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Meet the New Boss, Same as the Old Boss (Part II)

Four years ago in our December 2013 SEIA Report titled, "The Federal Reserve: Meet the New Boss, Same as the Old Boss", we offered reasons why analyzing the human makeup of the Board is so important (hint: they more or less set monetary policy for the world, affecting global capital markets everywhere). We opined that the new incoming Federal Reserve Chair Janet Yellen was very much in line with her predecessor and that her appointment was a "signal to all investors that easy monetary policy will be the policy of choice for the foreseeable future" and "short-term interest rates might be low for another three years extending through 2016." We concluded by stating "Yellen's policies should support 'risk assets' (Equities, High Yield Bonds, etc.) in the near term with her hopeful goal of higher inflation and economic overheating (not a typo) four years out which will in turn convolute her reappointment process (in 2017)."

Four years have now passed and while we can claim victory on our assessment of the stock market, our view of an overheated economy came up a bit short. As such, the reappointment process caused nary a ripple in global markets as the new-new boss is the same as the old-old boss.

Who is Jerome Powell?

On November 2, 2017, President Trump nominated Jerome "Jay" Powell to be the next Fed chair, providing clarification for the market and lessening monetary policy uncertainty in the near and intermediate term. Many believe that a Powell-led Fed will continue Chair Yellen's policies, which the market generally views as a positive sign.

Mr. Powell has been serving as a member of the Federal Reserve Board since May 2012. In addition to private sector experience as a lawyer and investment banker, he has previous experience at the U.S. Treasury during the George H.W. Bush administration. One important differentiator: unlike outgoing Fed Chair Yellen and every Fed Chair over the past three decades, Powell is not an academically trained economist which may appeal to President Trump's base. In the end, President Trump comes out a winner as he gets to appoint a new Chair yet still maintain a low interest rate policy (a major pivot from his earlier candidate Trump remarks).

What to expect going forward

…for Interest Rates: As stated, many economists view Powell as the "Candidate of Continuity", expected to maintain Chair Yellen's dovish policies. Supporting this view, as a Fed governor, Powell never voted against Janet Yellen on any interest rate policy decision. Powell has signaled his support to continue the trajectory of gradually raising the Fed Funds rate as long as the economy performs as expected. The median Fed projection is for three interest rate hikes over the course of 2018 assuming all goes as forecasted. Following the announcement of Powell's appointment, Treasury yields were relatively unchanged, signaling that the market expects no departure from the path of modest rate increases going forward.

…for the Fed Balance Sheet: It is expected that Powell will continue to follow the passive tapering schedule, which commenced in October. This plan, which was well-communicated to the markets, calls for a gradual and predictable monthly reduction in the Fed's Treasuries and mortgage security holdings as securities mature.

…for Regulation: In what may be the biggest departure from his predecessor, Mr. Powell generally seems to be in favor of deregulation. He has acknowledged that the economic costs of financial crises warrant higher bank capital ratios. However, he has also emphasized the importance of reducing the regulatory burden on small banks and of simplifying complex rules far more than Chair Yellen. Overall, he is likely to bring a somewhat lighter touch to financial regulation.

…for the Composition of the Fed: Separately, with Powell set to be Chair, there are three other vacancies on the seven-seat Fed Board (and potentially four if Yellen decides to leave). Who President Trump appoints to fill these positions will be well worth paying attention to. We would expect most of these new appointees to come from more traditional academic backgrounds and to generally be supportive of Trump's agenda.

What does this mean for my portfolio?

While the nomination of Powell is viewed by most as a continuation of the policies currently in place at the Fed, the unprecedented calm we are experiencing in the markets may have lulled many investors into a false sense of security. It's important to remember that market volatility is normal and will return at some point. Studying history as a guide for what the future might hold can often be helpful and here we have both good and bad news. Research from Ned Davis shows that while the average return within 6 months of a new Fed Chair has historically been positive (albeit marginally), the stock market has often experienced increased turbulence, with a median market correction of just over 10%.

Fed Chairperson	Year	Return (Six-Month)	Return (12-Month)	Max Drawdown (Six-Month)	Max Drawdown (12-Month)
W.P.G. Harding	1916	1.7%	2.1%	-21.0%	-21.0%
Daniel R. Crissinger	1923	-9.2%	-5.4%	-12.7%	-12.7%
Roy A. Young	1927	5.5%	20.7%	-9.8%	-9.8%
Eugene Meyer	1930	-22.6%	-49.7%	-33.8%	-49.8%
Eugene R. Black	1933	20.7%	11.5%	-23.0%	-23.0%
Marriner S. Eccles	1934	14.9%	46.7%	-9.8%	-9.8%
Thomas B. McCabe	1948	2.4%	-2.0%	-8.9%	-11.4%
Wm McChesney Martin	1951	11.2%	8.3%	-7.8%	-7.8%
Arthur F. Burns	1970	-1.7%	17.6%	-20.4%	-20.4%
G. William Miller	1978	20.9%	12.5%	-7.0%	-13.5%
Paul A. Volcker	1979	3.9%	10.6%	-11.2%	-16.0%
Alan Greenspan	1987	-26.8%	-23.9%	-36.1%	-36.1%
Ben S. Bernanke	2006	1.6%	15.7%	-8.0%	-8.0%
Janet L. Yellen	2014	7.3%	14.9%	-3.8%	-6.7%
Medium		**3.2%**	**11.0%**	**-10.5%**	**-13.1%**
Average		**2.1%**	**5.7%**	**-15.2%**	**-17.6%**

Source: Ned Davis Research

Even though expectations are for very few changes as we transition from a Yellen to Powell-led Fed, it would not be unprecedented to experience some turbulence as the market adjusts to the new Fed composition. Looking out past the short-term, to 2019 and beyond, Powell will be faced with important decisions such as how and when to end the process of policy normalization which is an economist's way of thinking about the ultimate top in short-term interest rates. Prior cycles have seen the Fed Funds top out at levels over 4% (remember when money markets yielded north of 6%?) but that was when inflation was over 3%. This cycle is different, whether due to demographics or globalization, and we would be surprised if it comes close to prior cycles. Nevertheless, an allocation to intermediate bonds is still warranted – offering a goldilocks combination of not too much duration and not too little yield. Moving into mid-2019, capital markets will be keeping a watchful eye on how Chair Powell navigates the potentially choppy waters and whether he can further elongate what has already been one of the longest business cycles in U.S. history. Similarly, we will continue to monitor these developments for our clients, and position portfolios accordingly.

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