ARE MARKETS READY FOR A POST-YELLEN FED?

Recent news articles suggest that the Trump administration is starting to consider a replacement for Fed Chair Janet Yellen after her term expires. It's part of a wave of potential turnover ahead for the institution's leadership. What does that mean for the Fed and markets?

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Speculation is beginning to build about what comes next for the US Federal Reserve in a looming transition. Recent news articles have suggested that President Trump and his team are starting to consider their options for replacing Fed Chair Janet Yellen when her term as Chair expires in early 2018.

In reality, the transition at the Fed will go well beyond the Chair. Several members of the Fed's Board of Governors have recently left—or may soon leave—the institution. There has also been significant turnover among the regional Fed presidents who serve on the Federal Open Market Committee (FOMC). By the end of 2018, it's very possible, perhaps even likely, that the majority of FOMC members will have little experience in their roles.

This sort of turnover isn't necessarily unusual; in the past, there has been turnover on the Board whenever the Chair changes hands. Still, the stakes around this transition are particularly high. The Fed has become very important to financial markets over the course of the last decade—from QE 1 through the "taper tantrum" and now during the transition to interest-rate hikes and toward balance-sheet normalization.

How is this process likely to play out? Who is thought to be on the short list of candidates? How will turnover on the Board of Governors and among the regional Federal Reserve Banks affect policy? And what could this mean for financial markets?

IN REALITY, THE TRANSITION AT THE FED WILL GO WELL BEYOND THE CHAIR.

THE INS AND OUTS OF THE COMING TRANSITION

First, a few of the basics about the Fed and how this process typically works. The Board of Governors is the governing body of the US Federal Reserve System (*Display 1, page 2*). The Board has seven members, nominated by the President and approved by the Senate for 14-year terms. The Chair of the Board is chosen by the President from among the various Board members, and is approved by the Senate for a four-year term.

The President can reappoint, or choose not to reappoint, a Chair when that four-year term expires. Yellen's term as Fed Chair expires on February 3, 2018, although her term as Governor runs until 2024. In theory, Yellen could stay on the Board even if she isn't

DISPLAY 1

HOW THE US FEDERAL RESERVE IS STRUCTURED

FEDERAL RESERVE BOARD OF GOVERNORS

The Board is an independent government agency that oversees the entire US Federal Reserve System.

- Chair
- Vice Chair
- Governor
- Governor
- Governor
- Governor
- Governor

FEDERAL RESERVE BANKS

The 12 District banks are the operating arms of the Federal Reserve System. Each has its own president, who is appointed by the board of directors of the individual banks.

Boston	New York	Philadelphia	Cleveland
Richmond	Atlanta	Chicago	St. Louis
Minneapolis	Kansas City	Dallas	San Francisco

FEDERAL OPEN MARKET COMMITTEE (FOMC)

The Committee is responsible for open market operations that support Fed policy. The Committee includes all members of the Board of Governors.

The New York Federal Reserve Bank president is a permanent member and Vice Chair. Four seats are filled on a rotating basis by other Fed Bank presidents (current members shown).

- Chair
- New York
- Governor
- Governor
- Minneapolis
- Governor
- Governor
- Philadelphia
- Governor
- Governor
- Chicago
- Dallas

As of July 31, 2017
Source: US Federal Reserve and AB

reappointed as Chair. However, that scenario would be contrary to historical experience—we don't expect that outcome. If Yellen is not reappointed, she will almost certainly resign from the Board, too.

There are currently three open seats on the Board of Governors, so there will be a transition in that part of the Fed's leadership as well. One seat is likely to be filled by Randal Quarles; Trump nominated Quarles to the Board in mid-July. If Quarles is confirmed by the Senate, he'll become the Vice Chair for Supervision, so he's likely to play a central role in considering changes to US banking regulations, including Dodd-Frank.

The new Board Chair has to come from the Board, so it's likely that the Trump administration will leave at least one seat unfilled until the nomination of a new Chair. That way, Trump can simultaneously nominate someone from outside the institution to serve on the Board and as Chair. Alternatively, Yellen could make a commitment to resign, ceding her seat on the Board to the new Chair even if all the other Board seats were taken.

In the past, nominations have typically been made several months before the expiration of the current Chair's term. This timetable gives the Senate enough time to vote on the nomination. Yellen, for example, was nominated in early October 2013 and confirmed late in that year before taking the reins early in 2014. This approach also minimizes the amount of time there will be essentially two Fed Chairs: the current Chair and her successor. Based on this precedent, we expect the President to announce a decision on a nominee in the next few months.

