Even With a New Chairman, It Will Be Business as Usual at The Fed

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The Federal Open Market Committee (FOMC) met this week and the outcome was...well, kind of boring.

Of course, it's strange to call anything the Fed does boring. They're charged with keeping the largest economy on the planet on track, after all.

But investors the world over expected them to hold on interest rates, and they did just that. The Fed also announced that it has begun the long term process of normalizing its balance sheet, as planned.

More interesting is the fact that President Trump has decided not to reappoint Fed chairwoman Janet Yellen for a second term. It's an unconventional move, but not unexpected and the market hasn't really noticed.

More of the same

New presidents have historically kept the incumbent Fed chair for another term, and sometimes longer. For example, President Reagan nominated Alan Greenspan, and his tenure lasted through the Clinton administration and into George W. Bush's presidency. But then again, when does President Trump do anything typical?

Enter the new Fed Chair: Jerome Powell. Mr. Powell is a Republican, has a finance and private equity background (he is the first nominee in nearly 40 years without an advanced degree in economics), and is expected to be less rigid on bank regulation than Janet Yellen would have been.

But that's where the differences end. Powell has been on the Fed's board of governors for the last five years and has consistently voted in line with its policy decisions. PhD or not, his views on macroeconomics appear to be similar to Yellen's.

Because Powell's nomination doesn't represent a radical change, the market hasn't moved significantly one way or the other in response to the news. It's business as usual.

But let's get back to what happened at the FOMC meeting, and what we can expect going forward.

They probably will, unless they don't

The U.S. economy continues to expand at a slow but steady pace, despite hurricane-related disruptions. So the FOMC is holding interest rates at a low 1-1.25% for now, in keeping with accommodative monetary policy. But analysts expect the Fed will resume its gradual pace of interest rate increases, with one hike expected in December and three more in 2018.

Whether these projected hikes actually come to pass will depend on the Fed's continued analysis of economic conditions. They have provided assurance that the economy looks reasonably strong today. But should their assessment change, so will their approach to rate increases.

Unraveling the inflation mystery will be a central part of this assessment: it remains lower than the Fed's 2% inflation target, especially given the current unemployment rate of just 4.1%.

But that figure, 4.1%, might be misleading. It represents the proportion of workers who are out of work *and* seeking employment. It doesn't account for all the people who aren't looking for work.

The large number of Americans who are no longer looking for work and not counted as unemployed could be the reason wage inflation remains subdued, and will likely keep the Fed's future schedule of interest rate increases slow and steady.

On the other hand, the economy has absorbed recent rate hikes without incident. And raising them another few percentage points would allow the Fed to lower them in the event of a future recession.

Legislating economic growth

The U.S. economy has grown steadily in the years since the 2008 financial crisis, and continues to be the backbone of the global economy. Consumer spending is solid, investment spending has improved over the last few years, and the trade deficit has remained stable.

Still, GDP growth has been sluggish relative to historical figures, and President Trump campaigned on his desire to increase it.

Mr. Trump is expected to propose a tax plan for Congress to consider this week, which includes tax cuts for corporations and individuals. Lower taxes could boost the economy with higher corporate profits and more disposable income for consumers, with the anticipated benefits of higher consumption spending, more jobs, and increased wage and consumer inflation. In fact, equity markets have been cheering on this kind of policy for quite some time.

Mr. Trump has also spoken of a $1 trillion infrastructure proposal, whereby roads and railways would be revitalized via a combination of government and private sector spending. In the process, he says, many new jobs would be created.

But even without such measures, the U.S. economy appears to be on a consistent upward trajectory, growing at a rate of 2.0 – 2.5% annually.

Barring any unforeseen crises, I expect it to continue chugging along, which should improve corporate profits and increase equity returns even at current lofty valuations.