Goldman Sachs Exchanges

2025 outlook: Will tailwinds trump tariffs?

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Allison Nathan: The global economy is coming off of another year of another year of relatively strong growth in 2024, led by the US. But new and important variables are now in the mix with the election of Donald Trump and the Republican sweep of Congress. So, can the solid performance continue amid the policy shifts ahead. And what might be the implications for markets? I'm Allison Nathan and this Goldman Sachs Exchanges.

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In this episode, I'm sitting down with Jan Hatzius, head of Goldman Sachs Research and the firm's chief economist, and Dominic Wilson, senior advisor in the global markets research group, to discuss the economic and market

outlook for the year ahead. Jan and Dom recently published their 2025 macro-outlook entitled Tailwinds Probably Trump Tariffs.

Jan, Dom, welcome back to the program.

Dominic Wilson: Thank you.

Jan Hatzius: Nice to be with you.

Allison Nathan: So, first of all, it's hard to believe a full year has gone by since we all sat down together to discuss the outlook for 2024. But here we are. And Jan, let me start by saying that when we sat down a year ago, you were forecasting resilient growth globally, and especially in the US. As well as continued disinflation in the major economies that would pave the way for major central banks to start cutting rates. And all of that has generally played out.

But meaningful US economy policy shifts are likely ahead with the election of Donald Trump and a Republican sweep. So, in your base case, is the trend a solid growth set to continue?

Jan Hatzius: Yes, we think so. We expect another year of above trend and above consensus growth and US outperformance relative to other advanced economies. We're looking for 2.5 in 2025, down a little bit from what we now think is 2.8 percent for 2024. And most of that is driven by strength that was already underway going into the election.

So, I would highlight the strength in real disposable personal income growth, which is really driven by the fact that price inflation has fallen a lot more quickly than wage inflation. And so, real hourly wages are now growing at a good, say, 1.5 percent pace.

Number two, financial conditions have turned from a headwind to growth in 2022, early '23, into at least a moderate tailwind to the tune of maybe half a percentage point or so. So, these were the trends that were already pushing the economy forward. And we think that's likely to continue.

If I look at the growth impact of the major policy changes that we expect in the Trump administration, unified

Republican control over the next several months, I think they're two sided. There are some drags and some boosts. I would say the drags are tariffs and slower immigration. I think on tariffs, our base case is a reasonably benign one where the tariffs are mostly confined to higher tariffs on China and tariffs on auto imports from Mexico and Europe. But we do not build a full across the board 10 or 20 percent tariff into our base case. That's an important assumption. But under that assumption, the tariff drag is probably reasonably limited. A few tenths of a percentage point.

Immigration, we think, is going to continue to come down substantially. And we do expect that to run at a slower pace than the historical average of about 1 million. But we don't have a large decline in the workforce from net negative immigration in our forecast. And there are, of course, some risks around that. But those are the negatives.

The positives are, number one, fiscal policy is probably going to be somewhat easier. Extension of the 2017 tax cuts. Plus, some more moderate additional tax cuts, both on the consumer and the business side. And then probably

a regulatory loosening that is going to be more industry specific, but probably will contribute to stronger business confidence and probably some boost to capital spending.

So, when I take it altogether, I'm still broadly comfortable with what was a pretty optimistic view going into the election.

Allison Nathan: And if you use those assumptions and apply it to your inflation outlook, because it seems like there seems to be a lot of concern about inflation given prospective policy, how do you factor that in? And do you think disinflation will continue?

Jan Hatzius: So, the underlying trend, again, going into the election I think is that we were on a good path with inflation gradually coming down. And we're now at 2.7 percent if you take the core PCE index. You're actually just over 2 percent if you take the headline PCE index. And the drivers of lower inflation, in particular, the rebalancing in the labor market and the slow down in wage growth, I think, are underway.

