Fed Unfiltered, Transcript
2/25/22 - Loretta Mester, Interview: Barron's Live

Speaker 1:

Speaker 2:

This is Barron's Live. Each weekday, we bring you live conversations from our newsrooms about what's moving the market right now. On this podcast, we take you inside those conversations, the stories, the ideas and the stocks to watch, so you can invest smarter. Now, let's dial in.

Lisa Beilfuss:

Hello, everyone. Welcome to Barron's Live. I'm Lisa Beilfuss, writer at Barron's. Thanks for joining us today. With us, we have Loretta Mester, President and Chief Executive Officer of the Federal Reserve Bank of Cleveland. Welcome, Loretta.

Loretta Mester:

Thank you very much, Lisa. Glad to be here.

Lisa Beilfuss:

So, let's start off with geopolitics. I know that one question so many investors and listeners have right now is, what do you think about the potential implications on the US economy from Russia's incursion into Ukraine?

Loretta Mester:

Well, it's really too soon to actually have an assessment of what the implications are going to be. It's a developing story, if you will. Your heart goes out to the people who are having to endure that. But the right way to think about this is, what are the implications for the US economy? Until more is known about how widespread the event will be, it's going to be hard to assess that. But we do know a few things. One, it's an upside risk to inflation. We've already seen oil prices move up a lot. Yesterday, they moved a little bit back down.

Loretta Mester:

Today, we've seen commodity prices being affected. Then it's also in the near term, a downside risk to growth because of the uncertainty that it entails. So, there's always risks around the outlook. Geopolitical risks that are unfolding now are another risk to the outlook. I haven't changed my modal view of the US economy this year, which is that I think the expansion will continue at a good pace, but it's still a developing story and we're going to have to wait and see what the scope of the invasion is and what plays out.

Lisa Beilfuss:

You mentioned upside risks to growth and downside... I'm sorry. I reversed that. Upside risks to inflation and downside risks to growth, and the Fed has the tough job of balancing those two things. How do you think about it now, these balance of risks, as we're already in this heightened inflation period, going into the March meeting where the Fed is largely expected to begin tightening policy?

Loretta Mester:

So, right now the economy, both on the inflation side and the growth side and the employment side, we have a dual mandate, maximum employment and price bill. They're all pointing in the same direction. Growth last year was five and a half percent, its highest level since 1984. Employment is moving at a very good pace, 550,000 jobs per month. Omicron didn't really slow down employment growth, even though many of us thought that we might see that, you didn't see that. The November and December numbers were revised up even, in terms of employment growth. So, labor markets are very strong. By many measures, they're tight. Growth is very strong, and this imbalance between supply and demand has led to very high inflation reading.

Loretta Mester:

So, all of those conditions really point to the fact that we have a very strong economy, and for a monetary policy maker it means that we really need to be removing that emergency level of accommodation that was very much needed early in the pandemic, but is not needed now. Our job at the Fed really right now is to reset monetary policy, recalibrate it to the challenges that are in the economy now. To do so remove accommodation at a pace necessary to bring inflation under control. At the same time, making sure that we sustain the expansion and economic activity in healthy labor markets. That's really what the key thing that the Fed will be doing going forward, including the decision at the March meeting and beyond.

Lisa Beilfuss:

Some of your colleagues have been expressing diverging views about how to go about starting this process. I think it was late last week, John Williams said that policy normalization should begin with half point increases for starters. Then Christopher Waller and James Bullard have said that they would like, I think... I'm sorry. A quarter point increase from Williams, and then half point expressed by Waller and Bullard. Now we've got the Ukraine uncertainty that you mentioned, where do you stand on the size of rate liftoff in March? Also, how important is it for the Fed to have some agreement among the committee members as you start this process?

