Arcapita Point of View

Special Report

January 2018

The New Chairman of the US Federal Reserve:
What Can We Expect?

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Executive Summary

In November 2017, U.S. President Donald Trump nominated Jerome Powell to be the next Chairman of the Federal Reserve after current Chair Janet Yellen's term expires in February 2018. Unlike Yellen, a Yale-educated economist with significant central banking experience, Jerome Powell is a lawyer and a former finance executive at The Carlyle Group who has served on the board of the Federal Reserve since 2012. Jerome Powell's appointment as chair of the Federal Reserve is likely to have the following major economic implications:

- *A broad continuation of the moderate monetary policies deployed by his predecessor, Janet Yellen - a willingness to tolerate rising inflation if counteracting it through an aggressive rate increase would cause a significant reduction in economic activity.*

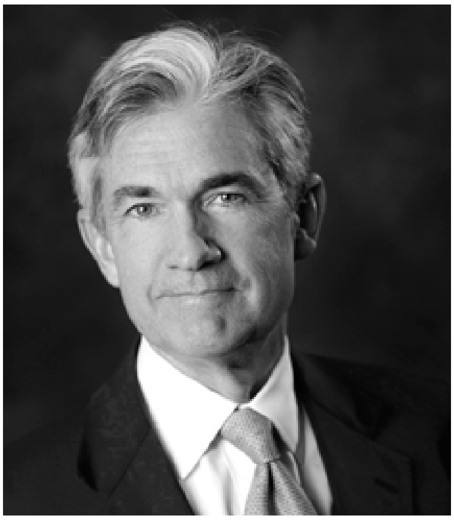
- *It suggests that Trump wishes to adopt fiscally expansive policies, such as an infrastructure bill and the recently passed tax bill, meaning a medium-term boost to the U.S. economy.*

Who is
Jerome Powell?

Jerome Powell is a Republican businessman, lawyer, and a former finance executive who was appointed to the Federal Reserve board of governors by former President Barrack Obama, a Democrat, in 2012. It was the first time since 1988 that a president appointed someone from the opposing political party to the board, which serves as strong confirmation that Powell is first-and-foremost a consensus builder.

As an illustration, during the U.S. government debt ceiling crisis in 2011, Powell made a strong bipartisan contribution by engaging congressional leaders from both parties and convincing them of the dangers of a failure to act.

Powell also has a reputation for being a moderate in terms of monetary policy, and his voting record at the board confirms that. That means exhibiting a willingness to tolerate rising inflation, and tackling it slowly over a longer period of time, when the alternative of rapid action would cause significant damage to the economy. He is broadly similar to Janet Yellen, the outgoing chair.



Trump's decision to promote Powell to the position of Fed Chair indicates that Trump may be looking to implement policies that require bipartisan support; he has thus far been unsuccessful in the political arena, due to a failure to pass anything of note through congress, and his headline executive orders, such as his immigration bans, keep getting blocked by the judiciary. After the healthcare debacle, where Republicans voted against a Republican proposal, Trump has correctly surmised that big-ticket policies will require Democratic Party support.

What power does the
Fed Chair have?

In de jure terms, the chairperson of the board of governors of the Federal Reserve System has limited power because they have to reach decisions by consensus with the other governors, who are appointed by the U.S. president, and because the presidents of the 12 branches of the Federal Reserve System can dissent. Historically, however, the other governors have exhibited a strong deference to the chairperson. Therefore, the chairperson de facto sets U.S. interest rates, and represents the U.S. in international economic crises. Usually this distinction between the chair's de jure and de facto power would be an irrelevant technicality. However, under Trump, several U.S. institutions have been pushed into uncharted waters and obscure constitutional clauses have been activated, such as a Hawaiian judge blocking the president's executive orders. Therefore, investors should be aware of the possibility of unusual events at the Federal Reserve should the president and board (including the chair) clash.