MEET THE NEW CHAIR: SOME LIKELY CANDIDATES

Several prominent economic and political figures have been mentioned as potential successors to Yellen, each with a perceived position on the policy spectrum (*Display 2, page 4*). It's impossible to know who the President will eventually choose—a dark-horse candidate could certainly emerge. The list that follows is by no means comprehensive, but it does cover several of the candidates whose names have been commonly mentioned as potential Fed Chairs starting in 2018.

Janet Yellen. President Trump could simply choose to reappoint Yellen as Chair, as has generally been the case with past Fed Chairs. This option might appeal to the President because the economy and financial markets are both performing well, giving him incentive not to rock the boat. Trump was quite critical of the Yellen Fed during his campaign, but he has been much more positive in his assessment of her tenure since he assumed office. In fact, in an interview earlier this year, Trump indicated that she might still be reappointed. Yellen's academic and policy credentials are unimpeachable, and the financial markets would likely be happy with this choice: markets prize stability, and also view Yellen as dovish on interest rates.

Jerome Powell. A current Governor, Powell would be a logical choice for Chair if the President wants to preserve continuity but also wants to make his own nomination. Powell's background includes both the Fed and the Executive Branch—he served as assistant secretary and undersecretary of the Treasury under President George H. W. Bush. Powell has served on the Board since 2012, and he's currently its only Republican, which may enhance his appeal to the President and ease his confirmation process.

Gary Cohn. News reports in July suggested that Cohn, currently director of the National Economic Council, is both leading the process to select the next Fed Chair and is himself the leading candidate. He lacks Yellen's academic gravitas, but is widely respected within financial markets for his stint as second-in-command at Goldman Sachs. Of course, his previous tenure at Goldman Sachs may make his confirmation process politically difficult, as could his lack of prior policymaking experience. Markets would likely take a positive view, though, largely because Cohn would be viewed as likely to advocate less regulation of the financials sector, given his Goldman experience.

John Taylor. Taylor, a Stanford professor, has excellent academic credentials and is a well-respected thinker on monetary policy issues. In the past, he has espoused a preference for "rules-based" policymaking over the more discretionary style historically favored by the Fed. He developed and proposed the Taylor rule, often used as a basic guideline for assessing the setting of monetary policy. Taylor would be a very popular candidate with the Republican Party's conservative wing, which has consistently chafed at the Fed's more improvisational style and willingness to use its balance sheet to support the economy. The impact of a Taylor candidacy on markets is uncertain. He is a heavyweight economist, but also the candidate with the most potential to make dramatic changes within the Fed. That sort of volatility could prove disruptive.

Kevin Warsh. As a Fed Board member during the global financial crisis, Warsh earned praise for his work as liaison between the Fed and financial markets. Since leaving the Board, he has been a vocal and public critic of the Fed's efforts to support growth. He has a limited background in economics compared with most of the other candidates, and he isn't perceived to be as much of a deep thinker on monetary policy issues. He is also the most partisan of the publicly discussed candidates. A Warsh appointment wouldn't be welcomed within the walls of the Fed, where he's viewed with skepticism due to his light academic and professional resume relative to several of the other candidates, as well as his public criticism of the institution he used to be part of.

THIS TIME, CHANGE IS DIFFERENT

Recent transitions between Fed Chairs have generally taken place without disruption. Both Bernanke and Yellen were former Governors and well-respected monetary economists when they were nominated, and both generally pursued paths that maintained continuity with policies already in place.

But both had an advantage that the next Chair may not. The potential turnover this time is much broader.

In fact, the Fed's Board of Governors is undergoing a massive transition (*Display 3, page 6*). Let's take a look at the current composition of the Board of Governors, along with a brief comment about how long each is likely to remain.

Chair Janet Yellen will likely resign from the Board if she isn't reappointed as Chair. This decision will likely be known later this year.

DISPLAY 2

HAWK OR DOVE? FIVE COMMONLY MENTIONED FED CHAIR CANDIDATES

MOST DOVISH

JANET YELLEN

Her track record on rates suggests she'll be cautious about hikes and will stick to a very gradual pace of balance-sheet reduction. She's a strong advocate of discretionary policymaking.

JEROME POWELL

As a member of the current FOMC, Powell would be expected to continue the current trajectory. He's perceived to have been more open to raising rates than Yellen during this cycle.

GARY COHN

Cohn's policy preferences are almost entirely unknown. The market may view him as somewhat dovish because of his financial market background and association with Trump's preference for low rates.

JOHN TAYLOR

Taylor's preference for rules-based policymaking would have led to higher interest rates much earlier in the postcrisis period—and still has hawkish implications at this point in the cycle.

KEVIN WARSH

Critical of the Fed's postcrisis policy, Warsh has argued against quantitative easing and in favor of higher rates and a lower inflation target. His critiques have been extremely hawkish.

MOST HAWKISH

UNKNOWN

There's certainly potential for a dark-horse candidate to arrive on the scene. It's impossible to know at this point what that candidate's policy orientation will be.

As of July 31, 2017
Source: AB

Vice Chair Stanley Fischer is serving a term as Board Governor that expires in 2020, but his term as Vice Chair expires in June 2018, and he'll likely resign from the Board if he isn't reappointed.

Governor Jerome Powell is the Board member most likely to remain both during and after a transition in the Fed's leadership.

Governor Lael Brainard has a term that runs until early 2026, but there are persistent rumors that she would like to leave. Brainard may serve as an economic advisor and Treasury Secretary-in-waiting for a Democratic presidential candidate in the 2020 elections, which would require her to step down.

Randal Quarles was recently nominated by President Trump as Vice Chair for Supervision.

Vice Chair for Community Banking (Open Seat): There has been little public discussion about whom the President might nominate. But it must be a community banker, so this seat is unlikely to be the one Trump holds open for the next Chair.

General Member (Open Seat): There is still one general opening. It has been rumored that President Trump will appoint Carnegie Mellon professor (and former Richmond Fed research director) Marvin Goodfriend to the Board. However, the President would then need to rely on Yellen to resign from the Board in order to have an open seat to nominate his new Chair.

Based on this landscape, it seems entirely likely that, if the President chooses not to reappoint Yellen as Chair but does fill the current and prospective vacancies, the Board will have six members with less than one year's experience by the end of 2018.

There's always turnover, especially around leadership transitions. But if the new Chair is a newcomer—not someone with significant institutional history—the degree of turnover will make his or her job that much more challenging.

TURNOVER AT THE REGIONAL FED LEVEL, TOO

The turnover isn't limited to the Fed's senior decision makers, which could compound the challenges if the new-look Board is short on experience. There's been significant change among regional District Banks, too. The presidents of the Atlanta, Philadelphia, Minneapolis and Dallas Federal Reserve Banks each have been in their roles for less than two years, and the Richmond Fed is in the process of selecting a new president.

The only current District presidents who served during or in the immediate aftermath of the financial crisis are Eric Rosengren (Boston), William Dudley (New York), Charles Evans (Chicago) and James Bullard (St. Louis). And given their relatively lengthy tenures, it's possible that one or more from this list could also choose to retire in the near future, further reducing the level of experience on the FOMC.

STAKES ARE HIGH FOR POLICY AND THE MARKETS

All of these moving parts add up to a sizable wave of transition set to sweep through the Fed's leadership over the next few years. With that change will come different perspectives and policy philosophies. The ultimate representation of those philosophies is difficult to forecast right now, given the large number of potential leadership changes.

We believe that the potential for such significant turnover is partly the reason for the FOMC's apparently strong desire to start reducing its balance sheet. This will allow the current Committee to hand its successors a process that's already in place and (ideally) running smoothly, reducing the need for a newer group of policymakers to make major decisions immediately upon arrival.

Of course, the current FOMC wouldn't shrink the balance sheet for that reason only, but it does give them some additional incentive to do so. In fact, this is partly why we have high conviction that a balance-sheet reduction will begin by the end of the summer in the US.

