Goldman Sachs Exchanges

Are inflation fears overblown? The outlook for inflation, US growth, and long-term rates

The outlook for inflation, US growth, and the Fed's path

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Date of Recording; April 12, 2024

Allison Nathan: Inflation has been higher than expected so far this year. So, what will that mean for the US economy?

David Mericle: What we are not seeing is a reigniting of overheating inflation. We are not seeing a retightening of the labor market, an increase in wage growth, a worrying rise in inflation expectations. All of those things, it was completely fair to worry about in 2022. But those problems, the problems that would give you a sustained inflation problem, those problems were solved quite a while ago.

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

[MUSIC INTRO]

Today I'm sitting down with our Chief US Economist in Goldman Sachs Research, David Mericle, to help assess the latest economic data and the implications for economic growth and policymakers.

David, welcome back to the program.

David Mericle: Thanks, Allison.

Allison Nathan: It's been a pretty busy week for US economy watchers like yourself.

David Mericle: Yeah, absolutely.

Allison Nathan: So, let's start with the hot topic of the week. See what I did there? Because inflation, hotter than expected. We did get the hotter than expected CPI inflation print last week. And the market reacted very strongly. We saw a 20-basis point move in the ten-year yield. It's come back a little bit since then. But I want to get your take on that inflation data. And I think, importantly, should the market be as concerned as it seems to be?

David Mericle: I don't think we've learned a lot. I think broadly, the right expectation is still that we're headed lower this year, part of the way, not all of the way, but part of the way back to 2 percent. We ended last year with core PCE inflation at 2.9. We now expect to get to 2.5 by the end of this year. And I think it's an easier than usual story for inflation to fall.

To be sure, as we've been reminded over the last few months, there are all sorts of idiosyncratic and quirky sector-specific things that can affect the inflation numbers to an appreciable degree. And the back half of last year was probably a little bit softer in retrospect than was realistic. And the first three months of this year, a little bit firmer than I think we're going to be trending at going forward.

But the strength that we've seen this year has mostly come from stories that don't worry me too much in terms of the forward outlook for inflation.

Allison Nathan: So, what stories?

David Mericle: So, for example, at the very beginning of this year we got an odd jump in the owners' equivalent rent component, a very large component. But I think there we know that shelter inflation is headed lower because the official government data are very lagging. And we have a bunch of leading indicators that tell us there's a long way to fall.

In March, the entirety of the surprise came from private transportation services, specifically car insurance. Now, what car insurance and housing have in common is that they're both examples of catch-up inflation. In the case of car insurance, if you're an insurer and you're on the hook to replace someone’s car, get them a new used car, and used car prices go through the roof, your costs have gone up a lot and insurance premiums need to rise to match that.

Similarly, with rents, we saw huge increases in market rents a couple of years back. Not every landlord passed those increases along immediately to continued tenants. So, there's some catching up. But the key point here is that that catch up eventually comes to an end. What we are not seeing is a reigniting of overheating inflation. We are not seeing a retightening of the labor market, an increase in wage growth, a worrying rise in inflation expectations. All of those things, it was completely fair to worry about in 2022. But those problems, the problems that would give you a sustained inflation problem, those problems were solved quite a while ago.

Allison Nathan: But aren't we seeing some tightening in the labor market? We did see a much bigger than expected payrolls report a couple weeks ago. So, what makes you so certain that we're not going to see that retightening?

David Mericle: I like to look at a bunch of different measures of labor market tightness: the unemployment rate, our jobs/workers gap, survey measures that ask workers how easy is it to find a job or that ask employers how hard is it to find workers. We just average them. And the message is that we've come back from a position of, perhaps, one of the tightest labor markets, if not the tightest labor market in history in 2022 back to roughly the balance that prevailed prior to the pandemic.

That balance, I think, served us extremely well. It was a very strong job market that provided plentiful opportunities to work. But it didn't create an inflation problem. So, I would say right now we've gotten to exactly where we want to be.

Allison Nathan: But let me just boil it down to a key question here, which is how did we add so many jobs and not see inflation become a bigger problem?

David Mericle: Part of the answer is that at the moment we're simply having more workers enter the labor force than usual. Last year, that was because of, both, a continued recovery of labor force participation and a huge surge in immigration. This year I think the participation recovery is probably complete. But we will probably continue to see immigration running above trend. And that just means mechanically more people joining the labor force, more labor supply. And so, if you create a lot of jobs, that doesn't necessarily signal that you are retightening the labor market.

