Goldman Sachs The Markets

Growth shocks, not just inflation, to be a primary driver of markets

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Sam Grobart: Why are stocks and bonds currently in a period of transition, both in the US and around the world? This is The Markets.

Hi, I'm Sam Grobart. Today, I'm joined by Kamakshya Trivedi, head of global foreign exchange, interest rates, and emerging market strategy research at Goldman Sachs Research. Kamakshya, thank you so much for joining us today.

Kamakshya Trivedi: Thanks for having me again, Sam.

Sam Grobart: So, Kamakshya, we've seen a pretty substantial rebound in yields since the start of the year. What has changed over the past two months?

Kamakshya Trivedi: Look, I think one way to address that question is that back in December, the Federal Reserve told us that under this baseline forecast, three cuts would be appropriate for 2024. I think the markets got carried away a little bit and went on and priced six plus cuts coming into this year.

And what you've really seen is that Fed policymakers and speakers have pulled the market back somewhat from that over exuberance. We also got some pretty hot consumer price inflation data at the start of the year.

But it's not just policy and inflation. I think the striking thing has also been the growth data. We've had stronger growth news coming out of the US. A stronger jobs report. Firm GDP growth. Improving manufacturing surveys. And I think putting all of those things together, the kind of more hawkish policy impulse, as federal committee members have pulled the market back a bit, and I think that stronger growth data has meant that five-year rates are up something like 40 basis points year to date. We've gone from pricing six plus Fed cuts this year to something closer to between three and four.

Sam Grobart: And do you think that adjustment from six down to three or four, is that, in and of itself maybe an overreaction? Are rates likely to back off as the Fed starts, we assume, actually cutting rates?

Kamakshya Trivedi: I don't think it's an overreaction to the information set that we have received. But what is probably true is that the market is a bit too sensitive to data in January. January data is often subject to severe seasonal issues. And it's possible that this year is no exception to that.

For example, you do typically get higher inflation readings at the start of the year. They tend to normalize as you get deeper into the year. We expect that to play out this year as well. We expect core inflation in the US to resume its decline. And I think one other encouraging sign is that disinflation is still very visible in other parts of the world. So, you are still seeing continued disinflation taking place.

I do think rates overall should back up once Fed cuts become more imminent. But we likely have more wood to chop before we get there around the kind of May/June period of the year.

Sam Grobart: I want to take a step back here for a second. And maybe if you can talk to us a little bit about the relationship between stocks and bonds and what it used to be, where it is now, and where it could be going.

Kamakshya Trivedi: Where it used to be is that we had a long period before the pandemic where stocks and bond prices both went up together. Bond yields were coming down for a long period and stock prices were going up. And even in the immediate aftermath of the pandemic, as the Federal Reserve cut rates, bond yields fell. Or bond prices went up. And that supported stocks.

We then had a 12-to-24-month period where inflation became the biggest risk, the biggest source of market volatility. And when that happens, the correlation typically flips. You saw bond prices go down or yields go up as the Fed was focused on tightening policy and bringing inflation lower. And stock prices went down quite meaningfully over that period.

I think where we are now is in a kind of transition phase. A transition phase from where inflation shocks were the main driver of Fed policy and market volatility to one where both inflation and growth shocks matter and are driving markets. And eventually towards a phase where growth shocks will take over as being the primary driver because inflation is at or close to target.

So, in this transition phase, which is where we are, we are to date, inflation fears have raised their heads again. But growth has also been stronger, as I mentioned. And so, we've had a bit of a pro cyclical rotation where stock prices are higher, but yields are also higher as bond prices have gone down.

Sam Grobart: And what does that mean, ultimately, for investors right now in this transition period that you're referring to?

Kamakshya Trivedi: So, I think in this transition period, we are going to have to navigate and investors are going to have to navigate how they combine their equity long portfolios with bonds. Over the medium term, as you look further out, as inflation starts to get under control, we do think once again we could go back to a phase where stocks and bond prices could go up together. Or at least that bonds start to provide a good hedge to long equity portfolios because if you do get growth shocks, if you do get weaker growth, the Fed has the ability to cut. The sort of Fed put that people refer to in markets is on its way back.

But that's not going to happen straight away. We are in this transition phase. The market is still worried about inflation. Probably a little bit more worried about inflation in the last couple of months than back in December. And it's certainly possible that in the next few weeks those worries can build. So, you have to be a little bit more careful with bonds right here and now. But I think we're on a phase to where bonds could start providing a hedge to work for the long equity portfolio over the medium term.

Sam Grobart: And Kamakshya, how about things internationally? What non-US trades should investors look at in this kind of transition environment?

Kamakshya Trivedi: Yes. Look, I think the markets have been very focused and investors have been very focused, obviously, on the US. But I think there's a less appreciated team that is beginning to bubble up in macro markets. And that is that it does look that for the first time in 18 to 20 months, the industrial cycle globally is beginning to inflect higher. The US is very much part of that. So, this is not like the old global industrial cycle. But it is one where in addition to the US you have parts of Asia, North Asia, Europe, you're beginning to see this more common increase in manufacturing surveys across the world.

And if that has legs, that typically tends to come with a broadening of the equity rally. So, you can imagine a situation over the next three to four months where together with any inflation relief that we get on the US side, this better environment for global manufacturing provides a tailwind for a broadening of the equity rally beyond just large-cap US tech in places like small-cap stocks, European and emerging market equities, ex-China. As well as some of the cyclical and higher beta currencies in both the G10 and the emerging market world.

Sam Grobart: Kamakshya, I want to jump to our final question here. What's on your radar for next week?

Kamakshya Trivedi: So, look, I think next week we'll get important information on some of the issues we've spoken about. I would highlight in particular we'll get the US Labor Market report for February at the end of next week. Remember, the strong January report with 350,000 jobs and strong wage growth was part of what sparked that rebound in yields year to date. We're still looking for a healthy labor market. But it is likely that those January numbers, again, overstated the strength. So, it's important to see if we get some payback there.

What I would say of course is, remember, there's no law that says that the payback has to come immediately the next month. So, it's certainly possible that we get somewhat sequentially slower but still a firm pace of job growth and earnings growth. And that could keep these fears of inflation alive or even boost them a bit further. But I'm very confident that as we go through the year, you should see some of those inflation fears abate as the labor market slowly rebalances.

Sam Grobart: Kamakshya Trivedi. Thank you again. Always a pleasure having you on the show.

Kamakshya Trivedi: Thank you, Sam.

Sam Grobart: 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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