There are also some lagging components of the inflation

indices. For example, in rent and owners equivalent rent, so the housing components, that should continue to help. So, X any tariff effects, I would be pretty comfortable with the idea still that we should get to 2 percent or thereabouts for core inflation by the end of next year.

However, tariffs will mechanically add to inflation. Under our baseline of China plus auto tariffs, that's worth about 4/10 of a percentage point. So, we've revised up our forecast for where our core PCE is going to be at the end of next year to 2.4 percent. And if we were to see an across-the-board tariff, that would not only hit growth harder, but it would also raise inflation probably to somewhere around 3 percent by the end of next year, if not a little bit higher.

Allison Nathan: I want to talk a little bit more about that risk case. But first, Dom, let me talk to you and talk about this relatively beginning outlook that Jan depicted as our base case. And look, it's a friendly backdrop for risk assets, but markets have already run very strongly. Valuation, arguably, is quite stretched. So, is this good news that we think is our base case already priced in?

Dominic Wilson: Yeah, look, I think that's exactly the

right place to focus. You said on a kind of outright basis, the backdrop that Jan, you know, just presented is a pretty friendly one. You've got robust US growth. You've got basically falling US inflation over that period. You've got rate cuts continuing without recession. You've got kind of corporate friendly policies coming, most likely. And there's also pretty strong flavor of US outperformance within that. But even outside the US, I would say our kind of baseline forecast is sort of stablish growth, more rate cuts, falling inflation.

I think the big challenge as you mentioned is we're very clearly above other forecasters in terms of our US growth outlook. But the market has already moved in that direction. If you look over the last couple of months, we've seen equities up. We've seen yields up. We've seen cyclical parts of the equity market outperform. We've seen the dollar stronger. And we've seen the sort of US outperformance come through.

And I would say some of that predates the election. Some of that is that we worried about recession risks in the late summer. Seems like a while ago now. But that risk has faded. But taking out that risk was the sort of first leg of it.

But we’ve clearly pushed further in that direction since the election.

And so, when we look at the judgment in the gap between what we’re saying and what’s priced, I think our judgment is still that at the margin our growth view is more positive in this mix of growth inflation more positive than the market is yet pricing. And that that US outperformance theme is still not fully reflected. So, our central case, that kind of baseline situation, we still think you’ve got some upside to equities. You’ve got some upside to the dollar. You’ve got some outperformance of non-US bonds and European bond yields falling relative to the US.

But I would say that judgment is much more finally balanced than before. I think we’re going to be much more conscious of when the market kind of questions that and the distribution of risks that Jan hinted at, that’s going to be a much more important part of the kind of investment picture than before.

Allison Nathan: And with that context in mind, Jan, I wanted to ask a little bit more about the Fed outlook. We’re obviously coming up on the December FOMC. You expect

another 25-basis point cut. But as I said earlier, there is a lot of concern about the inflation trajectory. Bond yields, as you just said Dom, have jumped pretty dramatically. So, are you concerned at all that inflation can prove sticker and that could put a wedge into the Fed's policy trajectory from here?

Jan Hatzius: That's definitely possible. And of course, monetary policy is a very pragmatic business. So, you're going to have to respond to new information on inflation and on the economy. One point I would just make though that's, I think, very important and is often misunderstood is that strong growth by itself is not really a reason for the Fed not to move. Their mandate is focused on labor market conditions, not on GDP growth. Those two are, obviously, related.

But if you look at 2024, we've had growth significantly above their own expectations, market expectations, even our expectations. But nevertheless, the labor market has rebalanced, and labor market utilization has declined on net. We're probably still in a process where labor market rebalancing is still continuing. And there is some risk. I think that we'll see further deceleration in the labor market

and, ultimately, a situation where they really won't find it appropriate to have the funds rate at levels that are, by their estimates, very clearly in restrictive territory. And I think that's one reason why they will want to continue cutting rates.

At the December meeting, we do expect a 25-basis point cut. That's not obviously a certainty. There's still data to be released that could change. But that is our expectation.

