Allison Nathan: The US economy has shown signs of surprising resilience this year, but concerns over inflation, recession, and the Fed's path are still looming. So where is the economy headed from here?

David Mericle: We continue to have a more optimistic view on our prospects for achieving a soft landing and avoiding a recession than consensus. We recently lowered our 12-month recession probability to 25% because we felt like we've seen enough in terms of the labor market rebalancing to feel more optimistic that that can be accomplished without a recession.

Allison Nathan: I'm Allison Nathan, and this is Goldman Sachs Exchanges.
To help shed light on the state of the US economy and drivers and risks for the second half of the year, I'm sitting down with my colleague in Goldman Sachs Research, David Mericle, our chief US economist. David, welcome back to the program.

**David Mericle:** Thanks, Allison. It's good to be here.
Allison Nathan: David, recession fears still appear to be looming large in the US. Give us an update of how the US economy is doing and whether those fears seem warranted at this point.

David Mericle: Sure. We've been on the optimistic side of this debate since early in 2022, but, at the beginning of it, we hadn't seen very much about how the rebalancing of the labor market that we thought we did indeed need to solve the inflation problem and avoid a recession would go. Now, I think we actually know a lot, and it makes me a lot more confident than I could have been at the outset.

At the outset of the Fed's hiking cycle, we did indeed have an overheated labor market. And in fact, our jobs-workers gap, which is just the difference between labor demand and labor supply, between employment plus job openings and the size of the labor force, said that we had not only an overheated labor market but the most overheated labor market in US history.

We've seen a big decline in our jobs-workers gap from about 6 million to about 3 million. And so far, it's been
remarkably painless. We haven't seen any increase in the unemployment rate. Instead, we've seen a big decline in job openings and a big recovery of labor supply do all of the work. I think that means that we're on the right trajectory, so we continue to have a more optimistic view on our prospects for achieving a soft landing and avoiding a recession than consensus.

We recently lowered our 12-month recession probability to 25% because we felt like we've seen enough in terms of the labor market rebalancing to feel more optimistic that that can be accomplished without a recession, and we've learned enough about the banking stress to be confident that it is probably not going to be a recessionary shock, although I do think it matters for the economy.

In contrast, the consensus still sees an over 60% probability of recession, so basically the same probability as last fall.

Allison Nathan: And that's the consensus of forecasters?

David Mericle: Of forecasters, right. Now, it is true that, as Chair Powell emphasized at the June press
conference, realized core inflation has not come down as much as we would have hoped by this point. But I actually think that the inflation outlook has brightened even though the realized data have fallen a little bit short. And so both because of the successful labor market rebalancing and because of a number of signs that I see that make me more encouraged about inflation coming down, I feel better about the prospects for achieving a soft landing based on what we've seen so far.

Allison Nathan: So you're focused on labor market rebalancing because, historically, we've seen a pattern where the Fed has had to hike substantially to increase unemployment in order to rein in inflation. As you said, the rebalancing looks to be going pretty well so far, but we are seeing initial unemployment claims ticking up. So how confident are you that that's not the start of meaningful increases in unemployment?

David Mericle: That's exactly right. You know, I think the reason that many people were pessimistic about the prospects for achieving a soft landing were that we did have an overheated labor market. And historically, if you want to rebalance supply and demand in the labor market, what
we've typically seen is that that happens alongside a meaningful increase in the unemployment rate. And so that's what led many people to think that would be necessary this time around as well.

Now, what made us more encouraged at the outset of this was that the labor market looked unusual by historical standards in that the level of employment was not particularly high, but the level of job openings was astronomical. And we thought that had two implications. First, that, if it's excruciatingly hard to hire people, you should be a little bit reluctant to fire people because you worry that you'll wind up understaffed. And second, if some workers do wind up losing their jobs in that process of raising interest rates and trying to restrain demand, there are a lot of job openings. They should be able to find a new job relatively easily.

Now, so far, that's basically what's happened. We've seen a historically unprecedented decline in job openings without seeing any increase at all in the unemployment rate. So so far, it's been very encouraging, and I think the Fed should be very pleased with all of that. But at this point, the starting conditions are not quite as attractive and not quite
as encouraging as they were at the outset precisely because we have achieved a lot of progress in rebalancing supply and demand. And so it's certainly fair to ask the Allison Nathan: Will further restraint on labor demand have a less favorable composition going forward? Will it entail more layoffs relative to the decline in job openings?

