

Goldman Sachs Exchanges

The recession question

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Allison Nathan: What will rapidly shifting tariff policies ultimately mean for the global economy and markets? I'm Allison Nathan and this is Goldman Sachs Exchanges.

Today I'm joined again by Jan Hatzius, head of Goldman Sachs Research and the firm's chief economist, and Dominic Wilson, senior advisor in the global markets research group. Jan, Dom, it's great to have you back on Exchanges.

Dominic Wilson: Thank you.

Jan Hatzius: Thanks.

Allison Nathan: Jan, it's been a week for the ages. And so much has happened since we last sat down in mid February. At that time, you believed that tailwinds in the economy were more likely to trump tariff headwinds. But we, of course, since have gotten what can only be described as a seismic shift in tariff policy from the Trump Administration that companies and investors are now grappling with.

So, first, catch us up on the implications of those shifts for your economic outlook. Are we facing recession at this point?

Jan Hatzius: Yeah, I mean, if we go back two or three months, we thought coming into 2025 that tailwinds would probably trump tariffs. That was the title of our outlook. And that was when we thought tariffs would rise by, maybe 4 percentage points or so, if you take the average US tariff rate.

Now it's much higher than that. And we now think that tariffs will trump the tailwinds. And we have a much more cautious view on the US economic growth outlook.

Tariffs basically weigh on growth via three main channels. Number one, you get a price increase, which eats into households' real income. And thereby cuts consumption. Number two, tariff increases tend to tighten financial conditions. Obviously, we've seen that in spades over the last week and a half. And then number three, uncertainty about trade policy, like other types of uncertainty, make it less advantageous for firms to make capital investment decisions. So, they sit on their hands and that weighs on growth as well.

Now, how big are these effects? Our estimate, and this is very rough, but our estimate is that a 1 percentage point increase in the average US tariff rate boosts inflation by something like 10 basis points. Boosts the price level by about 10 basis points. And hits growth by something like 10 basis points as well.

So, if you have a 4 or 5 percentage point increase in the tariff rate, that's approximately where we were two months ago, that impact is manageable. That's half a point. And there are plenty of other factors that go in either direction. And it doesn't put the economy close to a recession. At 20

to 25 percentage points, which is where we were a few days ago before President Trump delayed part of these tariffs by three months, that impact looked recessionary because then you're talking about 2 to 2.5 percentage points of growth impact and the economy is only growing, trend growth rate is maybe 2 percent.

So, where are we now? We've pulled back a little bit. We're in the 15 to 20 percentage point range for the increase in the tariff rate. And that puts us, our best guess is, to low but still slightly positive growth. But it's hard to estimate all of this. And it certainly could be recessionary. We're at 45 percent recession probability. We have briefly moved to a recession baseline before the delay. And now we're back to close to 50/50. But in any case, very weak in terms of growth. Only 0.5 percent Q4 to Q4 US GDP growth this year.

Allison Nathan: And what is the inflation expectation at this point?

Jan Hatzius: For inflation we're at 3.5 percent for core PCE. We've been running in sort of a 2.5 to 3 percent range for quite a while. And the latest inflation numbers, both

CPI and PPI have actually been a little bit better. But all of that is for March. Didn't really have a meaningful tariff impact in it. And we think we'll see an acceleration of close to a percentage point from here.

Allison Nathan: So, even if we are not forecasting a recession at this point, we are looking at, as you said, much lower growth. Much higher inflation than before these tariff announcements. Where does that leave the Fed? It seems like a very difficult spot. What do you expect?

Jan Hatzius: Oh, it's very difficult for the Fed, of course. This is the sort of shock that makes it very hard to know which way to go, even before you get to the magnitude. And I think it's going to really depend on two questions, one, as inflation in the short term is sure to rise, and probably rise pretty significantly, that's a done deal. But how do your expectations change for inflation a year out? Two years out? The sort of horizon for monetary policy?

And that's going to depend a lot on what happens to inflation expectations. Do inflation expectations remain anchored, or do they rise a lot, which would then cause

very significant second round effects and potentially higher inflation on a more sustained basis? And there are a number of indicators. They're somewhat contradictory. Generally, survey measures of inflation expectations have gone up. Market measures of inflation expectations, at least beyond the very near-term, still look well behaved. So, it's an open question. And we're going to have to watch it. Our expectation would be that inflation expectations long term remain reasonably anchored.

