2 Turbulences ahead for the Fed with the new administration

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Donald Trump will be sworn in as US President on 20 January. With the Congress Republicans, who do not think the same way as Donald Trump on many topics, he will try to set radical reforms, in particular about the Fed. We propose here to review the main changes it might have for the Fed.

What structural changes are in store for the Fed?

The platform promoted by Speaker of the House Paul Ryan dedicates a section to the Fed. "*A Better Way*" says the Fed must stay independent and be "insulated from undue political pressure in conducting monetary policy." Yet "*A Better Way*" posits that the US economy would fare better if the Fed "was more predictable in its conduct of monetary policy and more transparent about its decision-making" and that **"[w]e need to modernize the Federal Reserve."**

A bill to modernize the Fed has already been filed: the *Fed Oversight Reform and Modernization* Act (the FORM Act), called H.R. 3189 and sponsored by Representative Bill Huizenga, has already been approved by the House of Representatives. The FORM Act would require more explanations from the FOMC about its monetary policy decisions. **In particular, it would require the Chair of the Board of Governors to explain to Congress why its decisions about fed funds differ from a Reference Policy Rule, in other words a traditional Taylor rule.** The *Federal Reserve Transparency Act* (aka "Audit the Fed"), which did not make it through the Senate in 2015, proposed the same idea.

Donald Trump has been highly critical of the Fed's policy in recent years, specifically saying fed funds rates have not been raised fast enough. The media made a fuss over Yellen not being reappointed as chair of the FOMC (her term expires in February 2018). Soon, Trump will have to appoint at least two members to the Board of Governors (see the "*FOMC Composition in 2017*" box). John Allison is one of the people Trump met with recently whom he could appoint to the Board of Governors. Allison is in favour of a traditional Taylor rule. Among the other names floated are… John Taylor, the Taylor rule's theorist. **The nominations that Donald Trump will make will greatly change the balance of power within the FOMC.**

However, adopting a Taylor rule is highly controversial

Neel Kashkari, Chair of the Minneapolis Fed and a former Republican candidate for governor of California, is against adopting a Taylor rule ("*A computer can't do the Fed's job*," Wall Street Journal, 18 December 2016), primarily because the neutral rate has weakened so much in the last few years. **In a note published on January 5, Kashkari declared that the implementation of a Taylor rule over the last years would have kept 2.5 million Americans out of work.** Jerome Powell, a member of the Board of Governors, had already given a speech on 9 February 2015 denouncing the possible adoption of a Taylor rule, saying that such a rule was already used for informational purposes but that he doubted that "important decisions [could] be reduced to a single equation."

FOMC members don't know where they stand

On 14 December, the Fed raised the fed funds target range by 25bp to 0.50/0.75%. The market now anticipates two rate hikes for 2017 and almost two more for 2018. Investors quickly concluded that the new US administration's economic policy would drive growth and inflation hard. US ten-year bond yields moved from 1.82% in late October to 2.44% in late December.

There are still sharp questions about the new administration's economic policy, and, to put it mildly, FOMC members don't know where they stand. The following paragraph of the latest FOMC minutes is striking: *"Many [FOMC]*

The essential

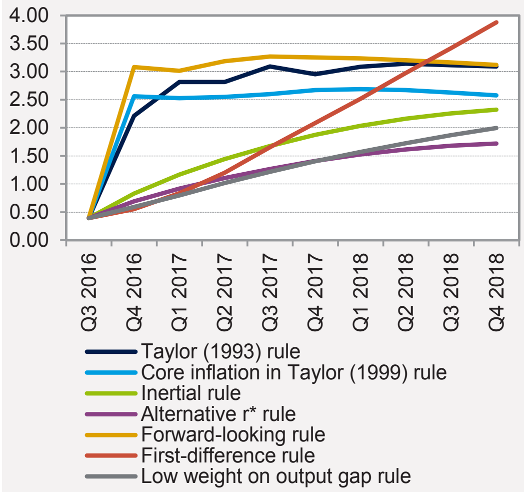
Donald Trump will be sworn in as US President on 20 January. With the Republicans in Congress, he will try to set radical reforms, in particular about the Fed.

In 2017, the Fed will enter an area of turbulence. The nominations that Donald Trump will make will greatly change the balance of power within the FOMC. The debates will mainly be about the necessity and the relevance of a Taylor rule. Furthermore, FOMC members don't know where they stand on the probability of fiscal stimulus measures. Last, we think that an acceleration of the fed funds normalization at this stage of the cycle would be counterproductive.

> "The nominations that Donald Trump will make will greatly change the balance of power within the FOMC"

1 Taylor rules for the Fed

One big issue with Taylor rules is that there are many ways to calculate them. Above, we represent seven estimations done by the Cleveland Fed on November 21.



Source: Cleveland Fed, Amundi Research *participants noted that there was currently substantial uncertainty about the size, composition, and timing of prospective fiscal policy changes, but they also commented that a more expansionary fiscal policy might raise aggregate demand above sustainable levels, potentially necessitating somewhat tighter monetary policy than currently anticipated."* The FOMC minutes also tell us that half the participants at the 14 December FOMC incorporated an assumption of more expansionary fiscal policy in their forecasts, the other half has not. As a reminder, Janet Yellen said in a press conference on 14 December that fiscal stimulus measures were not required for the US economy to return to full employment. John Williams, the San Francisco Fed president, has made similar comments at the beginning of 2017.

> The FOMC composition in 2017

In normal times, there are 12 voters at FOMC meetings (the last time they were 12 voters was in July 2013):

- 7 members in the Board of Governors
- the NY Fed's president has a permanent seat
- 4 of the 11 Reserve Bank presidents, who serve one-year terms on a rotating basis.

Currently, there are only 5 members in the Board as the Senate blocked Obama's appointments. Donald Trump will pick 2 Board members. There are also rumours of Daniel Tarullo's retirement and in this case, Donald Trump would have to pick 3 Board members. Appointments will have to be confirmed by Senate.

The four voting Reserve Bank presidents in 2017 will be :

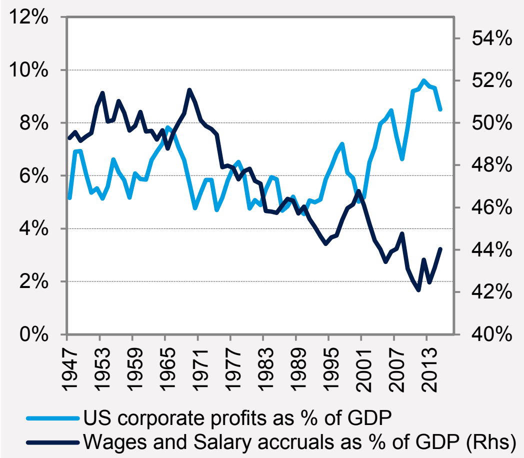
- **Charles Evans, Chicago**. He voted in 2007, 2009, 2011, 2013 and 2015. He dissented twice (November and December 2011) as he wanted an easier monetary policy. He is going to be one of the most dovish voters in 2017. This being said, he declared on October 24th that he was in favor of the December 2016 hike and of 2 hikes in 2017 and 3 in 2018.
- **Patrick Harker, Philadelphia**. He has never voted. He is an academic. He describes himself as a hawk. Several times in 2016, he declared that 2 or 3 hikes in 2016 would be necessary. He will definitely be one most of the most hawkish FOMC members.
- **Robert Kaplan, Dallas**. He has never voted. He worked 23 years for Goldman Sachs and he describes himself as a specialist of financial markets. He often advocates patience when making monetary policy decisions. He is concerned by student debt and by demographic trends. He will probably vote in line with the Board.
- Ne**el Kashkari, Minneapolis. He has never voted. He was the Republican candidate for the 2014 California gubernatorial elections.** He had contributed to the design of the TARP in 2008. He is against the Dodd-Franck act as he says that it would 'miss the next crisis' and he wants big banks to vastly increase equity capital holdings (to 15% of assets). Interestingly, even if Kashkari is a Republican, he is not in favor of a mechanical rule of monetary policy.

An acceleration of the fed funds normalization at this stage of the cycle would be counterproductive

The current cycle has been marked by high growth in US corporate profits. In recent quarters, margins have even hit all-time highs. This is a paradox given the weak economic growth seen during the cycle. This growth in profits is due to the weak increase in wages and to significant cost-cutting measures after the Great Recession.

Another feature of this cycle is that high profits have not meant an increased rate of investment. In recent years, businesses have profited from extremely accommodating financing terms and taken on massive debt. They

2 Corporate profit share of GDP rose to record levels



Source: Datastream, Amundi Research

have mainly financed share buybacks and acquisitions. Investment spending has remained very weak. The reason seems to be the flat demand environment. Yet weak investment today compromises tomorrow's potential growth. Ultra-accommodating monetary policies have been powerless to stem this.

The impact of Donald Trump's policy on the US economy is hard to predict. It is unlikely that fiscal policy will be as proactive as what is currently expected, and accelerating the normalisation of monetary policy would be counter-productive at this phase of the cycle:

- Global growth remains weak. As the monetary policies of the ECB and BoJ are still quite accommodating, a rise of US long-term rates would inevitably support the dollar's appreciation, which would harm the growth and inflation outlook. Remember, the dollar has appreciated more than 4% in effective terms since Trump's election.
- The US economy is close to the end of its cycle. Non-financial corporate debt is peaking. The resulting tightening of financial terms (dollar's appreciation and rise in long-term interest rates) has the power to quickly put pressure on growth.

Rebalancing is called for – away from profits and toward wages. The US economy is approaching full employment. Implementing Trump's plan (fiscal stimulus and protectionist measures) could spark tensions over wages. Rebalancing away from profits and toward wages could be a new negative – in the short term – for corporate profits, but would be excellent news for the US economy. Increasingly robust demand is indispensable to supporting the investment recovery.

> "Weak investment today compromises tomorrow's potential growth"

where **US dollar-denominated debt as a percentage of GDP has been rising in nearly every emerging country since 2013** (See Chart 2), a sustained appreciation of the greenback is **increasing the dollar-denominated debt burden**. In the second quarter of 2016, **foreign-currency-denominated debt as a percentage of GDP was greater than 100% of GDP** in Croatia, Hungary, and **Chile** and greater than **60%** in Bulgaria, **Malaysia, Turkey, Colombia and Peru**. For the countries in Emerging Europe, the euro remains the most heavily used foreign currency in debt issues, which limits their exposure to any further appreciation of the dollar. By contrast, the Latin American countries mentioned above are indeed fully concerned as are Turkey and Malaysia.

Furthermore, note that certain countries with **foreign exchange reserves less than or equal to 1/3 of foreign-currency-denominated debt (Argentina, Mexico, Colombia, Chile, Turkey, South Africa and Indonesia) are extremely vulnerable** to further strengthening of the US dollar (See Graph 3). **Peru, the Philippines, Malaysia and Korea** are also vulnerable, but to **a lesser extent**. Foreign exchange reserves cover nearly half of foreign-currency-denominated debt.

Lastly, **Donald Trump's harsh language** directed at some emerging countries – particularly China – **is in no way reassuring. Neither is Trump's picks to head the White House National Trade Council: Peter Navarro**, the author of "Death by China: How America Lost Its Manufacturing Base" and a vigorous opponent of China and R. Lighthizer[1] as US Trade representative. Either this is **a bluff on the part of Donald Trump**, or a **"declaration of a trade war"**.

