Gary Siegel:

The most important topics and the most influential voices. Leaders is a forum where industry experts and innovators share their experiences and perspectives on business critical issues. This is content that drives decision making. Join the conversation today at thebondbuyer.com/leaders. Hi, and welcome to another Bond Buyer Podcast. I'm your host, Bond Buyer Managing Editor, Gary Siegel. Today we're going to discuss the Federal Open Market Committee's upcoming meeting and possible changes in leadership. My guest is Jeffrey Cleveland, Chief Economist at Payden & Rygel. Jeffrey, welcome, and thank you for joining us.

Jeffrey Cleveland:

Thanks for having me.

Gary Siegel:

At the FOMC meeting, a taper announcement is expected, even more so after Chair Powell spoke this morning and said it's time to taper.

Jeffrey Cleveland:

Yeah, I think we're on track for a taper, Gary. I think an announcement at the upcoming meeting makes sense. The asset purchase program was put in place at least initially to offset the pandemic, the emergency response. Are we still in an emergency situation? I think many would argue that we are not. The economy's been growing strongly. We have seen the unemployment rate come down from 15% to 4.8%. Emergency measures are no longer needed. Mine is well, get started rolling back the asset purchases. I think they'll progress, they will start winding down the amount that they are purchasing by about 15 billion per month. In doing so, by next summer, Gary, they could be done with the taper, and that's my current expectation.

Gary Siegel:

I think that's our plan too. They want to be done by the summer because-

Jeffrey Cleveland:

Summer vacation.

Gary Siegel:

There's a word you didn't mention in your first response, and that was inflation. I think that's becoming a bigger question and a bigger problem for them.

Jeffrey Cleveland:

Yeah. You could ask why take taper now? What's the urgency? I think it achieves some ... I don't think asset purchases are doing a whole lot at this point, Gary. That would be my takeaway. By reducing the pace of asset purchases by 15 billion per month for the next few months, I don't think that's going to have a huge impact on economic activity or inflation, in my opinion. It's like someone cutting back on sugar consumption. You could go cold turkey and stop right now, but most people don't do that. They say, "I'm going to have less cookies, a fewer cookies in the month ahead and just taper things off."

Jeffrey Cleveland:

That's what they're doing here. I don't think it's a big change. But from a public relations standpoint, when investors, when politicians are screaming at you as the central banker about inflation, by saying, "Hey, no. We're doing something. Here it is. We're going to start tapering," it achieves that. I think it's more public relations that it's going to actually have impact on inflation, Gary.

Gary Siegel:

Well, Jeffrey, in addition to public relations, they want to stop the asset purchases before they were raise rates. Now people are assuming that they're going to need to raise rates next year because inflation is higher than expected.

Jeffrey Cleveland:

Yeah. The bond market is now pricing about two rate hikes in 2022, as you know, and there is a sequencing issue here where the Fed has said they wanted to taper down, get back to pulling the balance sheet steady and then do rate hikes. This is in sharp contrast actually to what we've heard from the Bank of England, for example, who said they might initiate a lift offer, rate hike even before tapering in. The Fed has a sequencing issue here. You are correct. I'm going to go out of the limb though. I know this isn't popular right now, Gary, but I don't think they're going to hike in 2022.

Jeffrey Cleveland:

The reason for that, part of it is the sequencing. If they only in their asset purchases by next summer, I don't think there's enough time. I think they are conservative enough that they're going to want to wait at least a little bit of time, maybe three to six months to see the impact of tapering on the economy before they initiate that first rate hike. Similar to what they did last time around when they wound down their asset purchases over the course of 2014, and then they did not end up hiking, lift off didn't occur until late 2015. I think they're going to want to have some time elapse.

Jeffrey Cleveland:

We've heard from at least one hawk. I would say Raphael Bostic at the Atlanta Fed has said he didn't think rate hikes in the next year were appropriate. If that doesn't happen in the next year, that means maybe, Gary, by the end of '22 December meeting or something. But I would think that, based on our economic outlook, we think inflation will come down and that will give them time to wait a bit longer. You don't get the first rate hike until 2023 in my opinion.