And number two is the unemployment rate rising. So far, while we've seen some weaker economic indicators, especially in surveys, we have not really seen a meaningful deterioration in the labor market. If and when that happens, that's going to be important for the Fed. It's partly important because it feeds into their longer-term inflation forecast. But it's also important because directly part of their dual mandate.

So, yeah, our best guess with our baseline forecast is that there's going to be a little bit of moderate easing. We have 75 basis points of cuts in the current baseline forecast. Basically June, July, and September. But I would say the range around that is very wide. It's very possible that we

don't get cuts at all if the economy holds up a little bit better and the inflation numbers are more concerning. But if the economy were to go into recession, and again, we're close to 50/50 on that, then I think they would cut a lot more. And, you know, maybe 200 basis points. Even 200 basis points would be quite a modest amount of easing by the standards of past recessions.

Now, I think there are good reasons why it would be more modest, because of the nature of the shock. But 200 basis points would be a more meaningful amount. And so, when we look at the probability weighted path of the funds rate, if I take these three scenarios and calculate a very rough probability weighted path, we think that we could certainly see more easing than what's currently priced in the market. In fact, when we compare our path with current market pricing, it's a little bit more aggressive, despite the fact that our current baseline forecast is still that we just about skate by with modestly positive growth.

Allison Nathan: Interesting. Dom, let me bring you into the conversation. Obviously, the markets have been incredibly volatile during this period. But I want to start by asking about the rates market off the back of Jan's

comments on the Fed. There've been a lot of questions about why treasuries actually fell, and bond yields rose amid this market turmoil. We generally think of treasuries as the ultimate safe haven asset. So, what's your view on what's driving those moves? And do you think this treasury route can continue?

Dominic Wilson: Yeah. More than somewhat surprising, I would say. And it is very unusual to see that mix of yields rising with the dollar weakening and equities falling, certainly in the way and the magnitudes that we've seen over the last kind of week or so.

I do think there were sort of two phases of that. I think, in the initial phase, I do think some of the constraints and the complexity for the Fed that Jan was talking about, this kind of tension between the inflation and growth side, played a role in the immediate aftermath. We saw treasury yields fall initially as equities came down. But they fall a lot less than you would normally expect, given the magnitude of the equity declines. And given what we've seen in some of the prior growth scares that we've had over the last couple of years. And so, that already spoke to kind of some of the tensions that Jan referenced between the kind of

grown and inflation sides.

Coming into this week then things changed much more sharply. You saw a lot more pressure on the back end of the curve. Again, I think some of that was sort of worries about the Fed, perhaps, being forced to ease into an environment where the inflation picture is still very uncomfortable and set to get more uncomfortable. I think there's also been a little bit of reemergence of worry about the fiscal backdrop, the acknowledgement that recessionary environment, much weaker growth is not going to be helpful for the budget and the public debt situation.

But against the backdrop of that, I think two big new issues have sort of come into play that really drove the last leg and the more kind of panicked action that we saw in treasury markets, particularly since Tuesday. I think one was worries that foreign investors might start to take a step back more meaningfully from the treasury market. We saw a pretty difficult bond auction on Tuesday and some signs that maybe demand for showing up at those auctions was falling back.

We haven't yet seen strong kind of broad evidence of the footprint that there's really been a big withdrawal by foreign investors when you look across markets. But definitely, anticipation and worry about that being something that might be coming.

And the second thing is alongside that unwinds very big levered positions. I think particularly people positioning for wider swap spreads that came under pressure as that kind of first round of fear took place. The market's been extremely liquid across a whole bunch of different asset classes. And I think what you've seen is then the kind of cumulative effect of those forces pushing yields up. And then some sort of heightened fear that's going to continue.

I think with the tariff pause, at least the pause on that sort of segment of the tariffs, we saw kind of a little bit of a reprieve. We had a somewhat better auction yesterday. But 30 day yields really haven't come down in a meaningful way yet. The situation feels very fragile still. It's always hard to know how long this will last. But I do think it's going to be hard for investors to treat longer dated treasuries as a comfortable safe haven given what they've just seen. And I do think there's a pretty good chance we'll

see new highs in those yields over the coming weeks.

