Innealta CAPITAL SPECIALISTS IN ACTIVE MANAGEMENT OF ETF PORTFOLIOS

# The Fed has a new chair: a brief review of the challenge ahead

**Key takeaways:**

- **We expect no major shifts in monetary policy if Congress approves Jerome Powell's nomination to head the Federal Reserve Bank.**
- **The main challenge of Powell's four-year term will be the reduction of the central bank's balance sheet, in progress since October.**
- **He will not be the only central banker doing this: the European Central Bank and The Bank of England will be attempting the same.**
- **The scale and pace at which this task is attempted are not straightforward choices, for they could affect many important economic variables.**
- **Absent major surprises, we believe that the Fed's balance sheet reduction should have a modest effect on the world's economy.**

President Donald Trump unveiled his nominee to head the Federal Reserve Bank on November 2nd. His choice was Jerome Powell, who has served as a member of the Federal Reserve's board since 2012 (nominated by President Obama). At 64, he will be the first former investment banker at the helm of the Fed. A lawyer by training, he will also be the first chairperson who is not an economist in more than 40 years. His deep knowledge of financial markets is one of the great strengths he will bring to the job. We expect the Senate to approve his nomination, despite rumors that many Republican senators favored a more radical change at the top of the Fed (namely, the nomination of Professor John Taylor). His voting record shows that he has sided with the current chair, Janet Yellen, to raise interests very slowly and to start reducing the Fed's approximately $4.5 trillion balance sheet. It is thus widely believed that he will continue with the pragmatic approach that characterized his two predecessors, Ms. Yellen and Ben Bernanke.

However, analysts are already speculating that he may not stay the course when it comes to regulations of the financial industry, especially those put in place after the 2008 crisis. Although he does support most of the Dodd-Frank reforms, he opposes the Volcker Rule, which forbids banks from making certain speculative investments (e.g., proprietary trading, investing in hedge funds). His opposition is based on the burden it allegedly imposes on small banks. Regardless of his stance on regulations and even interest-rate policy, we believe that his main challenge will be the reduction of the Fed's balance sheet. Interestingly, this is something his European and English counterparts will also be doing at the same time.

In the remainder of this commentary, we set out to review the main problems he could face during his four-year tenure, which would start in February of 2018.

**The road ahead**

The Fed is responsible for monetary policy. Its main targets are price levels (that is, keeping inflation low) and maximizing employment. If one looks at inflation and the rate of unemployment, it seems like the Fed is navigating through relatively calm waters. The Fed would probably like inflation to pick up a little bit, but that's it. Moreover, low inflation is not only the result of monetary policy, but also a product of demographic factors and low energy prices, among others.

Nevertheless, the next few years will be very challenging for the monetary authority. The reason stems directly from the policies the Fed has followed since 2008 to keep the economy afloat in the aftermath of the Great Recession. The so-called quantitative easing (QE) program led the Fed to buy, from 2008 until 2014, more than $3.5 trillion in government and mortgage-backed debt. The European Central Bank and The Bank of England implemented similar programs. This aggressive intervention helped, according to its supporters, to increase liquidity in markets, accelerate economic recovery

and boost confidence.

But now the time has come not only to stop the QE programs, something the Fed already did (2014), but also to dismantle them. This means not only that the central banks will stop buying new bonds, but that they will not roll over the ones that expire. Hence the bloated balance sheets of these central banks will have to slowly ebb back to something closer to its historical levels. The Fed started this process in October, albeit at a very slow pace, as we already described in a previous paper. The ECB has only committed to halving its purchases next January, saying they will continue at least until September (a date for rolling back the program is nowhere in sight). It is estimated that the Fed and the ECB will have to let go of more than $4 trillion in assets during the next few years. To put that number in context, Germany – Europe's largest economy – has a GDP of $3.5 trillion. How this is done in the US will now depend mostly, of course, on Mr. Powell.

