LPL RESEARCH

BOND MARKET PERSPECTIVES

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THE FED IS MOVING FORWARD

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KEY TAKEAWAYS

Jerome Powell will take over as Fed chair on February 3 and may continue the path of data-dependent, gradual rate hikes laid out by his predecessor, Janet Yellen.

Loosening regulations on banks, done in part by the Fed itself, could stimulate lending and provide another tailwind to an already strengthening economy.

If current Fed nominees are confirmed, President Trump will still have three vacancies to fill, which could change the makeup of the body.

Jerome Powell will begin his term as chair of the Federal Reserve (Fed) on February 3, following the Fed's upcoming January 30–31 meeting. He is largely expected to follow a similar monetary policy blueprint as outgoing Chair Janet Yellen, with balance sheet normalization continuing as previously scheduled and a gradual path of data-dependent rate hikes. With Powell's confirmation, and Yellen's upcoming exit, President Trump will have three remaining posts to fill on the Fed's seven-member board of governors (assuming the previously nominated Marvin Goodfriend is confirmed as expected).

DEREGULATORY PUSH

One of the key ways that Powell may differ from Yellen centers on his plan to potentially lighten regulation of the financial sector. Powell is viewed as receptive to the easing of regulatory burdens and has said that while regulation enacted since the financial crisis has made the financial industry safer, there is room for streamlining and some rollback. During his testimony with the Senate Banking Committee, Powell announced intentions to "continue to consider appropriate ways to ease regulatory burdens while preserving core reform," indicating that regulatory relief may be coming but wholesale, sweeping deregulation appears unlikely.

One person who is looking to help in the deregulatory effort is Randal Quarles. Quarles was confirmed by the Senate as a governor on the Fed's board, where he will vote on monetary policy. He will also hold the title of vice chairman for supervision. Quarles said during confirmation hearings that the government could relax or loosen some restrictions put in place post-financial crisis, as some of the regulations could arguably limit lending, and consequently economic growth. Data may back up Quarles' point: The increase in money supply from quantitative easing programs done by the Fed didn't have as much of an impact on growth or inflation as anticipated, largely because regulation kept much of that capital tied up on bank balance sheets.

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How Deregulation Could Be Achieved

- **Limiting the number of banks that are subject to certain requirements**, such as the "stress tests," that were designed to ensure that banks could withstand market shocks. During Senate Banking Committee testimony, Powell indicated he did not believe that any of Wall Street's largest banks should still be considered "too big to fail."
- **Making changes to the Volcker Rule**, which prohibits banks from proprietary trading (trading with their own capital). Powell has signaled that some of these rules may be too broad and should be limited to exclude smaller financial institutions, which don't pose any large systemic risk.
- **Loosening liquidity coverage ratios**, both short- and long-term, which determine how much liquid assets banks must maintain based on their asset and liability mix.
- **Introducing changes to the types of assets that would qualify as high-quality liquid assets** (HQLA) that are needed to satisfy those liquidity coverage ratios. Investment-grade municipal bonds, for instance, have previously not qualified as HQLA, yet a recently passed House bill seeks to change that.

Notably, not all of the deregulatory possibilities listed above are under the purview of the Fed. Some may necessitate legislation, while other changes can simply be made by bank regulators like the Fed, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation.

Simplifying regulations may have the added benefit of reducing costs associated with compliance. All of these changes combined could lead to increased profits for banks, but also to increased lending due to changes in allowable leverage ratios. This could be a further tailwind for an already improving economy.

MORE SEATS TO FILL

The president has significant leeway in how the makeup of the Fed changes in the near future. The Fed Board of Governors is a seven-member panel, and three of those positions are currently vacant. Former Governor Daniel Tarullo resigned in April, while Vice Chair Stanley Fisher stepped down effective mid-October for personal reasons. With Powell assuming his role as chair, there is an additional vacancy for his current role of Fed governor. The Senate did recently approve the president's pick for Vice Chair of Supervision, Randal Quarles;

THE FOMC STRUCTURE

The Federal Open Market Committee (FOMC) consists of 12 voting members—the 7 members of the Board of Governors of the Federal Reserve System; the president of the Federal Reserve Bank of New York; and, 4 of the remaining 11 Reserve Bank presidents, who serve one-year terms on a rotating basis. The nonvoting Reserve Bank presidents attend the meetings of the Committee, participate in the discussions, and contribute to the Committee's assessment of the economy and policy options.

