Global Views: A Headwind, Not a Hurricane

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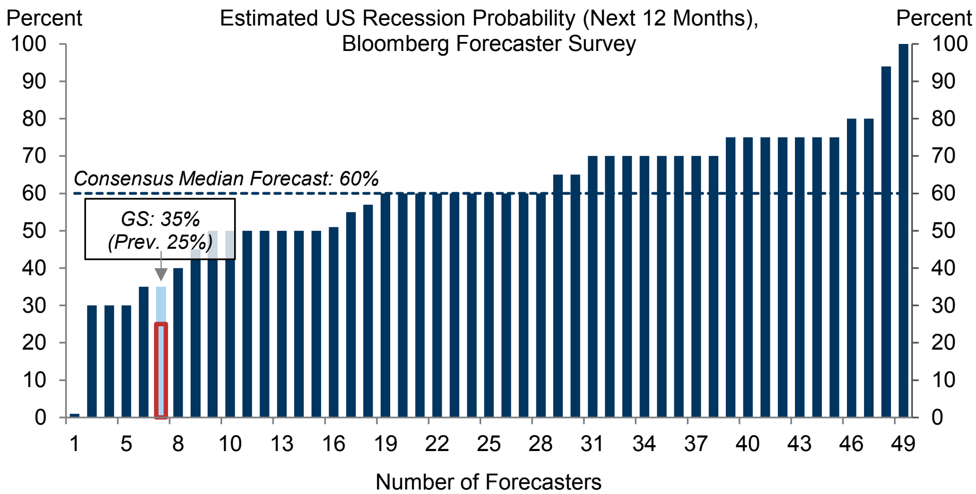
1. It is still too early to have a confident view on the implications of the current banking turmoil for the US economy. Our baseline expectation is that reduced credit availability will prove to be a headwind that helps the Fed keep growth below potential despite the support from rising real income and better global growth, not a hurricane that pushes the economy into recession and forces the Fed to ease aggressively. The risks are clearly skewed toward larger negative effects, and we have moved our subjective probability that the economy enters a recession in the next 12 months back up to 35% from 25%. However, this number remains well below the consensus of 60%.

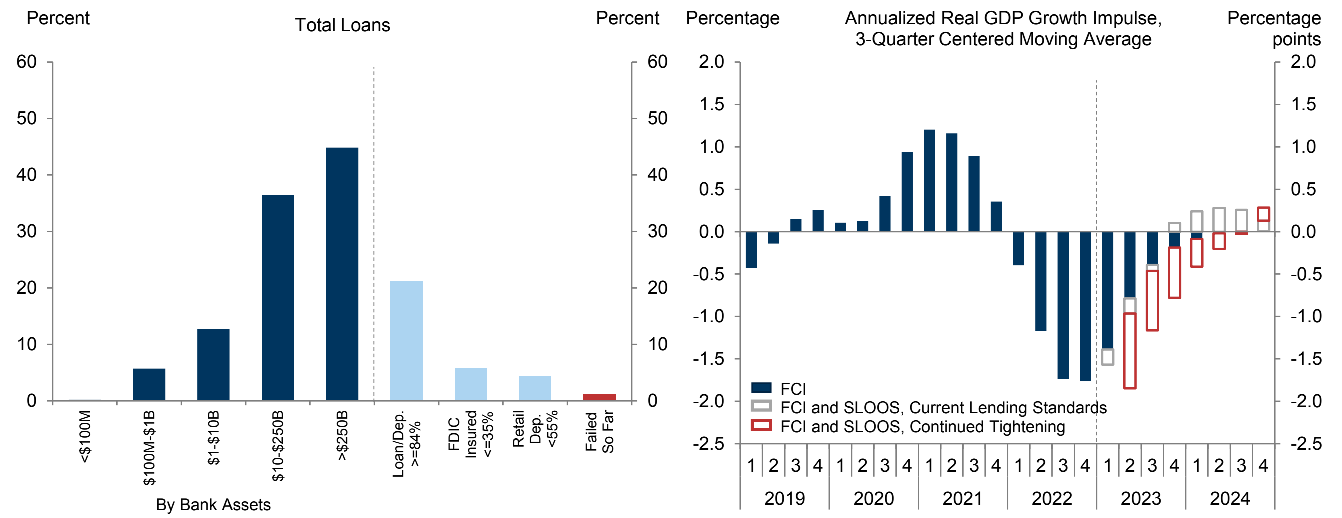
Exhibit 1: In Response to Recent Banking Turmoil, We Have Raised Our 12-Month US Recession Odds to 35%