And then we have ongoing cuts in early 2025. Cuts in January and March. And then a slow down to once a quarter in Q2 and Q3, which take us down to the 3.25 to 3.5 percent range by the end of the third quarter. And there are risks around those. If we saw more labor market deceleration, I think they might continue to go a little bit more quickly. But it's certainly possible that inflation will prove to be a little bit stickier. Certainly, on the surface it's going to look like more inflation, although you could also make the argument that an increase in the inflation indices that's really just driven by tariffs is a one-off price increase like a value added tax hike that monetary policy makers should not necessarily put a lot of weight on.

So, it's going to really depend on the numbers and on where they think that an appropriate monetary policy is based on inflation and the labor market. And I feel good about the idea that we'll get a reasonable amount of additional rate cuts given that the funds rate, at the moment, is still pretty high at 4.5 to 4.75.

Allison Nathan: And Dom, it's pretty striking to me that even as policy rates have come down and we continue to expect them to come down and the market, in general, also expects them to continue to come down, we have seen this big repricing in bond yields recently. So, do you think bond yields have gone too far at this point? I mean, at 4.40, 4.50 in the ten year?

Dominic Wilson: Yeah, look, we definitely have a group of people who worried a lot about kind of big spiking in bond yields and a further spike in bond yields kind of coming out of the election. And we've generally been less worried about that than I think a lot of investors have. As Jan described, we have a fiscal impulse. We don't have a very large fiscal impulse coming down the pipe. We have a Fed forecast that is now clearly below the market on the kind of baseline case. And so, those are things that should anchor you

lower.

And if you look at what we're forecasting for the ten-year yield over the course of 2025, it is somewhat lower, modestly lower, I would say, than we're seeing right here.

I would say I don't have a huge fight to pick with the level of bond yields. I think part of what happened and part of this sort of surge that we've seen is coming off levels that we thought were too low. The market did worry in August and September about recession risks that Jan and the team were pretty clear were not in the offing. And so, I think a decent part of that yield move has come really coming out of that position. Like I said, maybe a little bit high to our central case, but I would say not yet at a level that we think looks particularly odd.

Allison Nathan: So, we are now here again, as I said, flirting with 4.5 on the ten year. That is high. I mean, at what level does that become problematic for the equity bull case that you presented?

Dominic Wilson: Yeah. And we get this question a lot. And I would say there are kind of two answers. There's a sort of

local answer and a bigger picture answer. The local answer is usually that the market cares a lot about pace of movement. So, if there was expectation actually coming out of the election that we would see with a Republican sweep a sharper and faster move higher in bond yields. And I think in some ways the fact that we haven't seen that has probably been one of the things that has helped the equity market to move higher. So, that could reappear, but at the moment we're not really pushing quickly higher over these sorts of recent periods. Yields have sort of steadied out.

The bigger thing for us is generally, like, what is driving the yield increase? And as I said, a large part of that first leg of increase in yields that we've seen since September has been about relaxing about growth. If this is coming from a market that's getting more optimistic about growth, more optimistic about the kind of policy outlook and you're driving equities and bond yields higher together, in general, that's a more digestible and manageable situation.

I think what will be more damaging for the equity market is if the worries shift, either back towards inflation or towards this sort of notion of fiscal risks. So, if we start to see the market worry about the yield path because it thinks the

inflation profile is getting stickier or it worries that there's a sort of fiscal problem that it needs to be taken into account more, that's a further leg of yield spike. That will be more damaging, I think, and more difficult for equities to shake off.

We generally, you know, as Jan described, have more benign view in the central case of how those things should evolve. So, that's not a large worry. But to the extent that there's a risk kind of lurking there in the bond market, I think you need that driver of yields to shift to something that is more clearly negative. And I think if it's just the kind of growth environment driving, we'll probably be able to manage it.

Allison Nathan: And the other risk in our base case is valuation already being quite stretched across risky assets. So, should that be a concern?