Loretta Mester:

Yeah. I mean, I think there's more agreement here than maybe the way it's being reported, as 25 versus 50. I think the important message is, there's very much agreement that we need to start removing accommodation, and we need to start it in March. It's not going to just be one rate increase, whether it be 25 or 50, it's that we really need to have a series of moves to take back some of that extraordinary amount of accommodation that was needed early in the pandemic. Now, I'm on record as saying that I think that the case for 50, even before the events in Ukraine, really didn't necessarily mean 50 was the right way to start. I always think that you can start with 25, because even if the markets are expecting a move and shift in policy, there's always some reaction to the first move. But it's not going to just be one move.

Loretta Mester:

I think we should follow with a series of moves, after that March increase. So, in coming months, we're going to need to move the policy rate up again. At each meeting, we'll determine what the appropriate size of that move is. But then, it's all going to be driven by how the economy evolves. My forecast, and my modal forecast for inflation, is that we will see some improvement in inflation in the second half of this year. Partly because some of that imbalance between supply and demand will be less imbalanced.

So, some of the supply constraints that we're seeing in product markets, I think given the information we're getting from our district contacts, and also from national contacts, is that they're easing a bit. They're still in place, but there is some signs of improvement. So, my expectation is that inflation will come back down. But that's incumbent of the Fed actually taking the actions to remove accommodations.

Loretta Mester:

So, all those things in play, we're going to have to see how the economy actually evolves on the second half of the year. If you learned anything from last year, is that the economy can evolve differently than expected. At the beginning of last year, if you looked at the projections from FOMC members, go back to December, 2021. Look at those SEPs, that's the forecast that we put out, each participant puts out. We weren't expecting inflation to move up as it did last year. Inflation is very high, very above 2%. The last CPI report was seven plus percent increase. The PCE inflation measure came out today, and the January to January increase was over 5%. So, those numbers started increasing last year, and that's when the Feds started recognizing that this is something that is much higher than anticipated at the beginning of the year. You've seen that the Fed has changed its policy stance, and it's already began taking some moves towards removing accommodation.

Lisa Beilfuss:

You mentioned market expectations, and some of those expectations, at least as priced in the Fed Fund's Futures Market have fallen back a little bit, given the development with Ukraine. But markets are seeing somewhere between 1.5, 1.75 percentage points in tightening this year. That still is more aggressive than the Fed, at least according to the last summary of economic projections that you mentioned, I know we'll be getting an updated one soon. But how do you square this big difference between what markets expect, some Wall Street banks calling for say nine quarter point hikes this year? What's the reality between those expectations? You mentioned the hot PCE number today. I think it was again, above 5%. 14th straight monthly increase. How do you square all that with the concerns out there that the economy is slowing from lofty levels, as it was always going to, but that your job is trickier now to avoid a recession?

Loretta Mester:

So, we will have a new summary of economic projections coming out at the March meeting, so we're all right now in the process of putting together those projections that we'll be submitting. I don't see that there's that much difference between the market and the Fed. In fact, the Fed communications around are pivoting, in the fall last year, I think was well communicated to the markets. You saw the markets reacting when the Fed was in the midst of explaining that we really now need to be removing the accommodation. How many rate increases can you pencil in? The way I look at it is, I know that I support moving up in March, even with the uncertainties entailed with Ukraine, and I support more rate increases in coming months, after the March meeting. If we get to the second half of the year, we're going to be looking at how the economy's evolving.

Loretta Mester:

If it turns out that inflation isn't moving down the way I expect it to, then we would have to quicken the pace of removing accommodation. If it turns out that inflation comes down more than I thought, then we might be able to remove accommodation at a slower pace in the second half of the year. So, I think we've got to really be looking at... Be forward looking, and also be looking at the data and where it's pointing. So, the implications of the data for the median run outlook, and the risk around the outlook, are what's going to drive the pace of accommodation. You're right. You have to look at, okay. What's the situation and geopolitical situation mean for the US economy over the median run? That's going to be part of the consideration too. But at the moment, the main consideration here is making sure we get inflation under control, while we sustain a healthy economy and healthy labor markets. That's what we're going to be focused on at the Federal Reserve.