Now, one thing that many people have focused on -- and there are a number of indicators that point in this direction for example, as you said. Initial jobless claims have risen. We think that continuing jobless claims, when properly seasonally adjusted, have also risen quite a bit. The layoff rate and our real-time tracker of the layoff rate are up. And so I think the question has become: Is this the beginning of a trend? Or is this a one-time normalization back to conditions that look a little bit more like the pre-pandemic labor market?

It's hard to be completely sure, but my take would be that this is a one-time kind of level reset, which is simply the flip side of a healthy labor market rebalancing. Now that companies are no longer losing their workers as quickly and are able to hire much more readily, they're less reluctant to lay people off if someone's not doing a good
job. And so we've seen the layoff rate tick back up, part of the way back to the 2019 rate. And I think you see that in a number of measures of labor market turnover, including involuntary turnover like jobless claims.

So I think this is probably just an inevitable consequence of getting the labor market back into better balance, which is the goal after all. I don't think it's the beginning of a trend that will push the unemployment rate up substantially, but we'll follow these numbers carefully.

**Allison Nathan:** But as you said, even if inflation is moving in the right direction, it still remains very high. Core inflation remains stubbornly high, and yet the Fed paused its rate hikes as of June. So what do you make of that? How do you interpret that pause? And how concerned are you that they ultimately will have to do more?

**David Mericle:** Sure. The labor market rebalancing to date has been great, but it is, after all, just a means to an end. At the end of the day, the purpose of rebalancing the labor market is to dampen wage pressures and ultimately to dampen inflationary pressures. And at the last Fed
meeting, the June meeting, the FMOC surprised us and I think most market participants by showing that they expect two, rather than one, additional rate hikes this year. And the main reason that Chair Powell gave for that was precisely -- and he's completely right about this -- that core inflation has not fallen as much to date as we and I think most people anticipated it would. So there has been a bit of a disappointment there.

Now, for a number of reasons, though, I'm not that discouraged by that. I actually feel that the inflation outlook has brightened, that a number of things have happened since last fall or winter that make me more confident that we're likely to see a decline in spite of the disappointment in the realized data to date. One of those things is that the single largest category by weight -- shelter inflation -- it's lagging by construction, so it's the one category where I think we actually know quite a bit in advance. And what the leading indicators tell us is that there is a very long way to fall that will eventually take two to two and a half points off the core CPI, probably about a point off of core PCE.

Second thing I would highlight is that wage growth has
come down quite a bit from the peak. And again, that's happened with no increase in the unemployment rate, which I think suggests that maybe some of the increase in wage growth also reflected temporary things like this exodus from the labor market -- workers have now come back -- unusual labor market policies, or workers just demanding big wage increases because the cost of living had gone up as food and energy prices spiked. But now that wage growth seems to be softening, that should flow through to many labor-intensive categories.

Third thing that makes me more encouraged is we seem to have made a lot of progress in solving supply chain problems. I think they are largely solved on a flow basis but not quite on a stock basis, but that means that there is more room for a further deflationary impulse from these categories. If shortages push prices up, then fixing supply chain problems, restoring production, rebuilding inventories, and reintroducing competition should push prices right back down. And I think in the auto sector in particular, where auto production has finally, with an incredibly long delay, returned to pre-pandemic levels, we're due for further deflationary pressure.
Fourth, that high inflation psychology that I was worried about last summer seems to have been substantially broken. If you look at measures of near-term consumer inflation expectations or at a couple of our tools for measuring business inflation expectations and business pricing intentions, they've moderated quite a bit. Similar to the labor market data, we are not all the way back to pre-pandemic conditions just yet. We probably still have have a bit further to go, but all of those things make me quite confident that inflation will head in the right direction from here.

**Allison Nathan:** One more follow-up on that, though, because, as you said, it has disappointed so far, and a lot of people are making the argument that the easier part of combating inflation is actually behind us. Why are they concerned about that? And does that give you any pause?