Gary Siegel:

Well, you're not alone in that thinking, Jeffrey. There are others that believe that. In fact, some of the members of the Federal Open Market Committee believe that. There was some difference of opinions in last Summary of Economic Projections. Again, you never know because things change. Speaking of change, every January, the FOMC changes the voters, and there could be other issues that we'll get to later. But after this year, Barkin, Bostic, Daly and Evans are no longer voters. They're voters this year and not next year. Next year, it will be Mester, Bullard, Esther George, and whoever becomes president in Boston. Does that in any way impact how things work?

Jeffrey Cleveland:

Yeah. It sounds like you on the margin are going to have a little bit more hawkish voting contingent on the FOMC. As you noted going into this, we already had about half of the members thinking that there would be a hike in '22 and then half not. It's evenly split, in terms of all the members. But voting wise, I think you do get a bit more hawkish Fed. I think you already teed up the next topic though because a lot depends on the leadership and the Fed board, which, yeah, I don't know if you wanted to go there next, but it could get a bit more dovish.

Gary Siegel:

Right. Well, we'll get there in a bit. Let's discuss inflation and employment first. Let's finish with those. I think based on what Powell said this morning, he seems to be more concerned about inflation now than he is employment, whereas up until now they said they met their inflation target and were close on the employment mandate.

Jeffrey Cleveland:

Yeah. I think that's natural given that we're already back below 5% on the unemployment. We've made great progress there. At the same time, for most investors' clients that I talk to, friends in the market, inflation is uncomfortably high. Ask the average consumer, look what they're facing here in California at the gas pump. Inflation is a much bigger problem than it was even a couple of months ago. I think it's natural for the Fed to refocus it's rhetoric and it's talk. I still think, Gary, the critical question for us is the inflation pressures we're seeing, are they due to the pandemic? Are they supply chain driven? If the price pressures are really becoming because the supply side of the global economy is constrained, what can the Fed do about that with monetary policy?

Jeffrey Cleveland:

I submit to you there's very little they can do to change that by hiking rates. I think they could actually do damage, right? By tightening financial conditions. That would harm matters. They can't create more bust at the Port of Long Beach, they can't drum up more supplies of natural gas in the UK. There's very little they can do from a monetary policy standpoint, if it is driven by the supply side, which I think it is. I tend to come down on the side of a lot of this is supply chain woos, but it's nuanced, right? It's supply chain in the face of extraordinary demand. I think you have to step back and look. The consumer dramatically shifted how they're spending money.

Jeffrey Cleveland:

We've always been a very service-oriented economy. But if you look at spending on goods, spending on goods is 15% above trend as of the August data, Gary. We've been stuck at home. Instead of going out and getting a haircut or go having a meal, we're buying things at home and having them shipped to us. That's part of it. Also, many households got some pretty strong transfers from the federal government that boosted demand as well. You have this huge demand shift to goods away from services. At the same time, supply chain problems. Some of them are COVID-related, some of them probably pre-date COVID. But either way, that combination has driven higher prices.

Jeffrey Cleveland:

How does that fix itself or heal? I think it's going to be, as the economy reopens, people reorient their spending again back towards services. You see demand for goods abate a little bit. The fiscal transfers, as you well know, that's behind us. We don't expect ... Even in this new budget, should it get passed here sometime in the fall, we're not seeing the same type of government transfers that we saw in 2020 and early 2021. You should see demand for goods diminish somewhat, and that will help. Then talking to a lot of our big clients, global clients, they're heavily involved in shipping, in semiconductors.

Jeffrey Cleveland:

They think on a six to 12 month basis, Gary, we will get progress that will help the supply chain. Maybe in the short run though, through the end of the year and into early next year, we'll still be dealing with some shortages and problems there. Bu we should get some alleviation of the supply chain issues in the six to 12-month horizon. What does that mean? To me that means if we have this convers ... If I get invited back on your podcast after this extended rant, I don't know, [inaudible 00:11:31] But-

Gary Siegel:

Always invited back.

Jeffrey Cleveland:

Six to 12 months from now, you invite me back, I do think core measures of inflation will be lower, Gary. Now, 2% to 3% I think. We'll be in that range. Not 4% to 5%, but not zero. Not 1% to 2%, like we saw much of the last decade. We'll still have a moderate rate of inflation, but I think the Fed will be rewarded for being patient right now. That's my, I guess, takeaway message here.

Gary Siegel:

Well, Jeffrey, if you're projecting inflation of 2% to 3%, that's still above the Fed's 2% target. Although with the average inflation targeting, they will allow the economy to run hot. They haven't said how hot and for how long, and that's a big question to markets.

