Goldman Sachs The Markets
Are markets overreacting to inflation data?
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Ashish Shah: Big inflation miss this week. And the Fed dialing back its number of cuts to one. What does this all mean for investors? This is The Markets.

I'm Ashish Shah, global co-head and CIO of public investing with Goldman Sachs Asset Management. And I'm joined by my colleague Anshul Sehgal, the head of US interest rate products trading. Anshul, thanks for joining me.

Anshul Sehgal: Thank you for having me.

Ashish Shah: So, let's start with the piece of information that we got today. Core CPI rose just 16 basis points month over month, slowest pace in almost three years. I know there can be a lot of noise around these monthly figures. But do you take this as a sign that inflation is really cooling?

Anshul Sehgal: So, unambiguously, the number was very friendly for what the Fed wants to accomplish. Markets estimates were higher. Market was expecting somewhere between .22 and .26 month on month on core CPI. Instead, it came in materially lower. Unambiguously good news.

But under the covers, there were things that, again, leave the market a little more puzzled. Or maybe what I'm saying is that under the covers, the number wasn't as good as the headline suggested. There were one-off factors that contributed to a low print, like car insurance coming down. Secondly, as far as the year-over-year print goes, there are low prints that are also going to fall off over the next few months. So, if you don't get low prints in the summer of 2024, then year over year, inflation will actually start going a wrong way. So, therefore, we needed those low prints.

And then lastly, the part that concerns me the most is that the interest rate sensitive sectors of inflation have actually gone back to their pre-pandemic levels. It's the sticky price inflation or things that are not as interest rate sensitive like healthcare and medical services, those remain sticky high. And then the question then becomes can monetary policy

actually address that at all?

All remains to be seen. But for now, good news is good news.

Ashish Shah: We saw a pretty big market reaction to this number. Do you think it was an overreaction?

Anshul Sehgal: That's a very interesting question. To me, the market did overreact quite meaningfully to the print. One print does not make a trend. We've seen this before. It's happened numerous times. The Fed's actually gone and signaled a reversal in course, only to reverse again. So, the market's reaction did take me by surprise. It was a little larger than I would have expected it to be.

Ashish Shah: Yeah, you're absolutely right. Like, on Friday, we were all talking about, wow, is a rate hike back on the table given the strength?

Anshul Sehgal: That's right. So, for the market to pivot from that to what we got today on just one inflation print, I was taken by surprise by that.

Ashish Shah: So, you mentioned the Fed. Can you talk about the shift in number of rate cuts that we saw the Fed make? And your takeaways from that?

Anshul Sehgal: I was also surprised by the Fed pivoting from three cuts this year to one. My expectation was that they'd reduce the number of cuts. They'd signaled as much. Fed speak can signal that. I was expecting two cuts for this year. Instead, they took it to just one cut. And also, by decisive majority. They were 11 people that signaled either no cut this year or one cut. And only eight people that wanted two cuts this year. So, that was a meaningful shift.

Powell, I think, did an amazing job articulating the thought process behind that. One print, again, doesn't make a trend. You do have low prints falling off in the ensuing months. So, the combination of those things makes them want to be more cautious.

But more than anything else, if you take a step back, I feel like the reason it's prudent to be cautious on the number of cuts this year is because the labor market remains incredibly strong. The unemployment rate is at 4 percent,

which is historically a very low level. So, with a labor market that strong, there is always the risk that you might end up in a place where wages start going up because there's demand for labor. And that sort of follows through and you get higher inflation prints down the road.

I think it makes sense for the Fed to be cautious, signal just one cut. And if we were to be lucky enough to get low inflation prints in the next few months, then they could take it up to two cuts.

Ashish Shah: Yeah. I was a little bit surprised that they signaled 4 percent as the peak for this year.

Anshul Sehgal: That seemed very interesting too. Again, who knows? It's a collection of people's views. And the median does not really capture the entire story. But that said, perhaps it was an attempt to say, listen, we're definitely cutting at least once this year.

By lowering the hurdle to cut by having the U rate at 4 percent, so let's say next month it goes up to 4.2 percent, then the odds that you get a cut go up. Likewise, for core PC inflation, they were expecting at 2.6 percent at the end

of the year, they're now expecting 2.8 percent. Should you get low inflation prints down the road over the next few months, that again makes it easier for them to cut.

So, I think all in all, the combination of these things largely stabilized the market to a certain extent. And in which that is what we saw play out. If you look at rates vol, it came down after the event. Again, makes perfect sense for it to.

There is more clarity after today's inflation print and what the Fed said in terms of what we'll be getting this year absent a labor market that weakness markedly. Should that happen, we do expect the Fed to cut many more times. But absent that, we would expect to see one, maybe two cuts this year.

Ashish Shah: Okay, so what you're saying is that the Fed is doing a really good job managing expectations of the market.

Anshul Sehgal: Absolutely.

Ashish Shah: Volatility we should expect to be narrow unless something crazy happens with employment. So, as

you look at the next six months or the next 12 months, walk me through how you think this is going to play out.

Anshul Sehgal: So, the thing that really sticks out to me is, like, the impact of very loose fiscal in the United States and very tight monetary, what it means for other domains. How the strength of the dollar ends up affecting everyone from Europe to EM. And we've seen all of this play out in the last five trading sessions. And I think that interplay is what's going to be really exciting for the rest of the year in terms of macro markets.

Ashish Shah: Well, no lack of things to look forward to. But, you know, for those investors out there that are having to reposition their portfolios, what are you focusing on for the coming week?

Anshul Sehgal: Retail sales. Always super important. It's a leading indicator. It's the best read you have on the health of the US consumer. The US consumer drives global demand. So, very important print. We had a low print last time. Remains to be seen how that plays out. So, I think that's very important.

Then you've got global PMIs towards the end of next week. Now that the FOMC participants are out of blackout, we'll get to hear from them. And once again, we'll get to see what other central bankers globally make of the Fed's shift from three dots to one dot. I think all of these are meaningful things for the trajectory of policy over the next six months.

Ashish Shah: Okay, so, what I heard was it's about the consumer next week. It's about the rest of the world next week. And seeing how those things play out.

Anshul Sehgal: Absolutely.

Ashish Shah: Awesome. Anshul, thanks so much.

Anshul Sehgal: Thank you for having me.

Ashish Shah: So, that does it for another episode of The Markets. Be sure to find us on Apple Podcasts, Spotify, or wherever you get your podcasts.

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