The irony is that the inflation numbers in the near-term, the recent data's actually been better than expected, like meaningfully better this week. So, without that fresh shock, we'd probably be taking credit for somewhat lower yields. But I think these are the dynamics that are still going to overwhelm it. And there's going to be a lot of worry and nervousness about whether people are just going to take a broader step back from the allocations to US bonds.

Allison Nathan: Yeah. I think I saw when I left my desk on the way over here that yields were up again this morning. So, we'll see what the future brings. But as we've been discussing, markets in general have been extremely volatile. I mean, these equity moves, I mean, the whiplash is real.

When you think about what the market is pricing right now across assets, what looks appropriately priced for the risk we're facing? And what looks mispriced?

Dominic Wilson: Yeah, it's obviously a moving target. I'm sort of conscious that whatever I say now, by the time this

is released, which will be soon, but by the time anyone listens to this at any future point the observations could be out of date.

The process we've been engaged in is essentially to take the views that Jan and the team are coming up with on the economic front, these kind of shifting scenarios, both the central case and the risk scenarios around US growth and try and see broadly speaking whether we think as well as we can that's reflected in the way markets are pricing.

When we look at that right here, after the announcement of the delay to that portion of the reciprocal tariffs, we obviously saw a big kind of relief rally in equities on Wednesday. And when we looked at that sort of Wednesday night after that relief, it looked like we were pricing growth essentially somewhere close to the baseline that Jan outlined. So, low positive, non recessionary, but very weak growth.

And so, the problem with that is that, as Jan laid out, we're still seeing a very significant not quite 50 percent chance that a recession will occur. And so, essentially, you should be pricing some discount to that baseline to give you

something that lies in between those two outcomes at a minimum. And so, certainly as of Wednesday night, looked like we had removed that cushion more or less entirely in terms of the way things were priced. And we've put a little bit back since then. The market has come off from those very high levels on Wednesday. But our view is still, I think, that the market is vulnerable to any signs that recession might be coming.

So, it's not that we're pricing much more optimistic outcomes than that base case. It's just that we still see a meaningful risk that you don't end up there. And the markets should really be offering you protection in a discount against that.

I think because of that, our bias is to think that equities and credit should, if they were kind of correctly priced or fairly priced to that distribution of outcomes, they should be lower. And as Jan said, that the market should probably be pricing somewhat more Fed easing along the curve just as you wait the two different prospects. And so, the bias is that after that relief we got into a place where we were, again, underpricing some of that downside risk.

Allison Nathan: So, the takeaway for me is that there is more downside ahead if there is, obviously a more-- I mean, we are not that close to pricing a recessionary outcome at this point.

Dominic Wilson: Yeah. There's no doubt that if we get a recessionary outcome, I think there's a meaningful downside still in lots of different areas of the asset class. There are very few things, even at the worst of this downturn that in level terms we're pricing what we think of as full recession.

I would say we haven't really priced above the baseline forecast. So, I guess the kind of lucky version of this is we drag along the baseline and then, you know, you don't need a further meaningful adjustment on that basis. But I still think the skew of risks is still, like, the upside scope there is still limited by the fact that growth is going to be weak and we're going to be kind of tracking along that knife edge for a while. And if you get that downside case, yeah, there's still meaningful room to price it.

Allison Nathan: And let's not forget, we what at extremely high starting levels before all of this pricing a very good

growth outlook at that point.

Dominic Wilson: Yeah, I think that's part of the issue. The changes have been huge. But the starting levels were high. And so, what we've really done is taken ourselves from very optimistic levels of growth to what are now pretty modest levels of growth and much more pessimistic levels. But I don't think we've swung all the way to pricing proper recessionary risks. So, if we head there, that's where the vulnerability still is.

Allison Nathan: So, Jan, it seems like the market is still holding at least some hope, perhaps, that we will see these trade deals. We'll see some relief continue. But ultimately, there's just tremendous uncertainty about that. And if we zone in on uncertainty itself, how much damage is that in itself doing? And is any of that damage really somewhat permanent at this point? Can we unwind all that's happened?

Jan Hatzius: It's very hard to give a confident answer to that because if I go back to the three channels through which this trade war is weighing on growth: income effects, financial conditions effects, and uncertainty effects, the

uncertainty effect is the hardest to estimate because there are not really great metrics. I mean, the income effect you can put a number on that. On the FCI, financial conditions, at least you can sort of measure them as they change. And I think our models on that are generally pretty good. But for uncertainty it's harder.

