that what we previously thought of as being deminimous risks have been pretty material to companies and showing up in earnings and transcripts, etcetera, etcetera. So, clients have been overhauling their risk management practices as it pertains to foreign exchange and interest rates, and even less frequently, traveled risks like European natural gas and other commodity exposures.

And other things I think that corporates have been focused on as well is automation and technology, especially as it pertains to cost management opportunities. Treasury functions are looking at what can be outsourced, what can be optimized? There's analyses going on around build/buy/partner with respect to technology. And so those are, I think, some of the other things that are also top of mind within corporate America.

Sam Grobart: Jonny, last question. What's going to be on your mind for next week?

Jonny Fine: It's a holiday short week next week. It's a light data week. It's generally quiet in the capital markets as we approach quarter end in any regard. We have an interesting transaction or two in our market that I'll be keenly following and watching. And I think they're going to be pretty exciting for us to talk about with our clients overall. But I think a little quieter is what I'm thinking about next week.

Sam Grobart: Jonny, enjoy that quieter week. Thanks so much for joining us.

Jonny Fine: It's been a pleasure. Thank you for having me.

Sam Grobart: That does it for another episode of The Markets. As of next week, we'll be exclusively on our own new feed. So, look for The Markets on Apple Podcasts, Spotify, or wherever you find your podcasts.

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