

## **Exchanges at Goldman Sachs**

### **What the Fed's Hawkish Pivot Means for Economic Growth and Markets**

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**Allison Nathan:** This is Exchanges at Goldman Sachs, where we discuss developments shaping industries, markets, and the global economy. I'm Allison Nathan, a Senior Strategist in Goldman Sachs Research.

We're on the cusp of one of the largest monetary tightening cycles in recent memory. The Federal Reserve, European Central Bank and Bank of England are all looking to accelerate the pace of policy normalization.

To help us make sense of the central bank activity and the implications for markets and investors, I'm delighted to be joined by my colleagues in Goldman Sachs Research, David Mericle, our chief U.S. economist, as well as Brian

Friedman, global head of Market Strats in our Global Markets Division.

**Allison Nathan:** David, Brian, welcome to the program.

**David:** Thank you.

**Brian:** Hi.

**Allison Nathan:** David, let's start with you. Your team recently raised its estimate for the number of expected Federal Reserve interest rate hikes to a whopping seven hikes from expectations of just three hikes head into the year. What's changed that's led you to make these shifts.

**David:** I'd say a couple of things have changed. First, our assessment of wage growth dynamics look a lot more worrisome than we had previously thought. Late last fall, it seemed that, in the aftermath of enhanced unemployment benefits going away, wage growth was calming down to a rate that was compatible with the Fed's 2% inflation goal. The wage numbers that we've gotten since the start of this year, in contrast, suggests that the recent trend is about 6%, which is too high to be

compatible with the 2% inflation target. On top of that, we're seeing strong and broader inflation trends. And I would say the combination of strong inflation, high wage growth, and high short-term inflation expectations at the very least has a risk of being dangerous. The kind of classic wage price spiral concern. And I think for the duration of this year, the inflation numbers are likely to be high enough that Fed officials are going to see it as appropriate to tighten steadily, as Chair Powell has put it, with 25 basis point hikes at every meeting.

**Allison Nathan:** All right. So talk to us a little bit more about what you're expecting at this point throughout the year and in particular at the March FOMC meeting which is coming up.

**David:** Sure. There's clearly some debate on the FOMC about whether they should hike by 25 or 50 basis points. There is Fed official who has been arguing for 50 basis points. The bulk of them, though, seem to instead prefer to start with the 25 basis point hike and to keep at it but not to take the risk of doing too much too fast. So that's our forecast, that they will do a 25 BIP hike in March followed by another 25 basis point hike at the May

meeting. And then at the June meeting, do both a 25 basis point hike and start the process of reducing the balance sheet.

**Allison Nathan:** And so just for a little bit of context, if they did hike by 50 basis points, that's actually pretty unusual, correct?

**David:** That's right. It's been a long time since the Fed has hiked 50 basis points at all. And I think it's been since the 1980s that they've started a hiking cycle by 50 basis points. Now, you know, I could certainly see, if they go 25 basis points at each meeting and it doesn't seem to be working, if current wage and price dynamics persist, I could see how more members of the committee would be convinced that they need to consider other options. But for the time being, it doesn't look like that's how they prefer to start.

**Allison Nathan:** Brian, let's bring you into the conversation. How are clients and markets interpreting and reacting to this hawkish Fed shift, our change in forecast, and also the signaling that's coming directly from the Fed?

**Brian:** Sure. So the first place you would naturally look is the front end of the yield curve, right? Because the policy rate is the primary tool that the Fed would be able to use, and you can ascertain how many hikes the market is pricing. And going into the September meeting in September of '21, before they had started to pull away and pivot and move away from former guidance, you were pricing almost less than one, right? And now, earlier this week, you had hit seven, which matches the forecast. It routed a little bit over the last couple days. So now you have 150 basis points priced in for the year. So six hikes in total. So that's the first place that you would look to see that the market has obviously acknowledged the pivot that the Fed has made and is basically on board with the fact that they're going to be going basically every meeting. Again, we are just shy of that right now.

