US Daily: Why We Can Have Both Strong Growth and Lower Inflation (Mericle)

- We expect much stronger GDP growth this year than consensus but nevertheless expect core PCE inflation to fall meaningfully, enough for the FOMC to cut three times starting in June. We are often asked whether these forecasts aren't contradictory—won't stronger growth prevent inflation from falling or even reignite it? We don't think so, for two reasons.
- First, while our 2024 Q4/Q4 GDP growth forecast of +2.5% is well above consensus expectations of +1.4%, it is only moderately above our +2.1% estimate of potential GDP growth in 2024. We think that the supply-side potential of the economy is likely to continue growing somewhat faster than usual this year because elevated immigration is boosting labor force growth, which means that strong demand growth is unlikely to worsen the supply-demand balance by much, if at all. In fact, so far measures of labor market tightness have continued to fall or move sideways, not rise.
- Second, standard estimates of the slope of the Phillips curve imply that even if the labor market were to retighten a bit, the impact on inflation would be quite small compared to the impact of the major disinflationary forces that we expect this year, continued catch-down of the very lagging official shelter inflation numbers toward the much lower leading indicators, and continued reversal of shortage effects that raised the prices of autos and other goods. While inflation forecasting is always subject to substantial uncertainty, these two fairly straightforward stories should make calling the direction of travel easier than usual this year.

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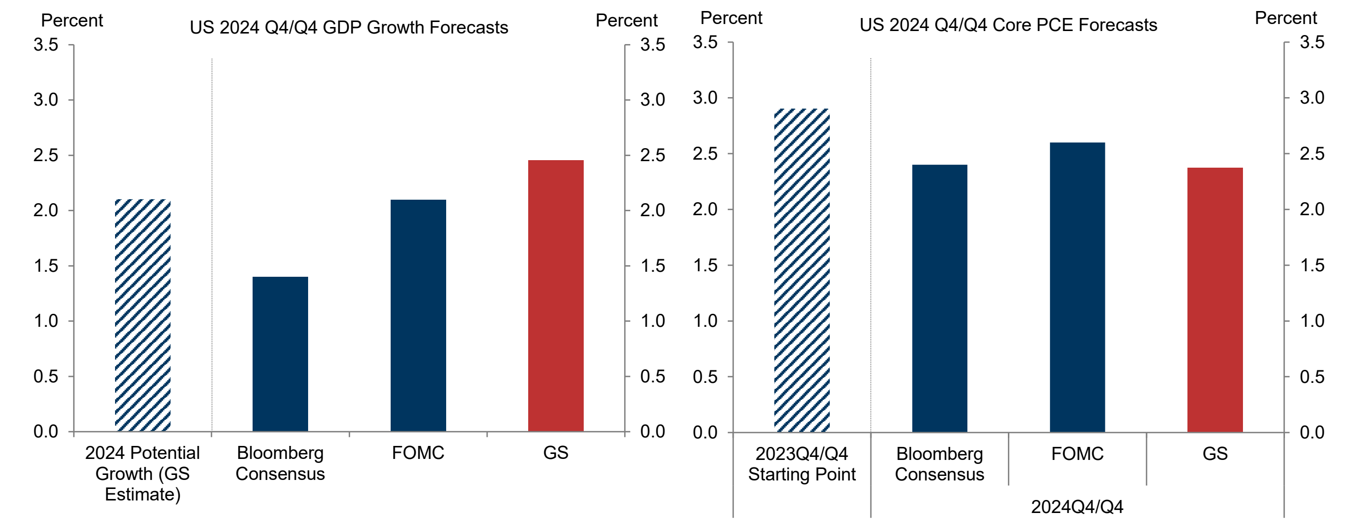
Why We Can Have Both Strong Growth and Lower Inflation

Our most differentiated view this year has been our above-consensus GDP growth forecast. While the consensus forecast has risen, our growth forecast remains substantially higher (Exhibit 1, left). We nevertheless share the consensus expectation that core PCE inflation will fall by ½pp to 2.4% year-on-year by the end of the year (Exhibit 1, right), enough for the FOMC to cut three times starting in June.

We are often asked whether these forecasts aren't contradictory—won't stronger growth prevent inflation from falling or even reignite it? We don't think so, for two reasons.