The reason to reduce the balance sheet is two-fold: economic conditions have improved dramatically, reducing the need for intervention, and central banks need to recover some margin of action in case their intervention is warranted again. The risk comes from drying up liquidity, which is why both the Fed and the ECB have been extremely careful in the steps they have taken, cautiously announcing their moves so that markets are not caught by surprise. What seems clear now is that the entire process will take years, meaning it will greatly define Mr. Powell's four-year term. If financial-market stability has heavily relied on the Fed's loose monetary approach, then it follows that the end of QE has to be conducted with extreme care. Governments, businesses, and households have benefitted from very low interest rates. What will happen when those rates go up? The Fed has already started the process of hiking interest rates (four times in the last two years), plus it has the advantage of a much smaller balance sheet relative to GDP than its European counterpart (23% of GDP versus 60% of GDP).

The main question is whether the scaling back of QE in the US can be done without upsetting markets. We believe this is possible, especially in light of two facts. First, much better economic conditions mean that QE is far less needed, and, secondly, the fact that the ECB and, especially, the Bank of Japan will continue with their asset-purchase programs in 2018 means that liquidity will continue to grow. But there is a downside, of course. As the cost of financing goes up, we may find that some companies are financially unviable in this new environment. Moreover, the price of financial assets could be affected. Higher interest rates always run the risk of popping bubbles. This risk is probably higher for banks in Europe, some of which are heavily exposed to public debt. Especially risky is that of so-called peripheral countries. At the same time, banks everywhere will benefit from reduced liquidity and a higher cost of borrowing. One of the problems with prolonged near-zero rates is the pressure they put on bank profits, yet another reason for ending QE.

As for inflation, even though the Fed targets a rate of 2%, the fact that the core inflation is considerably below the target may end up being a blessing for Mr. Powell. If inflation were high, the pressure to remove the monetary stimulus would be much greater. But in the absence of inflation, there is ample room to time the scaling back of QE according to other variables. Additionally, debt levels have ballooned, meaning interest rates will have to remain low for a long time. And finally, the fact that rates will remain at zero or near-zero levels elsewhere (think Eurozone and Japan, e.g.) will make it harder for the Fed to increase rates too much.

If inflation were to suddenly pick up – and there are analysts who believe there are pockets of latent inflation in the economy –, things would become much more complicated. The tightening of monetary policy would have to be harder and faster. The question is whether it would be wise to preempt this scenario with higher rates, with the obvious risk of slowing down economic activity and going back to a near-deflationary state. Inflation estimates are not the most reliable ones right now. Even Janet Yellen, the current Fed chair, has been very explicit about the uncertainty surrounding expected inflation.

On the other hand, rolling back QE slowly is not without its risks. If another crisis erupted, a Fed with an oversized balance sheet and very low interest rates would have little margin to maneuver.

Luckily for Mr. Powell, the QE program in the US, unlike in Europe, was not meant to give governments time to enact deep structural reforms to address problems like fiscal deficits, pension reform, and corruption. The ECB will have the added problem that many of those reforms have not happened (in no small part because these low financing costs have propelled growth), which makes similar future problems more likely. The fiscal union in the US is another advantage for Mr. Powell.

When it comes to employment, the picture looks better, at least in the short-run. The Congressional Budget Office (non-partisan) estimated at the beginning of 2017 that, within the next two years, there would be a continued expansion of the economy, such that virtually all unused resources would be put to work. The slack in the labor market should be gone in 2018, with hourly wages going up. Only after this period should we start to see slower growth. However, this narrowing in the output gap should put upward pressure on both inflation and interest rates. All in all, we believe that an orderly reduction of the Fed's balance sheet is possible and, absent major surprises, should have a modest effect on the world's economy.

### Conclusion

The nomination of Jerome Powell to the Fed should be taken as good news by markets everywhere. A pragmatist who brings deep knowledge of financial markets to the job, he should continue with the measured and careful approach the current Fed chair has followed. This should apply to both interest-rate policy and the reduction of the Fed's $4.5 trillion balance sheet. This means predictable and gradual rate hikes in the future, as well as a slow decrease in the total assets held by the Fed. The latter should, absent major surprises, have a modest effect on the world's economy.

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