Lisa Beilfuss:

Just a quick reminder to our listeners to please submit any questions that you have for Loretta into the Q&A box so I can ask her. On that note, we've got one from Dave that fits in with what we were just discussing. Dave asks, in your opinion, what should the Fed's neutral rate be?

Loretta Mester:

In terms of the long run Fed Funds rate? Yeah. So, I have two and a half, and that's, I think, the median now in the SEP, although we'll have to wait until March to see if those numbers change. So, that's where I am, in terms of the nominal long run Fed Funds rate. But one thing to keep in mind about all these estimates of long run interest rates is that there's a lot of [inaudible 00:13:18] large confidence spans around those. The other important point, which was also what drove the FMOC to revise the framework for setting policy is that, if you look over time, that neutral rate has come down, and come down quite a bit. So, I'm at two and a half, and I think that's basically where the median SCP participant is as well.

Lisa Beilfuss:

Is that really enough do you think, to bring inflation down from current levels? I know the Fed likes to focus on the core PCE, which is running a little bit lower than the CPI. But the latest CPI report showed 7.5% annual rate. When you look at the meat of the report, the details look worse to me, because you look at the double digit increases in basic food supplies, like flour and meat. You look at a 40% year over year increase in fuel. These are things that are hitting a lot of households, a lot of small businesses. Is a 2.5% neutral rate enough to bring inflation back down to the Fed's normal 2% target? Or are we looking at a trade off here? A much longer period of something that is above 2%.

Loretta Mester:

It's a really good question, and I think that's what we're going to be calibrating as we go forward. The first thing that we're doing is of course moving away from that very, very large amount of accommodation that was needed earlier in the pandemic. So, that's what the process we're on now. I think my own view is that over time, it's going to be a process, we may very well have to bring the funds rate above my long run level. But it's not going to be immediate, that's well out in the path. May not even be next year we need that.

Loretta Mester:

So, again, we have to be cognizant of the fact that we've got to look at how the economy is evolving, and what's happening to the economy with respect to both maximum employment and inflation. But I think we have to be willing to say, we're going to do what it's going to take to bring inflation under control, and to sustain the economy. I'm optimistic that we're going to be able to do that. I think the first step is what's going to happen in March, with this rise in the Fed Funds rate, and then subsequent rises as we go forward.

Lisa Beilfuss:

So, here's a question from John that connects to some of this. He asks if you can explain in layperson language, why the Fed continues to purchase mortgage backed securities. As we are heading into tightening, the Fed hasn't fully finished the taper. He says he has heard criticism of the Fed for continuing the purchases in the past few months, and injecting unnecessary liquidity into the housing market.

Loretta Mester:

I mean, it's an excellent question, and I think that that's something that different people can have different views about. Going back to when we started purchasing assets, and remember, it was treasuries and mortgage backed security, the rationale for the initial purposes was because the financial markets were very disrupted at the beginning of the pandemic, if you all recall. So, we went into the markets pretty aggressively to make sure that the financial markets, that very important treasury market, continued to operate, because having that market melt down in the midst of a pandemic would've been a horrible situation, for the whole economy. Not only in the US, but for the global economy. There's a big tie between the mortgage backed security market and the treasury market, so the decision was to purchase both of those assets. Then as time went on and the pandemic went on, those purchases were supporting the economy.

Loretta Mester:

The Fed Funds rate had been brought to zero and we continued to purchase assets. The amount of purchases once... We announced in September of last year, that it would soon be time to begin tapering those asset purchases. Then, in November, the next meeting, we began tapering. Then in December we actually increased the pace of the taper. So, then the question would've been, well, why don't we just end it? I think one of the guiding principles of this whole thing with the asset purchases has always been to communicate well in advance what we were doing. So, what happened at our meeting, the last meeting, was that we announced they're going to be done in March. I think that was where the committee came out as that was the better decision there, rather than halting them without giving that notice earlier. So, that was basically the decision. But the questioner is right in the sense that it is a little bit... We're pivoting. But the amount that we were buying at that point was small, in terms of the impact on the economy. So, that's where the committee came out.