The first reason is that while our 2024 Q4/Q4 GDP growth forecast of +2.5% is well above consensus expectations of +1.4%, it is only moderately above our +2.1% estimate of potential GDP growth for 2024. We expect the supply-side potential of the economy to continue growing somewhat faster than usual this year because elevated immigration is boosting labor force growth. This means that strong demand growth shouldn't worsen the economy's supply-demand balance by much, if at all, because supply is nearly keeping up.

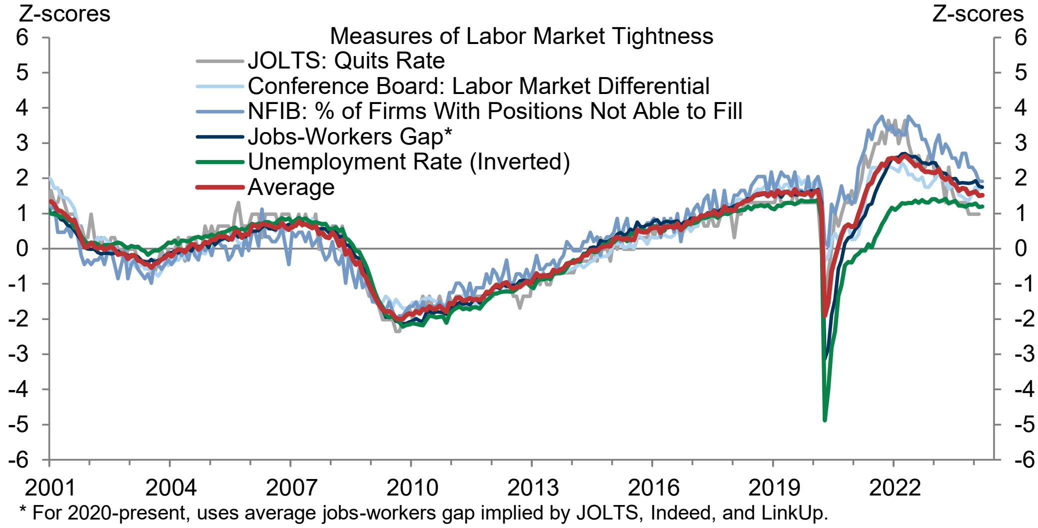
Exhibit 1: Our 2024 GDP Growth Forecast Is Well Above Consensus Expectations, But It Is Not Far Above Short-Term Potential Growth, and We Still Expect a Meaningful Decline in Inflation



Source: Goldman Sachs Global Investment Research, Bloomberg

In fact, as Exhibit 2 shows, so far measures of labor market tightness have continued to fall or move sideways, not rise, despite strong GDP growth. We expect these measures to remain roughly where they are through the remainder of this year.

Exhibit 2: So Far Measures of Labor Market Tightness Have Continued to Fall or Move Sideways, Not Rise



Source: Goldman Sachs Global Investment Research, Department of Labor, The Conference Board, NFIB

The second reason is that even if the labor market were to retighten a bit, the impact on inflation would likely be quite small quantitatively relative to the impact of forces associated with the unwinding of pandemic dislocations.

Exhibit 3 compares our estimates of the potential impact of these forces on inflation.

The leftmost bar shows the potential impact of a modest decline in the unemployment rate. Standard estimates of the slope of the Phillips curve imply that a 1pp decline in the unemployment rate raises core PCE inflation by about 0.2pp.[1] This means that even if the unemployment rate were to decline by, say, 0.3pp, that would tend to boost inflation by just 0.06pp. The estimated impact would remain modest even if we made a generous allowance for the Phillips curve being non-linear when the labor market is very tight, though it is less clear that this is necessary now that the labor market has regained its pre-pandemic balance, as Exhibit 2 shows.

The remaining bars capturing the two major disinflationary forces we expect this year are much larger.

The first is the continued catching-down of the very lagging official shelter inflation numbers toward the much lower pace implied by leading indicators. We expect shelter inflation to fall over 2pp from December 2023 to December 2024, shaving 35bp off of core PCE inflation, and further in 2025 when the catch-up effect that has delayed the decline in the official measures will have come to an end.