Our working assumption is half a percentage point to one percentage point of growth because of the uncertainty measures. But the range around that, I mean the true range is probably much wider. And probably skewed to the downside because some of these uncertainty measures, trade policy uncertainty, I mean, they're at unprecedented levels. We haven't seen this sort of thing. And there's also the risk that it becomes more non-linear at some point.

To your other question of whether we can unwind this if things calm down a bit? To some degree, no doubt. But can we fully unwind it? I think that's going to be very difficult. So, some drag on economic activity is very likely. Now, that's a statement sort of about the level of investment. The level of investment, I think, is going to be lower than it otherwise would be because of this probably for the foreseeable future. Of course, the changes can look a little

bit different if you have a really big shock to uncertainty in the short term and then the uncertainty diminishes. Then you can get a partial rebound. But it is likely to be a very significant issue for corporate decision makers in particular for a long time to come.

Allison Nathan: Yes. Can you imagine how corporates are managing this and investors as well? I mean, if you think about investors managing this uncertainty, Dom, what are you seeing in terms of actions they're taking? Are they hedging? And if so, how are they hedging?

Dominic Wilson: Yeah, look, I think the bottom line is it's an extremely challenging environment and this level of volatility moves in both directions. Just very difficult to manage effectively.

I think what you're seeing out at a high level, I think probably the most basic thing is people just reducing risk and just getting more defensive in their positioning. And I would say more diversification over time away from US assets. But also, people emphasizing diversification more in their portfolios in general.

You did see increased demand for protection going into the April event. Alec had been fairly explicit that the risks were skewed to the downside. I think that resonated with a decent portion of the investor community. So, buying puts in equities and credit and oil, there was definitely kind of increased level of activity. And that's been pretty valuable in protecting people, at least to a degree. You never have enough of that protection when things go bad. But--

Allison Nathan: Sorry, and you're referring to Alec Phillips, our political economist who kind of said, well, you've got to be concerned about the downside risk here.

Dominic Wilson: Yes. The chances of a negative surprise were rising. And that was the direction in which things were more likely to play out. The problem now is those hedges are extremely expensive. So, you're now finding people, I think, queue up to do that at this point. That was something you could do ahead of the event. But it's harder to do afterwards.

I think part of the additional challenge which we touched on before is that the kind of conventional things people have done in other assets to protect themselves, buy

treasuries or to protect your equity position, or be long dollars, which has been a popular way of kind of protecting equity positions, those things have not worked. So, you know, there's obviously people are looking beyond that bonds as a safe haven.

I think front end of the yield curve, that's been a little bit more reliable. There've been constraints there, but those yields have come down. People, I think, are a bit more comfortable using that as a protective asset. Long positions in safe haven currencies. So, not the dollar anymore, but yen and Swiss franc. And I would say gold, which has also been a very popular hedge, those are things that continue to perform quite well and have been widely seeing a lot more interest in that. But I do think the kind of broad problem is that once the event takes place, volatility generally explodes. It gets very expensive to buy auctions. And so, to hedge that way. And so, I think people are just more focused on those kinds of asset allocation issues, making sure they have the risk exposures that they're comfortable with. And as I said, part of that is this diversification into kind of non-US safe havens that is probably feeding some of the dynamics that we talked about with FX and rates.

Allison Nathan: Right. We just had a conversation with Daan Struyven, our commodity analyst earlier this week who was pretty optimistic that gold was going to be an effective hedge. And we're seeing that play out at this point.

Jan, let me turn back to you because at least at this moment, it could change, but at this moment it seems like China is really in focus a target of this tariff policy. So, what do we think is ahead for the economy in China off the back of all of this?

Jan Hatzius: Yes, that is the main focus at the moment. We've seen in total 145 percentage point increase in US tariffs on China. China has retaliated 125. So, that's the latest. Obviously, the situation is very in flux.

What we have done with our China forecasters, two things, we have put in more stimulus, in particular another 20 basis point cut in the policy rates. So, it's now 60 basis points. We've put in more fiscal. Bigger, augment fiscal deficit. Additional property easing. But nevertheless, we've cut our GDP growth forecast as well. So, we went from 4.5 to 4 percent for this year. And then from 4 to 3.5 percent

for next year because it will be hard to offset all of this.

