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US Daily: Updating Our Fed Scenario Analysis (Mericle)

- Our baseline forecast calls for the Fed to deliver a 75bp rate hike in November, a 50bp hike in December, and a 25bp hike in February, for a peak rate of 4.5-4.75%. To make our expectations comparable to market pricing, we update our scenario analysis of possible paths for the Fed.
- We consider four broad scenarios for the next couple of years. In a non-recession outcome, we see the Fed as most likely to follow roughly our baseline path (30% subjective odds), but we also see a meaningful risk of an upside scenario in which the Fed hikes more than we expect (20%). In a recession outcome, we see the Fed as most likely to cut substantially (30%), but we could imagine more limited cuts if inflation proved stickier in a downturn than we would expect (20%).
- We use these four scenarios and our subjective odds to calculate a probability-weighted average path of the funds rate. The resulting probability-weighted average path is a bit above both our baseline and market pricing in early 2023 but falls below both later on.

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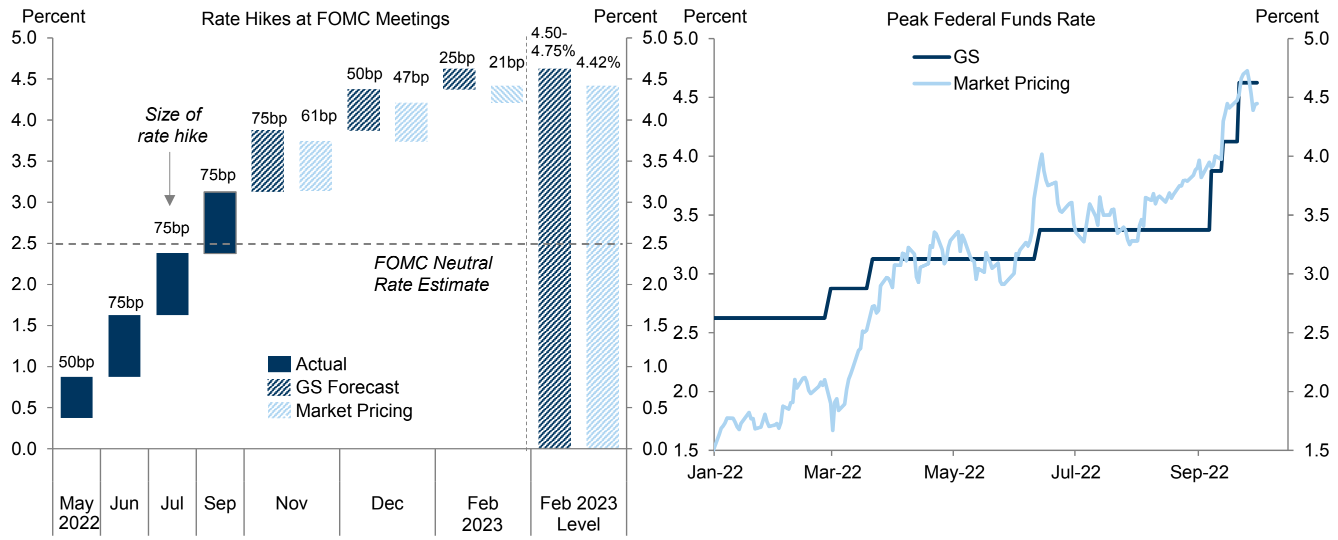
Updating Our Fed Scenario Analysis

Our baseline forecast calls for the Fed to deliver a 75bp rate hike in November, a 50bp hike in December, and a 25bp hike in February, for a peak funds rate of 4.5-4.75%, as shown in Exhibit 1.

Our baseline funds rate path is a modal forecast that is not directly comparable to market pricing, which is a probability-weighted average of many possible scenarios. To make our expectations more comparable to market pricing, we update our scenario analysis of possible paths for the Fed.

Exhibit 1: We Expect a 75bp Hike in November, a 50bp Hike in December, and a 25bp Hike in February



Source: Goldman Sachs Global Investment Research

We consider four scenarios, two where the economy avoids recession and two where it enters recession.

