Talks at GS

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Jan Hatzius: I think there are good reasons to think that we'll come down very, very substantially on these inflation numbers.

Tony Pasquariello: Good afternoon, everyone. My name is Tony Pasquariello. I'm a partner in the global markets division of Goldman Sachs, and I'm pleased to be joined by two great thinkers in the business today who really sit at the epicenter of their respective crafts.

Rick Rieder is the CIO of global fixed income at BlackRock. And Jan Hatzius heads the global investment research division at GS and serves as the firm's chief economist.

Gentlemen, a sincere thanks for being here today. There's so much going on in macro right now, and it's a remarkably interesting time. So there's no shortage of ground to cover.

Jan, I want to start with you, and then we'll have Rick follow on with his take on the same topic. And so as we sit here today, core inflation in the US is running at levels we haven't seen in 30 years. And the question of: Is that transitory or is that not transitory? It's an enormous one, and it obviously has huge implications for markets and the economy more broadly.

And so let's just level set your view. And I guess I'll lead the way to this a touch when I say that, on your estimates, this inflation surge, while it's currently huge, it won't stick forever. And in fact, by the end of next year, core inflation should be all the way back down to 2%. Is that fair? And can you take us through your current thinking?

Jan Hatzius: That is a fair summary of our view. And obviously we're far above that at the moment. 3.6% for core PCE inflation. More than 5% for headline CPI. But I also think we're going through an incredibly unusual environment where supply has been temporarily restricted in a number of ways, and demand has been boosted, especially as far as goods are concerned, temporarily but very significantly. And so I think in that environment, your bias should be that current data don't necessarily provide a great deal of guidance for where things are going to be a year from now. And I think there are good reasons to think that we'll come down very, very substantially on these inflation numbers.

And I'd say on the supply side, a few I think really important disruptions that I think are not going to be there to nearly the same degree a year from now. The COVID impact on semiconductor output, especially in Asia. Something that is probably diminishing and hopefully will continue to diminish. So that's the supply side.

On the demand side, we've had a huge amount of support obviously, and that's made a lot of sense from a policy perspective. And we'll get into some of these things a little bit more probably later. But because of the benefits and the enormous tax rebates that we saw, we've seen very large increase in household disposable income, again, especially in the US. To some degree in other places, too, but in the US we've been above the pre-pandemic trend in terms of disposable income.

And because service spending has been more restricted and people have been less willing to spend on services, they've had more money left over for goods. So goods demand has been particularly benefiting from that strength in income particularly. But again, I think all of these things are in the process of reversing or likely to reverse over time.

Tony Pasquariello: Thanks, Jan. Rick, same question, same topic. I guess my sense is you're a bit more open minded to the idea that inflation might be a bit sticker for longer. I'm really curious how you see things playing out perhaps a little bit differently than how Jan forecasted.

Rick Rieder: So I think I'd say a couple things. I mean, I think the general trend, I totally agree with Jan. The way we model it up, we think PCE peaks around 3.5 or maybe a little over that over the next few months and then starts to revert back down. So I would say a lot of the headline that Jan described, we're in agreement with. And by the way, we use his data in our models, too, so it's not surprising we agree with a lot of that.

Listen, I think there are a couple of things that are worth considering, though. Quite frankly, we think about rates. It's hugely important. What is that average number? And to think about, gosh, where are and what's the interplay between real rates and inflation to get a nominal rate perspective? But I think there are a few things worth considering. And the dispersion underneath inflation -- I just did a presentation talking about this -- is pretty incredible. And I think there are some things that are going to be stickier.

I think wages, earlier Jan described, I think wages are going to be high for a long time. I think we're going to hit historic levels of employment in this country, and I don't think there's enough humans around for the jobs that are available, particularly in the skill sets. I mean, look at the Amazons, the Walmarts, the biotech hiring, the tech hiring for cloud, etc. It is extraordinary. And I look at restaurants' ability to bring in people. It's hard because there are so many jobs available. So I think wages are going to be sticky for a longer period of time.

I also think, when you think about the lack of CapEx expenditure in energy and commodities, etc., my sense is there is some stickiness there for a longer period of time. And then quite frankly, exactly as Jan described, I think the demand function in the US is extraordinary and will continue. I have never seen a consumer in such good shape. Delevered, long cash, prospects for employment and income being so high. And I think that companies are in this luxurious position. By the way, I think there's a lot of price discovery going on at companies today. It's like, wow, you know? There's no degradation of demand. And maybe we can put through these prices.

