

Goldman Sachs Exchanges

What Trump's policies could mean for the Fed

Rob Kaplan, Vice Chairman, Executive Office, Goldman Sachs

Allison Nathan, Senior Strategist, Goldman Sachs Research

Date of recording: November 11, 2024

Allison Nathan: When people ask me about my job, I often say I have the best job at Goldman Sachs. And that's honestly no joke. And one of the things I love the most about my job is that it gives me the chance to speak to some of the most interesting and insightful people in business, economics, and finance. And today's guest certainly qualifies.

Rob Kaplan ran the Dallas Fed from 2015 to 2021. Before that, he was a professor at Harvard Business School and the global co-head of Investment Banking here at Goldman Sachs. Earlier this year, he rejoined Goldman Sachs as vice-chairman, so I am proud to call him my colleague again.

Today, Rob is joining me from our Dallas office to speak

about the Fed's rate-cutting cycle, the interplay between monetary and fiscal policy, and what investors might be missing about this unique economic moment. Rob, thanks for being here.

Rob Kaplan: Great to be here with you, Allison.

Allison Nathan: The Fed is continuing its cutting cycle. As we all know, it brought down the Fed Funds Rate by another 25 basis points last week, and it continues to try to walk this tightrope of bringing down inflation without tanking the economy. We'll get your views on what could be ahead, but let me first ask how good of a job you think the Fed has done so far in orchestrating a soft landing.

Rob Kaplan: It's done a good job in orchestrating a soft landing. Part of the thing that's helped them orchestrate that soft landing is that fiscal policy has been dramatically more accommodative, more stimulative than we're accustomed to. We've gone from pre COVID 70% of GDP to over 100% of GDP debt of the US government. But people have to realize post COVID, '21, '22, and '23, we've had outsized fiscal spending, particularly these very large directed programs like the Inflation Reduction Act and

Infrastructure Act. That has helped the Fed.

Now, on the other hand, it's caused the Fed to go higher than they thought they'd need to – 5.25, 5.5. It's caused them to stay there longer. And it's been stickier and slower for them to cut than they would have otherwise.

Allison Nathan: Right. As of now, the economy is still growing, even in this high-rate environment. So would you judge it as generally a success?

Rob Kaplan: For financial market people and more affluent people, it's been a success. For something like 65 or 70 million workers in this country that go paycheck to paycheck, make probably \$50-55,000 a year or less, the cumulative rate of price increases matters more than whether we're having a soft landing right now is heading toward 2%. For them, they've lost 20-25% purchasing power, and their wages have not kept up and they're struggling to make ends meet. And we saw that play out to some extent in this election this week. They probably would not give the Fed as high a grade, so I would say being slow to raise rates and stop the bond buying, they get a low grade for that. But I think once they did the pivot

and 180 to start raising rates and run down the balance sheet, I personally think they've done a good job. But they can't get away from that first period that I think is still causing struggles for a lot of the workfare.

Allison Nathan: Understood. You just mentioned, of course, the big event in the last week, which has been the reelection of Donald Trump. You ran the Dallas Fed during his first term, so let me first ask what that was like to be a sitting Fed official with Trump at the helm of our government.

Rob Kaplan: So what you had to learn to do is be prepared to assess new fiscal policies – tax cuts, tariffs, and others – and try to incorporate them in your outlook. In terms of the job owning from the administration, believe it or not, inside the Fed, I think we pride ourselves and prided ourselves on shutting that out to the extent humanly possible. It was more manageable and less stressful than people might think.

The one thing that does change, though, with administration and is political is supervision. And we had I think more constructive benign supervision during '16 to

'20. We had more stepped up supervision after that. And so that was something we also had to adapt to.

Allison Nathan: So just to clarify, your term actually spanned into the Biden administration, so you could tell the difference and supervision was stricter or more stringent in Biden versus Trump?

Rob Kaplan: It actually spanned Obama then Trump then Biden. And yes, whereas our approach to rate setting was very similar, the supervisory approach changed when the administration changed and people should be aware of that. And that does affect part of your job as a Fed president.

Allison Nathan: But you said you were able to essentially block out a lot of the noise. How convinced are you that's going to remain the case? There's some discussion that Trump will not reappoint Chair Powell and may try to influence the Fed to some extent. How do you view the prospect of Fed independence ahead?

Rob Kaplan: On the rate-setting process, I'm confident, under Jay Powell's leadership, they will try to make

decisions without regard to political influence or political pressure. They'll have to, though, adapt, which I know we'll talk about in a few minutes, new policies, understanding there'll be some structural shifts, and they'll have to adapt to that. And you'll see regulatory policy change again. And I think in between those two will probably be some discussion of the balance sheet in that the Fed has had very strong autonomy in how to use the balance sheet. I think there might be more debate about whether the treasury should have more power on the balance sheet as well as the Fed. I'd say that's a debate that's yet to come.

Allison Nathan: Interesting. So let's get into some of that. After the election result was known, we saw investors' expectations shift toward fewer rate cuts in 2025, and the presumption being that policies that will be implemented will on net be inflationary. So you've alluded to this even our comments in the last few minutes. How does the Fed embed potential policy shifts in its expectations? What does that process look like?