Dominic Wilson: Yeah, look, again that's something that David Costin and the team have highlighted. Valuations are high. They're high in equities. Credit spreads are tight. And so, that's part of the story, again, of having taken credit for a lot of the good news.

I think there's a horizon issue with weighting valuations. If you look over kind of ten-year periods, those sorts of long horizons, this tells you that your perspective returns on risky assets are going to be lower than normal. That's what David and the team found. That's a pretty reasonable conclusion from the starting point that we have.

Your ability to tell you where we're going over the next 12 months, maybe even the next couple of years, is much, much lower from valuation alone. We saw this year you came in with pretty high starting valuations. But if the cyclical backdrop is strong enough, then that's usually what dominates.

And I would say what we've tended to find is that you pay that price for equity valuations disproportionately when the cycle turns down. So, our expectation is that's not what we're going to see in 2025. If that's true, you can kind of probably manage this situation where valuations are high. It means that you're vulnerable to being wrong on that. If we're wrong about the assumption, if something happens that puts the economy into a more difficult place, then we think on our central case, you could find that you see a

disproportionate reaction to that. We saw maybe hints of that in August when the market panicked about recession risks. So, that tail is worth thinking about, worth protecting against. But in the central case, I think, you know, our view is that this is a longer-term problem, but not necessarily an obstacle for the next 12 or 18 months given the kind of cyclical backdrop we're talking about.

Allison Nathan: And Jan, let's then dig into that risk case, which primarily in our view revolves around policy developments more extreme than what we are currently assuming. So, what could that look like? And what are the implications or might be the implications for growth?

Jan Hatzius: Yeah, I'd say that's the key known unknown, what is going to happen to tariff policy? There are obviously, also, unknown unknowns. And overall, when we look at the risk of a recession since we always provide an estimate of that, looking forward 12 months, we're at 15 percent. That's not a big number. That's below the consensus as it has been throughout the last couple of years. And it's only about in line with the long-term average since there's been a recession about once every seven years in the post-war period.

We think that the probability of a higher tariff, key known unknown, at 10 percent, let alone maybe even 20 percent, across the board tariff, we think that probability is pretty high. But it's not quite the baseline. So, Alec Phillips, our chief political economist is of the view that, you know, it's maybe around 40 percent. It's certainly very possible that the Trump administration ultimately imposes an across-the-board tariff. But more likely that there will be negotiations. And in the end, there is not such a tariff.

If it does happen, we think it would hit growth pretty hard. We're getting a negative growth impulse of somewhere around 1 percentage point. And obviously, when that peaks depends on when exactly it would be implemented. Alec thinks it probably would take a little bit longer than the China tariffs which could happen very soon after inauguration. But it might take another, say, six months or so before a universal tariff would actually occur. But then the growth impact around a percentage point. And we think the inflation impact is probably also around a percentage point as it happens.

So, it's a more difficult environment from the perspective

of, certainly, the growth inflation trade-off. More unfriendly for sure. From a monetary policy perspective, it’s a little bit complicated because these things go in opposite directions. And I think it is worth noting that, again, this is a price level effect. The impact on inflation of even a pretty sizable tariff shock, it lasts for 12 months, but then barring ongoing escalation, it should drop out of the numbers. So, I think it would make sense in that sort of environment for monetary policy to also focus on the downside risks to the growth side. And this is what we saw in early 2019 when the Fed was faced with a trade policy shock and decided to cut three times.

Now, that was a different situation. Inflation was much lower. The funds rate was also much lower. So, it’s not necessarily what would happen that this would precipitate additional easing. But it certainly could. And I wouldn’t want to go into this kind of episode with a sort of strong ideological view on which way tariffs should affect monetary policy. It’s really going to depend on a lot of factors. But it will increase the uncertainty around the interest rate path as well, for sure.

Allison Nathan: And Dom, if we get an announcement

that we're going to have a 10 or 20 percent across the board tariff, what do US assets do?

