Goldman Sachs Exchanges: The Markets

Pricing in the probability of a recession

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Sam Grobart: Inflation is down, employment is up. But the debt ceiling looms. This is The Markets, a new series from Goldman Sachs Exchanges.

Hi, I'm Sam Grobart. Today we're talking to Joseph Briggs, an economist in Goldman Sachs Research. Joseph, thank you for joining us today.

Joseph Briggs: It's great thing here with you, Sam.

Sam Grobart: So, of course the big news this week, Joseph, was the release of the latest CPI data which showed inflation was slowing a bit more than expected. Markets have been reacting positively to this news. What's been your interpretation of the data?

Joseph Briggs: Overall, the CPI print was pretty positive.

41 basis points in core inflation is, obviously, too firm. But a lot of the strength was driven by an increase in used car prices that we expect is going to reverse as we move through the summer.

We also saw that the March slowdown in shelter inflation that we saw last month was sustained in April. Which is good news because we think that the shelter inflation should continue to cool as we move through the year because we've seen new lease prices run very soft over the last several months.

Sam Grobart: And is the market right in thinking that inflation is headed in the right direction?

Joseph Briggs: For sure. Chair Powell's preferred measure, core services excluding rents and OER or owners' equivalent rent, slowed to 11 basis points in April. Now, some of the softness reflected weakness in travel related categories like airfares and lodging. But even after adjusting for the weaker print in these categories, the underlying inflation trend was showing signs of slowing.

Sam Grobart: Let's move onto another data point.

Another one from this week was the Fed's Senior Loan Officer Opinion Survey, which looked at bank lending activity over the first quarter of this year. It reported that lending standards tightened, and demand weakened for both commercial and industrial loans. What's your take on this report and what it means for the economy and the Fed?

Joseph Briggs: The tightening in loan growth was expected. With the banking stress that we'd seen over the last couple months, most market participants were expecting the banks would be pulling back on credit provision of debt.

The tightening that we saw in the SLOOS report was maybe a little bit less bad than feared. Broadly similar to the assumptions that we had made in our analysis that suggested that the credit crunch was going to subtract about 4/10 of a percentage point from GDP in 2023.

Powell had a similar take on the SLOOS data that he shared at the May FOMC meeting. So, we think that the data's probably enough to conclude that they're comfortable pausing on hikes for now.

Sam Grobart: So, what do you think this means overall for rates?

Joseph Briggs: The growth slowdown from tighter credit is a reason for concern. And contributes to concerns that some market participants have that we will be entering a recession and that the Fed will be cutting rates later than year. Our analysis suggests that the size of the hit is probably more likely to be a headwind, but not enough to push us into a recession, and prompt the Fed to actually cut rates. Which is why we think that the current market pricing of rates is a bit overdone.

Sam Grobart: And when we talk about the tightening of lending standards and so forth, I mean, who's most affected by this?

Joseph Briggs: So, manufacturing companies and commercial real estate are two the biggest borrowers from banks. And so, they're going to experience the biggest pullback in credit provision and probably a little bit more of a hit to activity than other companies. We also see that some service industries, leisure and hospitality, other sources, also are highly exposed to bank lending. And so, we might expect that there's a little bit of a bigger drag on activity and investment in those sectors. And maybe some softer job gains as we move through the year.

Sam Grobart: All of this has been a result of some banking takeovers, some banking failures. What is your view on the overall banking stress that we've seen this year? Are there indications that this turmoil has been contained? Or are we actually far from that?

Joseph Briggs: There are some worrisome patterns in that some of the smaller regional banks are still facing pressure, particularly in equity markets. But the economic data over the last week has been pretty good news. Again, the SLOOS report, the Fed's Senior Loan Officer Survey was less bad than feared. We also got an update of the National Federation of Independent Businesses, the NFIB's small business report. And it showed that the share of small businesses reported having trouble getting credit actually declined in April relative to March. And so, you know, this maybe creates a little bit of downside risk to our estimate of a 0.4 percentage point growth drag in 2023.

However, any pullback in lending growth is probably going to take some time to play out. And so, this is going to be a story that we're watching for the next several months. And until we see loan growth hold up reasonably well, it will remain a downside risk to the economic outlook.

Sam Grobart: We're now at the tail end of earnings reporting season. And a large majority of businesses posted results exceeding expectations, both in terms of earnings per share, as well as revenue. What is this telling us about the strength of the American consumer?

Joseph Briggs: So, our view coming into the year was that the consumer would hold up reasonably well because consumer income is set to grow between 3.5 and 4 percent. But that's in real terms. This is a very healthy pace of income growth.

I think that this explained a lot of the strength in the consumer earnings reports that we saw in Q1. And we expect that this is going to continue and that the combination of recovering income growth and still strong balance sheets are going to keep the consumer above water for the rest of this year.

Sam Grobart: It was just a week ago that the Fed raised rates another quarter percent. But it did use language that left the door open to pause the hiking cycle. Since then, we've obviously seen strong job growth, tightening credit, as we just talked about, and a slowing down of inflation. What else is the Fed going to be looking at before its meeting next June?

Joseph Briggs: Our forecast is that the Fed does pause at the June meeting. We feel even better about that forecast after seeing the inflation data yesterday which showed a slowing in the underlying inflation trend. The last big data point that we have ahead of the June meeting is the May payroll report. But at this point, I think it would take a series of very significant upside surprises to prompt the Fed to hike in June. We do think that the probability of a pause is extremely high at this point.

Sam Grobart: Let's talk about one of those potential surprises, which of course is the issue of the debt ceiling. The White House and Congress are negotiating a deal around the debt ceiling, or at least attempting to negotiate it. We have an idea of what happens if the government defaults. And of course, it's not good. But what does the uncertainty mean right now in today's markets?

Joseph Briggs: So, taking it back to the Fed, you know, I think that the uncertainty around the debt ceiling is one reason, or one additional reason, why the Fed might be less likely to hike in June. Really, everyone is just focused on trying to see how this is going to be resolved. In reality, we're probably not going to find out too much about what any sort of compromise would look like until we're right around the date when the debt ceiling becomes binding. And so, for right now, it really is just a wait and see type of environment. But, you know, to your point, uncertainty is certainly very elevated.

Sam Grobart: And Joseph, what are you going to be keeping your eye on next week?

Joseph Briggs: Over the next week we have a relatively lighter data schedule. The one thing that I am paying attention to is retail sales. Retail sales have underperformed recently. And it will be interesting to see whether we see a bit of a rebound in goods spending over the next couple months.

Sam Grobart: Joseph, thank you so much for joining us today.

Joseph Briggs: Thanks for having me.

Sam Grobart: That does it for another episode of The Markets, a new series from Goldman Sachs Exchanges. Thanks for listening. And be sure to find us on our own, new feed, The Markets, now available wherever you get your podcasts. I'm Sam Grobart. We'll catch you next Friday.