Jeffrey Cleveland:

Yeah. This topic irks me. I have to tell you, this might set off another rant. The Fed, they had a shortfall of their 2% target since they launched the 2% target in 2012. I don't think that's the lookback period that they had in mind. I think it's something closer to since they launched the flexible average inflation targeting regime. Maybe that's summer of 2019. That's the more appropriate lookback period. But what I wanted to point out was that they haven't been able to meet their target for some time. Now they're saying, "Hey, we've met our target." No, you haven't. I have to call them out on this, Gary.

Jeffrey Cleveland:

We had a once in 100 year pandemic which throttled global supply chains, which boosted prices in a lot of ways that we don't want as consumers, and then they're saying, "We've met our target, our mandate?" No, this has nothing ... In my min, this is very little to do with the Fed. It has more to do with COVID and the supply chain situation that we discussed. I just had to get that off my chest, Gary. I really want to challenge them on this. That being said, we don't know the lookback period. I think 2%, two and a half percent inflation is nothing worrisome or burdensome. I think markets can digest that very well and they'll be fine with it.

Jeffrey Cleveland:

I do think if we do see this drop in inflation back to that 2%, two and a half, 3% range, that forestalls the rate hikes because it's just not a worrisome thing that they need to really react to, and it will give them room to be patient and get to maximum employment. I think that's ultimately going to be the bigger question. If I'm right about my inflation view, a year from now, detention will turn back to, well, okay, maybe we don't need to respond to inflation. We have this maximum employment goal that we've set. How close are we to that? That's the question for me. I think we're pretty far away from that right now.

You can slice and dice it different ways, but probably nine million jobs shy. We need to see nine million people employed from here to get back to having a conversation of full employment or maximum employment. That's going to take more than a year, in my view.

Gary Siegel:

I speak to a lot of people, and some people say that the inflation before the pandemic couldn't be raised to 2%. Once the pandemic is gone, they're going to have the same problem. Then others say things have changed. Wages are rising because companies can't find workers. After the pandemic, we're going to be stuck with higher inflation.

Jeffrey Cleveland:

I tell you what, as a forecaster, this is very difficult question. This is not a cop-out or anything. This is just ... In the midst of just an extreme amount of noise in the data, very unusual economic data because of the pandemic, I'm very hesitant to draw long-term conclusions or say that we're on a whole new trend. I'm much more likely, as some of the people you're talking to, to go back to, okay, where were we pre-pandemic? Once the dust settles, I think we'll be back in that range. That's my bias here, Gary. We'll be back closer to 2% on inflation. We'll be back to growth that's 2%, maybe two and a half percent growth, and not some of these projections that people are making based on a lot of the noise in the data.

Jeffrey Cleveland:

Time will tell, but I'm much more on that camp. The wage growth thing is interesting. So far though, a lot of the wage growth that we are seeing, the sharp pickup is in the first decile of the wage strata or the wage cohorts or the lower income jobs. Yeah, again, a lot of that has to do with the restaurants that are having a difficult time luring people back into the labor market, perhaps. But the broader wage growth picture, if you look at the median wage track from the Atlanta Fed, we like to look at that, you're talking about 4% year-on-year wage growth, to me. Gary, that's still consistent with 2% to 3% inflation.

Jeffrey Cleveland:

We had much higher wage growth, nominal wage growth in the late 1990s, early part of the 2000s, and we still had pretty moderate inflation, as you remember then. I'm still not throwing in the towel on the moderate inflation story based some of the wage anecdotal evidence and wage data that we are seeing.

Gary Siegel:

Fair enough, Jeffrey. We're going to take a short pause and we'll hack soon. Get analysis and insights to fuel your decision making with a subscription to the Bond Buyer, the industry's most essential resource. Unmatched coverage of the municipal finance world, original research and industry rankings, access to thought leaders. Gain a professional advantage by subscribing today at bondbuyer.com/subscribe.

Gary Siegel:

We're back with Jeffrey Cleveland talking about the Federal Reserve and their upcoming meeting. This might be a good time to switch to the possible changes coming in the near future in the leadership in the Fed. Randal Quarles's term as vice chair expired recently, and he was removed as chair of the committee on supervision and regulation. A lot of people believe that he will be replaced. Richard Clarida's vice-chairmanship is up in January, and Jerome Powell's chairmanship is up in February. A lot can happen between now and February.

