Allison Nathan: The global economy has outperformed even Goldman Sachs's optimistic expectations in 2023, led by the US. But with higher interest rates and rising geopolitical tensions still front and center on investors' minds, can this solid performance continue? And what might be the implications for markets?

Jan Hatzius: We expect more of the same, similar global growth numbers in '24 as in '23. And then as far as inflation is concerned, we expect to get back to the neighborhood at least of central bank inflation targets.

Allison Nathan: I'm Allison Nathan, and this is Goldman Sachs Exchanges.
In this episode, we're discussing the economic and market outlook for the year ahead with Jan Hatzius, the firm's chief economist and head of global investment research, and Dominic Wilson, senior advisor in the global markets research group. Jan and Dom recently published their 2024 macro outlook entitled “The Hard Part Is Over.” Jan, Dom, welcome back to the program.

**Dominic Wilson:** Thank you.

**Jan Hatzius:** Great to be back.

**Allison Nathan:** There's always so much anticipation of our outlook reports. And sitting next to you all for the last several weeks, if not months, and seeing how much work and effort and thought goes into them, I'm excited to dig into the report with you now and maybe put you in the hot seat. Let's get started with the observation that a year ago when we sat down to do this the investing community was largely convinced that the US economy was heading into recession, but that hasn't happened. And instead, economic growth outperformed, as I just said, even our own optimistic outlook.
Jan, first explain to us how did we achieve this better-than-expected outcome?

**Jan Hatzius:** I think this cycle is different. That was the title of our outlook piece a year ago. It's really been mainly normalization from pandemic and post pandemic imbalances in the goods market, in the labor market, and in terms of relative demand for goods versus services. All of this aided by normalization of monetary policy, but that's really the big difference with the prior cycles of postwar history that were much more overheating cycles that ultimately had to be met with the Fed causing a recession because that was the only way to get the economy back into balance.

**Allison Nathan:** And so what did people who were concerned about recession get wrong?

**Jan Hatzius:** I think there was too much extrapolation from the experience of past cycles that were fundamentally different. There was too much statistics on “whenever the Fed has hiked the funds rate by x-hundred basis points, this is what has always happened.” But that's a very mechanical extrapolation from cycles that
really were so different from what we've just been through.

**Allison Nathan:** So Dom, the markets were obviously caught somewhat by surprise by this positive outcome this year. What did they really get wrong?

**Dominic Wilson:** Yeah, it's been a trickier year for macro markets I think overall. And I would say it really reflects I think at the highest level what Jan was talking about. I think the biggest surprise and what got mirrored in the markets was markets underestimating the resilience of US growth in the face of higher rates.

If you look back at the progression of things that have surprised people in the markets, most of them come back to that. We came out of the regional banking crisis in March/April particularly with a lot of recession fear in markets. And since then, we've been grinding it out with rates pushing higher, with the back end of the yield curve kind of moving to a place that is more consistent with an economy that's not having a recession.

And I would say on top of that, equity markets also outperformed particularly in the US. I think people had a
story, even without the recessionary forecasts, that these kind of higher yields would be a real constraint on equity markets. And particularly for the US mega cap space, they've shown that, with kind of AI theme, with the sort of earnings power that they're generating, and with an economy that's still doing relatively well, that you can generate pretty significant positive returns. I think that was not what people were expecting. And if you told them the rate markets were going to do what they did, they still wouldn't have expected it.

Allison Nathan: And so markets got a lot wrong, but what did they get right?

Dominic Wilson: I think at a high level, one of the dominant themes coming into the year, including from us, was that cash was going to be a high hurdle to beat. We're seeing these cash rates that we haven't seen for a long time. And I think when you take a step back that that has mostly been right, which is that you've seen another year of underperformance in government bonds. You've seen very modest returns in corporate credit, definitely underperforming cash there. US equities look like an exception, and so, you know, you've had much higher
returns at the index level, but it's very narrowly based. When you look at an equal weighted version of the S&P 500, that's underperformed cash. When you look at a lot of international indices, particularly in dollars, they've underperformed cash. And so at a high level, I think it was true that these cash rates that we generated were just a hard hurdle to beat and that being in cash was a pretty safe place to be.

**Allison Nathan:** And Jan, let me circle back to you. The title, as I said again, is, “The Hard Part Is Over.” We were walking over here, and I told you how much I really liked that title because I think it says a lot, and it's also relatively optimistic in a world where there's a lot of bad news right now. Talk to us a little bit about your outlook for 2024. Does your title mean that growth is going to continue to hold up and we're going to continue to see disinflation?

