Strategy
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A Changing of the Guard at the FOMC

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Abstract

Jerome Powell is the new Chair of the Federal Open Market Committee (FOMC) following Janet Yellen's retirement from the Fed. In the near-term, Powell is likely to continue on the projected path of gradual interest rate hikes while also focusing on transparency and deregulation. However, as his background is not in economics, he will likely be more reliant on staff and fellow FOMC members in making decisions on monetary policy than his predecessors. Over the longer-term, questions remain about how long the tightening cycle will last, as well as what his response would be in a downturn.

Introduction

The top brass at the Federal Open Market Committee is undergoing a major overhaul. Over the past year, three members of the Federal Reserve's Board of Governors, along with several Regional Bank Presidents, have either left the Federal Reserve or have announced their intention to do so in the near future. The most noteworthy of these is Chair Janet Yellen, who recently stepped down from the Board after President Trump chose not to re-nominate her as Chair.

In the place of Yellen, Trump nominated Jerome Powell, a lawyer who has served on the Board of Governors since 2012. Powell was recently confirmed by the Senate and is now set to Chair the FOMC starting in February. Given the important role the Chair plays in setting the course of Fed policy, it makes sense to take stock of what changes may occur as we transition to a Powell-led Fed.

Powell's Background

For some perspective, Jerome Powell's background is not in economics, but rather law and finance. He spent four decades working in private equity and banking and was relatively unknown in political circles before a stint in consulting work on the debt ceiling negotiations in 2011. The following year, President Obama unceremoniously nominated him to the Board of Governors along with Harvard economics professor Jeremy Stein. For his first few years, he worked on mainly run-of-the-mill tasks, such as payments processing, and bided his time before eventually moving into more prominent roles.

Despite his experience at the Fed, Powell's background is highly unusual for a Fed Chair. The last Chair without formal training in economics was G. William Miller, who served only one year from 1978-1979. Miller was an unmitigated disaster as chair and his tenure was characterized by excessive levels of inflation and a collapse in the dollar. Following Miller's "demotion" to U.S. Treasury Secretary, Paul Volcker became the first of four consecutive Fed Chairs to have a background in economics.

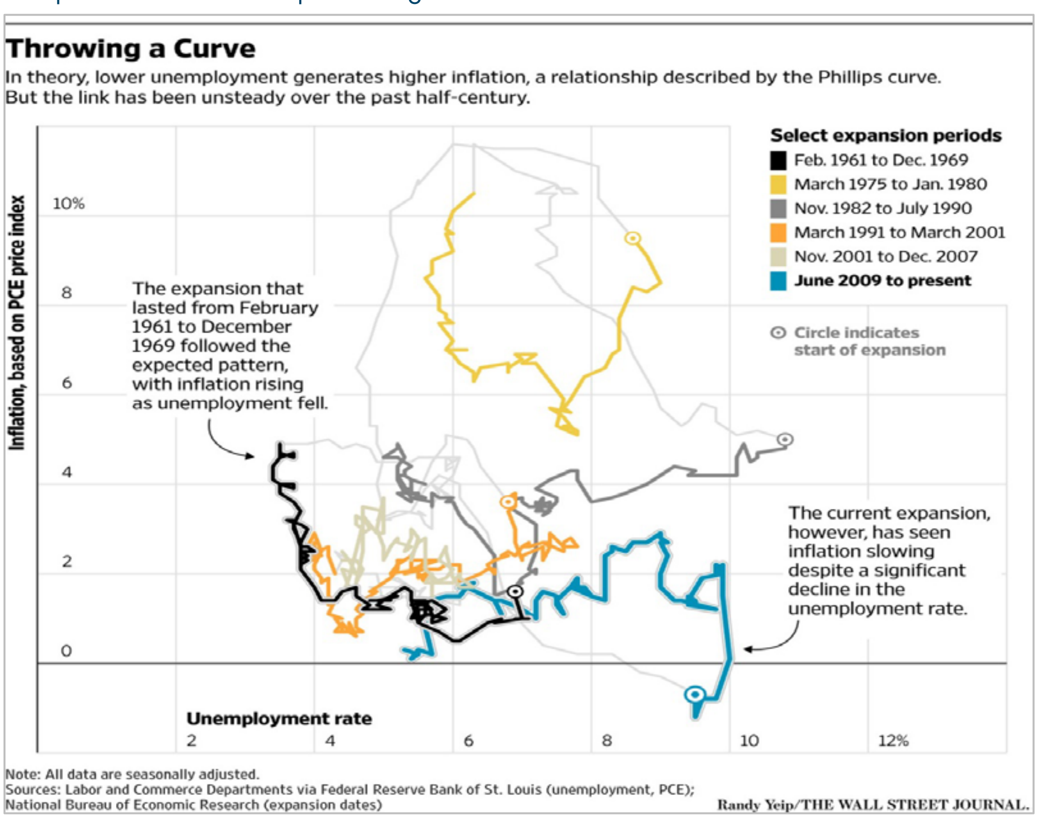
Powell's Policy Views

While Powell may not fit the profile of a typical central banker, he is held in ample regard both personally and professionally. He is widely viewed as a "continuity candidate," evidenced by the muted reaction from markets to his nomination. Powell's exact policy views are somewhat difficult to gauge, given his lack of public comments and research into the subject of monetary policy. However, in his confirmation hearing he expressed his intention to "normalize rates" in a gradual manner. This essentially echoes Janet Yellen's comments on the foreseeable path for monetary policy and comes in stark contrast to statements by other candidates President Trump was considering for the job whom held generally more hawkish stances.

Powell's Senate testimony does reveal some views that potentially diverge from those of the prior Chair's. Yellen's background was as a labor economist. She famously worked with her husband George Acklerlof on researching optimal wage structures, and perhaps as a result she was a strong adherer to the Phillips Curve model of inflation. That model suggests that a tight labor market causes firms to compete for workers which causes wages to rise and which in turn bleeds over into higher prices. In her confirmation hearing as Vice-Chair in 2010, Yellen asserted that the "Phillips curve model… has solid theoretical and empirical support." Throughout her tenure, she often referenced the model as the primary rationale for removing policy accommodation, fearing that an overly tight labor market might cause the economy to overheat.

Recently, though, many economists have openly questioned whether the relationship between unemployment and inflation is breaking down. Powell seems somewhat sympathetic to these arguments. In a speech concerning the state of the labor market, Powell observed that the correlation between the two variables has "weakened substantially" of late.

Phillips Curve: Relationship Breaking Down?



Source: WSJ article by Ben Leubsdorf entitled "The Fed Has a Theory. Trouble Is, the Proof Is Patchy"
http://www.wsj.com/articles/the-fed-has-a-theory-trouble-is-the-proof-is-patchy-1440352846

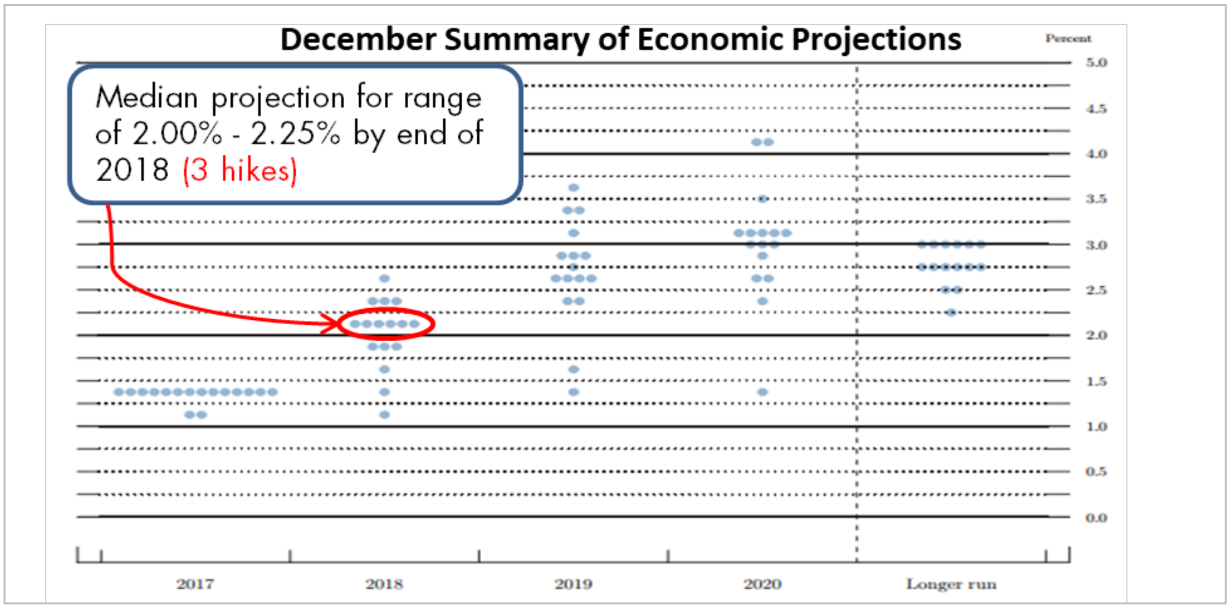
In addition, Powell has often cited well-anchored inflation expectations as a primary reason that actual inflation is less volatile than in the past. This view would portend that the Fed has more leeway in stimulating the economy and would thus align him with the more dovish members of the FOMC, such as Lael Brainard and Neel Kashkari.

On the other hand, Powell's views on the role financial conditions play in guiding monetary policy may lean more hawkish. When he first joined the Fed in 2012, he expressed fears that the costs of the Fed's QE program could potentially outweigh its benefits. And just two years ago, he stated that "tighter monetary policy might eventually be necessary" to counteract excessive risk taking. In comparison, both Ben Bernanke and Janet Yellen were of the view that monetary policy was "too blunt of an instrument" to be used simply for counteracting perceived financial excesses.

Outlook for Monetary Policy

So where does this all leave us? In the near term, Powell seems unlikely to deviate much from the groundwork that Yellen laid out for rate increases. According to the most recent Summary of Economic Projections, after raising rates three times in 2017, the FOMC consensus is for three more rate hikes this year. The market is slightly less optimistic on the outlook for higher rates; however, given a backdrop of 4.1% unemployment, core inflation around 1.5%, and incoming fiscal stimulus from the recent tax cut, three hikes seems to be a reasonable starting point.

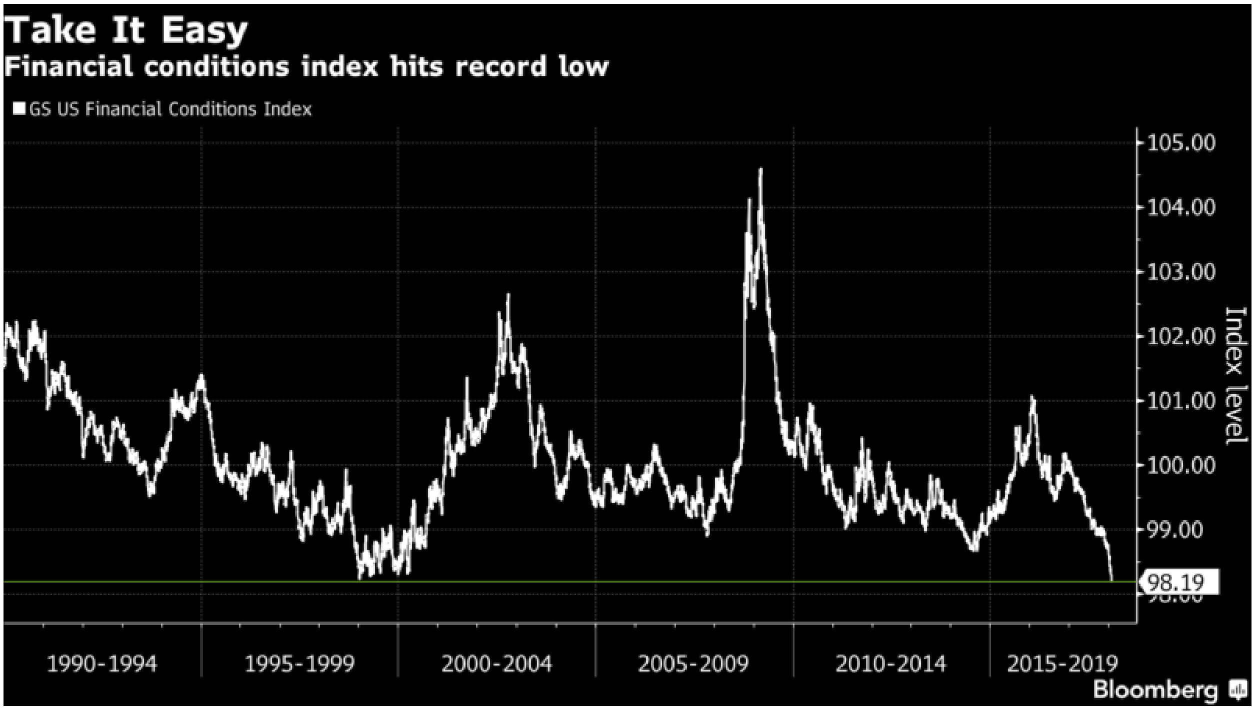
Summary of Economic Projections



Source: https://www.federalreserve.gov/monetarypolicy/fomccalendars.htm

There are caveats to this forecast. For starters, rising inflation expectations and wage growth suggest that the pace of rate hikes may need to quicken. Secondly, financial stability remains an acute risk. As evidence of this, in just the past month Goldman Sachs' Financial Conditions Index hit a new post-crisis low, propelled by a combination of elevated stock valuations, rising property values, high levels of confidence and shrinking risk premiums.