I look at all of these earnings reports that are coming out -- not all of them -- but a lot of the earnings reports that are coming to is they're able to maintain margins despite their input costs elevating significantly. So anyway, I've learned over the years that companies are in the business of trying to maximize ROE. And as long as you can keep putting it through and keep your margins sticky.

So I think there's some stickiness to higher levels of inflation going forward. I think the most interesting thing is underneath the surface. Part of what I did in this presentation is I looked at health care and look at price appreciation in health care over the last 20-30 years. There is going to be some discoveries, which we can talk about. But I still think that's durable in terms of increased prices.

And then we looked at things like autos. There's been price increase in autos, but if you actually looked at it over a 20-30-year period, it's actually nothing relative to the consumption basket for individuals. So I actually think that's a sector that can do well for a while because it actually, as a part of your consumption base, it's not that large. So from an investment point of view, I think the dispersion around inflation is pretty incredible.

By the way, last night I was booking a flight from New York to Florida, and I literally saw United Airlines, multiple $49 fares. And we're going to talk about inflation the next day, and it's like, wow, I can book this flight at $49. I paid up a little bit for a better seat. But it's pretty extraordinary today about the dispersion underneath in surface, as Jan said.

Services versus goods, you've had no inflation goods for 20 years. Supply chain dynamics, some of which are easing, that are pressed at higher. And like Jan said, I think you'll see some amelioration of that with some longer term stickiness to some parts of it for a period of time.

Tony Pasquariello: I think it's fair to say the past 18 months have been totally extraordinary. And so here I'm referring to a doubling of the Fed's balance sheet, an additional 5 or 6 trillion of fiscal spending, some bits of corporate QE, on and on. And so I think my question for each of you is, when we look back at the comprehensive US policy response to COVID in, say, 10 years, what do you think can wind up being the regrets of policymakers where maybe they went too far, they didn't go far enough? A given policy instrument was used too much versus too little? Rick, let's start with you on this one. And I think judging from some of your recent work, perhaps you can share a little bit about your view that the US should be able to successfully sustain the debt stack that's been built up over this period.

Rick Rieder: Yeah, I think we're in a very unique point in time. And I think people underestimate the demographic condition that we're in. As long as you keep interest rates down, as long as you are thoughtful about -- and by the way, I think there's a natural reason why real rates stay historically low. I use this example in the UK. I remember presenting at the Fed years ago and how the UK's pension scheme kept, incented long-durated investing. And so what happens is their real rates have stayed long for a long period of time.

I actually think now the pension funds are roughly fully funded in the US. They can defease their liability stream by buying long-durated, fixed income oriented assets. I actually think that real rates will stay down for a longer period of time. So by the way, I think that is significant.

And because of that demographic, because of the growth of pensions and life insurance companies and demographic evolution, I do think that you can absorb, the system can handle a larger debt stack that we've ever seen before as long as we're thoughtful about managing inflation, thoughtful about keeping those rates down. I think it's a unique point in time.

I did this analysis. I looked at the function of the US government relative to how I spent my whole career looking at companies. And if you look at interest coverage or you look to debt to EBITDA or you take your asset coverage, you look at the US and you put up all those metrics. Debt to GDP, I think when people look at sovereigns, they say debt to GDP, if you approach 100% that's really scary. If you're an emerging market country, I totally get that. With the reserve currency in the world, I'm not sure I totally get that. And if you look at your interest coverage, your asset coverage, and taxation, etc., then I think you can actually run it.

Like I said, if you thought rates would spike 200 basis points higher, that becomes a debilitating dynamic. And then you change that interest coverage dynamic. But I actually think the system is in a unique point in time. And I think there's real velocity to, if you're using that fiscal stimulus in infrastructure and areas that have lots of permanent durable velocity to it, then I actually think what happens in terms of tax proceeds and because of that velocity and because of that growth, that that spending and running that size debt load is just not that scary relative to where we were 20 years ago, etc.

Tony Pasquariello: Okay, Jan, a kind of similar question back to you. Curious, 10 years from now, policymakers look back, regrets?