Jeffrey Cleveland:

Yeah. Not to mention we have an empty seat, right? On the Fed board. It hasn't been filled. It could be filled potentially. Yeah. Lots to say here, actually. First and foremost, it's very unusual, as you know, to get to this ... We're pretty late in the game here. In past, the president would've already put forth a nomination or renomination. I think Trump was pretty late first week of November. If I recall, he appointed or nominated Powell when we had the exchange of power between Yellen and Powell. Seemed to be pretty late in the game on that. The betting markets, if can point to a oracle of sorts, the betting markets, something we'd like to look at, they still have a pretty high chance of Powell being reappointed.

Jeffrey Cleveland:

That being said, this week, we've seen a notable pickup in the likelihood of Lael Brainard taking the top job. I think that's interesting. Then everyone I talk to, Gary ... You probably talk to more people than I do. You should just tell me the answer here. But every person I talk to gives me names that I would say by and large are on the more progressive end of the spectrum. They would ultimately be more focused on the employment side of the mandate at the expense a little bit of the inflation side. I think that would be true of Lael Brainard as well. More emphasis on that. Maximum employment story that I was talking about. A full and inclusive employment as being a key goal for the Fed.

Jeffrey Cleveland:

I think it's hard to say how this shakes out, but I think you end up with a more dovish Fed when all is said and done. Because we've seen in recent decades how much power reside in the Fed Board in D.C. and with these empty positions or potential changes, the folks that fill them I think would be more on the focus on the employment side of the mandate. We'll get a more dovish Fed out of that, is my read right now. I think this is the consensus though. I don't know if that's very interesting for your listeners. I apologize, but that's how we see it.

Gary Siegel:

No, Jeffrey, that's fine. Everyone's got their opinion. If they're the same opinion, there's nothing we can do about that. Yeah. It looks like Powell will be renominated, and the only alternative that has been mentioned has Brainard. It's true that the president hasn't filled that last position, and there's a lot of pressure on him apparently to bring someone more progressive onto the board. You would think that if he had nominated someone that they would be a candidate to replace Powell. But with no one named and Brainard the only option, it makes it interesting that he hasn't made a decision yet about who will be the next chair or if Powell will continue.

Jeffrey Cleveland:

Yeah. The problem here is there's just so many pending issues as we head into the fall. You have this, you have the budget reconciliation, you have potential infrastructure bill, you have potential debt ceiling crisis. All of these things perhaps could come to the fall in December, and then we still don't have a nomination or a renomination. There's a lot of potential uncertainty ahead. You know what? Earlier, I was having a conversation with a friend in New York and he was saying to me he can't ... I said, "Lael Brainard could be more dovish," he said, "How could anyone be more dovish than Jerome Powell has been?" I guess we're just talking about degrees here. It's not a huge shift.

Gary Siegel:

Yeah. It's funny because you're right, Jeffrey. Everyone thought Powell was going to be hawkish and he's been quite the dove. It's also interesting to think that if he was nominated in November, we're now in late October, a decision needs to come soon. How late can Biden make a decision and still get the nominee through Congress? Because the Senate has to approve of the pick.

Jeffrey Cleveland:

Yeah. I guess he has until end of January, early February, I believe February 5th. There is some time. But again, like I said, there's this laundry list of issues that also are pretty important that need to be taken care of as well. You're running out of real estate in a sense.

Gary Siegel:

Yeah. Because Congress doesn't just drop everything.

Jeffrey Cleveland:

Yeah. Well, the other thing, how deep you want to go into this, it's possible that the Powell renomination is a bargaining chip that's being used for some other negotiations that are going on, with regard to the budget, for example. That's perhaps what's holding up the issue here. That's one possibility to consider. I think the concern that investors had last time we went through this was that they looked at what Powell had said about QE way back in, I don't know, 2012 or 2013, and then they said, "Oh, he's going to be much more hawkish." That turned out not to be the case. I would say though, Gary, why didn't that turn out to be case? Circumstances.

Jeffrey Cleveland:

He responded to the COVID crisis and he had a playbook that they'd already tested out, right? A post-08, had a lot of tools available and he learned from the prior crisis it's better to act quickly, act boldly and to cushion the economy and the financial system especially, and they did that. It was the circumstances of it that really dictated what policies he ultimately ended up pursuing. Similar thing, we talk a lot about this. It's fun, it's the intrigue, it's the politics who might be. But I think ultimately, it's going to go back to what we talked about earlier in this discussion. What happens with inflation in the next 12 months? What happens with employment?