If the latter is the **option being considered** by Donald Trump, then it is certain that the **Chinese authorities will fight back**. By once again modifying the reference basket of currencies used to set the yuan's exchange rate in late December 2016, **the PBoC appears to be keeping abreast of the latest developments**. In fact, by reducing the weight of the US dollar and currencies pegged to the US dollar to 2.4%, China is disconnecting a bit more from its peg to the dollar and has **opened the door to further depreciations**. **In addition to its currency, which it can depreciate considerably**, China has several more "deterrent weapons". It could, for instance, **opt to massively sell its US debt holdings**.

Naturally such measures are not in China's interests in an environment where fundamental changes are being made to its business model. A sweeping devaluation of its currency could sharply reduce capital inflows and would slow the yuan's process of internationalisation so hoped for by the Chinese authorities. Likewise, a liquidation sale of US debt issues could cause prices to plunge. **However, in the event of force majeure, the Chinese authorities will not hesitate to bring their full weight to bear.**

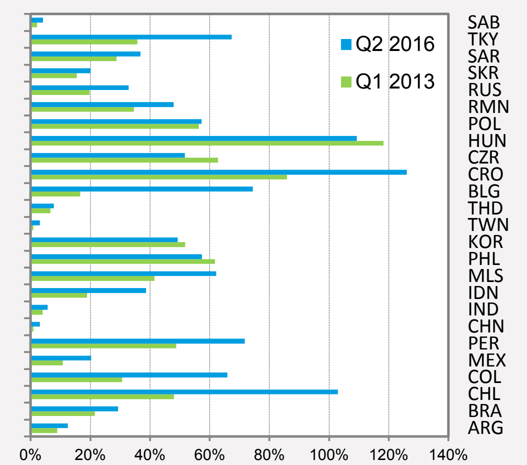
Under this scenario, China would not be the only loser. The global financial markets would be the first to be affected by these reprisals. In particular, **as far as the emerging countries are concerned, it is primarily the foreign exchange markets that could suddenly come unglued. Furthermore, as China represents the largest economy in the world** (in terms of real GDP) **and the No. 1 importer of commodities, most of emerging countries** which are highly integrated into the Chinese value-added chain (Asian countries), net exporters of commodities, or whose performance is tied to the yuan **will also be weakened**.

In conclusion, the arrival of Donald Trump to the highest offices of the US government is not, at this stage, the best one can hope for emerging market economies, particularly those countries who were just beginning to see their prospects improve after a number of fairly tough years. **If Donald Trump and his administration start implementing all the protectionist and isolationist measures they have announced, then the most vulnerable countries will not get away unscathed. A trade war with China would be a worst-case scenario. The emerging markets may be the most vulnerable but the world's financial markets will not be spared.**

[1] *R. Lighthizer has already occupied this position during D. Reagan and is known to be the one who was leading of the trade war with Japan.*

> If portfolio reallocations favouring the United States and the appreciation of the US dollar intensify, they could further weaken the most vulnerable emerging market economies

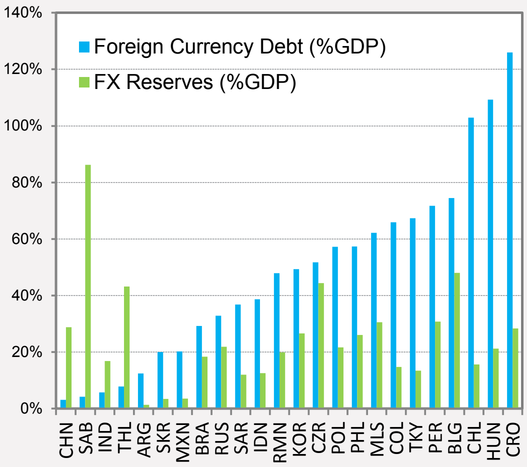
2 Share in % GDP of FX denominated Debt Outstanding



Sources: BIS, Amundi Research

> For emerging market economies, the worst-case scenario would be a trade war between the United States and China

3 Vulnerability to USD appreciation



Sources: BIS, Amundi Research

January 2017

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