However, there are also some very big questions. Of course, we don't know how long this phase of the US/China trade war really lasts. And that depends on how much pain is there in China, how much pain is there in the US. What's the pressure for settlement? At the moment, it doesn't look like it's very close. But that could, of course, change.

Number two, I think there are levers that could be taken to reduce the pain. Exceptions for particular product categories or potentially more tolerance for effectively rerouting trade and being a bit more relaxed about rules of origin, which is a similar kind of thing where the headline tariff rates might continue to be very high. But the impact of those headline tariff rates might be a little bit lower.

So, it's a fluid situation. China is definitely under pressure here. Right now, it doesn't look like they're really willing to give way. And yeah, they're going to be suffering in terms of a hit to economic growth. And the US is as well.

We've made bigger downward revisions to the US than to China. That continues to be true even after this latest

round of revisions. But we will see how the Chinese economy holds up.

Allison Nathan: Are there any economies that actually look well positioned given all this news?

Jan Hatzius: My basic answer would be probably not many. Because I think it's very much a negative sum game. And if it's a negative sum game, you're going to have a lot more losers than winners. Trade is positive sum. Economic exchange, in general, is positive sum. That's why people engage in transactions. But this is a negative sum game. And I actually just looked at the GDP forecast changes that we've made over the last four weeks. So, out of around 25 of the biggest economies that we forecast, we've had, I think, 21 or 22 countries cutting growth forecasts for this year. And then we've had a very small number unchanged. Very volatile EM economies like Brazil, Turkey, Russia. And then we had one increase for Argentina, which again, is a very volatile economy.

So, basically, we are seeing losers. And the degree of cuts differs a lot. But there have been downward revisions in the vast majority of economies that we cover.

Allison Nathan: Interesting. Dom, you mentioned this briefly, but before we conclude, I do want to dig a little bit more into the dollar because it has been a very surprising move. We expected coming into any extreme tariff scenario, that would be good for the dollar. But obviously, we've seen the absolute opposite. So, why is that? And basically, this narrative that the dollar is stronger, is that dead?

Dominic Wilson: Yeah, look, it's been a big shift here, both what the markets are doing and our own views on that. Last year and early this year, as you said, the conventional story, but also the way the market reacted to tariff news was pretty consistent. The dollar went up, generally speaking, when you saw kind of increased tariff risk or increased tariff proposals. And that is sort of the conventional way in which, at least without sort of significant retaliation, you would expect currencies to move on those tariffs' announcements.

I think that had already started to shift ahead of this. We started to see signs that it was shifting late January, early February already in the Canada/Mexico tariff episodes. And I think in the initial phase are reflective of two things. I

think one is realization that there would be retaliation. That this is sort of a two-sided story. But I think a lot of it was also growing concern about the frugality of the US economic performance. Signs that US growth was softening. And signs that the uncertainty around policy on top of that was creating unique risks for US growth.

And I think what we've seen is that narrative has only grown since then. As Jan said, we're cutting our US forecast now more than we're cutting our China growth forecast. That in itself is an indication that we see a kind of very different set of risks from the sort of 2018/2019 trade story for instance where we would have said that the damage for China was going to be meaningfully worse than the damage for the US economy.

And I think beyond that, the bigger issue and the one that's emerged which we touched on is that you've had a larger of overweight build in US assets. Lots of kind of outperformance of the US over a long period of time. So, foreign investors, very exposed to the US economy. The dollar's been strong. They've generally not felt they needed to hedge that exposure.

And now people, they were starting to question that allocation a little earlier in the year just on kind of relative economic performance and better news out of Europe and China and some softer news out of the US. But what you've added on top of that is a lot of uncertainty about what the policy environment's going to look like here, the institutional environment, and foreign investors, I think, have become a lot more nervous about the extent of that allocation and that overweight that they have for the US. We definitely have seen a sharp increase in questions from people about the risks to that position.

And I think when you go through an episode like the one we've just gone through over the last couple of weeks, it just heightens those risks. To see treasuries sell off in this environment. To see an episode where equities are down and dollar is weakening, which for an unhedged foreign investor, is a sort of double whammy that you're not used to seeing that frequently. Those are just going to kind of confirm the notion that these exposures and these risk exposures that people are carrying are uncomfortable for them.

