Investment Insights

The Fed's Next Chapter

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Highlights

- President Trump has tapped Jerome Powell to replace Janet Yellen as Fed chairman.
- Assuming the nomination is confirmed, we see Powell as largely following current policy trends, gradually increasing interest rates and reducing the Fed's balance sheet.
- To the degree his leadership marks a change for the central bank, it is more likely around financial regulation — he is perceived to prefer a modestly lighter regulatory touch.
- The coming weeks should also see a vice chair nominee — while this could influence markets over the very short term, we would continue to base our broader monetary views around the committee, not any one voter.
- Overall, we remain neutral equities, seeing support from solid global growth but modest headwinds from tightening monetary policy and increasingly stretched valuations.

On November 2, U.S. President Donald Trump nominated Jerome (Jay) Powell to be the Federal Reserve's next chairman. The news triggered almost no market reaction, in part as his name had been discussed for some time and he is seen by investors as likely to generally follow current U.S. monetary policy trends — gradually increasing interest rates and reducing the Fed's balance sheet.

In this note, we want to provide some general background on the person who could have one of the most powerful jobs in the world, impacting financial and economic conditions not just in the U.S. but also overseas. We also want to briefly review the process that key Fed nominees undergo and to review possible vice-chair nominees.

Who Is Jerome Powell?

Powell, 64, became a member of the Federal Reserve's Board of Governors in 2012. Prior to this appointment, he was a partner at The Carlyle Group (1997-2005). Powell has previous public-sector as well as private-sector experience, including time at the Treasury Department under President George H.W. Bush. His educational and professional background is focused in law (he studied at Princeton and Georgetown). This would make him an unusual Fed chair; historically, the U.S. central bank leader has had a background in economics.

Because of Powell's time at the Fed and previous career, which included delivering many public speeches and writing papers, investors have been able to get a decent sense of how he might act in the Fed chair role. Overall, he is seen as a "centrist" — not leaning toward exceptionally easy or hawkish policy out of ideology, but rather focusing on incoming information about the Fed's growth and inflation mandates to position policy. He also appears a careful speaker — especially in this role, word choice is critical. Investors will parse Fed chair phrases beyond what is done for most other policymakers or leaders. A Fed chief who creates uncertainty would likely mean relatively more market volatility. This does not seem likely with Powell.

Recent comments also suggest Powell will emphasize what the Fed can, but also cannot do to help reach certain economic goals. A little over a year ago, he said:

> "A period of low rates for a long time could present significant challenges for monetary policy. It could also put pressure on the business models of some financial institutions. Ultimately, the only way to get sustainably higher interest rates is to improve the broader environment for growth, by adopting policies designed to increase productivity and potential output over the long term — policies that are mainly outside the scope of our work at the Federal Reserve."

Media reports in recent weeks have suggested that Treasury Secretary Steven Mnuchin has strongly supported Powell's candidacy for the chairman role. Assuming Powell does indeed get the job, investors will be watching to see how the two interact, in part to monitor the Federal Reserve's independence.

What Happens Next?

Following this nomination, Powell has to be confirmed by the U.S. Senate for his first four-year term (Fed chairs can be reappointed for multiple terms). Historically, this process has taken a few months; to note, Yellen's term ends on February 3. (To the degree the confirmations are delayed for any reason, Yellen could offer to extend her term for a short period.)

At least on a relative basis, we expect Powell's confirmation process to be smooth. Powell is a Republican, so regardless of previous opposition, we would expect most Republican senators this time to support their president's candidate. In addition, Powell was originally nominated for Fed governor by President Barack Obama, with broad support at the time from Democrat lawmakers. As such, he should get at least some measure of support from those same legislators. Overall, we expect the typical congressional grilling during his Senate Banking Committee hearings, and possibly some interesting commentary (from an investment perspective) from Powell during the process, but nothing to prevent him from securing the position. The bottom line: we should have a new Fed leader by early 2018 — that would suggest his first policy decision in this role would be the March 21 Federal Open Market Committee (FOMC) meeting.

What Else to Consider?

As we have noted in previous communications, Fed leadership is undergoing a sea change. It's not just the chair but also the vice chair and several committee members who are playing musical chairs. Altogether, the Federal Reserve could see as many as five policymakers change over the coming months (chair, vice chair, three other FOMC board seats).

Beyond the chair, historically the two most important voices at the Fed have been the vice chair and the New York Fed president, the latter in part because this regional Federal Reserve Bank has responsibilities for financial institutions (it is considered "first among equals"). New York Fed President William Dudley is expected to retire at the end of 2018 due to age requirements. More immediate, though, Vice Chairman Stanley Fischer retired in October. While our sense is that the White House has considered both the chair and vice chair positions in tandem, remarks from Mnuchin suggest the vice chair nominee will be announced at some point after the chair nominee is made public.

So who could we see as the Fed's Number 2? We cannot say for sure, but for now wanted to give some color around two candidates frequently seen on short lists.

John Taylor. Taylor, an economist currently at Stanford University, is probably best known for what is called the Taylor Rule. The rule is actually a formula designed to provide policy "recommendations" for how a central bank, such as the Federal Reserve, should set nominal short-term interest rates in response to changing economic conditions. The formula's intent is to optimize the policy rate in a way that allows a central bank to achieve its goal of stable economic growth while at the same time controlling inflationary pressures within the economy. Taylor's model stipulates that real short-term interest rates should be calculated according to three inputs:

- Where actual inflation is relative to the targeted level the central bank wants to achieve.

- How far economic activity is above or below the "full employment" level.
- What the level of the short-term real interest rate is that would be consistent with full employment.

The Taylor rule determined that for each one percentage point in inflation, a central bank should raise its nominal interest rate by more than one percentage point, which is generally known as the Taylor principle. The Federal Reserve does not explicitly follow the Taylor rule, but it is frequently highlighted by various Fed policymakers during the course of normal economic and policy discussions.

One of the reasons why market participants have viewed Taylor's potential inclusion on the FOMC as an incrementally hawkish development is that his rule, as applied to the current economic conditions in the U.S., suggests that the federal funds rate should be higher than its current level of 1.16%, by roughly 2.5 percentage points. That said, it's our view that even if Taylor were to gain a seat on the FOMC, it's not clear that he would automatically push for higher interest rates, as his formula has been drawn into question given the recent evolution of global economic conditions (e.g., **2013 Fed paper pointing to lower current NAIRU**) and the widespread adoption of unconventional central bank policies such as quantitative easing. Taylor himself slightly revised his original 1993 formula in a follow-up paper published in 1999, though the basic construct remains the same.

Kevin Warsh. Like Taylor, Warsh is currently in academia, acting as a distinguished visiting fellow at Stanford University's Hoover Institution and lecturing at Stanford's Graduate School of Business. Warsh studied public policy at Stanford and law at Harvard. After graduation, he worked for Morgan Stanley in mergers and acquisitions, moving to the public sector in 2002 as a member of the National Economic Council under President Bush. He was nominated for a Federal Reserve governorship in 2006, making him the youngest appointment in the history of the Fed. At the Fed until 2011, Warsh played an important role during the 2008-2009 financial crisis, working closely with Treasury and private-sector leaders.

Over the years, Warsh has made some provocative statements around the Fed's policy and process, leading some investors to think that a leadership role could result in greater potential change in monetary-policy setting. At the margin, we would expect his nomination, like Taylor's, would be seen by markets as relatively hawkish, at least initially. That said, we would reiterate our view that broad monetary policy is unlikely to change materially due to the appointment of any one Fed voter given the generally collaborative nature of the Fed.

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