Goldman Sachs The Markets

"Long stocks, short bonds"

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Chris Hussey: The Fed does nothing. Rates remain high. And uncertainty abounds. What in the Earth does this mean for investors? This is The Markets. I'm Chris Hussey. And today is Thursday, May 8th. And we're coming to you from Goldman Sachs's trading floor where I have with me Anshul Sehgal, who is Co-Head of Fixed Income Currency and Commodities for Global Banking & Markets. Anshul, great to have you with us.

Anshul Sehgal: Thank you for having me.

Chris Hussey: Okay, let's start with tariffs actually, because you were last with us three months ago. And at that time, tariffs were looming. But now, tariffs are more than looming. How are you handicapping tariffs in the economy.

Anshul Sehgal: It's a loaded question. It's difficult. Some have called it the most beautiful word in the English dictionary. But essentially, the problem for markets is you have tariffs, but to what end? If it is to balance international trade, then that comes with consequences that are hard to handicap right now.

To take an example, let's say a US company buys lumber from Canada, year after year. Over the course of, say a decade, they buy lumber every year from Canada. But they use that lumber to build houses in the United States. So, over the course of a decade, the US corporate would have run a deficit against Canada, which is what the US runs as of today. But they would have added a lot more value within US borders by building houses with that lumber.

In fact, if you look at it over the last 20 years, that's exactly what's happened. The US net investment position has grown by 20 trillion. So, foreigners own $ 20 trillion worth of the United States. But domestic wealth in the United States has grown by 120 trillion. So, as a consequence, net-net, US households have gotten wealthier by a factor of four as compared to what the foreigners have gotten wealthier by. Is that a bad trade off for the United States? I don't think it necessarily is. The easiest way to reverse course on balance of trade is to basically make the US economy grow at a much lower pace, make it much weaker. In which case you would balance international trade. But it comes at a very punitive cost.

Chris Hussey: And maybe a cost you really don't want to incur.

Anshul Sehgal: That would be the assertion, yes.

Chris Hussey: All right. So, let's shift to the Fed because that's a big part of this calculus. And on Wednesday, the Fed did nothing. So, are they just stuck in the same situation we are, having to sit on our hands waiting for this uncertainty to be unwound?

Anshul Sehgal: Very much so. Like tariffs, again, inflationary shock to the economy. Some have compared it to the oil shocks in the '70s. Some have compared it to the COVID shock from four years ago. But it is an inflationary shock. And at the same time, it is negative for domestic growth.

So, if you're in a stagflationary world, the Fed doesn't really know what to do. And also, like, this is not legislation that's been passed through Congress. This is just the administration's executive orders. So, it can be unwound rather quickly as well should the administration want to do that. So, you end up in a place where the Fed has more of a hazard to acting too quickly. And it's almost easier for them to wait this out, see where this goes. And if the domestic labor market does indeed slow, I have full confidence, and Powell said this before, that they would prioritize that over the inflationary shock. The thinking goes that even if you do have an inflationary shock, if the labor market slows down, inflation will come down in the ensuing months.

So, I fully expect the Fed to cut. The market, at the depth of this last month, was pricing a little over four cuts. This year, right now the market's pricing a little under three cuts. So, the market on that is like the Fed has to cut twice. They said this even before the tariff thing started. So, how much more do they need to cut because of this growth shock from tariffs?

I think the market's fairly reasonable and fairly comfortable with the idea of three cuts this year. We'll see where it ends up. But right now, I think the Fed's in a good place. This is not their fight. They should sit it out. By mid year, maybe the June data that you get in July, we will have some clarity in terms of the impact of these tariffs on the domestic economy.

Chris Hussey: So, that's what we're having to wait for. We have to wait for the growth shock. And you don't see it comes around till June/July?

Anshul Sehgal: At the earliest, I think it's going to be the June data that you get in July. There's also the DOGE shock. We still have to handicap that. There's just a whole host of things that are going on. We haven't even seen tariffs that other countries have imposed on the United States. So, the combination of those things, earliest I'd say, June data in July. It could be as late as October.

