
Weekly Market Flash

The Market's Next Big Non-Event

October 20, 2017

And the band plays on. Some random convergence of factors could conceivably interrupt and reverse today's upward push in the S&P 500 before the benchmark index ends with its seventh straight record close...but those would likely be bad odds to take. Yesterday was the 30 year anniversary of 1987's Black Monday, when stocks tanked by more than 20 percent in a single day. Financial pundits, with not much better to do, spent much of the day in college dorm-style bull sessions with each other, speculating about whether 10/19/87 could ever happen again. It certainly didn't happen yesterday, even though lower overnight futures injected a frisson of excitement into the morning chatter that dissipated as the afternoon yielded a predictable recovery and small gain for share prices.

We feel for those journalists – it's tough being a financial commentator these days! Nothing ever happens except for the market shrugging off any potentially disruptive event, while displaying brief spasms of ecstasy whenever the subject of tax cuts percolates to the top of the daily news feed. Now the chatter is homing in on what may well be the only remaining story of any note (from the market's perspective) before the end of the year: the identity of the new Fed chair when Janet Yellen's term ends next January. A decision is supposedly forthcoming in the next couple weeks (the incumbent administration suggests it will be before November 3). Our sense is that, regardless of who among the short-listed candidates is tapped, the impact on markets will likely be negligible.

If It Ain't Broke...

There are two issues at stake here: first, who the winning candidate will be, and second, how that candidate would actually govern once ensconced in the Eccles Building. There are currently five names under consideration. On a spectrum from dove to hawk they read as follows: current Fed governor Jerome (Jay) Powell, current Fed chair Janet Yellen, former Fed governor Kevin Warsh, Stanford University economist John Taylor, and current Trump advisor Gary Cohn. Let's say right off the top that we see next to no chance that Cohn will draw the winning ticket; among insiders close to the decision process, his name appears to still be in the mix for cosmetic reasons only.

That leaves four. Two, Powell and Yellen herself, reliably fall into the camp of "stay the course" – their votes on FOMC policy decisions, after all, are publicly documented and widely known. Speculation this week has Powell as the overall front-runner with considerable support both from the administration's inner circle and among both Republican and Democratic senators who will be involved in the confirmation process. There would be a rational logic for Trump to ultimately thumbs-up Powell: in so doing, he would be making the safest choice for business as usual, while still getting to theatrically crow to his base that he dumped the Obama-era Fed head.

...Don't Fix It

Just because Powell's star seems ascendant this week, though, does not mean that the two more hawkish choices of Warsh or Taylor are out of the picture. This is not an administration known for predictably rational decision making. So what happens then? Speculation is particularly focused on John Taylor, the Stanford professor whose "Taylor rule" – a mathematical formulation of the responsiveness of interest rates to inflation and other economic inputs – suggests that rates should currently be higher than they are. Would a Taylor Fed necessarily mean a dramatic acceleration of rate hikes and attendant balance sheet normalization?

Perhaps not. It's worth remembering that a Taylor Fed would be looking at the same data as the Yellen Fed, and that data include inflation readings, the danger-zone indicators of which are conspicuously absent. The Taylor rule is not immune to the inflation conundrum with which the Fed's other analytical models have struggled. It's also worth remembering that the Fed chair still has to take into account the positions of the other FOMC voting members. Whoever the new chair is, he or she will not be any less interested in building consensus towards unanimous decisions than past chairs. That's how stable monetary policy is conducted.

The global economy is largely in sync with low to moderate growth, decently functioning labor markets and modest levels of inflation. That's the real context in which stock prices can keep drifting up with no sizable upside headwinds. We think it is unlikely that, come 2018, a new Fed will be tempted to push their luck with policies that could choke off the growth before its time. For these reasons we think it unlikely that the identity of the new Fed chair will stand in the way of a business-as-usual mood in the market that, barring something currently unforeseen, could carry into and through the upcoming holiday season.

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