**Jan Hatzius:** Broadly, yes. We expect more of the same. Similar global growth numbers in '24 as in '23, 2.6-2.7% in both years. In the US, we have a little bit less growth. We're a little above two. In the euro area, we have a little bit more. So there are some nuances, but broadly
speaking it is more of the same on the growth side.

And then as far as inflation is concerned, we expect to get back to the neighborhood at least of central bank inflation targets. We've seen a massive amount of disinflation. If you take core inflation across the G10 economies ex-Japan and the EM economies that had seen big unwanted post pandemic inflation increases, the average there for core inflation was about 6% in 2022. We're now down to 3% on a sequential basis, and we expect that three to get back down to the 2-2.5% range by the end of next year.

And I think it's going to be driven still by similar factors. Some of the post pandemic normalization that in some cases, if you look at the real economic numbers, is already pretty far advanced. That still has a ways to feed through into the price numbers. For example, in the labor market, labor markets are now quite close to balance by our estimates, but wages are only gradually adjusting to that. Similar, in the goods sector where there's also more disinflation that has yet to occur or in the rental housing market. So all of that we think is going to continue and is going to get us to a place that is fairly comfortable for central banks.
**Allison Nathan:** A lot of people, though, are concerned about the fact that rates are very high. We expect them to remain high. So this monetary tightening, we're still feeling the impact of it, and the fiscal situation as well is relatively tight, relative to what we saw post pandemic. And of course there's a lot of concerns about the sustainability of the fiscal situation in the US. All of this is going to continue to hang over the economy. Why aren't you concerned?

**Jan Hatzius:** I think some of these points are just pretty far in the past at this point. The fastest pace of rate increases was around the middle of 2022. The Fed shifted to a 75-basis-point a meeting pace in June of 2022. The pace of rate increases slowed in late '22 and has slowed further as we've gone through this year.

By our estimates, the biggest impact on growth from monetary tightening occurs with about a two-quarter lag. If the fastest rate increases were in mid '22, then we're probably past the biggest impact on growth, and that's in fact what our models would strongly suggest.
Similarly, on fiscal policy, there was a meaningful fiscal policy adjustment in early 2022 when the post pandemic support payments rolled off, but that's now safely in the rearview mirror. There are of course still fiscal issues, and we are concerned about the longer term fiscal outlook. The US and other governments are running very large deficits with an economy that's somewhere around full employment. Large structural deficits that will need to be addressed eventually. That is going to be a drag on growth. I don't expect that to really happen in the short term, though, so I don't think the fiscal issues and fiscal tightening are going to be a major drag on growth in 2024.

**Allison Nathan:** I'll just point out, though, that the consensus seems to be that the lags between the tightening of monetary policy and the hit to growth are larger than we expect, but we've done all this work to back up why we think they're shorter.

**Jan Hatzius:** And I think a lot of this rests on sometimes a misunderstanding or a confusion between the maximum impact of monetary tightening on the level of GDP, where the lags are in fact quite long -- we find something like a year and a half -- and the maximum
impact on the growth rate of GDP, which we think is about two quarters. And for me, the growth rate, as a forecaster, the growth impact is actually the most important because, if you've gotten past the maximum hit to growth, the economy is still standing, we're still growing at an okay pace, but we're still seeing a negative impact, I'm not going to be that concerned about that negative impact putting us into a recession, given that we've already survived the biggest hit.

**Allison Nathan:** Dom, Jan just painted a relatively optimistic view of the economy ahead, but I think the key question is: How much of this optimism is already reflected in the markets?

**Dominic Wilson:** Yeah, I think the simple answer is that the market is pricing less optimism than our forecast. As you said, it's a pretty optimistic view but probably more optimism than the consensus. So if we look across assets at the moment, I think it's hard to find a lot of assets that are pricing now a very high chance of recession. The market has adapted to the trajectory that we've been seeing.
If we look at the things we normally look at to find those clues -- equity volatility and credit spreads both relatively low, the relative performance of cyclical parts of the equity markets -- none of this is telling you that the market is putting a big weight on recessionary problems. We're not pricing very deep cuts in the funds rate. The dollar has remained pretty strong, so people have woken up to the idea that the US economy is still doing reasonably well. So I do think the gap between market pricing and our view is smaller than the gap between our forecast and other forecasters.