Allison Nathan: So, the labor market is looking a lot more balanced. Disinflation is still broadly continuing. And there are reasons for us to believe that it will continue. But, ultimately, when we think about growth, we, you at Goldman Sachs, we are well above consensus on US growth. So, why isn't there a contradiction between your above consensus growth view and your view that inflation trends are not worrying, and, in fact, we should see more disinflation ahead?

David Mericle: Our growth view has been our most out of consensus view since we put out our 2024 outlook last fall. We're looking for growth right now at 2.5 percent on a Q4/Q4 basis in 2024. Consensus expectations, Fed expectations have moved up quite a bit this year. But we are still at least a percentage point above consensus. And as these things go, that's actually a very large gap in forecast for the year. So, it's a great question, how can we share the consensus view that inflation's going to come down a bit this year even while having a much stronger growth view?

I think there are two answers to this. One answer goes back to the immigration story. And that is that if we are getting faster population growth, faster labor supply growth, then the supply side potential of the economy is growing faster than usual. So, again, strong growth on the demand side and the GDP statistics doesn't necessarily worsen appreciably, if at all, the supply/demand balance if supply is keeping up with demand.

Second point I would make here is that while this argument makes sense directionally, shouldn't we worry about stronger growth boosting inflation? Quantitatively, I think the stakes are pretty small relative to some of the disinflationary forces that we expect this year as the last of the pandemic imbalances unwind.

So, if you take any standard estimate of the slope of the so-called Phillips Curve of the sensitivity of inflation to changes in the unemployment rate, for example, even if the unemployment rate does fall two, three tenths this year, which is not our baseline expectation, standard estimates would say that's worth a tiny amount, something in the neighborhood of five basis points on core inflation.

In contrast, those official measures of rent inflation simply catching down to where the leading indicators are is worth many times that. And I suspect that another key story in our inflation forecast, namely that we should see continued reversal of pandemic shortages pushing down prices on items like cars, where shortages pushed prices up in years past, that will also very likely be worth several times the impact that a modest labor market retightening would have.

So, the thought that there's some contradiction here, intuitively, I think that's right. It's just quantitatively, these are small stakes. And while inflation is hard to forecast and a lot of unpredictable things can happen, as we've seen over the last couple of months, I do think that getting at least the direction right this year should be a little bit easier than usual because those two stories: catching down to the leading indicators in the largest component of the index and the continued reversal of pandemic shortage effects, those seem like much more obvious, straightforward stories than we have in a typical year.

Allison Nathan: But let me ask you a little bit more about the above consensus growth view. Because, ultimately, what's driving that? The market has pushed back expectations for rate cuts this year. Why are you so confident that we're going to see this strong growth?

David Mericle: Sure. Our forecast is on a relative basis fairly bold. We are more than a percentage point above consensus. But in an absolute sense, I actually think it's a pretty unremarkable forecast. At the moment, because of that faster labor supply growth, I would say the potential growth rate of GDP in the US probably something like 2.1 percent. So, yes, our forecast is above that. We're at 2.5. But by a pretty small amount.

One simple top down rationalization of why that's a reasonable place to be, even though that's well above where others are, would be to say that actual GDP growth you could think of as potential growth plus the impact of any big impulses from forces like, say, changes in fiscal policy or changes in financial conditions.

We think fiscal policy is pretty neutral this year. But financial conditions, measured by our financial conditions index, have eased a lot since last fall. And our estimate is that that is now providing a boost to growth this year of several tenths. So, start at 2.1, add a few tenths and you get to something like our 2.5 percent forecast.

Allison Nathan: By the way, what's driving that? So, equity prices are up. But rates are not much lower.

David Mericle: Rates are lower from the peak that we got to last fall. But certainly have come up a little bit as the market has become skeptical about the number of cuts that we might see this year.

Allison Nathan: And what else is driving that? So, financial conditions are super easy. What goes into that?

