Goldman Sachs Exchanges: The Markets

Can the global economy withstand higher interest rates?

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Recorded: June 22, 2023

Sam Grobart: Stock markets from London to New York shuddered this week as major central banks raised interest rates or, in the case of the US Federal Reserve, signaled more tightening could be ahead. This is The Markets, a new podcast series from Goldman Sachs Exchanges.

Hi, I'm Sam Grobart. Today, I'm joined by Ashish Shah, Chief Investment Officer of Public Investing in Asset & Wealth Management. And we're going to talk about all that hawkish sentiment out there, the continuing AI story in markets, and what the risk for a recession is looking like right now.

Ashish, thanks so much for joining us today.

Ashish Shah: Awesome to be here.

Sam Grobart: So, Ashish, this week we saw hawkish Congressional testimony from Fed Chair Powell. And of course, The Bank of England just raised rates by what many are calling an "aggressive" 50 basis points. Can the global economy withstand higher interest rates?

Ashish Shah: So, I think part of what you're seeing is that the global economy is showing a tremendous amount of resilience. Now, in the UK, there are obviously a lot of very specific things going on given the set up there between the Brexit that we've seen, the constraints that that puts on the economy, combined with the fact that Europe, in general, is lagging about six to 12 months behind the US in terms of the overall COVID reopening. And that's one of the reasons you're seeing all this inflation, particularly in services on the globe, is that you're still seeing people enjoying going out for the first time. Maybe not the first restaurant meal, but like really recharging on vacations and experiences versus goods and services.

So, the real economy, I think, can withstand these higher rates. Which is why we're seeing higher rates. I think the bigger challenge ends up being when it comes to asset markets. Because asset markets, for ten - 15 years, have gotten used to much lower yields. And the aggressive level of hiking that you're seeing, now starting with the BOE is starting to challenge the valuations there.

And one of the things that we know is that while central banks can be predictable in terms of their tightening, credit markets can be very unpredictable as we saw earlier this year. And predicting that unpredictability is going to be a real challenge for central banks.

Sam Grobart: I want to move to another part of the market, the tech sector, which, of course, has been experiencing a pretty strong rally given all the excitement around AI. What are you hearing about from clients on this topic?

Ashish Shah: This is a top topic for clients. They want to understand what is going on with AI. But I think we're at very early stages. And to be 100 percent honest, it reminds me of those early stages of the internet where a lot of people, a lot of companies felt the need to be developing a strategy. And when you're in that development stage, you're very much making investments without knowing what the returns at going to be.

So, I think there's no CEO out there that hasn't been asked by their board, "What is our generative AI strategy? Or what's our AI strategy?" And as a result, they're willing to write checks just to get involved.

Now, I think going from that period of time where people are just investing to learn, you're going to have to actually see return on capital and return on investment. And so, the potential, particularly for software companies to be able to capture some of that efficiency that AI can bring to the table, I think, is going to be quite substantial in the long-term. But I think we're still building out the use cases. And that's going to be 18 - 24 months before we really see the breadth of use cases.

In the meantime, there's probably a little bit of a spike given the amount of the constrained supply of things like chips and compute capacity that might lead to, I don't want to call it a bubble, but certainly an overshoot of the value capture that we've seen.

Sam Grobart: I wanted to ask you about China, which is seeing a slowdown or a slowing down maybe going against some of the expectations originally around a COVID reopening. How are markets looking at that right now?

Ashish Shah: Yeah. So, I think that, actually, China's playing out very much as we had expected. Which was valuations had gotten really hit. There was an opportunity there to be opportunistic. And particularly as they were shifting policies to a new framework, there was a lot of uncertainty in the marketplace. And that was priced into the markets.

As they've reopened, you've got the typical kind of first wave where it was good. Shifting then to services. But I think it's important to keep in mind that you didn't see nearly the fiscal stimulus that you've seen in other markets. And so, there wasn't nearly that pent up demand.

I think there's also the dynamic where, again, talking about the shift from goods and services globally, that China manufactures a lot of those goods. And so, it's not surprising to me that we're not seeing that kind of down shift.

I think on top of that, we haven't seen the aggressive stimulus that is the story of Chinese growth in the past where there's heavy infrastructure spending, there's heavy real estate spending. And a lot of that is because, particularly on the real estate side, they don't have the need to do the spending that they used to.

And so, we still see opportunities as the new framework comes into place and where companies start to learn to adapt to the new policy framework. And we also expect there thing further policy stimulus as the government looks to make sure that there's sufficient employment taking place in the economy. We just don't think it's going to be a take-off when it comes to the economy. But that has a benefit in that here's an economy where you're not seeing the inflationary pushes that we're seeing in Europe and that we saw in the US. And as a result, you can actually find attractive opportunities in the bond markets in China. And some of those are going to benefit the kind of longer duration, growthier equities from a valuation perspective.

Sam Grobart: So, Ashish, as you looked over the past week, was there any data point that caught your eye?

Ashish Shah: Sure thing. So, look, I think the housing data that with saw in Starts and Permits was a lot stronger than was expected. And I think speaks to, again, there's a shift in spending. But then there also continues to be consumer capacity, particularly in areas where there may be supply constraints within the marketplace.

And I think that housing, without question, was one of those areas. Higher rates have really slowed down construction. And people were worried about is this going to create a real dip in the housing market. I think that while prices have cooled off, that there's still underlying demand relative to the amount of supply that's available for housing as you get this demographic shift of people forming households.

And so, it's a reminder that 12 months ago, as we started to see a slowdown in home building, that gets normalized as you do see longer term rates come down. And despite the fact that the Fed is potentially continuing to hike here. And certainly, has hiked on a year-to-date basis, we've seen, actually, longer term rates have priced that in. Right? And so, longer term rates have actually come in from their highs of last year. And it's a reminder that you have to pay attention to both sides of financial conditions.

Sam Grobart: Ashish, last question. What are you going to be looking for next week?

Ashish Shah: So, one of the themes that we've been playing out is there are two things that basically matter. It's jobs and inflation. And maybe not over the next week, but over the next two weeks we're going to get more jobs data. I want to see if capacity is getting built on the employment side, because we're coming off this large deficit of supply. And that's going to feed into services inflation over time if it persists.

And I'm sure that's something that central banks and the Fed, in particular, are watching very carefully is how is that capacity building? And the second order effect there is, you know, if unemployment rises because more people are coming back into the workplace, okay, that's fantastic for growth. It increases the likelihood of a soft landing because you're adding supply to the market. If people are losing their jobs, you have to be worried about the slowdown in the economy. And the second order effect of people losing their jobs into a softer economy, what's going to be the impact of spending and the effect on the economy?

I don't think we're at the stage yet where that's a major concern. But it's something that in every data point we're looking for information.

Sam Grobart: Ashish, thanks so much.

Ashish Shah: Great to be here.

Sam Grobart: That does it for another episode of The Markets. Be sure to follow us on Apple Podcasts, Spotify, or wherever you get your podcasts. I'm Sam Grobart. Thanks so much for listening.