**David Mericle:** So I think that's certainly true of headline inflation. We had seen huge across-the-board increases in commodity prices. We saw further increases in food and energy prices when the war in Ukraine broke out. Obviously, it didn't make any sense to think that that rate of change would continue year after year after year.
And so as those increases have dropped out of the 12-month calculation to be sure, that was the easy part of getting headline in particular down.

Now, on the core, I think there's also an argument to be made that some of the worst of the pandemic shortages have now been reversed, and that has had some influence in bringing us down from the mid fives to the high fours and that's part of the easy part. But I would say the entirety of the pass through from commodity prices moderating has not yet shown up. The entirety of the effect of overcoming shortages by fixing supply chain problems has not shown up. And the entirety of the impact -- in fact, almost all of the impact -- of simply alleviating shortages for rental units in the housing sector has not flown through to the official core data. So maybe the easy things have happened, but I don't think that they've fully made their impression on core inflation just yet.

**Allison Nathan:** And so when do you see inflation getting back down to the 2% target?

**David Mericle:** Not for quite a while, realistically, and, you know, neither has the FOMC. I think they have had a
pretty clear-eyed view of how long it was going to take to completely get the labor market back to a place that's compatible with 2% inflation, to break that high inflation psychology and re-anchor inflation expectations. And I would also just add that there are many categories, price categories, that are just a little bit lagging because that's kind of how the economy works.

For example, in the last inflation report, the biggest upside surprise to core PCE inflation came from accountant services, where it turns out, intuitively I suppose, that once a year, during tax season, most of the price resetting is done. So they missed out on last summer's price resetting but raised prices with a lag. The same thing is true of healthcare prices, where we've seen big increases in health providers' costs, for example. Wages in the sector are up a lot, but we have not really seen commensurate increases in prices. And part of the reason for that is that contracts in the sector can be fixed for as long as one to three years. And so it is going to be a while before those prices get reset and those past cost increases increase, which I think means that there's going to be a time lag between creating the underlying conditions for inflation to come down and inflation actually getting back to the Fed's 2% target.
For that reason, we have core PCE inflation getting down to the high threes by the end of this year, the low to mid twos by the end of next year, and really not to 2% until 2025. But I think once you're at two and a half or so, most Fed officials would breathe a sigh of relief and say -- you know, they're not going to openly say “good enough,” but they might think that this is no longer a crisis.

**Allison Nathan:** In terms of the consumer in particular, you've made the point that, even though inflation is running relatively high, wage growth, while coming down, is still elevated so that real disposable incomes have actually held up pretty well and that's what's fueled the consumer to some extent. So do you think that can last?

**David Mericle:** That's right. You know, I think the biggest turnaround from last year to this year is, last year, you had a large decline in real disposable income. Consumers were able to offset a lot of that by saving at a lower rate or by tapping what, you know, we called excess savings during the pandemic. But from 2022 to 2023, that story changes quite a bit. Real disposable income starts growing again.
The reason for the turnaround is that real income fell because we were taking away all of these large pandemic transfer payments to households at exactly the same moment as households were having to cope with very high headline inflation that ate into their buying power. But in 2023, those things aren't true to the same degree. There are some transfer payments that are still going away, but they're not as big. And inflation has come down a lot this year and I would expect would run at roughly the same rate as wage growth or maybe even a little bit lower.

So that means you should have slightly positive real wage gains. You still have very strong job gains. And then you have a number of other technical factors like cost-of-living adjustments on Social Security, a reduction in the effective tax rate, and an increase in interest income that boosts real disposable income. So for that reason, because we were looking for real income growth of 3-4%, we haven't been that worried about an abrupt slowdown in consumer spending because household wealth is pretty high, consumer income growth, the flow of income growth, is quite strong, and that would usually translate to pretty strong consumption. In fact, we worried a little bit that it
would translate to too strong consumption because, if consumer spending is about two thirds of the economy and it's growing too quickly, then you might very well worry that overall demand growth is also growing a bit too quickly for supply to continue to catch up.

**Allison Nathan:** And so if you think about the other risks out there, we've obviously had earlier this year banking stress. So thinking about the supply side of that, not just the demand side, there was a lot of concern that we would see bank lending tightening pretty substantially. Are we seeing any of evidence that that's happening, either on the consumer side or the corporate side?