But I still think, despite that kind of valuation and pricing headwind, the story that we're talking about and that Jan has described and I would say particularly the combination of growth holding up and inflation continuing to normalize, I think that's not fully reflected. And so when we look at that balance, there's a bit of a tug of war between these valuation constraints and this very favorable macro backdrop. I would say our view is pretty firmly that the macro will win out, and that will allow you to have further at least modest positive returns in the kind of risky and cyclical sides of the complex equities commodities.
**Allison Nathan:** I'm going to ask you more about that in a moment, but before we do, Jan, I do want to talk more specifically about the Fed. We have a December meeting coming up pretty soon. We don't expect them to make any changes, but of course the market has again begun to anticipate when we're actually going to see rate cuts. So given your view of growth and continuing disinflation, do you think there is going to be room for cuts in 2024 and how soon?

**Jan Hatzius:** Well, first of all, we do think that the hikes are probably in the past. The Fed and other developed market central banks we think have all gotten to the sort of peak point for policy rates, excluding Bank of Japan, which is a different story. But all of the other central banks we think are now most likely done.

However, we don't expect cuts in the very near term. We do have cuts in 2024, but they are in the second half of the year. In some cases, a little bit earlier. The ECB, for example, the Bank of Canada we think are probably going to go a bit earlier. The Fed or the Reserve Bank of Australia we think are going to be more back loaded.
The drivers are the same, though, in all cases. The economies are holding up, but inflation comes down over time. You get down to levels that are fairly close to central bank mandates, and then we think most likely there will be a desire to start normalizing policy rates very gradually before you actually get down to literally the official inflation target. And that's for us a late 2024 type of situation.

**Allison Nathan:** When we think about normal rates or where we think rates are ultimately going to settle at, we hear a lot about higher for longer, structurally higher interest rates. Are you of the view that we are going to see structurally higher rates in the coming year or two or beyond?

**Jan Hatzius:** We have moved up our estimates modestly in terms of where policy rates are ultimately going to go. In fact, for all of the major DM economies, we've raised them by 50 basis points in this latest forecast round. So toward the Fed, that means 3.5 to 3.75. For the euro area, it means 2.5% with the other DM central banks generally somewhere in between.

And the reason why we've moved them up from where we
were are, number one, there are some drivers of interest rates that are pointing to higher rates. We talked about the budget deficit a little bit earlier. Large deficits tend to increase interest rates. We also expect pretty strong investment in general. There are a lot of investment needs, for example, in decarbonization and in making supply chains more resilient. And we also think that the AI revolution is likely to lead to very significant investment in the near term and then ultimately to stronger potential GDP growth. That's a number of years down the road, but, for the interest rate environment, it can matter. Those are the economic drivers.

And then I would say, lastly, we've long been skeptical of the idea that there is a very clearly defined level of interest rates to which interest rates really need to come back. We've always been more focused on especially changes in financial conditions as drivers of cyclical growth. And that sort of means, if you have seen the big increase in interest rates already, then you're just not going to be as worried about that transition. And if we were to get back to an environment where central banks actually start to cut gradually, even if the policy rate is still quite high, we wouldn't be too worried about that level of the policy rate.
And that's also a reason for why we think the cuts are ultimately going to be more limited.

**Allison Nathan:** And I know we've talked about it several times on this podcast, financial conditions. When we say tightening or loosening of financial conditions, what are we talking about?

**Jan Hatzius:** We're talking about changes in interest rates, changes in equity prices, changes in credit spreads, or changes in the currency. Those are the main building blocks of our financial conditions indices, which in one form or another, we've been using for a quarter century. And we have found them to be good predictors alongside obviously other factors but good predictors of impulses to growth.

**Allison Nathan:** And Dom, how much has the market embraced this narrative or this idea that rates are going to normalize to a higher level in this cycle?

**Dominic Wilson:** I think it depends a little bit where you look. And this a lot of volatility in rate markets also depends when you look. But I would say, if you think
about the Fed specifically in that near-term outlook that Jan described, after this latest round of optimism, the Fed is done. We're back in a position which Jan mentioned where the market is pricing more cuts than we think will be delivered in the near term, even adjusting for the kind of distribution of things that might happen, and that's part of the reason why we don't expect yields to fall a lot further unless the growth environment is different to what we expect.

I think we've been focused on that repricing of longer dated rates that Jan mentioned. Our view had been that the curve was very inverted with long-term yields well below short-term yields. We thought that was vulnerable to this kind of continued strength in US growth this “higher for longer” story on the funds rate. And I would say the good news is that the market has shifted rate levels there at that part of the curve back much closer to where you would expect to see them from past cycles.