Doves: Fed officials who favor the full employment side of the Fed's dual mandate of low inflation and full employment.

Centrists: Fed officials who strike a balance between hawks and doves, and may end up on either side of the discussion depending on the topic and data.

Hawks: Fed officials who favor the low inflation side of the Fed's dual mandate.

Marvin Goodfriend, a Carnegie-Mellon professor of economics, has been nominated as Fed governor, but has not yet been confirmed.

Within the rotating group of four voting members from the 12 reserve banks, there were three doves and one centrist in 2017. In 2018, the makeup will change to two hawks and two centrists, simply because of the rotation of Fed members. This move alone will push the overall FOMC toward a more hawkish bent, at least for 2018, regardless of what happens with the remaining vacancies.

DUAL MANDATE

The Fed's explicit mandates are maximizing unemployment and stable prices. The Fed seeks to have unemployment at or near its natural rate (as some unemployment is a sign of a healthy economy, with workers free to move from job to job) and inflation at or near the Fed's 2% target. With respect to these two mandates, the Fed has found itself in a goldilocks zone for the past several years. Unemployment has continued to decline, a positive sign for the economy, but inflation has not experienced a strong and meaningful pickup, which has allowed the Fed to raise interest rates in a slow and telegraphed manner. Wage growth has in previous cycles needed to push to about 4% to make the Fed more aggressive in its rate hike schedule. With wage growth currently running near 2.5%, this is another sign that the Fed can continue its tempered approach to raising rates.

We believe there is a third mandate, though not explicit, that the Fed no doubt keeps an eye on, and that is the strength of the U.S. dollar. Though recent dollar weakness has lessened this concern, the Fed remains cognizant of dollar strength relative to other global currencies. The Fed's optimal scenario is to raise interest rates without causing major dollar strength. An overly strong U.S. dollar can have negative impacts for the global economy. Many emerging market (EM) countries issue debt denominated in U.S. dollars to increase attractiveness for U.S. and global investors. A very strong dollar means that those debt payments become more expensive to make, potentially leading to delays in payments or even defaults on EM sovereign debt. This could cause a snowball effect that would harm the global economy. On a more practical level, a strong dollar can lead to price appreciation for goods in EM countries, such as food and energy, which comprise a larger portion of consumer pricing measures than in developed markets, and could lead to negative humanitarian consequences. This is another scenario that nobody, including the Fed, wants to see.

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CONCLUSION

Under Powell's new leadership, the Fed could remain data dependent, patient, and telegraphed in its gradual approach to raising interest rates. It is also anticipated that the Fed will remain on the same path with respect to balance sheet reduction, resulting in a continued ramp up over the course of 2018. The Fed is tightening monetary policy as other important central banks, like the Bank of Japan and the European Central Bank, are in a holding pattern with their easy policy, though they may too scale back accommodation in the coming year. Reducing the regulatory burden on banks may lead to an increase in lending capacity, which combined with the recent tax cuts could be a further tailwind for an already strengthening economy. If this happens, we could see stronger corporate profits, a steepening yield curve, and a pickup in gross domestic product growth. ■

IMPORTANT DISCLOSURES

The opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual. To determine which investment(s) may be appropriate for you, consult your financial advisor prior to investing. All performance reference is historical and is no guarantee of future results. All indexes are unmanaged and cannot be invested into directly.

The economic forecasts set forth in the presentation may not develop as predicted and there can be no guarantee that strategies promoted will be successful.

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Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values and yields will decline as interest rates rise, and bonds are subject to availability and change in price.

International debt securities involve special additional risks. These risks include, but are not limited to, currency risk, geopolitical and regulatory risk, and risk associated with varying settlement standards. These risks are often heightened for investments in emerging markets.

DEFINITIONS

Quantitative easing (QE) is 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.

The Federal Open Market Committee (FOMC), a committee within the Federal Reserve System, is charged under U.S. law with overseeing the nation's open market operations (i.e., the Fed's buying and selling of U.S. Treasury securities).

Gross domestic product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period, though GDP is usually calculated on an annual basis. It includes all of private and public consumption, government outlays, investments, and exports less imports that occur within a defined territory.

Yield curve is a line that plots the interest rates, at a set point in time, of bonds having equal credit quality, but differing maturity dates. The most frequently reported yield curve compares the three-month, two-year, five-year and 30-year U.S. Treasury debt. This yield curve is used as a benchmark for other debt in the market, such as mortgage rates or bank lending rates. The curve is also used to predict changes in economic output and growth.