Lisa Beilfuss:

That all ties into a question of my own, which is, we know that market functionality and asset prices is not an explicit mandate of the Feds, but we know how important it is to overall functioning of the economy. In the past, the Fed has paid attention to the types of tantrums that the market will throw, when certain policies are announced. I wonder, this time around a lot of pundits discuss the so-called Fed-put and the expectation by investors that if things get bad enough, the Fed might pull back or slow easing, something like that. I wonder what you think this time around, given where inflation is, yet given how much more leveraged the markets are, and households are connected to the gains in the stock market and the housing market and all that. I wonder your thoughts on how deeply connected Fed policy has maybe become to the financial markets and the housing market, and if you're concerned about that.

Loretta Mester:

So, we have a dual mandate for monetary policy, which is price, stability and maximum employment. The way monetary policy works, it transmits through the economy through broad financial conditions. So, when we look at what the impact of policy is in order to calibrate our policy settings to where the economy is and where it's going, those financial conditions are an important part of what's happening in the economy, and where our policy is relative to where it should be. But it's broad, in terms of broad financial conditions, not one particular market or another particular market. That said, we also want to make sure that we have financial stability, because you're not going to be able to meet your monetary policy goals if you don't have stable financial markets. Well functioning financial markets. As I mentioned, we went in and bought a lot of assets at the beginning of the pandemic, because the markets were very dysfunctional.

Loretta Mester:

But that was an emergency situation. Right now, if you look at the financial stability report that the board of governors puts out, and the analysis that's done around the reserve banks is, it seems like financial markets are... There's pockets of focused... Real estate prices are high, relatively elevated, relative to history. But overall, the financial markets and the financial system appears to be stable, and banks are well capitalized. So, that's not top of mind in terms of, will it prevent us for doing what we have to do in order to meet our monetary policy goals? But I do think we always have to be watching, to make sure that the markets are well functioning, because that's the way our monetary policy transmits to the real economy.

Lisa Beilfuss:

So, I think there's a question from Lee, that I think is a good segue. He asks if investors should be alarmed at the size of the quantitative easing that took place in response to the pandemic. He's specifically asking about mortgage backed securities, and it seems like that's a good question to get into the other part of this tightening cycle we're about to enter, which is what the Fed chooses to do with its balance sheet, that has obviously exploded, doubled since the beginning of the pandemic. It's now about 40% of GDP. It seems like there are a lot more questions and answers about how that part of the tightening cycle will be conducted, and what it means for markets in the economy. Can you discuss what you think should happen with the balance sheet?

Loretta Mester:

So, yes. You're right. The balance sheet is almost $9 trillion in assets now, because of what we needed to do, both to make the markets function early in the pandemic and then to support the economy later in the pandemic. We've announced that those asset purchases are going to end in March. We're still, as a committee, discussing what the right way of going about reducing the balance sheet. But in January we released principles that will really guide that significant reduction. One of the important things about those principles is that it reiterates that the Fed Funds rate, the interest rate is our main policy tool, and that the balance sheet, what we're planning to do with that is come up with a plan. It'll be well announced so that everyone knows what the plan is, that will reduce that balance sheet. My own view is that we should start sooner rather than later, and start to do that soon.

Loretta Mester:

I also think that given the strength of the economy, and the size of the balance sheet and the high inflation readings, I think we can go much faster than we did last time to reduce the balance sheet. If you recall, last time after the Great Recession, when our balance sheet also... We did add assets during that and bought assets during that episode. We began reducing the balance sheet, but not very close to when liftoff was. We waited almost two years after liftoff before we began reducing the balance sheet. Then the funds rate had already gotten up to one, to one and a quarter percent. Then it took two years, almost two years to reduce it. I think we can go considerably faster this time because the economy is just in such a different place now. Inflation is much higher. Balance sheet is much larger.

