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Amundi ASSET MANAGEMENT

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INVESTMENT TALKS

NEW FED CHAIR: CONTINUITY BUT LOOSER REGULATION

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The appointment of a moderate republican, like Powell, appears as a pledge given by Trump to the moderates of his camp that he needs to pass tax cuts.

What is your view on the new Fed Chair, Jerome Powell, nominated by President Trump?

DB. Jerome Powell will succeed Janet Yellen in February 2018. He was the candidate of continuity with the Bernanke/Yellen era. Appointed at the Fed in 2012, Powell has consistently supported the monetary policy decisions since then. Like his two predecessors, he thinks that the equilibrium interest rate has fallen and that inflation is not threatening in the short term. Conversely, unlike them or John Taylor, Powell is not an economist. Unlike the latter, he does not favor rigid rules of monetary policy. These two characteristics played in his favor. His reputation for pragmatism and his experience in the bank probably ended up convincing Donald Trump that he is the man for the job. At a time when the tax reform is becoming more precise, the appointment of a moderate republican also appears as a pledge given by Trump to the moderates of his camp that he needs to pass tax cuts. In addition, Powell is measured when it comes to financial regulation, certainly favorable to a relaxation of the latter but not prone to upheaval. Finally, it should be noted that Powell gives an important role to the evolution of monetary and financial conditions (US dollar, long-term bond yields, credit spreads, and equity markets). It turns out that the Fed's "reaction function" will remain flexible and its action opportunistic. So if an expansionary fiscal policy calls for a rebalancing of the policy mix, with less monetary accommodation, it will be small steps. The risk of a rise in the US dollar and long rates requires proceeding with caution.

What is the main area of difference with Chairman Yellen?

CM. In our view, the notable and perhaps critical difference leading to Powell’s nomination may have been his views on regulation. While Yellen has been outspoken in her defense of the increased regulation of the financial sector following the 2008 financial crisis, nominee Powell has taken a more pragmatic approach to regulation. While Powell voted for most of the financial reforms enacted since 2008, he has supported cost-benefit analysis with respect to financial regulations and believes the Volcker Rule should be amended. Some investors supported the nomination of John Taylor, who developed the Taylor Rule, which in its original 1993 form, currently would support a significantly higher Fed Funds rate. Taylor has been very critical of the continuation of extraordinary easy monetary policy even as economic fundamentals have normalized. Taylor’s hawkish approach, however, could have hurt future economic growth, thereby undermining one of Trump’s core campaign promises to create jobs.

How do you see this nomination impacting the US bond market?

CM. Jerome Powell’s nomination seems to support the status quo. We would observe, however, that Powell’s more mixed attitude toward regulation relative to Chair Yellen, coupled with the anti-regulation stance of Randal Quarles, vice chair for bank supervision, may lead to eased regulations for financial institutions and an increased supply of credit, which may contribute to stronger growth. With Powell’s appointment, we believe that the market continues to be “behind the curve” with respect to interest rates, and that the Fed may meet its forecast of raising rates four times by the end of 2018. We believe prudent investors may want to reconsider short duration strategies, and seek out thoughtful active flexible approach, who can help mitigate the impact of rising rates in a stronger growth environment.

The Fed kept rates unchanged in November meeting. What is the FOMC assessment of the economy?

AU. As anticipated, the Fed made no changes to monetary policy in its October FOMC meeting.

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The assessment of the economy is in line with our views: labor market is strong, incrementally absorbing the slack derived from the Crisis. Since September the labor market has continued to strengthen notwithstanding the drop in payroll caused by the hurricanes and the unemployment rate has continued to decline, perhaps below NAIRU[1]. The economic activity has been rising at a solid rate despite hurricane-related disruptions. Federal Reserve District Surveys point to positive current assessment and expectations for the next 6 months. Household spending has been expanding at a moderate rate, supporting internal demand as well as growth in business fixed investment which picked up in recent quarters (although some of it may be linked specifically to the mining oil and drilling). September headline inflation was temporarily boosted by Gasoline prices due to the hurricanes factor; however core inflation remained soft. On a 12-month basis, both inflation measured are running below 2%.

What is your expectation for the Fed monetary policy going forward?

We expect that the FOMC should be comfortable in delivering the 25bp hike in December.

AU. The released statement provided a positive assessment of the economy in line with previous assessments and therefore we expect that the FOMC should be comfortable in delivering the 25bp hike in December. Compatibly with our central scenario (broadly in line with central tendency range of the FED) for growth and inflation, we expect the FED to raise the rates twice in 2018. Should our upside scenario materialize (positive growth surprise coming from tax reform boost) another hike is possible, as the fiscal easing may be giving the possibility to monetary policy easing to be withdrawn more rapidly. Another hike going into 2019 is an additional risk associated with an environment of stronger growth and stronger inflation in our upside scenario. With regard to the headline inflation for 2018, we currently expect inflation to gently trend higher and stabilize around the 2% target. Between Q1 and Q2 2018 some base effects that kept the YoY inflation reading low should go out of annual comparison and therefore we may see inflation actually stabilize marginally above the average.
The core inflation, though, should still miss the target, although moving towards 2%.
A pattern of labor compensation that gently trends higher, but at a pace much lower than in the past, should confirm this scenario.

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