And if you look at real yields on bonds, on corporate credit, we're basically back to the kind of pre-GFC era rather than this post GFC era. We've talked about this is a great escape from we've spent 10-15 years talking about liquidity
traps, zero rates, lowflation, and I think we've moved beyond that. So there's definitely been some significant progress in adapting to that kind of a story.

**Allison Nathan:** Jan, so far this conversation has revolved mostly around the US. I do want to widen the lens out a little bit. If we think about China and Europe, US outperformed. I would say it's not a stretch to say China and Europe have underperformed this year. Do we expect that to continue in 2024?

**Jan Hatzius:** Well, if I start with China, we still expect deceleration in growth. Gradual deceleration for this year we think will be in the sort of 5.3% range. For next year, we're at 4.8%, which is obviously a half percentage point less, although it is a bit higher than what we had prior to this latest forecast round and also a bit higher than the consensus. And the driver of this is really the easing in financial conditions, Chinese financial conditions, that's brought about by policy stimulus. And we're seeing somewhat more of that feed through, so our China team therefore has increased their numbers for the near term.

That said, if I look out further, China still has a significant
number of challenges, and the longer term growth trend we think is downwards. So over the next decade, we think growth is going to go from the roughly 5% range down to the roughly 3% range. And some of that is demographic. The population is now shrinking. That's going to be difficult to turn around. Some of it, though, is really the significant housing bubble that built in China that is also going to be quite hard to offset. If you look at the last several decades, history tells a pretty clear story about how housing downturns tend to be quite bad for growth, and we think that's probably going to be a drag on China growth for a while to come.

**Allison Nathan:** And what about Europe?

**Jan Hatzius:** In Europe, we expect acceleration to close to 1% next year from what is currently quite a stagnant environment. The main driver of this is an improvement in real disposable personal income growth. That was the big growth driver in the US in 2023, and we've seen some improvement in Europe but it's lagged the US because of two factors. Namely, the drag from the Russian gas outage and, in addition, adjustable rate mortgages having a bigger impact on disposable income
growth. Both of these things are moving into the rearview mirror. Real income growth should pick up. That should help consumption, and that should also ultimately boost the European economy.

In an environment in which the European Central Bank is also done hiking pretty clearly and probably will move to rate cuts at some point next year we think in the third quarter.

**Allison Nathan:** And so Dom, what does this all mean for the US dollar and our view of US assets versus non-US assets more broadly?

**Dominic Wilson:** Yeah, ordinarily I would say that the mix of the Fed sort of ending their cycle and the global growth picture that's, you know, reasonably resilient, that would push towards a weaker dollar. And we do show some modest weakening in the dollar of about 2% on a trade weighted basis over the next 12 months.

But I think the general view is that the dollar is quite likely to stay strong. As you said, it's been strong in recent years, and the reasons to think that will shift a lot are
harder to find. I think part of the reason is just that our US growth forecast is just much further above consensus than elsewhere. We're optimistic in general, but the clearest gap is with the US.

And you asked about other assets. Our forecasts imply that US rate spreads to other developed market economies are going to remain wide, and there are still strong positive themes for the US equity market in particular around AI and the kind of earnings power of the big US companies.

I think it's also true that, when we think about tail risks, we worry more about that outside the US as well over the next 12 months than inside, and that also tends to limit the scope for dollar weakness. We saw end of last year, end of '22 into early '23 what it takes for the dollar to weaken a lot. And the Fed kind of easing back is part of it, but you really need strength in other parts of the world. So if we saw big upside surprises in growth in Europe and China, bigger than the ones that Jan was describing there, that's how I think you would get the dollar to weaken more significantly, but I think that's a bit harder to envisage right now than it was a year ago.
**Allison Nathan:** Let's talk about risks to our forecast. Jan, let's start with you.

**Jan Hatzius:** Obviously there are very significant risks in the global economy. That said, we are providing an estimate of the probability of recession at least in the US. We have that at 15% over the next 12 months. And I would say most of that 15% is what I would describe as more exogenous risks. For example, a very significant escalation of the turmoil in the Middle East and a widening of the war well beyond Israel and Gaza with potentially a widening that includes Iran that would result probably in a much bigger shock to global oil supplies and oil prices. So that certainly would be a risk. The biggest risk for economies that import most of their oil. The US is somewhat more resilient because of the much greater US oil production. We're seeing record US oil production numbers, but clearly that is probably at the top of the list in terms of risks.