Loretta Mester:

We have reverse repo and repo facilities that will help us make sure that markets function, and that we can reduce the size of the balance sheet. So, again, the last time we did it was the first time we really did a significant reduction. So, as the Fed is, we're cautious, it's like a Hippocratic oath. You don't want to do more harm with your own actions. This time we have that experience, but the economy is in such a different place that I think my own view is we should start soon, and we should go at a faster pace than we did last time. But again, it'll run in the background where the Fed Funds rate will be the main tool that we use to calibrate policy.

Lisa Beilfuss:

So, two questions on that. First, can you be more specific around starting sooner and going faster? When? Can you give us a month even? Or can you give us a dollar amount that you would like to set the pace at?

Loretta Mester:

Yeah. So, I think what we've been also announced in those principles is that it's mainly through runoff. In other words, when assets mature, or prepay and the mortgage backed securities will allow that to happen. Last time we had some limits, we put some limits on how much we'd allow to run off in last month. That's the kind of details that we're working through right now, as a committee. So, we haven't made any determination of what that plan would be, so I can't tell you exactly when it'll start, because that hasn't been determined, nor the pace. But I do think that we can go faster now, and it behooves us to go faster because of where the economy is, and how different it looks now than before. The last time we started reducing the balance sheet, inflation was still below our target. Now it's well above our target.

Loretta Mester:

So, this reducing the balance sheet will help reduce accommodation. It's going to be happening while we're increasing the funds rate. So, I can't give you any details on when, or by how much. But I do think that, as the principals say, a significant reduction. My own view is that over time, as the process gets underway, and at some point during the process, I'd be supportive of selling some of those mortgage backed securities. We did not sell any last time. It was all held through runoff. But this time it's important to get back to primarily treasuries in our portfolio, because we really don't want to be allocating credit to different sectors. I think this time I would support selling some of that portfolio. But not immediately. I think we let the process run for a while, and then we consider whether we should sell some of those assets.

Lisa Beilfuss:

So, the idea of potentially selling some mortgage backed securities alongside the desire for balance sheet runoff to happen in the background. I remember when Janet Yellen led the Fed, she expressed a similar desire. I think she used the term, it would be like watching paint dry, when the quantitative tightening happened, and it wasn't. I appreciate what you said. There are new facilities in place that are meant to prevent some of the chaos that happened last time. But I wonder, given the Fed's footprint, if the Fed owns roughly a third of both the treasury and the mortgage backed securities markets at this point, how do you let it run in the background? Especially if we're talking about potentially and eventually conducting sales, which I think that would be a big deal for markets. No?

Loretta Mester:

Yeah. So, your point is well taken, and that's why it's very important that whatever we do, we announce it, and we announce it in advance of the action, so that the markets have an idea of what's coming. So, again, my support of selling some of the portfolio would not be happening at the start of this process. We get the balance sheet starting to runoff first, and then consider whether it's appropriate to sell some of that portfolio, because we do want to get back to a balance sheet that's primary treasuries. One difference this time versus last time that also will affect things is that, the maturity structure of our treasury portfolio is shorter than it was last time. The last time when we did QE, after the Great Recession, we were buying long run, longer term maturity treasuries. This time we were buying across the spectrum.

Loretta Mester:

So, I think that also comes into play. That's exactly the kind of discussion we'll have in the committee, of what are those trade offs, and what's the appropriate speed. But running in the background doesn't necessarily mean we wouldn't change the plan as we go forward, depending on what's happening in the economy. What it means is, we'll announce a plan when the time comes of what it is, and then we may change and allow more runoff later on, as we feel the economy and the financial markets can handle it. But again, we'd announced it in advance. So, running in the background doesn't necessarily mean not talking about it or not announcing it. It really means being very deliberate in telling the markets, this is what the plan is, and having it being done systematically so that everyone can adjust to what we're planning to do with our portfolio. But again, just as we are with the funds rate, we've got to be willing to observe conditions in the real economy with inflation and with financial markets, to make sure that we're setting that runoff plan appropriately, given what's happening in the economy as well.