Source: Bloomberg, Goldman Sachs Global Investment Research

2. We have estimated the impact of tighter credit in three ways. The first is an accounting exercise that makes judgmental assumptions about new credit extension by banks with less than $250bn in assets and suggests a 0.25pp hit to growth. The second is an extension of our financial conditions impulse model that adds a role for bank lending standards and delivers a 0.5pp hit to growth. The third is a review of the academic literature on the effects of declines in both bank stock prices and accounting measures of equity capital on loan growth and GDP, which implies a 0.3-0.5pp hit to growth. On the back of these estimates, we have reduced our Q4/Q4 growth forecast by 0.4pp (from 1.5% to 1.1%).

Exhibit 2: Credit Tightening by Smaller Banks Weighs on Growth

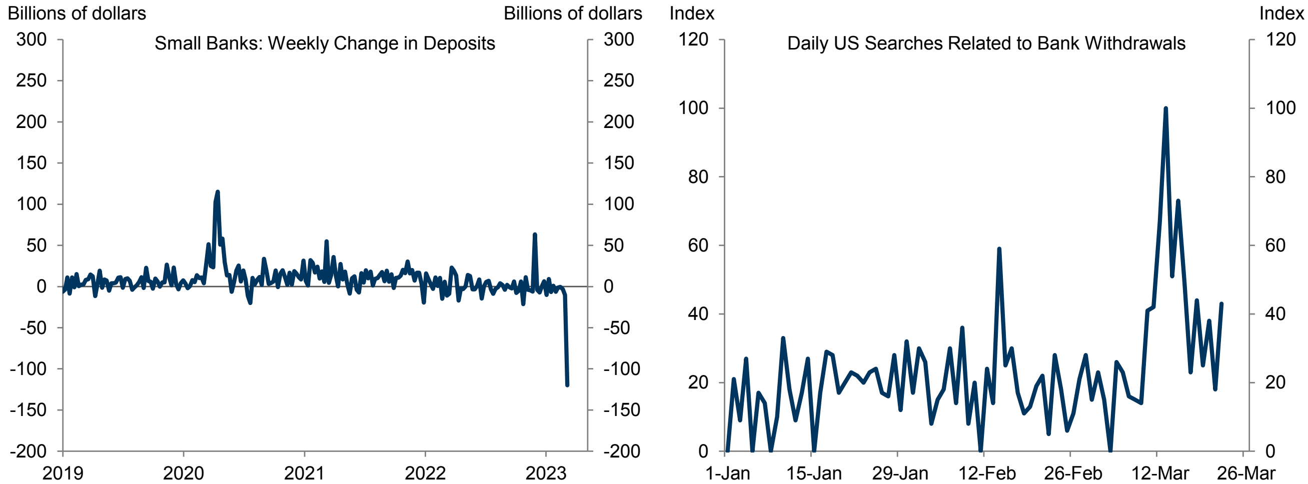


Source: FDIC, Goldman Sachs Global Investment Research

3. Why are these numbers not bigger? First, banks have already been tightening their lending standards since mid-2022, so the incremental impact of the recent turmoil on credit availability and growth should be much smaller than in a situation such as 2008 where the prior expansion was largely built on easy credit. Relatedly, the private sector runs a small financial surplus today, compared with a sizable deficit on the eve of the 2008 crisis. Second, we do not expect larger banks—which have higher capital and liquidity standards than smaller banks and are subject to more stringent stress tests—to reduce their loan supply further on the back of the recent turmoil. Third, unrealized losses on hold-to-maturity government bond portfolios have diminished in the recent rates market rally, another major difference with 2008 when the problem assets lost value during the crisis. And fourth, demand for credit in commercial real estate—where 80% of outstanding bank loans are from sub-$250bn banks—was already under pressure because of post-covid changes in the real economy, so the incremental impact of reduced credit supply may end up being quite muted in that sector.