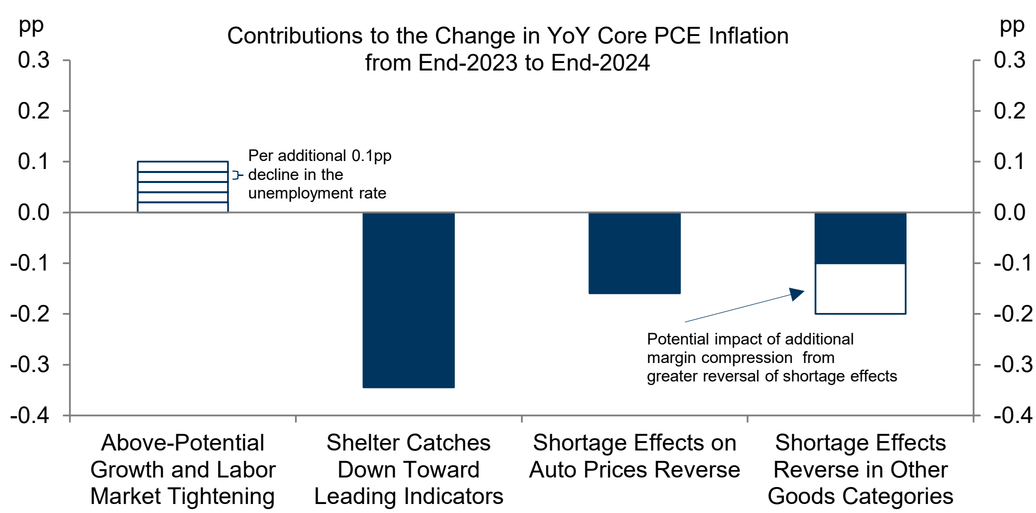
The second is the continued reversal of shortage effects now that supply chain problems have been resolved, inventories are being rebuilt, and competition is kicking

[1] See, for example, a summary of our estimates from last cycle in "Lessons of the Low Inflation Years", or Jonathon Hazell, Juan Herreño, Emi Nakamura, Jón Steinsson, "The Slope of the Phillips Curve: Evidence from U.S. States," The Quarterly Journal of Economics, August 2022. The slope of the Phillips curve is smaller in PCE terms than in CPI terms because much of the impact comes via the shelter category, which receives less weight in the core PCE index.

back in. We are confident that this process will yield further disinflationary pressure in the auto categories this year because dealer discounting has moved in lockstep with inventory levels, and the latter have only returned about halfway back to normal. It is harder to be certain that shortage effects drove prices up and have further to reverse in many other categories because equally granular inventory data are often unavailable, but the elevated level of profit margins in the manufacturing and wholesaling sectors hints in this direction.

Fading pandemic effects are likely to contribute to disinflation elsewhere too. For example, our analysis suggests that the still somewhat too high rate of wage growth largely reflects the lagged effect of past high inflation, which appears to have continued to create a bit more pressure than usual recently for delayed cost-of-living adjustments. As the final echoes of the 2022 inflation surge fade, wage and price pressures in labor-intensive services categories should continue to gradually diminish.

Exhibit 3: The Phillips Curve Effect of Modestly Above-Potential Growth on Inflation Is Likely to Be Small This Year Compared to the Likely Impact on Inflation of Further Unwinding of Pandemic Dislocations



Source: Goldman Sachs Global Investment Research

To be sure, inflation forecasting is always subject to considerable uncertainty. Last cycle we often emphasized that acyclical, idiosyncratic, and sector-specific factors can drive larger inflation fluctuations than changes in slack, that one can therefore get the economy basically right and still get inflation quite wrong, that average consensus inflation forecast errors have been surprisingly large, and that history teaches us that the confidence interval around our inflation forecasts is larger than we intuitively think.

But the two key disinflationary stories of 2024 appear to be more straightforward than usual, and we think this makes forecasting the direction of travel easier than usual this year.

David Mericle

Disclosure Appendix

Reg AC

We, Jan Hatzius, Alec Phillips, David Mericle, Spencer Hill, CFA, Ronnie Walker, Manuel Abecasis, Tim Krupa, Elsie Peng and Jessica Rindels, 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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