Goldman Sachs The Markets

"US exceptionalism all over again"

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Chris Hussey: License to cut. Does this week's inflation reading give the Fed the green light to continue cutting rates? This is The Markets.

I'm Chris Hussey with Goldman Sachs Research, and this week I'm joined by Anshul Sehgal, head of US Interest Rate Products in our Global Banking and Markets business. Anshul, great to have you with us again.

Anshul Sehgal: Thank you for having me.

Chris Hussey: All right. Let's go to the CPI print which we got this week. What did you make of the CPI print? Does the CPI matter anymore here?

Anshul Sehgal: I think it did. I think it was a good print for the Fed. One of the key things with inflation has been that rents have been stubbornly high, and leading indicators of rents like Zillow have been pointing to a decline in rents. So this is welcome news. Rents is also OER, which is the owners equivalent rent, for those that own their place and rents themselves, are inertial numbers. Once they start coming down, the expectation is that they will continue to stay low.

So in aggregate, it does give them the license to cut. I think it makes sense for them to cut. Labor market has more slack in it today than it did six months ago, without a shred of doubt. And I think this is like everything's moving in the right direction for the Fed, at least for now.

Chris Hussey: All right. Let's just flesh that out a little bit because the Fed is going to meet next week. They tend to focus maybe more on PCE than CPI, but they're not going to get PCE. They got the CPI. You've said it gives them the license to cut. So a cut next week and then keep cutting after that? Is there a pause at all in the future? You talked about a pause when you were back with us in September. Is there anything like that coming?

Anshul Sehgal: My expectation is -- and that's not that different from the market's expectation -- that they will pause in January. Over the last few years, as you rightly point out, there has been data seasonality to both inflation and growth numbers. This time around, there's a change in administration. The S&P's done really well over the last year, which generally plays into hard data with a 6-month lag. The combination of all of these things can actually give growth data a bump early next year.

So my guess would be that they would have cut 100 basis points after the "deese" cut. At that point in time, they can afford to actually skip a meeting and see how data turns out. There's so much in the air in terms of the new administration's policies, their ramifications on the domestic economy. The combination of all of these things will give the Fed a very good picture on whether they need to continue cutting or whether they need to pause here for an extended period.

Chris Hussey: Right. Data seasonality, a little wonky. But that new administration one, I want to jump into that a little bit here because that obviously is top of mind across so many markets, particularly the rates market, as you point out. Walk us through what exactly is going on with policies from the new administration that might get the Fed's attention here?

Anshul Sehgal: Yes, every part of their policy is going to impact the Fed's decision making. They're going to be addressing immigration, tariffs, obviously the strength of the dollar has been brought up, and the cost of government financing its debt. So the combination of those things will have an impact on what the Fed does. A lot's uncertain, but the closest parallel we have is the early '80s when Reagan came in. He deregulated.

By and large, the way it worked back then, as we see it, is that the US had very high fiscal expansion. So fiscal policy was very loose, and monetary policy was very tight. Like, rates were north of 10%. The combination of loose fiscal and tight monetary, along with trade frictions, essentially led to a stronger dollar. Essentially, real rates in the US were very high, and because real rates in the US were very high, investment income in the US was higher than the rest of the world.

All of these things are true today already. And the dollar at least historically over the last, say, four decades has been such that dollar strength feeds on itself. So once the dollar starts strengthening because real rates are high, the Fed's on hold, I'd say, 4.5% or 4.25% when inflation is closer to 2%. Whereas, the rest of the world has real rates between minus 50 and plus 50 basis points. Like, that dollar strength will continue to feed itself.

And as that happens, the US imports disinflation because foreign goods become cheaper. So that sort of feeds on itself, and that eventually gives the Fed the ability to actually cut rates. In the '80s, you eventually had the Plaza, the dollar got too strong, and there were ramifications to that further down the road. But essentially sitting here today, like, it's a great economy to inherit for the new administration. You've got inflation coming down, labor market in balance, you've had four years of expansion economics, stellar economic expansion that was mainly driven by fiscal. And now with the Fed cuts, the ones that we've already got in the bag, you can have a credit-driven expansion currently. And there is room for the economy to accommodate that, and there's room for the Fed to let it run because inflation's coming their way.

So the combination of those things, we're looking at it, like, for the US, it's going to look like US exceptionalism all over again.

Chris Hussey: The analog to the '80s is a fascinating one, obviously. A couple of differences there. The Fed Funds Rate I think was, like, 15%.

Anshul Sehgal: That's right. But inflation was also very high. It started out at around 12%, so 300 basis points real rates. But as inflation came down, the Fed was a little slow to react by choice because fiscal policy was lax. And as a consequence, real rates kept going up. And as real rates kept going up, more investment was attracted by the US, which again led to an industrial revival in the US in the '80s, the tire sell, like Japanese automakers, built plants in the US back then.

So the combination of all of these things -- loose fiscal, tight monetary, and trade frictions -- essentially plays to the dollar's strength, which imports disinflation for the US and creates jobs domestically. Now again, in the long run, the ramifications of all of this are unclear, but in the near term, the combination of these things ought to help the new administration achieve their policy objectives.

Chris Hussey: All right. Let's cut to the chase. What's the trade?

Anshul Sehgal: The trade is a longer dollar. The trade last time I was here I said was long the S&P. It continues to be long the S&P. In terms of rates, the rates market is in balance. There isn't any risk premium in the rates market. The distribution of rates really depends on the policies that are enacted. So I don't see an opportunity in the rates space that is asymmetric. But I do see in the combination of long the dollar and long the S&P ought to continue to work well.

Chris Hussey: Okay. What are we watching for next week? What are we watching for from the Fed specifically, and what else are you watching?

Anshul Sehgal: I think data is very important. We get retail sales. We get a read on the health of the economy. The Fed will be looking out for it, so we're obviously very focused on that. In addition, obviously we have the Fed meeting. They will cut the markets pricing in 24 basis points at this point in time. In addition to that, they will be giving us the summary of economic projections, or the dot plot, which will give their estimate of how many times they'll be cutting next year.

At last meeting, they showed four cuts next year. This time around, our model outcome is they will show two cuts. If they show just one cut, that would be a hawkish signal for markets. If they show three, that would be a dovish signal for markets. But that is what's in the crystal ball for this meeting.

Chris Hussey: Anshul, thanks so much for joining us.

Anshul Sehgal: Thank you.

Chris Hussey: That does it for this week's episode of The Markets. I'm Chris Hussey and thanks for listening. And if you want to hear more from Goldman Sachs, listen to Exchanges, our weekly podcast about the long-term trends impacting the economy and investors' portfolios.

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