The issue is, like, the Trump Administration is actually spending a lot more than the Biden Administration was. So, on the one side you've got about $300 billion annualized tariffs, or 1 percent of GDP which they're collecting as a tax. On the other side, they're spending about that much more. It's going to defense. It's going for

VA spending. It's going for Social Security spending. All of these are up double digits and percentage points.

So, net-net, are they actually impeding growth in the domestic economy? It really depends on the distribution of who they're taxing and who they're giving money to. Only time will tell. Domestic households are still flush with savings, not as much as they were, say two years ago. So, they have a buffer. They can work through it.

The really dire scenario is the tail for the markets is, you get people losing jobs. And then house prices start coming down. Once that is in motion, it doesn't matter whether it started out because of tariffs or some other reason. It's very, very difficult for the Fed to unwind that because they don't really have the tools to unwind it. Even if tariffs go away, once house prices start going down, inventories start building, it just takes time. And that's a very, very painful deleveraging. So, you hope you don't get there. But it's definitely possible.

Chris Hussey: All right. Let me go back to one other thing you said earlier which is that, you know, foreigners have taken $20 trillion out of the country with that imbalance over the last, you know, 20 years or so. That's the US exceptionalism though that people are worried could get unwound here. Talk to us a little bit about that US exceptionalism because we've seen the weaker dollar. We've seen Europe stocks outperform the US. Are we on the cusp of a structural shift in investing as well?

Anshul Sehgal: That's very much possible. Obviously, if you look at FX markets, the dollar has weakened about 10 to 12 percent. The US exceptionalism trade was predicated on the US fiscal expansion. So, if the US government's fiscally expanding by $2 trillion every year, some quantum of that stays within the country. Some quantum of it goes to foreigners. And that is how the US had had a trade deficit for 40 years at this point in time.

And as a consequence of that trade deficit, foreigners leave their wealth denominated in dollars, whether it's corporate credit, S&P, hard assets domestically. Now at this point in time, if you're a foreign investor, you still want to own those assets because the US government's still spending $2 trillion in excess of what they're collecting every year. Those assets ought to, over long enough horizons, keep going up in nominal value.

But do you really want to take the FX risk embedded in that trade? You don't. So, essentially what we're seeing a lot of our clients do, and I think this is not going to reverse course, is they're hedging the FX exposure of owning these US assets. Which in the long run increases the cost of capital for US corporates. So, it does erode some of that US exceptionalism. But this is still early innings. You can recover from this. Only time will tell. My expectation would be that that train where hedge their FX exposure continues.

Chris Hussey: Okay, so let's put a bow around all this. What's your favorite trade here?

Anshul Sehgal: Long stocks, short bonds. So, the US government's still fiscally expanding at $2 trillion or 7 to 8 percent of GDP every year. Stocks are the main beneficiary of that. It's a nominal asset. It is inflation protected. In the long run, I still expect stocks to do well for that reason. The US government, at seven to eight percent of GDP, is fiscally expanding at a much higher pace than any other developed market domain out there.

And in terms of being short duration, it's long-term unsustainable for the US government to be spending the way it is. Necessarily, the cost of funding that debt will grow over time. So, long stocks, short bonds.

Chris Hussey: Yeah. It's a great point. You may get GDP slowing, but inflation rising. And so, the nominal--

Anshul Sehgal: Nominal. Exactly.

Chris Hussey: Could still be growing. And of course, the S&P is a nominal asset.

Anshul Sehgal: That's right.

Chris Hussey: All right, what are you watching for next week and after that?

Anshul Sehgal: Next week we've got CPI. Very important. Last print was weak. But again, people are looking for early impacts of tariffs there. There's just so much going on. It's like our trading horizon used to be six months in terms of any position we take. And now we're down to, like, maybe two hours. So, that's where we find ourselves.

Chris Hussey: Welcome to the world of uncertainty.

Anshul Sehgal: That's right.

Chris Hussey: Anshul, thanks so much for joining us.

Anshul Sehgal: Thank you for having me.

Chris Hussey: That does it for this week's episode of The Markets. I'm Chris Hussey, thanks for listening.

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