David Mericle: It is a bit of a surprise that, you know, the Fed funds rate is much, much higher than before the pandemic. That the level of interest rates across the curve is much higher. And yet, our overall financial conditions index is actually in a place pretty similar to where it averaged from, say, 2017 to 2019. Basically, the message is that risky assets have offset that, that risk sentiment or optimism about future growth and future profits, some combination of all of that has so far offset the impact of appreciably higher interest rates. And on net, that has meant that our financial conditions index, where we take many different market indicators and weight them based on how much they affect the economy, that hasn't moved very much.

Allison Nathan: And so, then we look at the other side of the equation, which I mentioned, which of course is the rate outlook. And as we've touched on, expectations for Fed rate cuts have been pushed back. We've moved our rate expectation back. We're now at July for the first cut, and two cuts this year, which is right around the market on any given moment. But I think it's important to get some perspective. Markets are very focused on the trajectory of Fed policy rates. But if the Fed cuts in July versus in November, given everything you've just said about the backdrop, how much does that really change the economic outlook?

David Mericle: It matters to the degree that it transmits more broadly to the interest rate curve and to broader financial conditions and, ultimately, to the economy. To the extent that the market roughly holds steady in its expectations of the number of cuts the Fed will deliver over the next year or two and just kind of tweaks its expectations about the timing, you know, pushing back the date of the first cut, as we recently did in our forecast from June to July, probably isn't going to have a huge impact on financial conditions.

What would matter more would be rethinking the stopping point, where the Fed will ultimately leave interest rates. The thing is that a lot of has already happened. The market has already gone a very long ways in all of that.

Allison Nathan: Meaning that long-end rates are higher?

David Mericle: Yes. That over the next couple of years, the market now expects rates to stay higher, long-end rates have moved higher, and, you know, relative to the pre-pandemic environment, this thought that far into the future we would need very, very low interest rates in order to achieve full employment, the market has moved a long ways away from that.

So, at some level that's already baked in. Certainly, there's room for further rethinking of the Fed path to affect interest rates. But I think that the high stakes moves have probably already taken place on that.

Allison Nathan: And if we take a step back and look at how the economy has evolved at the higher interest rates and now, as you said, we're pricing higher interest rates for longer, what is the broader takeaway when we think about the Fed's ultimate goal of getting to what is seen as a neutral rate, a rate that isn't going to overheat the economy, but keep the economy relatively robust which, historically, is thought of to be around 2 percent? Are we learning that that neutral rate is actually higher?

David Mericle: That's been our view for the last decade. Last cycle, there was a thought embraced by central bankers, academic economists, and most investors that neutral had fallen very sharply, that we would need a 2 to 2.5 percent nominal rate, which is basically a barely positive real interest rate in order to achieve full employment. That changes and the kind of deep structural forces in the economy meant that you needed very, very low interest rates in order to stimulate enough demand to keep the economy at full employment.

We've been arguing since last cycle that the long run neutral rate is actually higher than that. That essentially the conventional wisdom learned and inferred too much from a post-financial-crisis environment, which across history, across countries tends to be an environment of slow, painful, gradual recovery. Learned too much from that. Assumed that the forces, the headwinds that we saw last cycle would be truly permanent and persistent. And got a little bit carried away in assuming that we would need rates near zero in real terms forever.

So, our starting point for what I would call long run neutral, more like 3 to 3.5 percent. Long run neutral I would define as the interest rate that other things equal, other forces in the economy that affect demand, assuming they're in equilibrium, what interest rate would you set in order to achieve full employment and 2 percent inflation?

Now, in practice, of course, other things are never all perfectly equal. Other forces are never all perfectly in equilibrium. And one point that we have made this cycle is that one force that is decidedly out of equilibrium is the fiscal stance. We are running large budget deficits despite being, you know, happily, in a full employment economy. Where normally, historically, we would have been running moderate budget surpluses. If the government is boosting aggregate demand by more than usual, then the economy can withstand higher interest rates and their depressive effect on private demand and still operate at full employment.

In fact, econometric estimates of the sensitivity of, yeah I guess you could call it, the short run neutral rate to the size of the deficit says that those much wider than usual deficits might prop up the neutral rate, at least for now, for as long as we have those deficits, by something like a point to a point and a half.

There's a similar argument that was also made by some economists at the New York Fed last summer very much in the spirit of our financial conditions index for why the short-term neutral rate might be higher than the long-term neutral rate. And that was, as we discussed earlier, that the Fed funds rate is much higher than before the pandemic and rates across the curve are much higher, it's not the case that broad financial conditions are, on net, substantially tighter and, therefore, the transmission to the economy has been a lot more limited. So, that's another factor that means we can have these higher interest rates and still operate at full employment.