**David Mericle:** We've tended to view the banking stress is likely to cause a moderate tightening in credit with a moderate effect on the economy. I would say the signals are mixed so far, but overall that looks basically right to me. Why a moderate tightening in credit? Three reasons.

One, unlike in past credit crunches, today, our financial sector is more diversified. There are more alternatives to your local bank if your local bank is not willing to lend to you. Two, there's no reason that big banks necessarily
need to reduce their lending. Some of them have, if anything, benefited from deposit inflows during all of this. And third, we're not going from a normal level of credit conditions or lending standards to a very tight one overnight. We've actually already seen the largest tightening in bank lending standards outside a recession in the 30-some-year history of the Fed senior loan officer survey prior to the bank failures because most bank risk divisions were told that most economists expected a recession. And the prudent thing to do seemed to be to tighten bank lending standards to avoid credit losses.

Now, I absolutely do think that what we experienced and the ongoing problems facing banks will be incremental to that, but I would say slightly incremental, not dramatically incremental. So far, that looks right. If you look at the senior loan officer opinion survey, it shows some further tightening but not a huge change from where we already were since the bank failures.

If you look at the small business survey from a borrower's perspective rather than a banker's perspective, it would actually say, surprisingly, that things were no different in April or May than they were back in February. If you look
at bank lending volumes rather than bank lending standards, there is a visible slowdown in the Fed's weekly H8 report. Total bank lending does seem to have dropped off quite a bit, so averaging all of these different signals, I would say this is real. I do feel confident it will have some impact on the economy. Our baseline estimate is that this will shave about four tenths off of GDP growth, but it doesn't look to me like a recessionary shock.

And if you accept our starting point, that the economy began a little too hot rather than a little too cold, then throwing some cold water on it with tighter bank lending standards might actually be somewhat helpful in getting demand growth back down to that nice subdued pace that we ran at in 2022 and that I think the Fed would like to achieve for the remainder of 2023.

**Allison Nathan:** So what are you most concerned about if you think about factors that could derail your expectation of a soft landing?

**David Mericle:** I think there are three big concerns that probably are maybe relevant at slightly different horizons. First, while I'm less worried about the banking stress than
I was in the initial weeks of this, I do think there are still some risks there. We have seen a very large increase in lending standards for three quarters in a row. I'm not peculiarly sympathetic to those who are inclined to just, you know, say this hasn't turned into a crisis and so it's not a big deal. I do think that will have some impact on the economy, and it's certainly possible that it could have a larger impact on some pockets of the economy.

For example, we've highlighted in our research that small banks are especially important for lending to small businesses in small towns, and that's not something I've ever had to think about before as a macroeconomist, the kind of rural-urban divide. So that's something we'll keep a close eye on.

Second, as you noted earlier, the jobless claims numbers have come up. The layoff rate has come up. I think that this is just the flip side of a healthy rebalancing of the labor market, but that trend, if it were to continue, would certainly eventually lead to a bigger increase in the unemployment rate. So that's a risk as well. That the composition of this labor market rebalancing might not be as beautiful going forward as it's been so far.
Then the third thing to worry about is, while I feel confident that goods inflation will come down a fair bit and confident that shelter inflation will come down a fair bit because we have a clear signal from leading indicators there, it's a little bit more unpredictable what will happen to other core services. I think wage growth is softening. Inflation expectations are normalizing. Pressures from commodity price increases have gone from positive to negative. So all of the signals I would look at tell me we're headed in the right direction, but, realistically, these things are a little bit tricky to model with great conviction. And so there's some risk there, too, that [UNINTEL] wage growth or inflation could be a little bit stickier and the cost of getting it down could be higher.

Overall, I would say I feel good about our soft landing view. I think developments in the labor market and with inflation have been supportive of it, but those are the three key risks I would focus on.

**Allison Nathan:** Thanks very much, David.

**David Mericle:** Thank you.
Allison Nathan: And before you go, we’d like to introduce a new podcast from Goldman Sachs Exchanges. It’s called The Markets. Each week in just ten minutes or less, we'll be breaking down the key issues moving markets that week, giving you the information you need to stay ahead. Search for “The Markets” and follow wherever you get your podcasts.

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