Dominic Wilson: Yeah, I mean, the clearer and larger impact is on known US assets. I would say for the US, the thing we think is clearest is the impact on the dollar. We've estimated sort of dollar outcomes under different assumptions and think that if you get a full shift of that across-the-board tariff, you should see meaningfully further dollar appreciation than we've seen. The market's moved in that direction. But we think has priced something much more like a narrowly focused agenda at this point.

I think the impact reflecting a little bit what Jan said about monetary policy, I think the impact on other US asset markets is less clear. I think the full risk case and the threat of retaliation to that could, I think, weigh on US equities, you know, clear or overseas, but could weigh on US equities. And I think in the end will probably push US yields lower like it did in 2019. But the kind of distribution and variance of those outcomes is definitely going to go up. And I think it's just easier to be confident about effects than the others.

Allison Nathan: Well, Jan, let's talk a little bit about X US. Europe and China already experiencing economic challenges and now are facing the threat of some policy shifts ahead that could be unfriendly. Let's start with Europe. What's our mainline view and what are the risks around that?

Jan Hatzius: We're below consensus on Europe. We're not forecasting a recession. But we definitely have below consensus and actually below trend growth in the Euro area, looking for 0.8 percent for 2025. The consensus is at 1.2 percent. The ECB is at 1.3. So, pretty clearly below. We did make a downgrade to our European growth forecast on the heels of the US election outcome. Basically, because we found in our research over the last year that European companies are more sensitive to trade policy uncertainty than US companies.

So, even though we don't have a universal baseline tariff in our forecast, and the only thing that really directly affects Europe is the potential auto tariff, we nevertheless felt that the increase in uncertainty and the potentially looming baseline tariff is already enough to take something like a half percentage point out of European growth on a Q4 to

Q4 basis or a few tenths at least on an annual average basis.

As I said, this is slightly below trend for the Euro area, which is also why we expect the so far very strong European labor market to slow, and we do see at least a small increase in the unemployment rate in the Euro area.

From an inflation perspective, we don't think that the tariffs and the likely retaliation against the tariffs is really going to move the needle. We think we'll continue to see declines in inflation back to 2 percent for core inflation by the end of next year. And that means from a monetary policy perspective, it's much less complicated in Europe than in the US. It's a negative growth shock. But not really an inflation shock. And so, I think the ECB is going to continue easing. And we actually added 25 basis points of easing to our forecast. We're now at 175 by late 2025.

Allison Nathan: And what about China?

Jan Hatzius: In China, we also made a small downgrade to our growth forecast. We're at 4.5 percent. That's actually in line with the consensus. And it is not a huge downgrade.

We've only shaved 2/10 from our pre-election forecast because we're assuming that while the increase in tariffs could subtract as much as 7/10 from growth, we expect more than half of that to be offset by additional policy easing along some of the same lines that we have already seen over the last couple of months. Easier monetary policy, probably some additional rate cuts, increased lending by banks that are, effectively, state directed, and easier fiscal policy.

So, we do think that the headwinds for China, not just from trade policy, but also from the property downturn and the demographics, those headwinds are likely to be pretty serious. But policy is now also making more of an effort to offset some of those headwinds.

Allison Nathan: And Dom, you alluded to this, but for all the reasons Jan just laid out, you are more cautious on assets outside of the US.

Dominic Wilson: Yeah, I think that's fair, particularly because of that risk case. I mean, I don't think that's true in the central case, but it's obviously clearer in that risk case. I think there's a bit of a differentiation reflecting what

Jan just mentioned about the risks for Europe and for China.

I think there's been a lot of focus on the prospect of China tariffs. That's part of our baseline. It's part of a lot of people's baselines. And expectations that's coming are pretty high. We saw in 2019 that the actual announcement of tariffs still moved markets, particularly for the Chinese currency. So, you could still get reaction to that. But I would say overall markets feel better prepared for that as the outcome in China related areas.

