PICTET 1805

Flash Note

Federal Reserve – New sheriff in town

Powell is cut from the same cloth as Yellen

Pictet Wealth Management - Asset Allocation & Macro Research | 3 November 2017

President Trump has nominated Jerome ('Jay') Powell to succeed Janet Yellen as Chair of the Federal Reserve from February 2018.

Powell is likely to stay true to Yellen's approach and unlikely to accelerate the tightening cycle set in motion by his predecessor.

Many politicians' focus is on banking de-regulation, a task likely to be carried forward by the newly appointed vice chair for banking supervision, Randal Quarles.

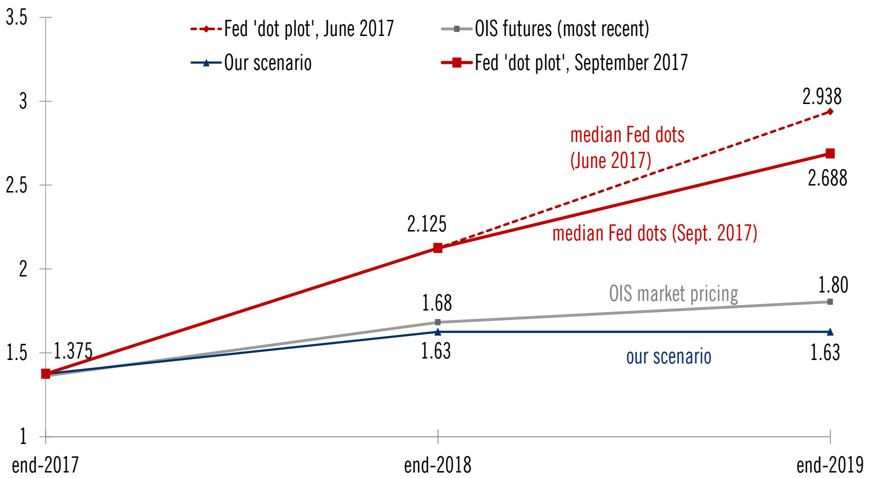
Our Fed scenario remains unchanged. We still see two further rate hikes (one in December, the other in March next). The risk of a June rate hike is rising given recent stronger-than-expected economic momentum.

On 2 November, President Trump nominated Jerome ('Jay') Powell to succeed Janet Yellen at the helm of the Federal Reserve System, confirming recent press speculation. The next step before the new Fed chairman can enter office next February is Senate confirmation. This looks unlikely to be problematic for Powell.

From a monetary policy perspective, Powell is unlikely to be very different from Yellen (who was herself very much in the vein of her predecessor Ben Bernanke). Powell is centrist-to-dovish, and the Fed is likely to remain prudent in its rate-hiking cycle as a result. In other words, rate hikes will most probably remain on the slow track. Powell's landing the role therefore leaves unchanged our monetary policy scenario, which foresees two 25bps hikes ahead (one in December, the other in March 2018).

Powell has broadly followed the Yellen line since being appointed Fed governor in 2012. Powell, who does not have a PhD in economics (he is a lawyer by education), appears to be strongly influenced by the Fed research staff, which tends to be dovish. This influence will most probably continue. The key pillars of the Yellen-Bernanke policy 'dogma' are likely to remain in place. Like them, Powell believes in the Philips curve link between a tighter labour market and higher inflation. He also believes that the theoretical neutral rate has shifted down significantly in recent years, which should limit the magnitude of rate hikes in the current cycle. This is why we think the Fed will indeed stop when short-term rates near 2% (by comparison, the Fed's interest rate on excess reserves now stands at 1.25%).

Rate hikes: The gap between Fed members' views and market pricing is still large



Source: Pictet WM-AA&MR, Thomson Reuters (as of 2 November 2017).

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Will the Powell Fed step back from the spotlight?

Powell, also a former executive at a large Washington DC-based private equity group, has generally kept a low profile during his time as a Federal Reserve governor. His speeches have been very measured in tone, in contrast with that adopted by some regional Fed presidents. Powell's pronouncements generally reflect strong consensus-building skills and an ability to listen (particularly to the academically oriented Fed staff).

This contrasts somewhat with Trump's bombastic rhetoric and his willingness to rock the boat in Washington DC. Powell will definitely rock no boat at the Fed. His nomination probably echoes many Republicans' desire to see the Federal Reserve take a backseat after having been constantly in the spotlight since the financial crisis and several rounds of highly controversial quantitative easing. In a sense, Powell's nomination is the embodiment of efforts to push the Fed back to its more traditional role of payment-clearing house.

Many politicians, including probably Trump himself, are less interested in the Fed's role in setting monetary policy than in its role as banking regulator. Looser banking regulation is the current key priority of many Congressional Republicans, who have complained that the post-crisis regulation push went too far, choking credit to the economy and actually weakening the banks themselves (a view that remains debatable). In that respect, the spotlight will be on Randal Quarles, the Fed's newly appointed Vice Chair for Supervision.

While Powell has been advocating a more relaxed approach to regulation, but no deregulatory big bang, we think that Quarles, an avid de-regulator, will probably take the lead in the deregulation efforts. It will be interesting to watch how the relationship between the two men evolves.

It will be equally interesting to see who is nominated to the other vacant seats on the Fed board. The nominations could affect how decision making evolves at the Fed. Trump has remained quiet about these vacancies.

In the near term, the Fed appears very likely to hike rates another 25bps at the 13 December meeting, given solid economic data (which trump weak core inflation readings) and loose financial markets conditions. The current market probability of a December rate hike is 88%, according to Bloomberg data.