Jan Hatzius: Yeah, I'm totally on the same page with Rick on debt sustainability, and I don't have a lot of complaints, I would say. I think on monetary policy, they've done a great job. Decisive on the way in. And they're being very deliberate on the way out. I'm also generally very positive on the fiscal policy response. I would say especially in 2020, the CARES Act was very decisive.

I would only have some small quibbles with the policy in 2021 where I think the enhanced unemployment benefits and the top-up payments were a great tool in 2020 and early 2021. With the benefit of hindsight, I think it would have said that maybe they should have ended somewhat earlier. Not Labor Day but maybe three to six months earlier to boost labor supply.

And then number what, I think the $1.9 trillion American Rescue Plan Act was larger than it needed to be. I think it did contribute to a temporary overheating of the goods sector. And so I think probably would have been better if it had been spread out over a longer period of time. But overall, I would give very high marks.

Tony Pasquariello: Okay, Rick, so let's get into the markets and translate some of what we just discussed into a markets framework. So you're responsible for nearly $2.5 trillion of assets. You command a huge business. You have a huge canvas. You have lots of arrows in your quiver in terms of markets and products. And so whether it's your short-term bucket or the medium trends or the major secular trends, I think you kind of carve into those three pieces. Where do you have conviction now across that range?

Rick Rieder: So, I mean, I would say I always talk about this, like, knowing who you are is really important, and sometimes I'm not really good at that. But I think being an investor means where do you think the puck is going over this sort of intermediate term? Listen, I think the equity market is going higher, and I've been pretty adamant about that for a while. I think the ability for companies to create ROE and book value accretion is extraordinary. And as I said, I think rates can move moderately higher, but I think this discount rate is going to stay down for a longer period of time. So I think equities are going high.

I always find that when you look at credit assets, once you run out of things to buy, you say, "Gosh, you know what? It's all too high today," then you're out of steam. Including today, looking at equities, there are a bunch of equities that traded with their ROE is high. Your multiple, you look at your free cash flow yield, your earnings yield. By the way, I'm not saying equities can't pull back a few percent, but I think we're going higher. And I think even when you look at asset allocation and think about what's going to drive, if I need to hit let's just say a 7% return and I think about my portfolio mix, you have to be erring on the side of the bottom part of the cap stack. And I think that will continue to drive your return.

Listen, I think rates can move moderately higher. And so where I think there's opportunity, yeah, I think US equities still are very attractive. There are parts of Europe, I think the banks are interesting and try to discount to book. Not so much, I think Japan is more of a tactical trade. And then in fixed income, I think you've got to get yield into the portfolio. And you have to be thoughtful about at some of these levels that aren't terribly cheap today. But, boy, I think the securitization market, I think bespoke assets. If you use your illiquidity buckets and hold higher levels of cash, use your equity beta, I think there's a lot of interesting things to do where you can be a mezz financier in commercial real estate, resi real estate, etc.

There are parts of the credit market. Actually, European credit, I think the [UNINTEL] what the ECB is doing. I think European credit will continue to perform at a particularly high yield. It's backed up a fair amount recently. So those are the primary areas. And we get into -- I mean, I actually find growth equity to be the most exciting thing in the world today. Boy, you look at how some endowments and foundations have done. I don't think that was just a one-year phenomenon. I actually think growth equity, the extent you can use that in your portfolios. Take a little bit of that illiquidity bucket and say, gosh, I'm going to look at businesses that are scaling quickly. That to me is the most exciting thing in markets today.

Tony Pasquariello: Okay, so I want to skip ahead. And I guess if we take a quick step back and talk about process and really your process. So what I mean here is you guys apply slightly different trades but in a similar sense. The world really only sees your conclusions and your track record. And of course there's a tremendous amount of work and process that goes into reaching those conclusions. And so, Jan, let's start with you. Can you just kind of take us through how you get from A to B?

Jan Hatzius: I think the easiest way to think about it is that the process is centered around the forecast, and the forecast is a living organism. It evolves via data releases that shape history and tell you about current conditions. It evolves via topical research that suggests where we need to change something. It indicates where you should focus analysis. If you see, for example, that you're far away obviously from market pricing or consensus, then that's an area to really dig into. And because it's sort of out there for everyone to see and people can see where it differs from what other people are saying, it triggers questions from clients that require research, which again often results in changes.