4. An immediate source of downside risk is another deposit run. The most effective way to reduce this risk would be an unlimited deposit guarantee. But that probably requires an act of Congress, which is unlikely to materialize barring a more intense crisis. Instead, Treasury Secretary Yellen has signaled that the FDIC will continue to use the "systemic risk exception" aggressively to protect all depositors (insured and uninsured) in the event of additional bank failures. At least for now, this message seems to have helped, judging from both our "big data" indicators and the statements by both Yellen and Fed Chair Powell that outflows have declined in the past week.

Exhibit 3: The Squeeze on Deposits at Smaller Banks Seems to Be Abating



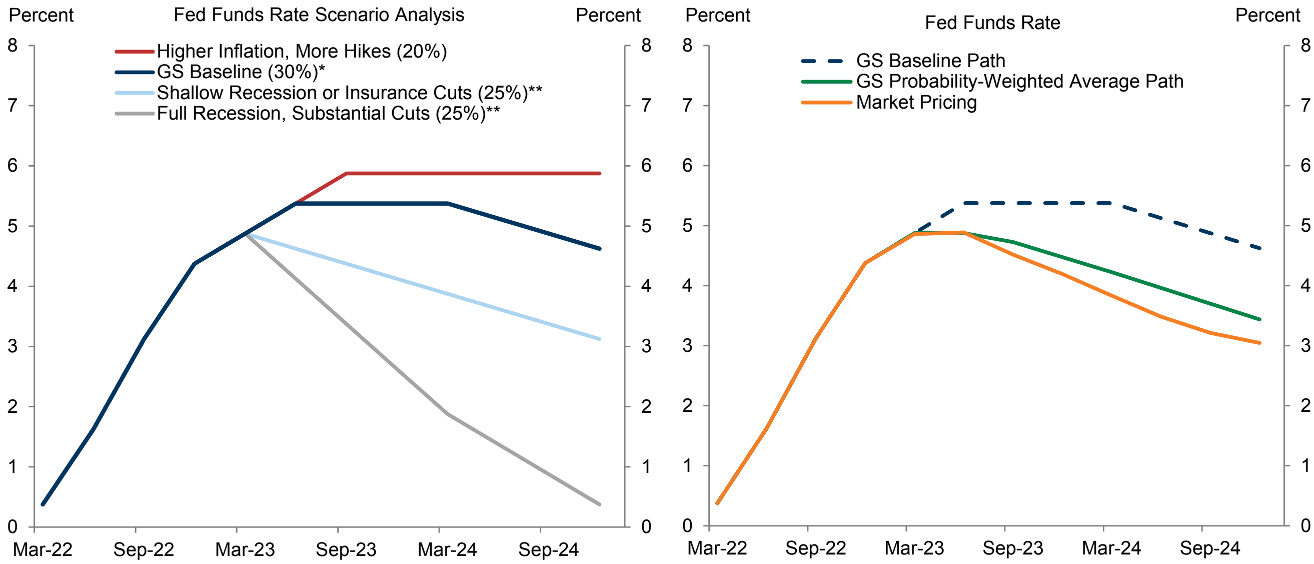
Note: "Small banks" here refers to all domestically chartered commercial banks, excluding the top 25 as ranked by total domestic assets.

Source: Federal Reserve, GS Data Works, Google Trends, Goldman Sachs Global Investment Research

5. A more subtle risk comes from upward pressure on deposit rates. Although it is well-known that banks "borrow short and lend long," their earnings have historically been remarkably resilient to monetary tightening because deposit betas—the effects of funds rate changes on deposit rates—have been quite low. But this is the first bout of turmoil of the truly digital age, in which residual concern about bank solvency may interact with frustration about low deposit rates in an environment where depositors can quickly move funds by just tapping an app. This could put more significant upward pressure on bank funding costs and create greater downside risk to credit availability than our statistical analysis would suggest, even in an environment where aggressive policy action protecting depositors and funding bank balance sheets has reduced the tail risk of another large deposit run.

