Goldman Sachs The Markets
Inflation cools, election heats up
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Jen Roth: Inflation's coming down, but interest in the US election is going up. This is The Markets. I'm Jen Roth in Goldman Sachs Global Banking and Markets, joined by Mike Cahill, our senior currency strategist within Goldman Sachs Research. Mike, great to have you here. Can you start off by discussing today's CPI print?

Mike Cahill: Yeah, so it was supposed to come in around 20, 21 basis points on core, which is the metric that we all watch. And instead, 6.5 basis points, so a lot softer than what was expected. Under the hood, it was a pretty broad miss relative to our expectations. Some of it can be explained with some one-offs that looked a little too high last month and now have come down. But generally speaking, I think it is a very friendly report for policymakers that have been waiting for inflation to turn, and now this is the third good inflation report in a row.

Jen Roth: From your perspective, to what extent was this print just a one-off? Or is this really more of a trend?

Mike Cahill: I think 6.5 basis points is a one-off to the extent of the weakness here. However, I think more friendly inflation reports should be more of a trend now, and I think we can be a little bit more confident about that now that we've seen three in a row. I think now what is giving extra confidence here is that other metrics like the loosening of the labor market should support return to inflation around target over time, and the Fed can take a more balanced approach around both sides of its mandate -- the labor market and inflation.

Jen Roth: Can you talk a little bit about the market reaction? Obviously the rates in the currency space had the biggest reaction. Anything else on your reader from market reaction to the print?

Mike Cahill: So I think the question going into this was we've seen a broad weakening in the activity data in the US and especially a loosening in the labor market over the last number of months, and so the question was whether inflation would allow the Fed to respond to that weakening. And I think that the print today makes it clear that they can. And so I think that helps explain the magnitude of the move in rates, and then what we've seen in the FX market is some of the most rate-sensitive currencies, especially the yen, are reacting to that. And so I think that makes sense in that it gives the Fed room to operate, and so that's what the market is responding to here.

Jen Roth: Staying on that point, how do you think this print could potentially impact the Fed's path? Up until the print, we were talking about two cuts for the year. Do you think that's still baseline, or do you think we could be talking about more cuts this year?

Mike Cahill: So I think that's still a reasonable baseline, given that while we're talking about slightly softer activity data, we're not talking about problematic activity numbers. I think that softer inflation gives the Fed that kind of room to operate, but it doesn't signal that the need to move a lot swifter. I think that we're still talking about a two-cut baseline and a pretty controlled move out of restricted territory, but still this print will probably give them confidence that the conditions are in place for inflation to be moving back to target.

Jen Roth: Let's pivot a little bit. I'd love to spend some time talking about the US presidential election, which you and I have talked about a lot, has really dominated a lot of our client conversations. What are the key events to watch over the next couple of weeks? And what client discussions have you been focused on so far?

Mike Cahill: So I think the key questions over the next few weeks is going to be mostly about who's in the race? What is the shape of the nomination process? So the summer before the election is always about whether parties can build some momentum, both among their base and in the polls. It's more about the building narrative.

Jen Roth: Given you are currency strategist, I'd love to talk a bit about currencies as well. So far the market reaction has been relatively muted given the large swing in the polls post the debate more towards a Republican sweep. Why do you think that is?

Mike Cahill: I think the smaller FX response than what we have estimated is really down to two things. The first is that the prediction markets are assigning a fairly high probability that this is not the head-to-head matchup that we will see in November. They're assigning a greater than a

50/50 chance that there is a different Democratic nominee, and so I think markets are not really sure with how much to press on the current polling.

The second factor is that, when I talk to our clients, I think that our estimates for tariffs in a potential second term for Trump are larger than what others have penciled in. Our FX response is calibrated on our expectations for tariffs, and that is the biggest driver for FX in the different election scenarios. It is not supposed to be a one-day move. It will take some time for the market to understand how many new tariffs are introduced, how broad they are, where they're directed, and we saw the same thing in Trump's first term when there were different tariff proposals, some of which never really got priced very much and others where the market really underestimated how large the tariffs would be.

Jen Roth: Makes a lot of sense. And then what currency pairs should we be watching that you think the election would have the biggest impact on?

Mike Cahill: I think that there's kind of two channels to look at here. One is the -- and the most important one -- is where is trade relatively concentrated and with the US and in products that are less substitutable? And the second channel is how the policy response will be.

But then if we look at, like, product concentration, then it's more things like Mexico and the LatAm currencies that trade a lot with the US and not a lot with other trading partners. On this metric, Europe actually ranks lower because Europe has pretty high value added trade and trades with a lot of different countries. Europe, I think, and the euro is what will be more important will be the policy response. If we see substantial tariff policy, if we see, as the Republican Party platform says, using tariffs to generate lower taxes in the US and more investment in the US, then we can see more policy divergence between the US and Europe. And I think that's where the euro-dollar would start to be impacted more, but won't have to see what the policy response is and how broad those tariffs are.

Jen Roth: All right, Mike, last question. What's on your radar for next week?

Mike Cahill: So it's a pretty quiet week in macro, and actually it's a big part of our thematic for near-term dollar weakness is that there's not a ton going on for at least the next couple weeks. But next week, we do have an important ECB meeting. It's really one where they should be setting up the discussion for a cut in September but an important marker along the way for that.

Jen Roth: Great, Mike. Thanks so much for your thoughts on CPI and the US election. And thanks so much for being here today.

Mike Cahill: Thank you.

Jen Roth: And thank you for joining us for another episode of The Markets. I'm Jen Roth.