I think the risk that we ultimately still need to see a recession in order to get inflation back down, which was probably the risk that was at the very top of people's minds a year ago, that risk now looks much lower. But we're
more focused on maybe the exogenous factors.

**Allison Nathan:** Dom?

**Dominic Wilson:** I'm a warrior, so I thrive on this question. I agree with what Jan said about the inflation risk being much lower worry than before. I still think, at a market level, it's the one that is most challenging to most of our forecasts. And, you know, if we did have stickiness there, if central banks had to keep going, step in again, the markets worry more about the growth picture as well as the rate picture. And so at some obvious level, that's the point that the biggest risk to your forecast is the opposite of your forecast, but I do think that's something, at least over the nearer term, that I think there's still going to be some focus on.

I think, again, going back to some of the discussion you had with Jan about lags, there's a risk that the impact of higher rates is larger than we expect. I don't think really the kind of US story is that story, but we worry a little bit about cracks emerging, sovereign pressures in Europe or new financial issues, which is harder to be sure of. And the worsening US fiscal outlook, again, I think probably a
slow burn issue but worry a little bit if unfunded plans for fiscal expansion feature more prominently in the run-up to the election, whether that crystallizes some of those risks. So there's definitely some things to keep an eye on in terms of the sort of “higher for longer” theme.

And then I would say, you know, echoing what Jan put as kind of the main kind of exogenous risks, geopolitics obviously feel unstable. I think we've seen through some of the recent crises that, as Jan mentioned, it's really commodity prices that are the key transmission mechanism. When you imagine how does that affect the global economy most quickly, that's the thing to watch. So there needs to be a story about how those disruptions affect commodity prices. That's the fastest impact that could have, but definitely obviously things feel more fragile in a number of parts of the world where those risks are more in focus than they have been.

**Allison Nathan:** It's striking to me, Dom, that the 2024 US election has barely been mentioned in our conversation. Don't you think that could be a source of market volatility next year?
Dominic Wilson: Look, I think the reality is we're far out enough that it's hard to tell exactly what it's going to shape up to be. And I would say, somewhat surprisingly, markets tend I think, perhaps because they don't know what to focus on, to focus very late on those issues. If you look at the history of when does that stuff get priced, the answer is either after the election or only in the kind of immediate run-up, usually within two or three months of the actual election date do those things get crystallized.

As I said, I think there are lots of obviously issues at play in the election. At the macro level, it tends to be around the fiscal policy shifts, some of those things. I think those could be areas of stress. There are going to be a lot of other things to worry about as we head through 2024, so maybe as we move into the summer and beyond that it becomes clearer what's at stake there. That's when the market may wake up to more of the issues.

Allison Nathan: Dom, with these risks in mind as well as our mainline views, which assets do you think are set to perform better than others?

Dominic Wilson: Yeah, so we talked last year about -
- and I talked at the beginning -- about the kind of attractiveness of cash. Cash still obviously a good asset. I think people are enjoying the fact that they get a yield on their deposits. But unlike 2023, our central case is that other assets will probably beat the cash return.

We're showing the strongest returns in commodities. That's a mix of some price pressure but also you've got good carry. You've got collateral return in that asset class. We've got modest positive returns in equities and credit. For the first time in a while, we're showing bonds again marginally outperforming cash, only by a hair but we've had three negative years for bonds so having positive returns should feel like a new place to be. And their value as a protection against downside risks is rising.

And I think that's one of the other things that we've emphasized. You're getting positive returns in our central case across the major asset classes, but they also give you different kinds of protection against some of the risks that we're talking about. Commodities give you protection against supply disruption. Equities give you some exposure to a very optimistic inflation picture or to the sort of AI themes. Bonds give you protection against
recessionary risk I think to a greater degree than before. So you're moving back towards the old arguments for having balanced portfolios, more diversification.

People who are more negative about growth than we are, of which in the macro community there are many, would probably lean more towards the bonds, longer dated bonds or leveraged positions in shorter maturity bonds, and a little bit less towards the risk asset side. But I think overall, as I said, we're emphasizing that people should be looking for a broader diversification of their positions and that this should be a relatively friendly backdrop.

**Allison Nathan:** Jan, Dom, thanks very much. Always great to have you.

**Both:** Thank you.

**Allison Nathan:** Thanks for listening to another episode of Goldman Sachs Exchanges, recorded on Monday, November 13th, 2023. If you enjoyed this show, we hope you follow on your platform of choice and tune in next week for another episode. Make sure to share and leave a comment on Apple Podcasts, Spotify, Google, or wherever
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