Lisa Beilfuss:

We have a question from Doug. He asks, with all of this said, and with these plans being formed, what do you think will happen with the housing market? Housing prices have obviously really boomed since the beginning of the pandemic, in part because of the Fed's purchases. But also because of just some pandemic factors, people moving, things like that, from cities. What happens to this market? What happens to the gains? Does the housing market give back some of these gains, do prices slow? Does affordability become better?

Loretta Mester:

So, it's a good question because you're exactly right. The pandemic and people's preferences for where they live changed quite a bit. We were just talking about that before the show started. So, what's happening in the housing market, and also related to the pandemic, is the supply has not kept up with demand. So, some of the increase, and I would say a lot of the increase in house prices, is demand for different types of housing than before. Also the constraints on supply. So, there's a lot of building going on, especially in the rental market, to try to increase the housing stock. That's putting upward pressure on prices. Just as it's true in product markets. Some of that will be, I think, this year, as supplies of materials for building ease up. So, some of that price change in the housing market, that'll probably beat down, moving down as well. Although they'll still probably be elevated, just because there's a lot of demand for different types of housing than before.

Loretta Mester:

When you say about the housing market, what they say, location, location, location. I think that's also applies to this. There's the rental market. There's the market for, I guess, commercial. But for residents, older Americans, so some of that there wasn't demand for that when COVID hit, because people were loathed to go into those, given the impact of COVID on some of the nursing homes and the retirement homes. So, again, the market's going to play this out, and we're going to see how it evolves, and we're going to see how demand evolves. But right now, supply is constrained and that's putting a lot of upper pressure on the prices.

Lisa Beilfuss:

I think we have time for one more reader, or I should say listener, question. Here's one from Scott. He's asking if you can address how concerned you are about the market's increased attention to 70's style stagflation, are you concerned about stagflation?

Loretta Mester:

Well, it's always something that's in your mind, you want to avoid that situation. The economy is just very strong right now, in terms of employment growth, in terms of economic activity. So, we're not in that situation. We've got a very strong economy coupled with very high inflation. So, the Fed now is focused on getting inflation under control, and at the same time, maintaining healthy labor markets and continued expansion. So, I think that's what we're focused on doing. But you have to understand that there's risk to any outlook. So, we talked earlier about the geopolitical risk, but there's other risks. We're not through the pandemic yet.

Loretta Mester:

So, that's why we know we're going to be removing accommodation. The pace at which we remove accommodation will be driven by developments in the economy, as they inform the outlook and the risk. That's going to be the challenge of the year is, how do we do that to make sure that we're maintaining a good recovery and expansion, healthy labor markets and getting inflation under control? I'm optimistic that we can do that, but it's going to take some action on the Feds part to follow through and get inflation under control.

Lisa Beilfuss:

I have one last question for you of my own. Given what you know now, would you change anything about the Fed's response to the pandemic?

Loretta Mester:

Well, I think there's going to be dissertations, many PhD dissertations written about the pandemic. Look, I think the thing to remember is at the beginning of the pandemic, and this is hard to remember because it's gone on long enough, there was incredible uncertainty about what the implications would be for the economy. At the beginning, most people thought, oh, it'll be over in a month. Then on the other hand, the financial markets were going crazy and were not functioning at all. So, that uncertainty around everything, I have to say that the combination of the strong fiscal policy actions that happened very quickly, and the monetary policy actions, got us to this point. So, given the uncertainties around things, I think we'll have to wait until those dissertations are written to do the real analysis here. But you look back at last year, and it was a very strong economy, and we got through the pandemic. Things could have been much worse, and now we have challenges this year. That inflation is a challenge, but we're committed to getting inflation under control.

Lisa Beilfuss:

Well, that is all the time we have for today. Thank you so much, Loretta, for being here.

Loretta Mester:

Thanks for having me. It's been a pleasure.

Lisa Beilfuss:

We hope you listen to our next episode on Monday. Barron's Senior Managing Editor, Lauren Rublin, and Deputy Editor, Ben Levisohn, will discuss the outlook for financial markets, industry sectors and individual stocks. Thank you for listening. Be well, and have a nice day.

Speaker 1: