Will the Recent Shake-Up Alter Policy at The Fed?

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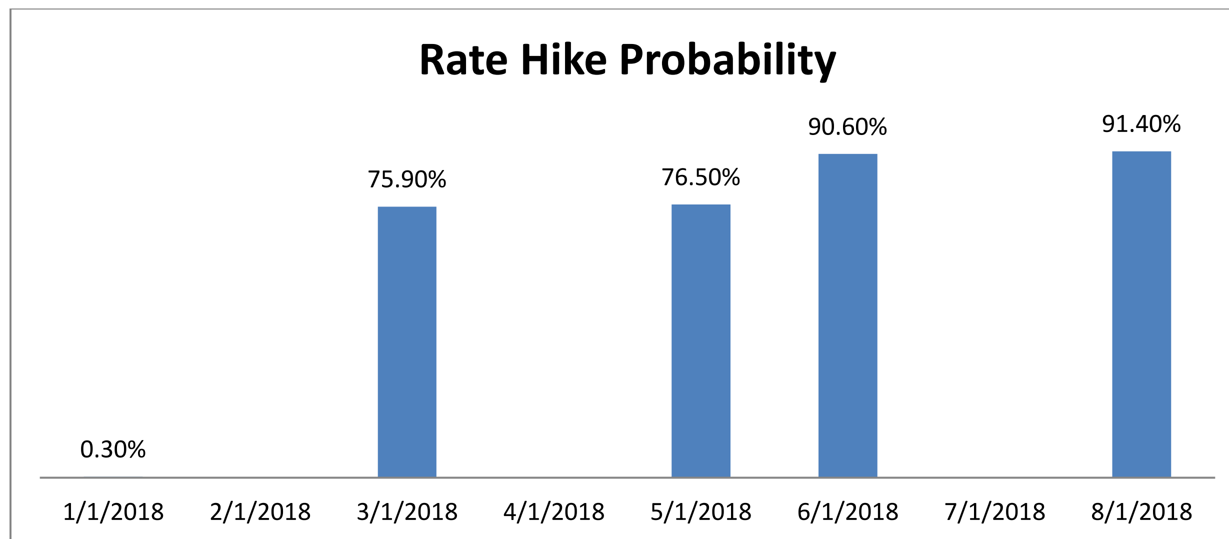
The nomination of Jerome Powell to lead the Federal Reserve, while expected, has generated uncertainties among market participants. Although Powell's near-term policy is anticipated to remain consistent with that outlined by Janet Yellen, his disposition during cyclical downturns has yet to be tested. Given that Powell's appointment to the Board occurred during a recovery and that his academic credentials are in law and not in the economic policy realm, little is known about how he expects policy to be implemented during times of stress. Compounding this uncertainty is the number of vacancies on the board of governors and the membership changes to the Federal Open Market Committee.

Powell's nomination was generally well received. His stance on monetary policy, despite his political affiliations, is considered to be dovish and consistent with current Chair Janet Yellen. Nonetheless, Powell has no experience in policy making during downturns. Accordingly, little is known about how he will handle a market disruption. Moreover, Powell's lack of academic credentials in monetary economics puts him at a disadvantage relative to previous Fed Chairs and creates uncertainty among market participants who can't ascertain what his actions will be when confronted with a deteriorating economic environment. This implies that Powell will likely rely heavily on his fellow board members and his internal advisors at the Fed to inform his decision making process. Although he will have a deep institutional brain trust at the Fed to draw from, the potential changes to the FOMC will further exacerbate the uncertainty.

The FOMC consists of the seven Board Governors, the President of the New York branch, and four members drawn from the remaining pool of branch Presidents who are rotated annually. In 2018, there will be a new slate of branch Presidents and a new Vice Chair (New York branch President) due to William Dudley's announced retirement. Moreover, the Board of Governors currently has three vacancies. In other words, the FOMC will experience a major shake-up in 2018. The extent to which the vacancies on the board are filled and the degree to which the ascending members influence the incoming Chair will, in turn, determine how policy will be molded in the future.