From the perspective of the White House, the Fed chair has the ability to obstruct a fiscally expansive policy. Trump is seeking to implement two stimuli: a broad tax cut (which was recently passed by the House and the Senate and signed-in by Trump), and an infrastructure investment program. In both cases, if the Fed chair responds by increasing interest rates as an anti-inflationary maneuver, Trump will consider the move disruptive to his ambitions, and he is unlikely to accept the Fed's policies quietly.

Commentators are yet to arrive at a consensus regarding the reasons for Trump's surprise victory, but many experts agree that economic deprivation among the middle and lower classes was a key factor. Much of Trump's platform is based on raising the living standards of these groups, and so his reelection prospects will probably hinge upon success in this realm. Therefore, Trump's choice of Fed chair should be interpreted as part of a broader strategy seeking to provide an economic boost to the middle and lower classes.

What does Powell imply **for the Economy?**

Powell's consistency with Yellen means that the most salient implication of his promotion to Fed chair is a continuation of the prevailing moderate monetary policy. Unemployment is at its lowest level since 2007, and has been declining consistently since 2009, but Yellen has not been hawkish: she has raised rates, but slowly because of the failure of wages to grow. There is some uncertainty as to how quickly Powell will raise rates in the event that unemployment falls and wages rise at the same time, which may well occur in the near future, but his reputation as a political moderate open to bipartisan cooperation suggests that if the improving economy is the result of a policy favored by both Democrats and Republicans, then he will not look to counteract it.

Second, Trump seems to be abandoning his policy of governing without seeking the support of Democrats, and is likely looking to seek bipartisan support for future policies. In terms of his election manifesto—which should be considered as indicative but not binding—one of the few policies consistent with Democrat principles, including Hillary Clinton's own manifesto, was an infrastructure investment bill. Promoting Powell, a Republican appointed by a Democrat and someone who is known for reaching across the congressional aisle, is a signal to Democrats that Trump is willing to strike a deal. As part of the bill, it is likely that Trump will likely seek to acquire funding for a watered-down version of the Mexico-USA border wall, as the Democrats look to compromise.

Third, Trump wants to stimulate the economy. Powell's reputation as a relative inflation dove gives Trump the green light to increase net spending. This is reflected by the recently-approved tax bill which is expected to provide a major boost to corporate profits, and an infrastructure bill that is very likely to secure the requisite support.

Consequently, we expect economic growth to increase moderately during the next two years, and for unemployment to fall. As labor markets tighten, the Federal Reserve will have to raise interest rates, but it will likely be a gradual process. Since the economy is already doing quite well, and government-led investment has a tendency to be inefficient, the infrastructure spending is unlikely to pay for itself via a compensatory increase in economic growth. As a result, the national debt is likely to increase—possibly quite sharply—creating the need for tax rises further down the line, and generating long-term upward pressure on U.S. Treasury long bond yields.

As the 2016 presidential election demonstrated, U.S. politics is highly unpredictable. However, there is a reasonable chance that a successful infrastructure bill, and the accompanying boost to economic activity, will secure reelection for Trump. Yet it is highly uncertain what economic policies he might espouse four years from now, as Trump is yet to exhibit an economic philosophy or ideology.

Finally, Trump's status as a political outsider means that he has struggled to find true allies to occupy key government posts; he does not have an established pool of friends working in Washington to call upon. This has led to significant tension between him and senior cabinet members, such as Jeff Sessions and Rex Tillerson. While Powell is a consensus builder, he could easily find himself in disagreement with Trump over monetary policy. Were such a clash to erupt, we could expect Trump to replace Powell, and/or disrupt the traditional working protocol of the Federal Reserve.

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Arcapita Overview

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Arcapita originates alternative investments, which comply with Shari'ah principles, for its investors and shareholders. At the center of one of the fastest growing wealth markets in the world, Arcapita's management has been serving an exclusive group of investors in the GCC region and Southeast Asia over the past two decades. With offices in Bahrain, Atlanta, London and Singapore, Arcapita's management team has completed over 70 transactions with a total value of approximately $30 billion and possesses a footprint to invest on a global scale. The business is defined by the quality of its people - a management team with extensive experience gained in all market conditions and a group of professionals with deep expertise in their areas of focus.

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