Goldman Sachs The Markets

How markets are responding to central bank moves

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Sam Grobart: How are investors responding to central bank decisions across the globe? This is The Markets.

Hi, I'm Sam Grobart. Today, I'm joined by Vickie Chang, macro strategist at Goldman Sachs Research. Vickie, thanks so much for joining us today.

Vickie Chang: Thanks for having me.

Sam Grobart: So this week, the Bank of Japan raised interest rates. That shouldn't sound momentous, but it was. Tell us why.

Vickie Chang: Historically, it's pretty important. It's their first rate hike in 17 years, and it ends eight years of negative interest rate policy for them. With the policy changes they made this week, we've mostly returned now to more standard monetary policy where the policy rate is the main tool of transmission again.

The Bank of Japan had until now been really an outlier in continuing to keep policy easy in this recent period, where what's really been a story is central banks worldwide having to tighten policy substantially in the face of high inflation. Going forward, they seem to want to avoid rapid rate hikes, but they've also implied that they see room to tighten policy.

Sam Grobart: And what is that significance for markets in general?

Vickie Chang: In terms of the significance for broader macro markets, we think that's actually more limited. The move had been pretty well telegraphed ahead of time, and so you see that's why rate markets have been pretty calm in the aftermath. Even with this rate hike, the rate differentials between Japan and the rest of the world are still large. And so we think that the yen is still going to be a more US yield and risk story rather than a BoJ story.

Sam Grobart: Got it. So let's turn our attention a little bit closer to where we are here in the US. The Fed had their big meeting this week. What did they signal about their thinking on inflation?

Vickie Chang: To us, the message from the Fed at yesterday's meeting was that they're still anchoring on and we're still on track for a June cut. They didn't seem overly concerned about the recent inflation data that's been higher for the last couple of prints. And they still expect three cuts this year.

But Chair Powell did reiterate yesterday that they're waiting for more confidence that inflation is coming down sustainably. So in other words, the plan as of now is unchanged, but we need more confirmation from the data before we go forward.

Sam Grobart: You mentioned the number of cuts that we are expecting this year. That number is three. That is in line with Goldman Sachs Research forecasts for the year, the first of them happening in June. How is the market feeling about that outlook?

Vickie Chang: Yeah, the market is pricing a bit more than three cuts this year right now, after this week's FOMC meeting, which is about in line with our current outlook, like you said. And price have been less than three going into the meeting because people worried that the Fed would surprise on the hawkish side. But what --

Sam Grobart: Maybe cut it to two or something, right.

Vickie Chang: Exactly, yeah. And show two cuts in their projections. What I think is interesting is that, even as the market has pretty steadily since January been reducing the number of cuts that it expects this year, at the trough, they were pricing six cuts this year.

Sam Grobart: Six, right.

Vickie Chang: Mostly what's been changing in the last couple of months are those near-term policy expectations while longer-dated forward rates, which we can think of as how the market is pricing the neutral rate, haven't moved much until pretty recently. So even as the market was pricing out easing in the near term, It wasn't revising higher its view of where short-term rates will ultimately settle.

Sam Grobart: Right.

Vickie Chang: And we've thought that the longer that the economy remains resilient in the face of higher rates, the more that the risks to these forward rates are likely to be to the upside. You know, it becomes harder and harder to envision that long-term forward rates belong in the high threes the longer that the economy continues to grow at this rate and the labor market stays solid with a policy rate above 5%. And we actually saw that yesterday.

The market took the FOMC statement and press conference dovishly overall. But even as yields across the curve came down, those deeper forward rates that again are a proxy for how the market is pricing the policy rate many years out was actually up a few basis points on the day.

Sam Grobart: So there's obviously the question of how many cuts in a given period of time that we're going to see, but perhaps the thing that has been less focused on is ultimately where that rate settles. And what you're saying is perhaps it could be a little bit higher than maybe what was being thought of a month ago or two months ago?

Vickie Chang: Exactly. So we've worked our way through all of the hiking cycle, and it's apparent that we've hit the peak policy rate. Our focus and the market's focus and the Fed's focus can now turn to, okay, so where does this policy rate ultimately belong in the long run? And we're coming out of this long period post financial crisis of very low policy rates worldwide. The phrase then was, "Lower for longer."

Sam Grobart: Right.

Vickie Chang: And so now, with the economy so strong at these policy rates, the question is: Do they really belong that low? We don't think it does.

Sam Grobart: We don't go back to that status.

Vickie Chang: Exactly. But the question is there is a lot of room between where we were then and where we are now.

Sam Grobart: We were basically at zero.

Vickie Chang: Yeah, exactly. And so we think that the going forward, the market is going to be more focused now on where to price that long-term policy rate, and we think the risk to the upside.

Sam Grobart: Got it. We talk a lot about -- we have been now for some months -- the question of a soft landing. Do you think a soft landing has been priced in markets?

Vickie Chang: Yeah, it's true that the valuation picture now is less friendly than it was before, and the market's priced for a pretty good outcome already. But the macro dynamics that we expect going forward -- so a stable unemployment rate that's near cycle lows, 10-year yields around current levels, and inflation that's still continuing to fall -- those are all still forces that argue for modest positive returns in risk assets. And it's why we still like being long risk because we think there's still room for the market to relax about both the growth and the inflation side.

But the market's closer to our view than it's been in some time, and so we're watching for the point where it feels like our views are fully reflected in the market.

Sam Grobart: And Vickie, what's going to be on your radar for next week?

Vickie Chang: Well, it's a light week after a very macro heavy one this week, but we'll be watching the inflation data. So particularly, February PCE in the US. The inflation data is really the key data to watch right now. We have to be able to get comfortable, at least over time, that the disinflation process is continuing. And so that's going to be key for markets.

Sam Grobart: Vickie Chang, thank you so much.

Vickie Chang: Thank you for having me.

Sam Grobart: That does it for another episode of The Markets. But sure to find us on Apple Podcasts, Spotify, or wherever you get your podcasts. To learn more, please visit us at GS.com and sign up for Briefings, our weekly newsletter on the global economy. I'm Sam Grobart. Thanks so much for listening.