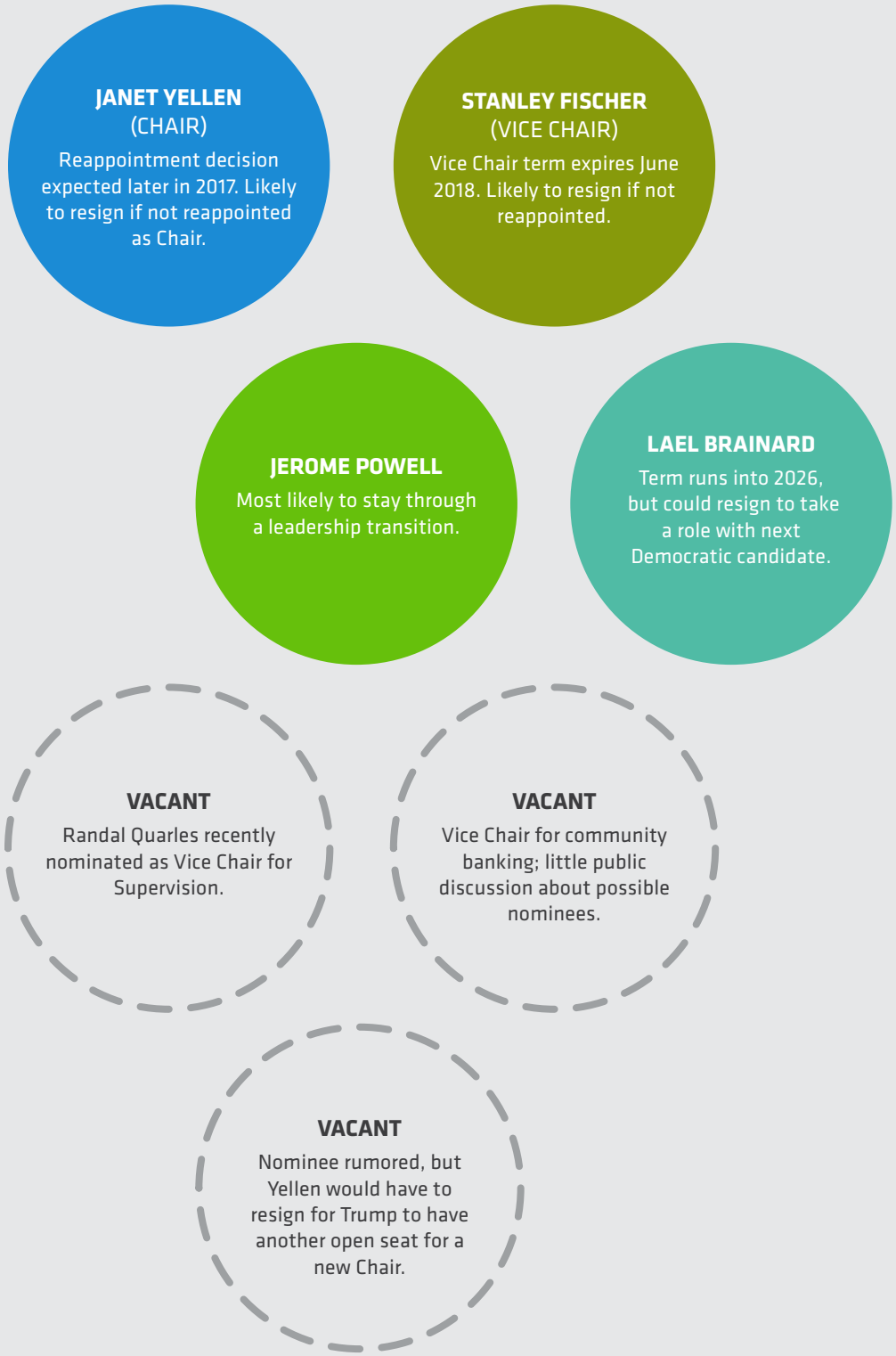
Balance-sheet reduction is part of a broader path of policy normalization that will put a lot on the Fed's plate during this period of transition. There are many critical policy decisions to be made, including the relationship between balance-sheet reduction and the pace of interest-rate hikes. Many important decisions also loom with respect to financials sector regulation: it will take a lot of political skill to navigate the priorities of the Trump administration and the existing regulatory infrastructure—both domestically and internationally.

Then there's the matter of how the Fed communicates—markets tend to hang on its every word, and with so many new players, will the Fed's style and approach to communicating evolve?

With the stakes so high, the identity of the new Fed Chair (or, if Yellen is renominated, the incumbent Chair) and the composition of the Board of Governors will matter a lot to financial markets. Investors have come to rely on stability and predictability from the FOMC. If that changes or is perceived to have changed, due either to new policy preferences or inexperienced leadership, it could make capital markets more volatile in 2018 and beyond.

DISPLAY 3

MOVING PIECES: THE FED BOARD OF GOVERNORS IN TRANSITION (CURRENT MEMBERS & STATUS)



As of July 31, 2017
Source: AB

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