MESTER: FED RETURNING TO NORMAL POLICY FRAMEWORK

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Loretta Mester, president and CEO of the Federal Bank of Cleveland, was a 2018 Federal Open Market Committee (FOMC) voting member of the board that sets interest rates, but she will not be in 2019. She appeared on our "Behind the Markets" podcast with Professor Jeremy Siegel to discuss the important FOMC decision and the market's reaction.

Here are some highlights from the conversation:

Fed policy is going back to being data dependent, not preset on a policy normalization course. This was the way it used to be, and it seems people may have forgotten this.

- This means we should not expect a rate hike at every meeting; instead, economic data will determine the ultimate course for future Fed policy. The Fed is not "prejudging."
- We discussed the balance between responding to financial conditions and market reactions—which, as Mester put it, can be heavily influenced by short-term sentiment—versus the hard data and what the Fed learns business contacts in their regions. The Fed needs to weigh all of these factors, but Mester's comments seemed to imply being less confident in the higher-frequency market indicators than was our past guest, James Bullard.

Mester sees a strong, above-trend economic backdrop currently, but she acknowledges that some slowing from 2018's pace probably will occur next year:

- On the plus side: labor markets and businesses are maintaining their plans.
- On the negative side: rate-sensitive sectors are showing signs of slowing.

Mester apparently does not foresee a recession looming on the horizon, but she also admits that recessions are not predictable:

- She is watching these things closely: global economies, tighter financial conditions from recent market weakness, leveraged lending ("covenant lite") and non-financial debt being the most worrying of the factors.
- She does not see another subprime situation and thinks the Fed is better equipped to monitor these developments.

- Mester looks at both U.S. and global financial institutions; she sees no big U.S. exposures to Italy but is always wary of markets "seizing up."

Mester may not see this latest version of an inverted yield curve as the same predictor as in the past:

- She cited a lower-term premium being natural given structural forces in the economy and said that we may need a bigger inversion in order to have the same predictive value as in the past.
- Mester said one must look at causes of inversion and how the Fed had to play catch-up to inflation and has tightened too much in the past. Mester wants the Fed to help navigate softer landings in the economy.

The outlook—Mester sees the economy doing quite well but said the Fed is listening to the markets (markets see things differently than what data is showing):

- The Fed is grappling with growth and inflation in trying to follow its dual mandate—stable prices and maximum sustainable employment.
- If the need is to lower rates, the Fed would do so (although there is no sign that Mester leans in that direction).
- Lack of inflation allows patience.
- Mester seemed to be in the two-rate hike camp for 2019 as of now, although she did not state that outright.

With all the volatility in the markets that came after the Fed meeting, it was great to have Dr. Mester on the program.

Listen below to our full conversation with Dr. Loretta Mester.

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