Goldman Sachs Exchanges: The Markets

Are investors betting the worst is over for U.S. inflation?

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Recorded: July 13, 2023

John Detrixhe: US inflation cooled in June. Central bankers in Europe are hawkish. And just how high will interest rates go or not go? This is The Markets.

I'm John Detrixhe filling in for Sam Grobart. Today I'm joined by Gurpreet Gill, macro strategist in the Fixed Income team of Goldman Sachs Asset Management. We're going to talk about how US inflation stacks up against other big economies, and what that means for financial markets.

Gurpreet, welcome to the show.

Gurpreet Gill: Hi John.

John Detrixhe: Let's start off with the US inflation

number for June. It came in at 3 percent, lower than expected. Core CPI had its smallest increase since February 2021. What's your take on that news?

Gurpreet Gill: So, overall, I'd say that the June US inflation data was a much welcomed, positive development for investors and policymakers and that 3 percent annual headline inflation you mentioned, that's the slowest rise since March 2021. And it's down from a peak of almost 9 percent last June. And that optically has helped [UNINTEL] inflation expectation.

Core inflation, which excludes food and energy, also moderated. House related categories that account for around a third of the average US consumer spending each month, those categories slowed further. We also saw used car prices pull back. Now, used car prices account for less than 3 percent of the US CPI basket. But I can't overstate just how volatile prices have been in recent years.

And most importantly of all, core services inflation, excluding housing, was unchanged on the month. And those domestically generated prices are the ones that Fed policy seeks to influence. And so, the latest reading is going

to offer policymakers some assurance that policy is working.

John Detrixhe: Great. Well, you went into what I wanted to ask next, which is, what do you think this means for the Federal Reserve? Where do they go from here?

Gurpreet Gill: Yeah, so, 25 basis points rate hike this month still seems likely. Inflation is still above 2 percent. And Fed officials need to see evidence of a sustained downtrend in inflation. But the outlook for beyond July has turned a bit more uncertain. We previously thought that we could see another rate hike. But it's plausible that this month could mark the peak in the Fed's hiking cycle.

And much will depend on how inflation and labor markets evolve from here. But bit picture, the Fed is entering its final phase of policy tightening.

John Detrixhe: Great. Let's talk about the markets now. Does the market think the worst is behind the US when it comes to inflation?

Gurpreet Gill: Well, we saw equities gained ground

yesterday. Credit spreads tightened and US treasury yields moderated. And so, there is building optimism over disinflation progress.

But I'd flag two things. The first is that some Fed officials have cautioned that housing disinflation faces risks from structural undersupply of housing. And the second thing to keep in mind is that some services prices could still trend up from here, particularly things where contracts reset and really [UNINTEL] they've yet to reflect the high inflation we've seen over the past year.

John Detrixhe: Now let's look across the Atlantic. Is inflation coming down on the UK and the rest of Europe the way it appears to be in the US?

Gurpreet Gill: When in the case of the UK, we'd say that progress on disinflation has been disappointing. Annual core inflation is more than 7 percent. And it's been moving in the wrong direction since February. That contrasts with core inflation of 4.8 percent in the US. And the challenge for the Bank of England is that part of the strength is structural. Wage growth, which is a key driver of services prices, is also around 7 percent. That's more

than double the 3 percent pace that's consistent with 2 percent inflation. And getting that down requires better balance between labor supply and labor demand. And that's proving tricky because we've got reduced migrant labor post Brexit. We've seen seen increase in long-term sickness linked to COVID. And we have an aging population.

I'd say that the story in the Euro area is more similar to the US but with a lag of several months. So, headline inflation has peaked and continues to climb down as energy prices ease. And although core inflation is still elevated at 5.4 percent, it's starting to show signs of normalizing. And so, we don't expect a return to the low [UNINTEL] regime of the last cycle. But the Euro area is slowly, but surely, making progress on disinflation as the economy responds to tighter policy.

John Detrixhe: And what does that mean for policy at the likes of the European Central Bank and the Bank of England going forward?

Gurpreet Gill: So, the persistence of inflation in the UK actually led to the Bank of England to ramp up tightening

in June. So, the central bank raised rates by 0.5 percent. And the expectations for the terminal or peak rate in the UK have increased sharply this year. So, entering the year, the market was pricing a terminal rate of 4.75 percent. Today, the market is pricing a peak rate above 6 percent.

Now, we think the Bank of England will stay on this hiking path until it reaches a policy rate of 5.5 percent. But we do acknowledge risks are skewed to the upside. There'll be a lot of focus on next week's CPI data.

And then in the case of the ECB, policymakers have been championing a resolutely hawkish tone this summer to avoid the experience of an entrenched inflation that we've seen in the UK. And so, we expect another 25-basis points rate hike this month. And we think that we'll see more tightening in September and October for a terminal rate of 4 percent. And that's broadly in line with where the market is currently pricing.

John Detrixhe: Let's take a step back and look at the big picture. What does all of this mean for the big economies we've been talking about? Are we looking at a rocky landing? A soft landing? No landing?

Gurpreet Gill: I think it's important to keep in mind that we need a great deal of humility when making judgments on the economy outlook. That being said, we titled our third quarter fixed income outlook Risks & Resilience because we think it's important to acknowledge both. And so, some sources of resilience include healthy labor markets. Strong private sector balance sheet. We have an ongoing recovery in the services sector. And we've even seen a stabilization in some housing markets before policy rates have peaked.

But in terms of the risks, we're mindful that excess savings are compressing. Household space, higher debt servicing costs, particularly in the UK. And there are some areas of weakness in commercial real estate, particularly the office sector that we're alert to. And so, all of this suggests that the resilience of the economy to future shocks might not be as robust as it has been to shocks of the past year.

And so, all that said, amongst the major economies if I'm to use the terms that you mentioned, we think a soft landing is more likely than not in the US. Is somewhat likely in the Euro area. And least likely in the UK.

John Detrixhe: And what are you watching next week?

Gurpreet Gill: Let me pinpoint two macro and one policy area of focus. The first key item on the macro agenda is US retail sales. Consumer spending has held up so far. But we're going to be looking at the impact of tighter credit conditions and a smaller savings buffer. Also, worth noting that from October, 17 percent of US households will receive student loan repayment, which have been on pause since 2020. And so, that could also be a headwind to future discretionary spending.

The second macro area of focus is key economic data for China for the month of June, like industrial projection, retail sales, and fixed asset investment. China's reopening has recently slowed. And so, we're going to be looking for continued signs of a rebound in the services sector and any policy announcements.

And then the final item on the agenda is the Bank of Japan meeting. So, in our opinion, macro conditions in Japan are increasingly evolving in a way that warrant a departure from ultra easy policy. Wages are rising at their fastest clip

in decades. Inflation is broadening out. Even core measures are running above 2 percent. And so, we do anticipate further shifts in the yield curve control policy. Possibly even next week. And at some point over the coming year, we would expect the Bank of Japan to bid farewell to negative interest rates.

John Detrixhe: Gurpreet, thanks for joining us.

Gurpreet Gill: Thanks for having me.

John Detrixhe: That's it for another episode of The Markets. Be sure to subscribe to our feed on Apple Podcasts, Spotify, or wherever you get your podcasts. I'm John Detrixhe. Thanks for listening.

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