Neither of these things is likely to be true forever. Presumably we can't have budget deficits this big forever. But for now, this is the environment in which the Fed is operating. And so, I think both of these things help to explain why it is that the economy has done well at higher interest rates.

Allison Nathan: So, it seems like investors, as you said, have begun to really price the notion of a higher neutral rate at this point. Where are they today? Are we mostly through? You said most of that adjustment has already taken place. Could there be more? What do you think the Fed's perspective is on this? And so, where do we go from here?

David Mericle: Yeah. Markets have already changed their views pretty substantially. Investors tend to be willing to rethink things like this pretty quickly, more quickly than central banks do. I think for most economists and policymakers at central banks, neutral is supposed to be a deep structural parameter of the economy that depends on slow moving forces, something like demographics where, you know, there's just no reason to drastically change your view from one year to the next. And so, the thought is that you're not supposed to extrapolate too much from the current state of the economy. The way that many investors have said, "Well, we're at 5 and 3/8, everything's going fine. So, why can't this now be the neutral rate?" I think that logic will appeal to Fed officials too. They're just going to move more slowly.

When I look at the set of information that Fed officials will consult in thinking about neutral, I think they're going to look at market pricing, which is now much higher than before the pandemic. They're going to look at their econometric models, which are now meaningfully higher than they were, say, five years ago. And they're probably also going to do that same kind of intuitive, gut feel check that investors have done. How are we doing at 5 and 3/8? And the answer is pretty well.

So, I think all of those thought processes will lead the Fed to reevaluate neutral upward. I think this is going to be a key debate over the next year or two. Where is the FOMC comfortable stopping? Frankly, I think there's a lot of uncertainty about this. And I'm not sure as of today. I do feel strongly that the Fed leadership is not going to want to keep the funds rate at 5 and 3/8 indefinitely if the inflation data are cooperative because I think they feel that that is inviting trouble to go so abruptly from a world where we had near zero real rates, people assumed they would last forever, and made economic decisions premised on that, to a world with much higher rates. So, I think some amount of normalization Fed officials are going to want to achieve as long as the inflation data allow them.

I also, though, don't think that we're going all the way back to that 2 and 3/8s starting point, or ending point, rather, that we got to last cycle. I don't think we're going to go back to the current long run neutral rate estimate in the dot plot of something like 2.5 percent. But where in between they wind up stopping, I think, is very uncertain.

Allison Nathan: So, you say the Fed is looking at the market and what it's expecting for long-term rates. But how successful has the market really been in predicting them?

David Mericle: Yeah. I think most economists would say that the market tends to infer a little bit too much from precisely where the funds rate is now. And, you know, we probably saw this last cycle. Funds rate was very low. People assumed low interest rates forever. Now the funds rate is high. And I think there's a risk of making the same mistake in the opposite direction. That last cycle we had these non-monetary headwinds from the aftermath of the financial crisis, something separate from monetary policy holding the economy back. And by saying we would need very low interest rates forever, we were effectively implying, without realizing it, that those headwinds would be with us forever. And that turned out, I think, not to be right.

Now there's a risk that perhaps we're getting a big tailwind from running budget deficits that are not going to be sustainable indefinitely. And, perhaps, we're inferring a little bit too much from the economy's ability to withstand high interest rates under these circumstances.

So, I think directionally, rethinking neutral upward, that makes a lot of sense to me. But there is a risk that we see historically of the market drawing a little bit too much from precisely where we are at the moment.

Allison Nathan: And so, David, what I've taken away from this conversation is that any one inflation print is not worth substantial worry. That there are many reasons to believe that the disinflation trend you've been expecting is still relatively on track. And the outlook for US economic growth remains relatively strong. But rates may ultimately end up at a higher place than what we've been used to historically.

David Mericle: I think that's exactly right.

Allison Nathan: Thanks so much for joining us.

David Mericle: Thank you, Allison.

Allison Nathan: Thanks for joining us for another episode of Goldman Sachs Exchanges, which was recorded on Friday, April 12th, 2024. I'm your host, Allison Nathan.

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