Rob Kaplan: So I'll start with pre-election, my own view, and you've probably heard me say this. I felt, even under

the Biden administration and continuation of the Harris administration if that had happened, I think there are two phases to rate cutting. And I think this is the mindset of the Fed before the election.

Phase one is they can get the Fed Funds Rate down to 4.25 to 4.5 if inflation is running around 2.5. However, I think it was going to be stickier than the markets may have expected to get below 4.25-4.5 unless service sector inflation particularly moderated somewhat more. And the question was, with all these open-ended fiscal spending programs and with 7% of GDP deficits, would service sector inflation moderate? We know goods are disinflating, but services have been sticky. So that's pre-election.

Post election, you've got those questions still, but I think you're going to see some changes and here's how. The Fed is led by predominantly PhD economists. PhD economists, not exclusively but heavily, look at cyclical factors and they like to use models. When you have a new administration, you're going to get structural changes. May not be amenable to a model. So let me give you the structural changes we're likely heading into, and I think this will get into the Fed's thinking.

Heavy regulation currently versus the past in the US economy. Not just in the financial sector but more broadly. We've had an excess supply of labor force growth mainly due to immigration. That's going to change most likely. In addition, you've got these directed government programs I talked about that are sizable, that are bidding directly on labor. Inflation Reduction Act, Infrastructure Act, CHIPS Act. And that labor they're bidding on tends to create jobs at 35, 37, 50 an hour for people that maybe before that were making \$20 or 22 an hour. It's affecting service sector inflation.

We're shifting now toward probably a regulatory review with intention of creating more productivity growth. These directed programs, I don't know but it sounds like they may get stood down or repurposed. And it looks like the immigration growth that we actually benefited from, it's why we're growing at 3% this year, at best it will get eliminated and at worst you might even see a reduction in the labor force due to some of these new immigration policies that are being discussed. Those are very significant structural changes.

And you're also going to see, by the way, one other. In the energy transition, which is very significant, you're likely to see much more pressure on more oil and gas production, lower prices at the pump, again, to attempt to help low- to moderate-income families make ends meet. Those are some pretty substantial changes.

Tariffs is the one other policy I haven't talked about. We live with tariffs now. You're likely to see tariffs increase. However, tariffs are only on goods, and there's always a consumer response to tariffs – i.e., you don't have to buy an imported product if it's too expensive. And so that will work itself out, but the Fed is going to have to try to assess those tariffs and what those impacts are on inflation and unemployment.

We're used to cyclical changes in the economy. It's been a while since we've had a range of structural changes. Now, COVID and post COVID created a set of structural changes which we've been adapting to the last few years. We're now going to go through a new transition where, on some of these big issues about labor force growth, technology disruption, regulatory pendulum, globalization versus deglobalization, the energy transition, government debt

spending, those are all big structural drivers and probably there's going to be changes in every one of them. So that's a lot.

Allison Nathan: So with the exception of the pressure on energy prices – downward pressure on energy prices – it sounds like these policies will largely lean toward more inflation, not less inflation.

Rob Kaplan: I don't think so. No, I think – I'd be careful. You may have heard me say this is puzzle that will have to fit together and let me explain. The regulatory review is likely disinflationary.

Allison Nathan: Right.

Rob Kaplan: Higher productivity is likely disinflationary. As you talked about, lower energy prices is disinflationary. I'm not sure yet whether the tariffs, a one-time increase in tariffs, I don't know whether it's going to be a negotiating tool to get more domestic consumption and production or how it will be used. And again, it's only on goods, and consumers may adjust. It may not be as inflationary as people think.

The big question for me, to your point, is what happens with the labor force. And if you get a meaningful reduction in the labor force, that's going to, again, stretch I would guess labor costs. It may put more pressure on service sector costs. And that's why I think the jury is very much out. Do you see only criminals and people with known records deported? That may not affect the labor force that much. Or are you going to see something much deeper? That's probably number one on the list of things I'm going to be watching, and I'd encourage people to watch.

Remember, if you have tariffs and you encourage more domestic consumption and production, it could actually work if you have more labor. If you have less labor, it might actually put more strain on the labor force. So this is a puzzle that we're going to have to understand how it fits together, and it's a little unclear at the moment.

Allison Nathan: Interesting. A lot of moving parts. So you don't necessarily then share the market's view that the Fed will most likely cut rates less during a Trump administration than would have been the case under the Harris administration because we just don't know yet what

these policies are going to look like.

Rob Kaplan: Yeah. My strong advice outside the Fed and if I were at the Fed is let's be risk managers, not prognosticators. Let's slow down. We are not going to have good clarity on some of these policies maybe until spring of next year. I don't know. I think the Fed does well when it acts like a risk manager. When it starts prognosticating – what's an example of a prognostication? Transitory was a prognostication. It gets itself into trouble. And I think it's okay to admit that there are structural policies that are going to affect the landscape. And what you may see the Fed do – and I might be an advocate for this – I'm not as certain – it's likely they'll cut in December, but I'm not certain yet. And I think you may see them take a little bit of a pause depending on how the rest of the economy unfolds to try to allow themselves time to understand this better. And I'd be careful not to be rigid or predetermined if I were at the Fed.

