Goldman Sachs The Markets

As the Fed stays put, markets bet on timing of rate cuts

Josh Schiffrin, global head, trading strategy, Global Banking & Markets, Goldman Sachs

Sam Grobart, Host

Recorded: December 14, 2023

Sam Grobart: From soft landing to soft landed? This is The Markets. Hi, I'm Sam Grobart. Today I'm joined by Josh Schiffrin, Global Head of Trading Strategy in Global Banking & Markets here at Goldman Sachs. Josh, thanks so much for joining us today.

Josh Schiffrin: Great to be here with you, Sam.

Sam Grobart: This week, the Federal Reserve announced it was holding interest rates steady and penciled in three rate cuts in 2024. Just big picture, how has the market responded?

Josh Schiffrin: The market responded in a strong way to the news from the Federal Reserve yesterday, in particular to Chair Powell's press conference. In advance of the meeting, there was a debate about how many rate cuts the Fed might pencil in in their dot plot for 2024. Many people expected two rate cuts or 50 basis points. Some expected three rate cuts or 75 basis points. They actually showed 75 basis points, which was a dovish signal. But then in the press conference, Chair Powell had a very dovish spin on the outlook and noted the need to cut rates before inflation gets to 2 percent, even well before 2 percent at one point. And the overall characterization of his answers made it clear that rate cuts were a topic of discussion on the committee. It feels like something that will be actively debated in Q1.

Sam Grobart: Those dovish remarks you're referring to, sounds like the Fed is worried about waiting too long to cut rates. Is that correct?

Josh Schiffrin: It is. And Chair Powell made it clear that the committee was very attuned to that risk, which is a different tone than we've heard from him in the past. But yesterday, he took pains to note that the committee was attuned to the risk of staying too tight for too long. He noted that they would look at both sides of their mandate. And it was a different take than he's had in the past.

Sam Grobart: Is there any consensus in the market right now as to when we might start to see future rate cuts?

Josh Schiffrin: My view is that they will get started in March. That the groundwork is being laid to change the statement more formally. The statement still feels like it has a relatively stale hiking bias in it. I think the statement will change in January. And I think the baseline for me is they begin a cutting cycle in March.

Sam Grobart: Now, the US Fed was not the only central bank making news this week. We saw a sort of super Thursday in which the European Central Bank, The Bank of England, as well as Switzerland and Norway's central banks all made announcements. What's important to note there?

Josh Schiffrin: So, those central banks didn't have as dovish a tone as the Fed did. I really think the Fed was the main news of the week. The European Central Bank moved forward on articulating a plan to get its balance sheet running down, and that will happen in 2024. And that was an open question for the meeting, is how they would address that. With the balance sheet issues settled, they can now turn to the discussion of rate cuts in Q1. And while Lagarde said that rate cuts weren't discussed at today's meeting, I would expect the topic to turn there as you enter the calendar in Q1.

European inflation dynamics have been as weak, if not weaker than the US. And I ultimately personally expect the ECB to be cutting right around the same time as the Fed does in March, even if at today's meeting they didn't sound as dovish as the Fed did yesterday in terms of how advanced that discussion is.

The Bank of England also had a much more wait and see attitude with more people, in fact, voting for a hike. But ultimately, I think that if the Fed and ECB are cutting, The Bank of England won't be that far behind, even if they aren't yet in a place where they want to acknowledge that.

Sam Grobart: And what about The Bank of Japan? I know they're meeting next week.

Josh Schiffrin: So, The Bank of Japan is certainly a bank that's gotten a lot of market attention recently. I don't think next week's meeting will be a meeting of action. But I do feel like The Bank of Japan is in a mode to get out of NERP, negative interest rate policy in Q1. And very possibly the January meeting. So, they have managed to conquer deflation. They've made significant progress towards this goal. And they just no longer need to have a negative rate policy in place. And that would continue on with some of the policy removal that they've been doing over the last few months around yield curve control. And I think the next step is an exit from NERP.

Sam Grobart: Josh, this is going to be our last episode of 2023. And I wanted to take a step back and run something by you. With the benefit of hindsight, do you think that investors went into 2023 too pessimistic and, conversely, might they be coming out of 2023 too optimistic?

Josh Schiffrin: Look, hindsight's always 20/20. And it's kind of easy to look back and make judgments. I do think that there has been a chronic concern that the US economy would be going into a recession at some point on a rolling six-to-12-month forward basis. And that has just not been the case. And I think that there's been a, maybe, general under appreciation for kind of the underlying strength of the economy, the strength of the consumer coming out of the very large fiscal transfers and fiscal support from the COVID period to kind of buttress the economy, even with very large series of rate hikes and monetary tightening.

So, I think that there probably was too much pessimism just around the economy in general and under appreciation for the strength of the consumer.

I think right now looking forward, I do think there are a lot of reasons to be quite optimistic about things. The central banks did a very forceful job of fighting inflation. And we're very close, if not basically accomplished the elusive soft landing. We have a very nice growth/inflation mix. My strongest conviction view over the last few months is that the disinflation process has been very strong and likely to continue. And just like the inflation process surprised people to the upside in '21 and '22, I think that the disinflation process will continue to surprise people on the downside.

So, I think there are very good reasons for optimism going into 2024. I think it's actually possible that people aren't optimistic enough about things looking at kind of the overall positive trend in kind of a series of developments over the last few months. And I'm certainly looking at 2024 as a glass half full environment as we begin the year.

Sam Grobart: It is kind of amazing, right? You talk about the elusive soft landing. It wasn't that long ago where that was still very much in doubt. I'm going to torture a terrible metaphor here. But it's sort of, like, yes, the Fed has landed. They just have to taxi to the gate.

Josh Schiffrin: Yeah. Listen. At some point I think it's fair to conclude that we've soft landed. And we need a little bit of a different term for it. I think the last leg of the soft landing is making sure the central bank doesn't take too long to cut rates and reverse course and allow the tight policy to drip into the economy and kind of start a negative feedback loop.

And I think what we're hearing from the Federal Reserve is they're very attuned to that risk. So, I feel very good about the fact that the economy's managed through this process, guided by some effective policy making in the 2022 and

2023 period. And I think should the economy go into a recession, it'd likely be because some new, unforeseen broad shock takes place. I think that we have managed to thread the needle and come out of the post COVID period in a good place on an economy-wise basis. And I think the Fed has done a nice job of catching up and fighting inflation. And now it looks like they're going to do a good job of kind of landing things. And I think that's just an overall good thing for the outlook, and it leaves me in a very glass half full place to start the next year.

Sam Grobart: Normally, we would ask you what's on your mind for next week. We're entering the holiday season. We'll be coming back in January. What's going to be on your mind at the very beginning of 2024?

Josh Schiffrin: So, I think there are going to be three topics that dominate the discussion as people return from vacations and the holiday season. I think, number one, is going to be the timing and scale of these interest rate cuts that the market is certainly beginning to really anticipate. And I think there's going to be a lot of focus on the pace, the scale, which central bank is going first and the precise timing of that. And I think that will be a very dominant part of the discussion.

I think number two is the market focus will turn to the election campaign, the election calendar, when we return. There'll be primaries and caucuses. And I think the election will be a big event in 2024.

And then I think the third topic which we haven't touched as yet is the continued discussion around the impact of AI. You know, I think when you look back at 2023, I think AI really took off as both an investing theme and something that entered the day-to-day lexicon. And I think that's something that will continue. So, those are the three things I'm looking forward to be center stage as we start 2024.

Sam Grobart: Josh Schiffrin, thanks for closing out the year with us.

Josh Schiffrin: Great to be here.

Sam Grobart: That does it for another episode of The Markets. We'll be off for the rest of 2023. But we'll be back on Friday, January 5th. As usual, you can find us on Apple Podcasts, Spotify, or wherever you get your podcasts.

I'm Sam Grobart. Thanks so much for listening. And have a happy new year.