I'd say the other thing that's noticeable is that the market has kind of changed its perception of financial conditions, right? So Chairman Powell had mentioned in the January press conference that the way that they expect policy to filter into the real economy is through financial conditions. And, you know, we know what finance conditions are made

of, right? So financial conditions are an index made up of a rate component, so short-end rates and long-end rates. It's made up of an equity component. It's made up of a credit spread component. And the dollar is an input there as well. So when central banks are trying to ease monetary policy, right? You're trying to lower rates to generate future growth and trying to reflate assets. And it's the reflation of those assets that provides some wealth effect that allows the economy to start to grow.

And conversely, when they're trying to bring inflation down, they do so by trying to lift rates and trying to get assets to wealth destruction, if you will, to some extent. And that provides a headwind to growth going forward.

As we said, the rate component now matches pretty much the pivot that the Fed made, so there's been a big change in the rate component of financial conditions.

You can see within equity markets, right? You can see that people have taken down their exposures. So net long right now are at a year low, so people are no longer as bullish as they were in equities when the Fed was trying to ease to financial conditions over the past couple of years. You can

see it in credit where you've seen a record amount of outflows over the past couple weeks from both IG and high yield. And you can see it in [UNINTEL]. So all of these kind of vols are elevated for your kind of classic risk off or a tightening of financial conditions. So the market is much better positioned for a tightening of financial conditions than they were call it six months ago or a year ago.

**Allison Nathan:** So David, if we bring you back into this then and as you're looking at financial conditions, something that you're very focused on, how have they, in aggregate, responded at this point? Is what the Fed trying to achieve already happening?

**David:** I would say the striking thing is that we've undertaken this big hawkish pivot, that the market has taken it seriously and then some, pricing six to seven yikes. And yet the tightening in broad financial conditions, at least as captured by our financial conditions index, is really fairly limited so far. It is there. It has happened over the course of this year, but it's not particularly large. And what that means is that the impulse to the real economy is also not particularly large so far.

We estimate that the impulse to growth from tightening and financial conditions that we've seen in the aftermath of the Fed's pivot is worth about a one quarter to one half percentage point drag on growth this year. Now, is that a lot? Or is that a little? Is that enough or is it not enough? It depends on what you think growth would have been in the absence of this financial conditions tightening. Our own view is a below-consensus growth view. We're currently looking for 2.2% growth. You know, that is inclusive of the tightening in financial conditions we've seen so far.

But the Fed, at least as of December when they last submitted economic projections, thought that growth this year would be 4%. Now, if you decide that the economy is getting to a dangerous place, that further increases in the level of resource utilization, that further tightening in the labor market against a backdrop of wage and price growth that's already quite high is a dangerous thing that's best avoided, then you might be in a rush to slow things down to a point where the economy is growing at its potential pace, not faster. And if your belief is that the economy would have grown 4%, well, then you have an awfully long ways to go because we and Fed officials think that the



economy's potential growth rate is below 2. And certainly the tightening in financial conditions that we've seen so far, that quarter to a half point drag is not going to close the gap between their 4% forecast and that sub 2% rate of potential.

Now, arguably, that means you have to do more. And it's crucial to point out that means you have to do more not just than they're already planning to do but than the market is already expecting them to do. Because if the market is anticipating that, you know, something similar to our forecast of seven rate hikes, there's no obvious reason that delivering on that should have an appreciable further effect in tightening financial conditions. You would need to surprise the market by doing more.

**Allison Nathan:** Right. I mean, what does explain the lack of response in the market? Have you looked at that?

**David:** It's difficulty to say. You know, I would say, to some degree, some people seem to imagine that the Fed simply can't take rates above a certain level, so that more tightening now perhaps means less later. Some people might think, yes, I can envision a scenario where

high inflation generates much higher Fed funds rate, but if there's a good chance that that is sort of an out-of-control scenario that leads to recession, then you might have a higher funds rate but not for very long. And so the transmission to longer term rates wouldn't be very high because, sure, the funds rate gets to a high level, but if it only lasts for a year or two, then it's not a very large share of, say, the average rate over the next ten years.

There could be a number of other things going on, but for now it looks like the Fed's rather considerable pivot and the market taking that seriously has not really been enough to have a large negative impact on the real economy's growth rate.