6. Given the growing downside risks, we had expected the FOMC to pause last week and wait for more information before marching further in what could turn out to be the wrong direction. That said, our baseline growth forecast for 2023 of 1.1% on a Q4/Q4 basis remains well above the committee's 0.4%, so it is not surprising that our baseline forecast of 5¼-5½% for the peak funds rate—with 25bp hikes in May and June followed by no cuts until 2024Q2—is also higher than the committee's 5-5¼%. Because of the downside risks, our probability-weighted forecast for 2024Q2 is a substantially lower 4%. However, even this estimate is above market pricing of 3½%.

Exhibit 4: Fed Rate Cuts Have Become More Plausible, but Yield Curve Inversion Has Probably Overshot

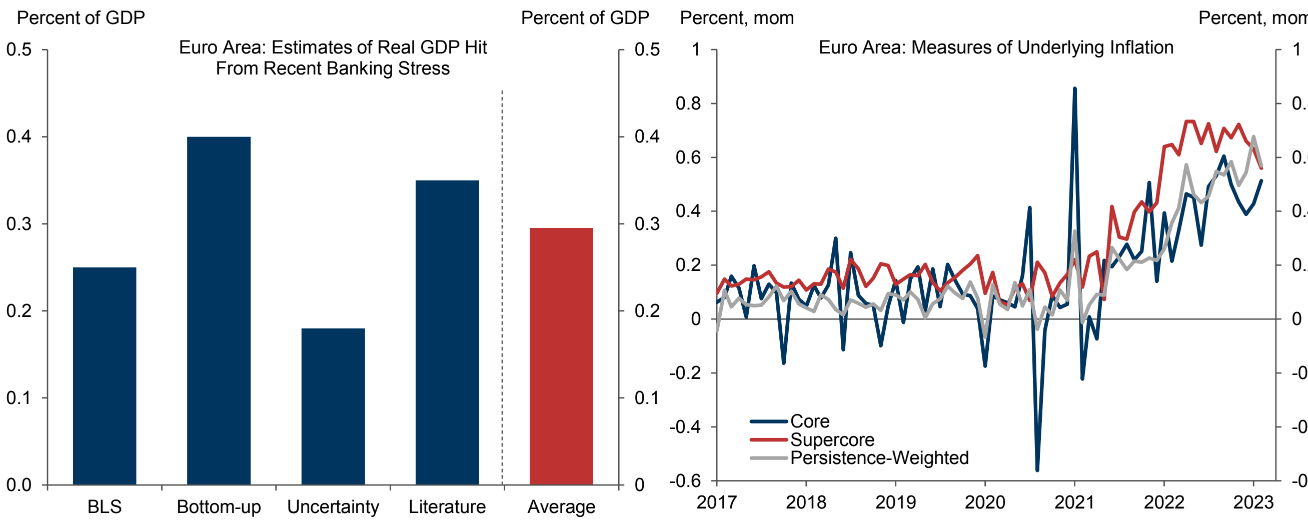


* The cuts in our baseline scenario are meant as a placeholder for an uncertain future date when a material risk to growth emerges.
** The recession scenarios show unrealistically slow cuts to capture many sub-scenarios of recessions starting at various points in time. The recession scenarios reflect our subjective recession probability of 35% over the next 12 months and continued elevated risks thereafter.

Source: Goldman Sachs Global Investment Research

7. The banking sector turmoil has led us to shave our Euro area growth numbers modestly. As in the US, however, we remain above consensus and maintain our baseline view that both the Euro area and the UK will avoid an outright recession because the European banking system is far healthier than 10-15 years ago and other drivers of growth—lower energy prices as well as the post-covid rebound in China—are helping offset the impact of tighter lending standards. With both wage and price inflation still very high, we are above market pricing on ECB policy, with a forecast of two more 25bp hikes in May and June to a terminal rate of 3½% that is subject to risks in both directions. Our baseline view remains that the Bank of England will keep Bank Rate at 4¼% after Thursday's 25bp hike, but we think the risks are skewed to the upside as the bar for another 25bp in May looks low.