And so, it's a little bit as we discussed before, that the risks really are this across-the-board kind of tariff outcomes, that that's the risk that would lead to, I think, more significant further repricing. And in line with what Jan just laid out, I think that's particularly true for the incremental impact on Europe and some of the non-China economies in the emerging market space.

I mentioned the dollar, which is obviously both a US and non-US asset, so further depreciation in other currencies against the dollar likely in that case. But I would say also meaningful downside potentially in non-US equities,

particularly those sort of non-China equities that have perhaps reflected less of that risk already. And we also think that bond yields, in line with the notion that the ECB and others would probably cut rates more quickly as Jan described to respond to those growth risks that bond yields in Europe could then fall more sharply. So, it's another reason for thinking that bonds and European bonds may be better diversified in portfolios than treasuries that they have some ability to rally further in one of those major risk cases.

Allison Nathan: Yeah. When I put this altogether, it seems like investors right now should be feeling generally pretty good, especially investors in US assets. And we think that that's going to continue. But it's tricky because the downside risks feel very meaningful. So, how do you think investors should be positioning relative to this outlook?

Dominic Wilson: Yeah, I mean I think that's exactly the right way to describe the challenge, which is the facing view is you want at some level to be maintaining this theme of exposure to the US growth resilience that we still expect. And to further upside that we think probably still exists in equities, particularly US equities, as that happens. And

then you've got two risks to contend with. One is is the market at a point where it's reflecting that sort of already? And the other is these sorts of tail risks that we focused on, tariffs and perhaps some of the other kind of risks that we touched on.

And I would say in some ways that's a continuation of 2024. We have had a similar view that you're trying to keep your exposure to that US growth theme while also being sensible about the kind of tail risks that might appear and protect yourself against it. But the key risks are a little bit different.

I would say we're still in the mode where, again, because the market's taking credit for this, you're going to feel better fading worries, and probably not the tariff worry, that's the one we would probably say as we've outlined is a serious one that needs to be taken. But if the market worries about other aspects of the growth and inflation view, in general, our bias is going to be to push back against that. It's easier to find opportunity when the market is worrying about things than when the market is not worrying about things.

But in terms of kind of the broader set up, I would say there are two things you can do to help yourself with that exposure. One is diversification across assets. We think that even with some of this inflation and risk, fiscal risk, that bonds, particularly non-US bonds as I mentioned, if you hedge if the FX part of it, offer good protection against an equity portfolio for some of these risks. And I think even US treasuries and tips, we expect modest positive total returns. And they could help if growth disappoints.

We've talked on the equity side about broadening out the US equity exposure towards a more equal allocation and mitigating some of that concentration risk that has appeared. And I do think keeping this long dollar exposure against long equity positions, both fits the kind of broad direction of travel that we have in our base case, but also hedges you against some of these tariff risk cases, US rate upside cases that could be more difficult for equities.

The other thing I would say is we think there's sort of strong argument still also for looking at options, protection too also to help you protect against those macro tails. You've seen the price of optionality in the major markets come down after the election, which is something that we

expected to happen. And so, it's easier to use options, both in equities and in terms of expressing some of those long dollar views, maybe also in commodities, gold and oil, which we haven't really touched on, but as protection against some of those kinds of key risks. And so, we think for investors who are able to do that, who have mandates to do that, that using kind of options either to express the views that you want to or to protect them is also going to be a thing that's worth a higher level of focus than usual.

Allison Nathan: Dom, Jan, thanks so much for joining us.

Dominic Wilson: Thank you.

Jan Hatzius: Thank you.

Allison Nathan: This episode of Goldman Sachs Exchanges was recorded on Tuesday, November 19th, 2024. I'm your host Allison Nathan. And tune in this Friday for the second episode of our four-part series on the changing dynamics at the intersection of sports and finance. We'll be discussing the new sports media landscape and how media rights deals and the growth of direct-to-consumer models

are disrupting the business of sports.

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