**Allison Nathan:** Well, if they get very aggressive, as we already anticipate but potentially even more aggressive, and we are already looking at fiscal stimulus fading as we are emerging from the pandemic era stimulus that was provided in 2020 and into last year, are you worried that we actually could be looking at increased recession risk at this point? What's the likelihood that we end up back in recession?

**David:** Look, I think, you know, if there's one thing we've learned during the pandemic, it's that it's a lot harder to do economic forecasting than usual. That the big factors that matter for the economy this year are very large risks and very uncertain risks. We estimate a very large, roughly 4 percentage point fiscal drag. Our best guess is that other positive forces -- increment reopening of the economy, further spending of accumulated excess savings, rebuilding of inventories, and so on -- will offset those negatives. But a lot of these things are, you know, a little bit hard to quantify. We don't really have modern parallels, for example, to the excess savings story. That reopening story is sort of prisoner to developments with the virus itself. So there is I think more uncertainty than usual, and that very large fiscal drag is I think a substantial downside risk. Certainly a much bigger risk than anything I had to contemplate as a forecaster in 2017 or 2018 or 2019.

Now, it is certainly not the Fed's intention at this point to induce a recession. They are, rightly I think, worried about price and wage dynamics, as are we. But they certainly have not concluded that the only way to deal with them is by inducing a recession. So if it looks like the economy is flirting with recession, I think they would back off.

In my mind then, fiscal policy tightening is actually a bigger risk than monetary policy tightening, both because we estimate that the impact on the economy of fiscal tightening is much larger than the monetary policy tightening we expect this year and because I would suspect it's less likely to be flexible. If the Fed thinks it's overdoing it, I could see them slowing the pace to once per quarter or backing off entirely if it looked like serious downside risk to the economy were emerging. Whereas I don't think we're going to get a sudden round of massive fiscal support if it looks like the pullback and fiscal support has overdone it and threatens to push the economy to a very weak place.

**Allison Nathan:** Brian, what are you hearing from clients? Are you hearing any rumblings about concerns about the growth outlook?

**Brian:** Yes. So there's definitely concerns about recession risk, right? And you could even see within the yield curve, it's slightly inverted where the yield of late '23 is higher than the yield of late '24. So you're actually pricing in that the Fed's going to hike, and then they're going to have to cut over the course of '24 in large part

because of worries about recessions. I would say, like, this is very much in line with past tightening cycles, right? If you look at how rates performed in past tightening cycles, what you notice kind of definitely happens is two things. The yield curves flatten, and that the market significantly underprices the level at which the Fed is going to get to.

This time around, what's interesting about the curve maybe is that you flatten to levels where you usually end hiking cycles before the Fed has doled out the first hike, but we don't think that's a huge opportunity there. What is a bigger opportunity is the fact that we think, like the last two hiking cycles, the market has significantly underpriced where the Fed will have to get to. And really why the market does that is because kind of by construct you are hiking into slower growth. And the market always is a little bit worried that a slower amount of hikes or less amount of hikes will kind of accelerate the deceleration and will force you to stop at a lower level. And then, as David was alluding to, these rate hikes don't have a major effect on the inflation rate or the growth rate at the very beginning.

And if you think about what the Fed is telling you, they're

more worried about the other scenario where growth and inflation don't come down as much as they need to, right? And they're going to have to go deeper. And they're presented with a bigger bit of a problem because, if you think about it, like, the building blocks of growth are actually pretty healthy. You're already growing above trend. As David alluded to, you have an inventory cycle ahead of you. Anyone who wants a job has a job at higher wages than you had before the pandemic. Financial conditions are still easy. Rates are still very low. All of these things, none of them really forebode a recession that's going to happen at a relatively low level of rate.

**Allison Nathan:** Right. David, do you have a response to that? I mean, ultimately, the underlying economy does look in reasonably good shape.

**David:** Yeah, I think that's right. You know, at the moment, it's somewhat difficult to interpret the data because of the effect of Omicron, which looks short lived but serious in some areas. And I don't think we've seen the full impact by any means of the pullback in fiscal support. I think that will evolve gradually over the course of the year. But, yeah, for now, the economy grew strongly in Q4.