Allison Nathan: And I think that's an important point you just made because I was just about to ask you about what this all means for December. And look, Chair Powell I think himself said during the last press conference he does

not want to speculate, so you think there's room for them to potentially pause.

Rob Kaplan: I think it's probably still more likely than not that they'll cut in December. But if I were in my former seat, I would want to make it a game-time decision. I want to see the November jobs report, which we're not going to get until early December, because the hurricane and other weather events may have depressed the last jobs report. You may see a rebound. We'll get more clarity over the next month on what new policies might be. And if I were at the Fed, I'd want to take every bit of the time allowed before I had to make a judgment about December. And I hope and expect you'll see them do that.

Allison Nathan: So Rob, just to conclude, help us understand what this all could mean for markets. We've obviously seen a significant move across markets on this election outcome in the equity market, in the bond market. What, if anything, should investors be paying more attention to that they're perhaps underappreciating at this point?

Rob Kaplan: So some of the folks around the new

administration have used the term “we want to re-privatize the economy.” I’m observing this. And I think what they mean is you may see less government directed spending. You may see an effort to improve productivity through regulatory reform and an effort to create more organic GDP growth that’s spread throughout the economy.

What could that mean? It could mean, interestingly, that top-line GDP growth might actually be lower. In other words, I don’t know that we can keep growing at 3%. It might be closer to 2-2.5 than 3. However, you might see corporate earnings benefit more. Certainly, depending on what happens with the tax law, that’ll be a factor, also. And so the one thing I would say if I were advising people what to watch first, second, and third, to me, the labor force and what’s done with the labor force is probably right at the top of the list.

Tariffs would come behind that, but if you simply stop the growth in immigration, that’s one set of facts. If you actually reduce the size of the workforce, I think you’re going to need an adjustment through technology and technology-enabled disruption accelerated. What’s an example? Robo-taxi, driverless car.

So I think people should be thinking about it as a puzzle. Don't get hung up too much on any one policy. It needs to fit together. But I think there's a chance that you could see more organic growth, better earnings from corporates, obviously be positive for the markets, and I think some of the inflationary budget impacts are not yet clear to me but they'll become clearer as policies become clear.

Allison Nathan: Rob, thanks so much for your time today.

Rob Kaplan: Thanks, Allison. Good to talk with you.

Allison Nathan: This episode of Goldman Sachs Exchanges was recorded on Monday, November 11th, 2024. I'm your host, Allison Nathan. And tune in this Friday for the first episode of our new four-part series on the changing dynamics at the intersection of sports is finance. We'll be discussing the scale of the investment opportunity and hear from team owners and leaders who are at the forefront at the transformations happening in the industry. Look for it wherever you get your podcasts.

The opinions and views expressed in this program may not necessarily reflect the institutional views of Goldman Sachs or its affiliates. This program should not be copied, distributed, published, or reproduced in whole or in part or disclosed by any recipient to any other person without the express written consent of Goldman Sachs. Each name of a third-party organization mentioned in this program is the property of the company to which it relates, is used here strictly for informational and identification purposes only, and is not used to imply any ownership or license rights between any such company and Goldman Sachs. The content of this program does not constitute a recommendation from any Goldman Sachs entity to the recipient, and is provided for informational purposes only. Goldman Sachs is not providing any financial, economic, legal, investment, accounting, or tax advice through this program or to its recipient. Certain information contained in this program constitutes “forward-looking statements”, and there is no guarantee that these results will be achieved. Goldman Sachs has no obligation to provide updates or changes to the information in this program. Past performance does not guarantee future results, which may vary. Neither Goldman Sachs nor any of its affiliates makes any representation or warranty, express or implied,

as to the accuracy or completeness of the statements or any information contained in this program and any liability therefore; including in respect of direct, indirect, or consequential loss or damage is expressly disclaimed.

This transcript should not be copied, distributed, published, or reproduced, in whole or in part, or disclosed by any recipient to any other person. The information contained in this transcript does not constitute a recommendation from any Goldman Sachs entity to the recipient. Neither Goldman Sachs nor any of its affiliates makes any representation or warranty, express or implied, as to the accuracy or completeness of the statements or any information contained in this transcript and any liability therefor (including in respect of direct, indirect, or consequential loss or damage) are expressly disclaimed. The views expressed in this transcript are not necessarily those of Goldman Sachs, and Goldman Sachs is not providing any financial, economic, legal, accounting, or tax advice or recommendations in this transcript. In addition, the receipt of this transcript by any recipient is not to be taken as constituting the giving of investment advice by Goldman Sachs to that recipient, nor to constitute such person a client of any Goldman Sachs entity. This

transcript is provided in conjunction with the associated video/audio content for convenience. The content of this transcript may differ from the associated video/audio, please consult the original content as the definitive source. Goldman Sachs is not responsible for any errors in the transcript.