So I think the forecast is really sort of the key part of it. Obviously point forecasts aren't everything. It's important to have a sense of the alternative scenarios and the range of possible outcomes. And I would say we're doing more of that. We're looking more at probability distributions and probability weighted outcomes as opposed to just the baseline case. But the starting point for both the analysis and the communication with clients and with the wider world is the forecast.

Tony Pasquariello: Rick, similar question for you. What goes into a day? What's the process for trade construction, market outlook? And how do you get to your conclusions?

Rick Rieder: So, Tony, I'm pretty excited about something in development. You know, we talked about data before. We are crazy, maniacal today about using quantitative analytics and marrying it to fundamental research. And I may be dead wrong, but I'm convinced that if you err on one side or the other, I think it's hard to create durable alpha. And so the idea of being able to use data assimilation in your process to think about when there's transitional moves in the economy or markets, etc., the ability just to study -- I mean, the data that's available now to make you smarter about what companies are doing, etc., that's all public and through analytics and text mining, etc. It's pretty incredibly powerful.

But then I think marrying it to understanding the regime you're operating in. I mean, we start with what is the big picture regime you're operating within? And if you get that regime right and then they use your analytics and your fundamental research and think about, okay, how do you express that efficiently? I do these monthly calls where I lock myself in a room for an entire weekend, which is socially enhancing like nobody's business, and I find, Tony, that there's a lot of following the news of the day. And probably dollar-yen just moved a tick and what happened and what drove that? I feel like I've got to, you know, for a month, we have our teams, for two weeks, we start brainstorming around what does this mean, what does that mean, why is that happening? And then literally I need two days of quiet time and just to try and put it all together. Not that I do it effectively. But try and put it all together and say, gosh, now I understand why dollar-yen is doing what it's doing. Or I understand what the fundamental underpinnings of inflation are.

To me, that's been a really healthy process. And then I think technology is changing so quickly. And I think young people probably are better or more versed and thoughtful about some of the tools you could use and some of the things that are developing around the markets. So one of the things I've been a big believer in, let a lot of your young people drive your thought process and drive your risk taking and give them some rope. Let them be creative and entrepreneurial. And then try and bring that back and think about how are you managing all of the portfolios relative to that? So there's a bunch of things that go into it. It's hard to articulate specifically how much weighs in different areas. But that is generally the idea around the process.

Tony Pasquariello: Rick, who are the other great investors in the marketplace today that you look up to and say?

Rick Rieder: Names?

Tony Pasquariello: Yes.

Rick Rieder: This is where I get in trouble. I don't know what the distribution of this is. It's nice that you said "other great investors." I don't know about that.

I would say -- listen, I met two people that I think are extraordinary. Stan Druckenmiller, who you just did an interview with, and David Tepper. And listen, I think there's a couple things they do that are pretty unique. Maybe one of the things I've learned over the years is to be able to see the forest through the trees and think about there's news that comes across all day. And it's like news, news, that's a big deal. And I think those people have an incredible ability to separate the news from the noise and say that's a big deal, that's a secular evolution that I need to be attached to. And I'm going to position the portfolio around that.

And then I think, I just find it interesting, when I talk to people that aren't taking risks, they tell me, “This is what's going to happen.” But then you talk to a couple of those people that are amazing investors, there's an incredible amount of humility. They start with, “I don't know.” And then you dig in, and they do know. But they're willing to have some real humility around the positioning and say, you know what? This may not be the right timing for an expression. And I think they've done a pretty good job of that.

I'd say there's one other person who hired me, which doesn't mean he necessarily is a smart person. But Bart McDade years ago, who has owned -- I got to trade credit, I started trading credit. By the way, taught me about the business, taught me about research. And that we're in the business of -- we're not in the business of being right, we're in the business of generating return and making money. And that's a very, very different -- I've learned over the years, it's a very, very different phenomena. You know, it's not about being right. It's when others think you're going to be right and then try and anticipate that and position relative to it. And Bart was pretty incredible. He taught me a lot about philosophy and mindset around generating we're making money or generating returns. So a big influence on how I think about things.

Tony Pasquariello: That's great. Jan, similar question. Perhaps maybe more with a historical bent, but who are the two or three great economists or policymakers who've earned your respect?

Jan Hatzius: Well, I think you have to start with Keynes, who was really the first person to say something profound about business cycles and therefore the most relevant of all the pantheon of great economists from a forecaster. And I love this quote from Fisher Black, when he moved from MIT to Goldman Sachs. He said that markets look a lot less efficient from the banks of the Hudson than from the banks of the Charles.