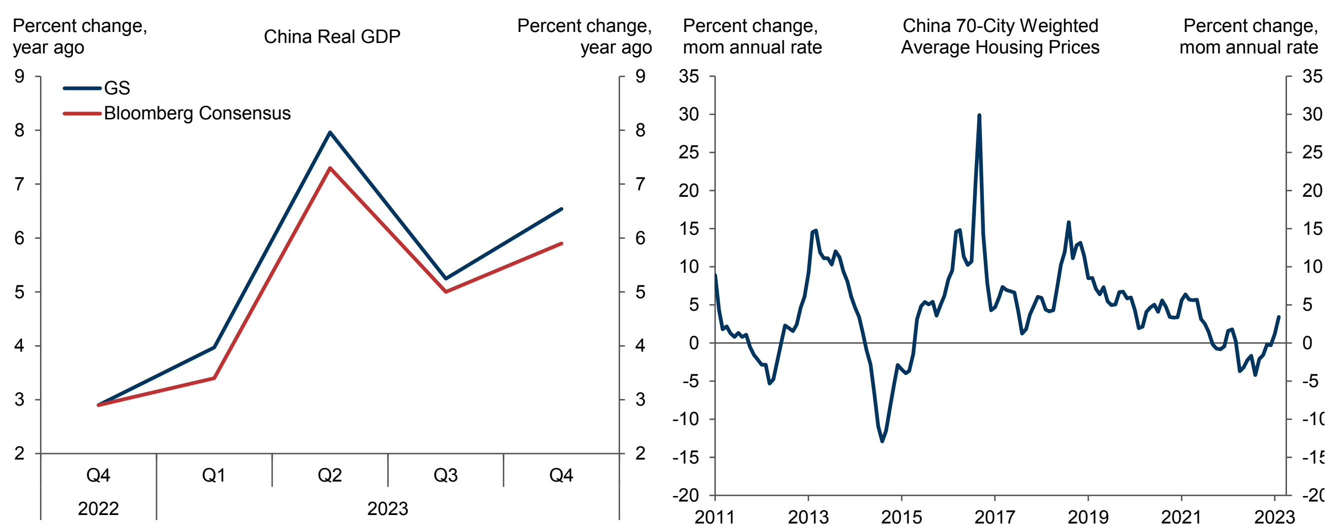
Exhibit 5: A Modest Drag From Tighter Credit in Europe, but Inflation Remains Far Too High



Source: Haver Analytics, Goldman Sachs Global Investment Research

8. In contrast to the downgrades in the US and Europe, we have raised our 2023 China growth forecast further to 6.0% on an annual average basis. The upgrade mostly reflects stronger near-term data, but we would also note that a substitution of US bank stress for Fed rate hikes is a less adverse policy mix from the standpoint of China and other Asian economies. Moreover, financial stress in the US and Europe could persuade Chinese policymakers to keep their policies easier for longer, lending further support to our above-consensus growth forecast. The long-term challenges for the Chinese economy—especially demographics and property—remain unchanged, but even the long-suffering housing sector is showing some improvement, with home prices increasing sequentially in February for the first time since mid-2021.

Exhibit 6: Cyclical Improvement in China, Even in the Long-Suffering Housing Sector



Source: Bloomberg, CEIC, Goldman Sachs Global Investment Research

9. This is a difficult environment, not only for policymakers but also for investors. It is hard to simultaneously explain the large rally at the front end of the yield curve and the resilience of the equity market in the face of what looks like a negative growth shock of uncertain magnitude. Part of the disconnect may reflect an expectation that the credit tightening will mostly hit sectors of the US economy that are less heavily represented in public markets but still matter for monetary policy, such as commercial property and small business. But we suspect that two less benign explanations—an overly dovish view of the Fed's reaction function and a simple disagreement between equity and rates investors about the growth outlook—also play a role. If so, expected returns on both stocks and bonds are likely to be relatively low.

Jan Hatzius

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