Taking the latest FOMC meeting as a starting point, it is clear that the committee believes that economic circumstances have been revalued to the upside. As the minutes reveal, the FOMC staff viewed developments since the last meeting as a signal of a stable to an improving economy. Moreover, the growth outlook for 2018 was revised upward as a response to fiscal stimulus, thought to be a result of the recently passed tax reform. As expected, the committee voted to raise the Fed Funds Target Rate to 1.25%-1.5%. Additionally, in keeping with previous projections, the FOMC’s forecast of the policy rate remained at approximately 2.1% for yearend 2018. This would imply that the committee sees three rate hikes in 2018, consistent with market expectations. The following graph shows market participants'

perceived probability of an interest rate hikes for the next several meetings, beginning with the January 2018 meeting.



Source: Bloomberg Data, CME Group (1/8/18)

More recently, transcripts from the Fed's 2012 meetings were made public. These minutes provide some insight into incoming Chair Powell's thoughts as they relate to the monetary policy authority's unprecedented actions taken in the aftermath of the Great Financial Crisis. The transcripts reveal Powell's reservations with respect to the Fed's large scale asset purchasing program and its' impact on inducing risk seeking among market participants. Similarly, he expressed his concern with the future unwinding of the program as it relates to the volatility in rates. Now that he is likely to be heading the unwinding that he'd referenced back in 2012, his past comments have gained a resurgence in interest. The market commentary on the matter has been notably confusing, with debate arising regarding whether Powell's concerns are even valid given the changing MBS landscape and financial environment. Nonetheless, the minutes reveal something more important about Powell's attitude and disposition. A cursory reading of the transcripts indicate that Powell displays a flexible understanding of monetary policy and a healthy skepticism towards difficult to communicate actions. In addition, he gives off the impression that he is especially focused on the Fed's credibility vis-a-vis its communications strategy and its reflexive relationship with markets. While market participants should be wary of making conclusions based on comments made over half-a-decade ago, Powell's insistence on holding views that are domain dependent and consistent with a predictable unwinding of stimulus are good indications that policy will not experience a massive shock in the near-term (absent a dramatic change in economic variables). Coincidently, a recent Bank of America Merrill Lynch Global Research note indicates that the biggest risk in 2018 is rising inflation which may induce a more aggressively hawkish monetary policy.

While Governor Powell is not scheduled to take over until February, an incoming slate of new FOMC members will be present at Yellen's last meeting that will take place January 30th-31st. Hopefully, their participation at this final meeting, headed by Yellen, will illuminate on their respective policy predilections. This will, in turn, allow market participants to better understand what the policy leanings

are of the committee Powell is likely to inherit. Although there is a general consensus that the incoming FOMC will be, at the very least, less dovish than the previous one, many of the new voting members will have only been recently appointed to their respective regional Federal Reserve Banks and thus, little is known about their policy inclinations. The following table summarizes the incoming changes to the rotating component of the FOMC.

	2017	**2018**
New York*	Centrist	Centrist
Chicago	Dovish	
Philadelphia	Centrist	
Dallas	Centrist	
Minneapolis	Dovish	
Cleveland		Hawkish
Richmond		Centrist
Atlanta		Centrist
San Francisco		Hawkish

Source: Board of Governors of the Federal Reserve System, Reuters data, VAAM
* Permanent member - current President William Dudley expected to retire in mid-2018

A number of Fed officials have voiced their concerns with the recent flattening of the yield curve. Their worries are rooted in the yield curve's historically reliable characteristic of serving as a harbinger of a deteriorating economic environment. Accordingly, some have even indicated this development as a reason to explore a more dovish approach to policy. Notably, the Dallas Fed President, Robert Kaplan, has indicated that continual flattening would limit flexibility in pursuing the FOMC's tightening agenda. Kaplan's qualms are echoed by his 2017 FOMC colleagues, Kashkari and Bullard of the Minneapolis and St. Louis Fed respectively[1]. Nonetheless, the incoming slate of FOMC members appear to hold more hawkish views. Therefore, only experience will indicate to what extent this development continues to influence policy.

Although the FOMC is likely to undergo a massive change over the course of 2018, it is unlikely that policy will be influenced more by the intellectual preconceptions of its incoming members than by the incoming economic data. Furthermore, Powell's ascension to Chairperson is expected to be a continuation of Yellen's tenure. While it is certainly true that his disposition has yet to be tested in a crisis, the institutional

[1] https://www.bloomberg.com/news/articles/2017-12-19/fed-s-kaplan-warns-inverted-yield-curve-would-limit-flexibility

strength of the Fed and the degree to which Powell is influenced by incoming members will determine the future path of policy.

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