Goldman Sachs' Financial Conditions Index



Source: Bloomberg and Goldman Sachs, https://www.bloomberg.com/news/articles/2018-01-29/goldman-gauge-of-market-health-flashing-green-for-economy-growth

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A sharp reversal of these trends poses potential risks to markets and the broader economy. Janet Yellen viewed such a reversal as unlikely, noting in December that indicators of financial stability risks are not "flashing red… or possibly even orange." However, given his background, Powell seems more likely to be wary of this possibility, and to use monetary policy to lean against it.

Additionally, part of what separates Powell from past Chairs is that he is likely to be less of a thought leader on the FOMC and more of a consensus builder. The Fed has been moving towards a more democratic system ever since Bernanke became Chair in 2006 and at this point, the days of the Alan Greenspan autocracy are ancient history. Even so, Bernanke and Yellen were often given deference (especially by those on the Board) based on their policy expertise. Powell, on the other hand, will not be given that deference, nor does he seem to desire it. In his testimony to Congress, he expressed a desire to continue the trend towards a more meritocratic system.

Consequently, Powell's policy decisions are likely to be influenced by his staff and the rest of the Board. Currently the Board has four open seats, one of which could potentially be filled by Carnegie Mellon Professor Marvin Goodfriend. Goodfriend is a perceived hawk based on past remarks warning of the potential for high inflation, as well as his negative critique of the inclusion of mortgage-backed securities in the Fed's QE program. Nevertheless, he is traditional in the sense that he believes the Fed's credibility is tied to achieving its dual mandate.

There are also rumors that San Francisco Fed President John Williams is a front runner for the Vice Chair position. Williams is a moderate whose extensive work on the natural interest rate underpins much of the Fed's current economic modeling. Given his expertise and experience at the Fed, he would likely be Powell's go-to advisor and would offer policy prescriptions similar to Yellen's.

Finally, on the communication front, Powell seems likely to make some slight adjustments. While he does not support auditing the Fed's policy decisions, he has expressed a desire for greater transparency into their decision-making process. Some ways he could potentially do this include:

1. Holding impromptu press conferences. This would have the dual effect of allowing for greater transparency while also convincing market participants that meetings without a pre-scheduled press conference are still live for rate hikes.

2. Offering greater detail on the underlying factors affecting the balance of risks to the economy. This could give greater insight into the committee's current views.

3. Clarifying the Fed's reaction function (i.e., what would cause the committee to change their outlook on the economy and short-term interest rates.).

Such actions could go a long way in helping the Fed achieve its dual mandate, while providing greater insight into how it operates and makes decisions.

Outlook for Regulatory Policy

Powell's confirmation may also coincide with a shift towards a more dovish regulatory environment. President Trump and Republican leadership in Congress have expressed a desire to reduce regulatory burdens on the financial services sector. In his Senate testimony, Powell expressed a similar sentiment, emphasizing that while the post crisis Dodd-Frank and Basel III accords have been important in reducing overall risk in the financial system, regulations could yet be "tailored" more effectively. Specifically, he floated support for less frequent stress testing, as well as a reduction in capital requirements and an adjustment of the Volcker Rule (which bans proprietary trading) for non-systemically important banks.

Such proposals would certainly have a positive impact on equity valuations, all other things equal. As is, financial stocks have rallied over the past year in part due to expectations of reduced regulatory burden. However, from a credit perspective the effect is more convoluted. Higher profitability would be a positive development but would need to be taken in the context of any changes to an institution's asset-quality, capital position, and liquidity profile. Should greater profitability be achieved via a material uptick in risk-taking, this could reflect negatively on a firm's credit-worthiness.

Conclusion

Overall, it seems more likely that Powell's tenure as Fed chair will be marked by subtle changes from Yellen's, rather than a stark overhaul. In the near-term, he has expressed a desire to continue removing policy accommodation at a "gradual pace" in order to avoid disrupting the economy, while also suggesting that he'd like to continue the Fed's move towards greater transparency. On the regulatory front, he seems open to finetuning the existing frameworks, even while reiterating their importance to financial stability.

For investors then, the real questions lie in how Powell will fare over the longer term. How high will short-term interest rates go, and how quickly will the high point be reached? In the case of a downturn, how aggressive will a Powell-led Fed be in cutting short-term rates, and what is his willingness to engage in further unconventional policy? The answers to these questions are, and will likely remain, highly uncertain.

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