WILL THE NEXT FED CHAIR BE "TAYLOR-MADE" FOR THE POSITION?

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In the midst of everything else that is making headlines in Washington, D.C., of late, one of the more interesting story lines concerns who the next Federal Reserve (Fed) chair will be. As a reminder, the term of the current chair, Janet Yellen, is scheduled to end on February 3, 2018. The process for finding a potential successor (or maybe not if President Trump decides to reappoint Yellen) is apparently well underway, with a variety of candidates being interviewed.

Although when he was on the campaign trail, then-candidate Trump seemed to intimate that Yellen would not be reappointed, apparently she is one of the candidates being considered. The remaining names that reportedly are on the short list are the current Fed governor Jerome Powell, the ex-Fed governor Kevin Warsh and Stanford University economist John Taylor. A few months ago, Gary Cohn, director of the National Economic Council, was considered to be in the running, but according to recent press reports, his star has faded.

So, is there a front-runner as I write this blog post? Interestingly, depending on the week, or even the day, the names change on a regular basis. At the outset, the markets seemed to operate under the assumption that Cohn was out in front, but that line of thinking then turned to Warsh as a potential favorite. Lately, there has been a back and forth between Taylor and Powell, but just last week, it was reported that Yellen was seen for a second White House visit following her formal interview. The latter point is a perfect case of "Fed Chair intrigue". While Yellen may have been brought back for another meeting with the president, remember that she still is the reigning Fed chair as well, and such a meeting may have been related to current policy.

The financial markets always seem to have a preconceived notion regarding how a "next Fed chair" would tend to lean from a policy perspective, either hawkish (more aggressive about raising rates) or dovish (less aggressive on the rate front.) In my experience, the track record on these preconceived notions can leave a little to be desired. At times, events or developments occur that call for a decision-making process that requires fresh thinking, with past policy biases being rendered unhelpful.

With all that being said, how does the U.S. Treasury (UST) market view the potential candidates? For this blog post, I'm going to take a leap of faith and remove Cohn from contention. That leaves us with Warsh, Taylor, Powell and, of course, Yellen. Trying not to complicate the reasoning here, Warsh is viewed as leaning a little more to the hawkish side based upon his published views that his preference would be for a smaller Fed balance sheet. Although the current Federal Open Market Committee (FOMC) is embarking down this normalization path, the UST market seems to think a Warsh-led Fed could be more aggressive. Taylor is also viewed to be on the hawkish side of the equation based upon his well-known work, dubbed the Taylor Rule, a formula devised to set the Federal Funds Rate based on a target inflation rate and economic output. Both Yellen and Powell are viewed more favorably to the U.S. rate setting because they would represent a continuation of current monetary policy.

Conclusion

At present, the UST market is operating under the assumption the next Fed chair will be either Taylor or Powell. The preference is tilted toward Powell for the aforementioned reason, while the likelihood of a Taylor-led Fed being viewed as more of a potential negative development based on past experience. Indeed, back in 2011, Taylor wrote that he thought the Federal Funds Rate should be 1% based on his work (it was zero at the time) and that the Fed should not be contemplating another round of quantitative easing (QE). QE3 was later announced at the September 2012 FOMC meeting. Interestingly, the Fed chair and vice chair positions both need to be filled, so perhaps the markets could see a kind of two-for-one announcement. Bottom line: the markets may find out sooner rather than later, as expectations are that President Trump will announce his decision before his next Asian trip on November 3.

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Federal Reserve : The Federal Reserve System is the central banking system of the United States.

Hawkish : Description used when worries about inflation are the primary concerns in setting monetary policy decisions.

Rate Hike : refers to an increase in the policy rate set by a central bank. In the U.S., this generally refers to the Federal Funds Target Rate.

Dovish : Description used when stimulation of economic growth is the primary concern in setting monetary policy decisions.

Treasury : Debt obligation issued by the U.S. government with payments of principal and interest backed by the full faith and credit of the U.S. government.

Federal Open Market Committee (FOMC) : The branch of the Federal Reserve Board that determines the direction of monetary policy.

Inflation : Characterized by rising price levels.

Monetary policy : Actions of a central bank or other regulatory committee that determine the size and rate of growth of the money supply, which in turn affects interest rates.

Quantitative Easing (QE) : A government monetary policy occasionally used to increase the money supply by buying government securities or other securities from the market. Quantitative easing increases the money supply by flooding financial institutions with capital, in an effort to promote increased lending and liquidity.