It looks to us like it will grow at a decent pace of about 2% in Q1. I think that the rate of growth this year is going to be much slower than we became accustomed to last year and slower than consensus expects, but we're certainly not calling for a recession.

**Allison Nathan:** And Brian, you mentioned that you think longer dated interest rates at the long end of the forward curve are too low relative to what the Fed is likely going to have to do over the course of this cycle. Is there anything else that looks mispriced to you? And, you know, how are you advising clients to position themselves at this point and maybe hedge some of the risks? Maybe not our mainline scenario but some of the risks we've discussed?

**Brian:** Sure. Well, the first thing is that you do have to be cognizant that the Fed is trying to bring inflation down from 7.5 to 2 over a reasonable amount of time. And you would have to expect that in order to accomplish that, you're going to have to hike rates, take out accommodation, potentially go into restrictive, and tightening financial conditions, right? So again, financial conditions generally means all assets down.

Now, within the basket of financial conditions, there are clearly some that we think are more vulnerable than others. As I alluded to, rates would be a big one of those. Right now, you're essentially saying that the Fed is going to peak out at around 2%. With inflation well above 2%, that still leaves real rates deeply negative, so it's hard to imagine that leaving deeply negative rates in the economy is going to be enough to pull inflation down as fast and as far as the Fed wants it to. So we still think that short rates is a high-quality trade.

I think, of all of the assets that are maybe most vulnerable within a financial condition tightening, it's credit. I think that, when you look at all in credit, I think the market has been trained to view credit only through the lens of defaults. If companies are not going to default, then your money is good. And that's largely been true, but it's very much true because rates have been coming down for 30 years. So as long as rates are coming down, your credit portfolio is going to be okay.

This time around, though, you're coming from a place where both rates are at record lows, and credit spreads were at historic tightness in the middle of the pandemic



because the Fed did something that they never did before, which was kind of backstop credit. So now, when you look at all-in credits or just a 10-year bond for an IG company, that all-in rate, both the rate component and the credit component, are very, very low. And what we're seeing is that, if you're long a portfolio of credit, you are vulnerable to just growth being and inflation being very high and just kind of eclipsing your yield.

So credit's already down 7% this year, and you still have to pay your 7% inflation bill on top of that. And you've already started to see a significant amount of outflows. So in a world in which the Fed is telling you that they want to tightening financial conditions, which are bad for spreads, by hiking rates, which is bad for the rate component, we don't see what the advantage is or what the upside is for holding a portfolio of credit. And if there was one asset, given that it's a long-only asset where, if you start to see material outflows and asset managers and stuff have to get out, the clearing level gets a little bit fuzzy of where the next buyer will come in. We think that's the asset that is most at risk. Definitely be a big role in the financial condition tighten or trade.

Equities we have a preference for over credit just because equities are a real asset. So in a world where nominal growth is still good and rates are still relatively low, that's still kind of a tailwind for equities, and corporates are in very strong shape with respect to both earnings, growth, and margins. So we much prefer the combination of being long equities hedged with short credit.

**Allison Nathan:** Interesting. And the other interesting point that you brought up in the context of that conversation was the fact you mentioned this in the context of credit. But David, the other big aspect of the Fed tightening cycle will be balance sheet. You know, shrinking the balance sheet. There's even some discussion of not only rolling off assets from the balance sheet but even actively selling the balance sheet if there's more work to do to tighten financial conditions. What are your thoughts and expectations around that side of things? And Brian, I'll turn to you and talk about the implications of losing that big buyer in the bond market.

**David:** I would think of balance sheet reduction is very much a secondary tool in terms of monetary policy tightening relative to interest rate policy. Our estimates

suggest that the impact of balance sheet reduction should be equivalent of something like a 30 basis point rate hike. And with seven hikes for this year, our forecast calls for 175 basis points of rate hikes. So that would account for the great bulk of the tightening.

I think they'll start this process, though, sometime around the middle of the year. We expect them to shrink the balance sheet ultimately from about 8.8 trillion today down to the low to mid 6 trillions. That is about three to four times as much in dollar terms as they did last cycle, so it's a lot more.

