CORE Comments

ON PLANNING AND INVESTING FOR THE TWENTY-FIRST CENTURY

November 14, 2017

Changing of the Guard at the Fed

The recent nomination of Jerome Powell to lead the Federal Reserve is consequential. More consequential are the several nominations that will follow this one.

Given the exceptional importance of the Fed to the US and the global economy and its profoundly influential role in the stock, bond and real estate markets, it is hard to overstate the significance of the nominations Mr. Trump will make.

By

Jack Mayberry

In these *Core Comments,* I have often remarked that our central bank, the Federal Reserve, is the largest factor in the markets for stocks and bonds, both in the United States and for the world as a whole. Thus, the chair of the Fed, now Janet Yellen, is widely regarded as the single most important actor in global economies and asset markets. Dr. Yellen's four-year term expires in February and, contrary to the four-decades long tradition of reappointing Fed chairs for a second term, President Trump has nominated Jerome H. Powell, a governor of the Fed, to succeed Chair Yellen.

The nomination of Mr. Powell appears designed to continue--and not to disrupt--the policies the Fed has pursued under Dr. Yellen's leadership. Mr. Powell has never cast a dissenting vote against the policies adopted by the Fed in his five years as Fed governor. Mr. Trump had put forward others as possible nominees, others who would likely have been quite disruptive, indeed. However, the full scope of the administration's plans for the Fed will not become clear until Mr. Trump makes further appointments.

Other Fed openings. The principal leaders of the Federal Reserve are its governors, of whom there are meant to be seven. At present there are only four, Dr. Yellen, Mr. Powell, Randal Quarles and Lael Brainard. Since Mr. Trump's inauguration, two Fed governors have resigned and Mr. Trump has appointed one new governor, Mr. Quarles, as Vice Chairman for Supervision. As such, Mr. Quarles is now the Fed governor with primary responsibility for bank regulation. Mr. Trump has three Fed governor vacancies to fill. Moreover, we learned only last week that William Dudley, the president of the Federal Reserve Bank of New York, will resign by the middle of next year prior to the end of his term. As president of the New York Fed, Mr. Dudley is a permanent member and Vice Chairman of the Fed's Open Market Committee, which sets its monetary policy, arguably making the New York Fed president the second most important member of the Federal Reserve.

Mr. Trump's administration has been avid for deregulation of banks, as have most Republican members of Congress. It is, therefore, entirely possible that, despite the nomination of Mr. Powell as the new Chairman, a nomination that, on its face, argues for continuation of existing Fed policies, we may see in the next year a Fed that reflects Republican views for lax banking regulation and that is much more 'hawkish' about monetary policies generally.

Because of uncertainties about the monetary policies the Fed will pursue, the large number of vacancies at the Fed gives the Trump administration scope for shaping these policies. It is worth pointing out that Mr. Quarles, Mr. Trump's first nominee, and Mr. Powell are both former partners of The Carlyle Group, a prominent New York-based private equity firm, and that neither is an economist by training. In this respect, they are somewhat typical Trump administration appointees, rich white men who are not specialists in the fields over which they are given authority. If Mr. Powell is a nominee for 'continuity' of policy, as is said, why did not Mr. Trump choose the better qualified incumbent, who really would continue the Fed's policies? To pose the question is to answer it: Mr. Trump prefers a rich white man, and not a woman, to be the world's most important economic policy maker.

In light of strident opposition from Republican members of Congress after the financial crisis to the policies of Dr. Bernanke and Dr. Yellen, we may well find that new Fed appointees are ones with a mission to undo recent policies and relax the Fed's bank regulatory policies and actions. Given that the financial crisis was brought about in substantial part by acts of loosely-regulated banks, and given that millions of Americans lost their homes, or their jobs, or both in the crisis, we may come to see a destructive tilt to upcoming Federal Reserve policies.

The Fed's role in the aftermath of the financial crisis was enormous and, in my view, constructive and necessary.

Many disagree with the view that the Fed's actions have been useful and effective. Opposition to them is especially high among Republican members of the House and Senate.

Current Fed policies. As things stand now, the Fed is in early- to mid-stages of 'normalizing' the extraordinary monetary policies put into effect during and after the financial crisis of 2007 to 2009. During the crisis, the Fed cut the short-term interest rates it controls directly, the Fed funds rate, from 5% to zero. At zero Fed funds (and money market funds) stayed until December 2015, when the Fed began a glacially slow process of rate increases. Rates are now 1% and another quarter point increase is expected in December.

Apart from cutting interest rates to stimulate economic recovery after the Great Recession, the Fed also undertook what came to be called Quantitative Easing ("QE"), whereby it purchased for its account US Treasury bonds and mortgage-backed securities. Prior to the crisis, the Fed held $800 billion of Treasury bonds; by the end of its QE program, its assets stood above $4 trillion. The purchases removed from circulation some $3.5 trillion new dollars to the economy. Critics of the Fed characterize QE as the 'printing of money' and disparage the lowering of interest rates as providing an artificial stimulus to the economy. Many predicted that the Fed's actions would cause 'hyperinflation.' Of course, the inflation predictions have been unrealized; by contrast, a principal concern of the Fed has been the persistence of low inflation and risk of deflation.

Beginning in October, the Fed began a slow process of reducing assets it holds, by reducing the reinvestment of proceeds from maturing bonds. Although the Fed has been forthcoming about its monetary policy actions and plans, it is unknown—to us and, one suspects, to Fed policy makers—how high will be raised Fed funds and by how much the Fed's bond holdings will be reduced. With such consequential Fed decisions ahead, Mr. Trump's appointments loom large.

Meanwhile, in financial markets, the steady advances in stocks have continued since our last *Core Comments.* Since that end-of-September letter, US technology stocks and Japanese stocks have led the way; overall stock markets in the US and in Europe have also continued to be strong. Forward-looking economic reports suggest that the US economy is improving its rate of growth. As a result, the likely beginning of the next recession seems well off into late next year or later. Thus, we can have somewhat larger than typical portions of stock investments in the portfolios we manage.

CORE Comments

CORE ASSET MANAGEMENT

PO Box 1629
108 Caledonia Street
Sausalito, California 94966
(415) 332-2000 • (800) 451-2240
fax (415) 332-2151
www.coreasset.com
info@coreasset.com