Jeffrey Cleveland:

That's going to be the key for whoever is in charge, because if I'm right, inflation comes down, we're still not to full employment, then I think whoever's in charge is going to keep rates at zero for longer than the market is currently pricing. That's a really key thing, I think for the bond market. I think that will impact everything from two-year yields to five-year yields to 10-year yields to investment grade bond spreads. Everything will be driven by that. It's going to be circumstances that I think drive the Fed less than it's going to be the leadership driving the Fed. How's that for a new angle on this?

Gary Siegel:

Perfect. I think everyone agrees with you, Jeffrey, that inflation will come down. The question is how much? What the market is worried about is is the Fed behind the curve already? Are they close to getting behind the curve? Are they at risk for being behind the curve?

Jeffrey Cleveland:

I think the biggest risk, Gary, is that the Fed has less control over inflation than they imagine. The Fed has less control over inflation than some investors imagine. That's the biggest risk here. The Fed, if you talk to central bankers, if you spend your time doing that, right? Really important part of the process for them is inflation expectations, and they think as long as we keep inflation expectations in check, then we can keep the overall inflation picture in check. But what if, Gary, I posed to you, what if it doesn't work that way? What if inflation expectations aren't the end-all be-all here and there's just less they can do? I think that's something to consider.

Jeffrey Cleveland:

Same thing for investors. Investors shouldn't be too comforted. But I think Powell said today, "Hey, if inflation picks up, we'll do something about it. Don't you worry." I don't think investors should be completely comforted by that. I think you should do your own due diligence and that's what we do. When we come back to it, there's some tools I think for us that are pretty effective on looking at where inflation is going to be in 12 months time, Gary. One for me is looking at trimmed mean PCE inflation, tabulated by the Dallas Fed. That's been a good guide for us in the last two decades on where inflation ends up a year from now. You look at it where it is today. It's about two and a half percent.

Jeffrey Cleveland:

It's been a good rough and ready guide. There are other more complicated models you can build, but they don't necessarily do any better in predicting where inflation will be. That gives me more comfort, Gary, in the inflation forecast I gave you than listening to central bankers tell me that they're on the case. But I don't think they're behind the curve. I just think what's happening right now is very unusual. We have that big supply-demand mismatch that's really having an impact on prices, and I think those price pressures will fade somewhat in the next six to 12 months. That will happen regardless of what the Fed does here, it would be my key message here.

Gary Siegel:

Well-

Jeffrey Cleveland:

Maybe we put too much faith ... We attribute too much control to these central banks. Maybe they don't have as much as we think

Gary Siegel:

Fed officials seem to have much more confidence in their ability to stop high inflation than they were able to raise the low inflation, Jeffrey.

Jeffrey Cleveland:

Yeah, they do. But it's one of those things where do we have a lot of historical examples of this in the last 50, 60 years? Really?, you could argue, we just have the one. We have the Volcker Moment in the early 1980s. I guess I would just say, I think I have less confidence in them that they can reign it in than they do, and that's just ... We haven't really seen that. Much bigger problem more recently has been low, moderate inflation. I have to say though, as a bond investor, there's this consternation about inflation being too low. I don't think so. I think inflation, Gary, last decade when it was 1%, one and a half, nothing wrong with that from an investor perspective, especially a bond investor.

Jeffrey Cleveland:

That was great. That was fine. From an equity perspective, that was good too. We had great equity returns. Much more worrisome for me is volatile and high inflation. Those periods where we have had that, most notably, let's say 1972 to 1978, 1972 to 1982, whatever period you want to look at, that was bad for stock investors and bond investors. I say be careful what you would wish for if you're a central banker. Low and moderate inflation was just fine. I don't really think we need to have higher inflation. I don't like it. Again, I don't think they're behind the curve. I'm not worried. I think inflation will come down. But I don't think we should really try to pursue with this vigor higher inflation. For investors especially, this is not a good situation to be in.

Gary Siegel:

Well, you've been great to talk to. This was a nice conversation. I thank you for your time.

Jeffrey Cleveland:

My pleasure. Gary, have a good one.

Gary Siegel:

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