And I think most economists that move from academia to a forecasting or policy role would say that economies look a lot more Keynesian from the banks of the Hudson than from the banks of the Charles, at least in terms of the near-term ups and downs of the cycle.

I'd also give a shout-out to somebody much less well known. Wynne Godley was a professor of economics at Cambridge who died seven or eight years ago. And for many years, he emphasized the importance of the private sector financial balance. Just the difference between total income and total spending of all households and businesses as an indicator of overall financial imbalances and susceptibility to financial friction and downturns. And I personally found that extremely useful to look at and not least I would say in the run-up to the 2008 crisis.

And then on policymakers, I would say Paul Volcker, Mario Draghi, and frankly Jay Powell all deserve a huge amount of credit for doing the right thing at the right time and making a huge difference. I mean, I think we've seen some really terrific sort of policy decisions at very, very pivotal moments, including over the last decade.

Tony Pasquariello: So Rick, I know you don't have a lot of spare time given your job description, but if you could pick one must-read book for an up-and-coming money manager or a trader, what would it be?

Rick Rieder: I mean, I'll tell you right now, I'm reading a lot about China and philosophy and culture, etc. And that to me, you know, today, because the influence I think is hugely important. You know, I think there are a bunch of books over time. Because I'm so immersed in so technology, I mean, this is not necessarily trading or what have you, but I think some of these books recently around -- maybe not recently, the last few years -- *The Second Machine Age.* There's a book called *Capitalism Without Capital.* But the growth of IP as an asset. Anyway, I think those are miraculous in terms of thinking through how the world is evolving, how commerce is evolving, how financial transmission is changing, etc. But those to me have been hugely impactful thinking about where opportunity sets are today.

Tony Pasquariello: Jan, same question. What's one book you'd recommend for an aspiring economist?

Jan Hatzius: Well, coming back to the Keynes theme, I think the 3-volume biography by Robert Skidelsky I think is really terrific not only about the economics but also just about the time of the early part of the 20th century and then into World War II.

I also think, on a similar kind of period but focusing on the central bankers of the 1920s and 1930s, *Lords of Finance* by Liaquat Ahamed -- I think that's you pronounce his name -- I think was a terrific read. I think a lot of these sort of histories of economic thought and doctrine and policymaking are very instructive even from a modern perspective.

Tony Pasquariello: And then, Jan, let's just stick with you. What's one call from your career that you're most proud of? And then maybe one call, if you could have it back, you'd have it back?

Jan Hatzius: Sure. So on the positive side, I would say the negative view on housing consumption growth and ultimately the financial system in the run-up to the 2008 crisis. And I would say specifically the work on mortgage equity withdrawal and leverage losses, the impact of mortgage losses on lending capacity of banks and ultimately economic activity.

I think, on the negative side, our various quibbles with secular stagnation and the decline in neutral interest rates in the last cycle, in the sort of 2010s. And I think a lot of the quibbles, even in retrospect, I think were right. A lot of these models don't really work very well, but I think, to go back to something that Rick said earlier, we were missing the forest for the trees. And I think that was one reason why we overstayed our welcome on the hawkish side of the Fed call in the second half of 2018.

Tony Pasquariello: Rick, your greatest hit and then maybe the not-so-much?

Rick Rieder: I mean, I will say the easier one is the not-so-much. You know, I'd been on the sell side for 17 years, 18? I wanted to invest and I was at Lehman and I wanted to leave in '06 and started an investment firm. And then when things started bubbling in '08 and I left in the spring of '08 thinking this is the greatest opportunity ever for investing, particularly in credit. Anyway, it wasn't exactly the perfect timing. I didn't think the world would come to an end. So that was definitely the biggest miss.

And I would say I think we've -- I've hired and worked with a lot of amazing people, and I think we've built a good franchise around our funds. We've gotten a lot of awards, medals, and quantitative awards for our funds. And I think putting the right people in the right place and collaborating has been good for us overall.

Tony Pasquariello: Okay. I think we should end on a high note. That was fantastic. Rick, Jan, this was a treat for me. I think this will be a great piece of content for clients of both of our firms, so thank you so much for taking that time.

Rick Rieder: Thanks, Tony. Thanks for inviting me. Thanks, Jan.

Jan Hatzius: Thank you, Tony. Thank you, Rick.