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Market Impact of Fed Chair Nomination

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Key Takeaways

- *We expect the nomination of Jerome Powell as the next chair of the Federal Reserve (Fed) to solidify the Fed's gradual pace of interest-rate increases.*
- *Our interest-rate forecasts for 2018 remain intact. A continuation of current Fed policies should help to support continued U.S. economic growth.*

What It May Mean for Investors

- *We expect the U.S. market impact of this change in Fed leadership to be minimal. We believe that the Fed will continue to keep rates relatively low in the near term, and we would view any U.S. equity-market pullback as a buying opportunity for investors.*

On Thursday November 2, President Trump nominated Jerome Powell to serve as Fed chair when the term of the current Fed chair, Janet Yellen, expires on February 3, 2018. If confirmed by the Senate (which we believe is very likely), he will become the 16th Fed chair in our nation's history and will serve a four-year term.

It had been rumored for several days that Mr. Powell was the leading candidate. Yet, traders still breathed a sigh of relief in the immediate aftermath of the Powell announcement.

Jerome Powell is a moderate—and a consensus builder—who is likely to continue the monetary policies of Janet Yellen. His selection should soothe market participants who were concerned that a new Fed chair could implement more aggressive Fed tightening. The Powell nomination allows the president to appoint "his" Fed chair, while (at the same time), providing a continuation of the supportive monetary framework that is currently in place. We would expect Powell to favor the low interest rate, easy-money policies that align with the president's economic agenda. Perhaps most importantly, Powell is a seasoned veteran and is likely to continue the Fed's long history of political independence that is critical to the central bank's market credibility.

With Powell leading the Fed and likely continuing current monetary policies, we do not see a material change in our interest-rate expectations— and reiterate our expectation of three Fed rate hikes between now and year-end 2018. We look for the Fed to continue its measured pace of balance-sheet reduction, with little deviation from the previously announced plan. In a June speech, Jerome Powell stated that he believed the Fed balance sheet was unlikely to decline below $2.4 trillion (or even $2.9 trillion) once normalized—which further supports an easy monetary stance.

There is some risk in the president appointing his own Fed chair today, rather than continuing the Yellen regime. After one of the longest periods of continuous economic growth on record, the next four years are unlikely to be as kind to Jerome Powell. When the economy inevitably turns, the president may look to cast blame, and Jerome Powell could be a convenient scapegoat.

What Does the Powell Nomination Mean for Portfolios?

Fixed Income

While a continuation of current policies should allow fixed-income investors to continue to clip coupons, we still favor upgrading a portfolio's fixed-income credit profile in the face of rather expensive valuations. Investors should consider allocating a small portion of the portfolio to Treasury Inflation-Protected Securities (TIPS) to help mitigate an unexpected increase in inflation expectations, should low-rate policies unexpectedly accelerate the economic-growth trajectory. We favor intermediate-term fixed income maturities that should continue to provide investors with modest returns, coupled with limited downside volatility.

Equity

We believe that equity investors have priced in a December rate hike for most of this year. The concern has been (and continues to be) what our central bankers will do with rates in 2018. While the Federal Open Market Committee has hinted that three rate increases are likely next year, the equity market has priced in fewer hikes. The Powell nomination will be interpreted by equity investors as a positive—as Powell likely would take a more dovish stance toward monetary policy relative to some other candidates (as we have noted). We continue to recommend using any 5 to 7 percent market pullback as a buying opportunity.

Real Assets

We expect a deliberate pace of interest-rate hikes to support higher-yielding real assets, such as real estate investment trusts (REITs). Should the interest-rate curve unexpectedly steepen, fixed-rate REITs could initially come under pressure. This would be especially likely if longer-term rates moved higher than is expected. For commodities, we suspect that the overarching influence remains the commodity bear super-cycle. We look for the Fed chair announcement to have limited impact on the commodities complex.

Alternative Investments

With an assumed continuation of the current path of the U.S. economic and fiscal trajectory, we would expect to see "dispersion strategies," such as trading long/short equity and credit, face a favorable environment as a result of decreasing correlations and rising dispersion among securities. We also believe that this will create opportunities to generate "excess return" (versus benchmark indices), while (at the same time) giving investors the potential to insulate and diversify their long-only equity allocations. Further, we would expect to see an extension of the opportunity in Structured Credit strategies that generally benefit from fundamental support and strong technical factors. We also would expect Structured Credit strategies to continue providing compelling yields in what is expected to be a "lower-for-longer" interest-rate environment with minimal duration risk (interest rate sensitivity) in the near term.

Risks Considerations

Each asset class has its own risk and return characteristics. The level of risk associated with a particular investment or asset class generally correlates with the level of return the investment or asset class might achieve. All investing involves risk including the possible loss of principle. **Stock markets** are volatile. Stock values may fluctuate in response to general economic and market conditions, the prospects of individual companies, and industry sectors. **Bonds** are subject to market, interest rate, price, credit/default, liquidity, inflation and other risks. Prices tend to be inversely affected by changes in interest rates. **Treasury Inflation-Protected Securities (TIPS)** are subject to interest rate risk, especially when real interest rates rise. This may cause the underlying value of the bond to fluctuate more than other fixed income securities.

The **commodities** markets are considered speculative, carry substantial risks, and have experienced periods of extreme volatility. Investing in a volatile and uncertain commodities market may cause a portfolio to rapidly increase or decrease in value which may result in greater share price volatility. **Real estate** has special risks including the possible illiquidity of underlying properties, credit risk, interest rate fluctuations and the impact of varied economic conditions.

Equity long/short investing refers to buying perceived undervalued equity positions and selling short perceived overvalued positions. The strategy attempts to capture returns from both types of trades. Significant long or short exposure to a particular sector or sub-sector can magnify the risk level of a particular long/short equity strategy. Short sales theoretically involve unlimited loss potential since the market price of securities sold short may continuously increase. **Structured credit strategies** aim to generate returns via positions in the credit sensitive area of the fixed income markets. The strategy generally involves the purchase of corporate bonds with hedging of interest rate exposure. Credit strategies are subject to security-specific risks in addition to the risks associated with fluctuations in interest rates, credit/default, liquidity and forced deleveraging.

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