I would also expect them to go more quickly than they did last cycle at something like double the peak pace. Maybe a peak pace of \$100 billion per month. If they didn't do that, it would simply take a very, very long time. And I think they want to get this done on a reasonable time horizon.

My sense is that most investors would not be particularly surprised if the Fed delivered a balance sheet reduction plan along the lines that I've outlined. And in that sense, I think it's plausible that much of the impact is already priced and that, if the Fed does deliver something like what

most of us are anticipating, the further incremental impact of that would not be particularly large in the same way that delivering rate hikes that the market has already priced should not have a large impact on markets.

**Allison Nathan:** Brian, but at the end of the day, we are losing this big buyer bonds in the market, which some people have actually argued has somewhat distorted the bond market over this period. What do you assess to be the implications of that?

**Brian:** Yeah, so I do agree with David that the Fed will use the policy rate as their primary tool. However, we do have to be cognizant of the thing that's different going into this hiking cycle is just that inflation is just much higher than we've seen in the past 40 years, right? So it's very hard to compare the last two hiking cycles, especially the last hiking cycle where they went well before you ever had inflation to this one. And I think David brought up the key point before where the key part of this year will be as you go into the second half when both the Fed and the market expect for inflation to come down pretty meaningfully, right?

If inflation is not coming down as quickly as either the Fed or the market expects, then everything has to be on the table for the Fed, be it selling bonds, be it a faster pace of rate hikes. They're going to need to get rates higher, much higher than what's priced. And they're going to have to use all of these tools. So I think it's the combination of if they're selling bonds, that means that inflation has not come down as much. And chances are they're also going to be hiking more. And we do have to be cognizant that it's not just the Fed, right? It's all of the major central banks that are walking away from QE and turning to QT in a much tighter time frame than we've ever seen before.

So again, it's just one more reason why we think that being short rates is a high-quality trade, and that the market is just mispricing the rate at which the Fed will be able to get rates to.

**Allison Nathan:** Let's end with a quick discussion on emerging market central banks because it's an interesting situation in the sense that emerging market central banks usually start to tighten after developed market central banks. This time around, it looks like emerging market central banks are more on the tail end of their tightening

cycle. So what are the implications of that, especially as you think about differentials in yields across geographies?

**Brian:** Yeah, so this time was a little bit different in that, during the peak of the recession, you had EM central banks do essentially what their DM brethren did, which was just cut rates as low as you can, right? Usually when you have a shock, they have to keep rates higher or even hike in order to make sure you don't have capital outflows. So the fact that they cut to such low levels, coupled with the fact that DM central banks switched to average inflation targeting, where they allowed themselves to stay lower than usual, right? While DM central banks have the credibility to stay low in the face of high inflation, EM central banks are not afforded that same luxury. And therefore, EM central banks had to hike much earlier and much higher than either they or the market thought that they would going into last year.

So it's been a pretty impressive hiking cycle. And because of the fact that now EM central banks are at the tail end of their hiking cycles while DM central banks are just beginning, it's leaving rate differentials at very, very high levels. And because of that, we think that buying either

EM currencies or EM local bonds is actually a pretty safe place to hang out, right? Because if in fact inflation doesn't fall as much as what's priced into these inflation markets, then DM central banks are going to have to hike a lot more than what's priced, while it's not clear that EM central banks have to hike a lot more from these levels.

And if DM inflation markets are right and inflation does fall starting the end of the year pretty meaningfully, then it's not clear that DM rates have to rally at all from, while EM rates will look high from these [UNINTEL]. So it's a very wide rate differential, and that just presents an opportunity to hang out in those markets while you wait to see what DM central banks are going to have to do over the course of the year.

**Allison Nathan:** All very interesting. We'll be watching. We have a few big upcoming central bank meetings that we will be monitoring quite closely. Thank you, David and Brian for joining us today.

**David:** Thank you.

**Brian:** Thank you.

**Allison Nathan:** That concludes this episode of Exchanges at Goldman Sachs. Thanks for listening. And if you enjoyed this show, we hope you subscribe on Apple Podcasts and leave a rating and comment.

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