And so, I think what you are seeing at some high level is

the beginning of a shift in just preferences for US assets overall relative to where we've been on the basis of some of these moves. And I think that is probably going to continue.

We as a team, our FX team shifted their forecast view pretty substantially recently. And the forecast is now for kind of extended dollar weakness through the course of the year. I think there's some self-fulfilling element to that that the more that is reinforced by the way the market behaves, the more people, as I said, are going to kind of question the exposures that they already have. And given where we've come from, there's probably quite a lot of room for that process still to run.

I think it's a little harder if you look at the mix of currencies, cyclical and risky currencies in an environment like this, it's hard for the dollar to weaken a lot against that group. But if you think of the core group: euro, yen, Swiss franc, maybe even sterling, the kind of core G10 alternatives, I think there's room for that reversal and that appreciation against the dollar that we've been seeing to continue. And we're seeing one of the interesting things with this pause is that we've, again, we've had reversals to

some degree in some assets, but the dollar weakening trend has continued through all of this.

Allison Nathan: So, let me just conclude by asking you both what you're watching from here. Jan?

Jan Hatzius: I mean, I think a lot of the markets issues that Dom just talked about are very much top of mind. And not just for investors, but also in terms of processing how the economy is going to get through this because in the past if you look at significant periods of volatility and downturns, there was always a lot of room for US policymakers to ease aggressively because they were able to rely on the safe haven status of the US dollar and US treasuries. If that's no longer true to the same degree, then that could also constrain their room to some degree. So, I think this is a really first order economic issue as well.

I think in terms of tariff policy, the focus is really going to be on what happens between the US and China. I think on other things, yeah, there are negotiations going on. But that's not quite as urgent, probably. There's also the question of, again, how much are these tariffs, extremely high tariff rates on China, really going to bite around

exemptions and potential rerouting?

And then otherwise we're going to be more focused on the data. The first order, first-time data releases are probably still not that useful. We had some good inflation releases this week. Didn't really matter. Last week's employment report didn't really matter. Next week's retail sales report probably won't really matter because it's going to be distorted potentially by pre-buying. So, the things to focus on are probably some of the surveys. We've seen huge declines in expectations. Current conditions, both businesses and consumers, still look okay. So, we're going to have to see whether that changes. We'll be focused on the weekly jobless claims numbers. I would say so far, we haven't really seen any significant signs of increases in layoff activity, either in the claims numbers or in higher frequency measures like announced layoffs.

We've seen the DOGE layoffs in the federal government. But outside of that, there hasn't really been anything. But that would be a very important shift.

And yeah, otherwise, business confidence measures. And hard economic activity to the extent we can get something

very timely. But it'll be probably similarly busy as it has been. But the focus might shift a little bit more to the consequences.

Allison Nathan: Dom?

Dominic Wilson: I was going to say, we're going to be watching Jan. And I mean that somewhat flippantly. But I do think, like I said, the process that we're going through as a team is a lot of it is where are the economic outcomes? Where do Jan and the team think the economic outcomes? How they think that's evolving. And we're looking at the pricing of that in the market. And that process, I think, is going to be over the next couple of months.

The things that Jan said I think in terms of watching things, obviously China/US tariffs and this kind of recession watch in the data seems like that's going to be the most critical element of that.

On the market side specifically, the one new thing which is something you never want to be doing but always have to when these huge shifts take place is we're watching for measures of market stress. For the first time, again, really

since COVID, looking at measures of funding stress. Measures of liquidity stress. And just trying to keep an eye on the notion of whether there are secondary effects and signs as we started to see a little bit in the treasury market earlier this week that markets are not functioning properly.

Overall, outside that kind of treasury pocket, mostly this has been a story of illiquid markets rather than dysfunction markets. But I think the risks have risen and we're going to be keeping a much closer eye on that than we have done for several years now.

Allison Nathan: Jan, Dom, thanks so much for joining me today. I look forward to continuing this conversation. There's going to be a lot to talk about.

Jan Hatzius: Thank you.

Dominic Wilson: Thank you. No doubt.

Allison Nathan: This episode of was recorded on Friday, April 11th, 2025. I'm Allison Nathan.

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