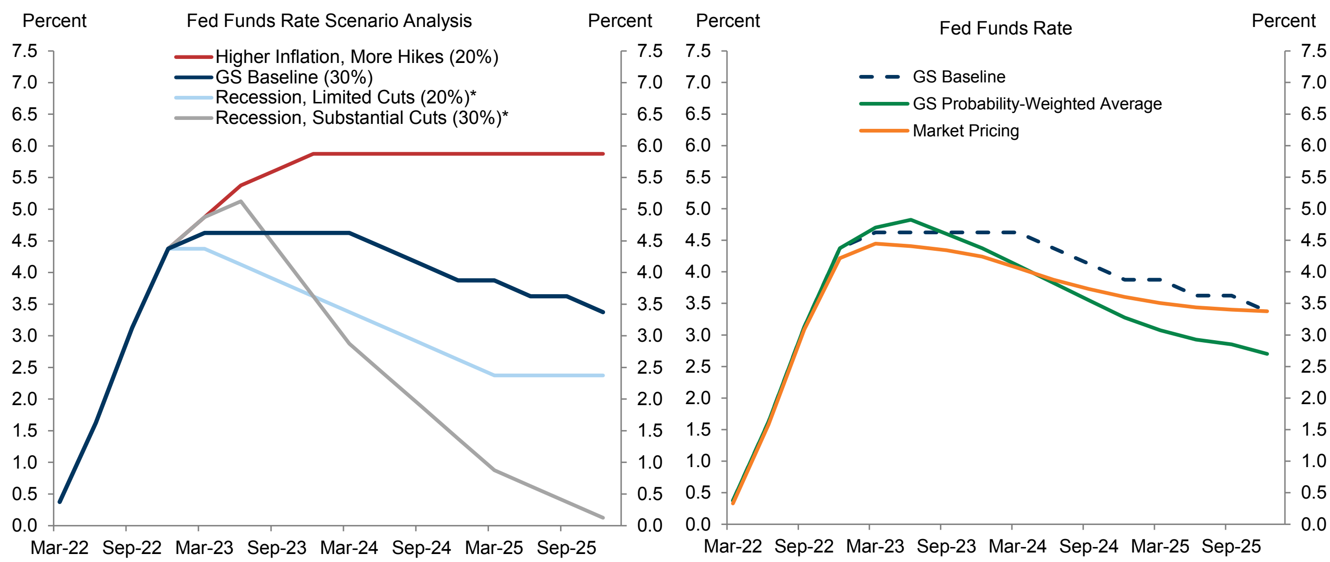
If the economy avoids recession, we see the most likely outcome as something like our baseline path in which the Fed raises the funds rate to 4.5-4.75% in 2023 and then cuts in subsequent years whenever downside risks arise, eventually lowering the funds rate to 2.75-3% (the dark blue line on the left of Exhibit 2, 30% subjective odds). But we also see a meaningful risk of a more hawkish scenario in which the Fed hikes by more in 2023 than in our baseline (the red line on the left of Exhibit 2, 20% odds).

We see hawkish risks from both the Fed's reaction function and the trajectory of the economy. The key reaction function risk is that the FOMC might find it hard to follow through on its plan to raise the funds rate to a restrictive level and then stay there because this would likely mean pausing with services inflation still running above 4% next year. A key economic risk is that more rate hikes might be needed to keep GDP growth below potential now that the fiscal tightening is mostly behind us and disposable income will likely start growing at a solid pace, which could cause consumer spending to accelerate unhelpfully. In these scenarios, we assume that the FOMC would hike by 25bp per meeting in 2023H1 and 25bp per quarter in 2023H2, taking the funds rate to 5.75-6%.

If the economy enters recession, we see the Fed as most likely to cut substantially (the gray line on the left of Exhibit 2, 30% odds), but we could imagine more limited cuts if the recession were shallow or if inflation proved stickier in a downturn than we think is likely (the light blue line on the left of Exhibit 2, 20% odds).

We see recession risk as highest in 2023 because the FOMC is likely to continue to take decisive enough action over the next year to bring about either a recession or a meaningful reduction in the inflation problem, which should mean that the conditional probability of entering recession is lower in 2024 and lower still in 2025. To capture this, the substantial cuts scenario is steepest in the second half of 2023, somewhat steep in 2024, and least steep in 2025. Our recession paths implement cuts with a bit of a delay in order to allow for some initial hesitation until the FOMC is very confident that inflation is falling.

Exhibit 2: Our Judgmental Probability-Weighted Average Fed Path Is Somewhat Above Both Our Baseline and Market Pricing in Early 2023 but Falls Below Both Later On



* The recession scenarios show unrealistically slow cuts to capture many sub-scenarios of recessions starting at various points in time.

Source: Goldman Sachs Global Investment Research

We use these four scenarios and our subjective odds to calculate a probability-weighted average path of the funds rate (the green line on the right of Exhibit 2) that is more directly comparable to market pricing (the orange line on the right of Exhibit 2). The resulting probability-weighted average path is a bit above both our baseline and market pricing in early 2023 but falls below both later on.

David Mericle

Disclosure Appendix

Reg AC

We, Jan Hatzius, Alec Phillips, David Mericle, Spencer Hill, CFA, Joseph Briggs, Ronnie Walker, Tim Krupa and Manuel Abecasis, hereby certify that all of the views expressed in this report accurately reflect our personal views, which have not been influenced by considerations of the firm's business or client relationships.

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