


**The Federal Reserve:**

One could easily argue that the person running the US Federal Reserve (“The Fed”) is the most powerful person in the world. Its policies help to determine everything from the health of the American economy to the price of credit in various emerging markets. Unlike elected officials, this individual is selected by the President and gets to serve a 6-year term. Also, unlike political elections, this individual is supposed to be “independent” and devoid of political influence.

Chairwoman Janet Yellen’s term will expire in February of 2018 and she was obviously appointed by Democratic President Barack Obama. With the surprising retirement of legendary technocrat and Vice Chairman Stanley Fischer, there are massive changes and openings at the Fed. Every president since Reagan has asked the incumbent Fed leader to stay at their job at the start of his presidency. If not re-appointed, Yellen would be the 3<sup>rd</sup> Fed chair, since 1934, to only serve one term. Would you be surprised if Trump decided to depart from traditional, prior norms? If President Trump does not re-appoint Yellen, there will be four vacancies among the twelve seats on the Fed’s interest-rate setting committee. No recent President has had the wide latitude to re-shape the Fed, and inadvertently the US’s balance sheet, as much as President Trump.

**A Decision by Halloween?**

If we believe recent media reports, President Trump is looking to make a decision of a Fed Chair by the end of October. When we focus on interest rates and where they are headed, we typically rely on the market expectation. For Fed Funds, that is the CME’s Fed Watchtool, located [here](#). For the “horse race” of who will lead the Fed, we found this recently. While there appears to be 6 potential candidates for the job, the market believes Kevin Warsh is the early front runner.

Who will be Senate-confirmed Fed Chair on February 4, 2018?		
FED.020418		
Posted on <b>Latest</b> The Daily Shot 03-Oct-2017		
	<b>Kevin Warsh</b> WARS.FED.020418	43¢ ↑ 21¢
	<b>Jerome Powell</b> POWE.FED.020418	29¢ ↑ 3¢
	<b>Janet Yellen</b> YELL.FED.020418	17¢ ↓ 3¢
	<b>Gary Cohn</b> COHN.FED.020418	16¢ ↑ 2¢
	<b>John Taylor</b> TAYL.FED.020418	5¢ NC

**The Perfect Candidate:**

With his tax reform policies pushing a pro-economic agenda, President Trump will look to the Fed for strong economic leadership. We can only surmise, but we believe President Trump will look for an individual to lead the Fed that is aggressive, business-like and charismatic. We envision President Trump will seek to put his own people in charge and who he stacks the Fed with will be critical to watch.

The Fed adheres to 2 main tenets or standards in setting interest rates. The first is full-employment, which at 4.4% is clearly being met. The second is price stability, which is measured through targeting a 2% inflation rate. While US growth has been solid, it has not led to a wildly inflationary environment. Macroeconomists remain unsure how removing this monetary stimulus will impact our economy and whether or not keeping rates low has artificially spurred growth. No Fed officials, especially a new chairman would want to be blamed for “removing the punch bowl” too early.



### **The Incumbant:**

Chairwoman Yellen has done an excellent job. The markets appreciate her tone and delivery of “Fed speak”. There would be some benefit to allow her to continue doing the job she has admirably done for the last 5+ years. She is absolutely an academic and this entity has been run by academics for decades.

Following recent Fed speeches, we get a sense that the Fed is somewhat confused about its path forward. At the recent National Association for Business Economics conference, Chairwoman Yellen said the Fed’s understanding of inflation is “imperfect” and that it “remains a mystery”. It is only natural for her to question policies and their intended and un-intended consequences. She has been publicly grappling with subdued inflation, despite a growing economy and strong labor market.

This type of uncertainty, however honest, does not seem to be a trait President Trump would feel comfortable with. We believe that President Trump enjoys “breaking the mold” of traditional posts. Nothing about Yellen’s demeanor or public persona screams “Trump”. This is why we believe she will not be re-appointed.

### **The “Goldman Sachs” Entrant:**

We worked at Goldman Sachs Asset Management for nearly 20 years and have tremendous respect for many of the individuals we had the pleasure to work with. After serving GS for decades, Gary Cohn was a surprise addition to President Trump’s inner circle. He is the director of the National Economic Council and is spearheading the tax reform package. He is the absolute polar opposite of Chairwoman Yellen in many respects. He has spent his career in business, at a pre-eminent global brokerage. He is straightforward and some find his tact and speaking style to be abrasive. He is an absolute “trader” in the purest sense of the word.

Last year, we had the pleasure of hearing him speak at an exclusive business conference. While we have heard Director Cohn speak numerous times, we did not know he had struggled with school as a youngster and had/had battled dyslexia. Having this academic hurdle and still reaching the #2 spot at GS is really a herculean feat. We have tremendous admiration for him and know he is a brilliant man very capable of running the Fed. On a personal note, we would love to see him get selected to run the Fed. However, we do not believe he will get the nod. Why?

The Fed is and probably always will be an academic institution. Its leader will have to be voracious readers and work with Fed employees to craft speeches and economic policies. At GS, Cohn led the trading efforts and is much more of a “gut” or “feel” kind of guy. We would not expect him to fit-in terribly well with the academic and PhD types currently at the Fed. Maybe he’s the ideal choice for President Trump to shake things up? However, his comments following Charlottesville (while 100% “spot on” in our opinion), will ultimately impact his chances to be the next Fed Chair.

### **The Likely Winner:**

In our opinion, we believe the choice will come down to two individuals. One is Kevin Warsh and the other is Jerome Powell. Kevin Warsh is a scholar at the Hoover Institution and has served as a Fed governor from 2006 to 2011. Having experience at the Fed, during the financial crisis, is an absolute plus. Being an economic advisor to President Bush should be viewed (especially in GOP circles) positively too. In President Trump’s eyes, Warsh fits the mold, as he has stated that he thinks government and the Fed suffers from being a “groupthink of academics”. He checks all the boxes, which President Trump might look for, of being polished and TV worthy.

One aspect we worry about, is Warsh’s stance on QE. Warsh has been a vocal critic of the Fed’s aggressive monetary easing, which many believe saved our economy from ruin. Interestingly, Warsh is married to Jane Lauder, the granddaughter of cosmetic icon Estee Lauder. If nominated, Warsh may become an easy target for Democrats. He could be painted as an elitist, billionaire heir, that is out of touch with Main Street. We do not believe this is the case, but we can see the headlines on CNBC already. We believe Warsh is a wonderful candidate and worthy Fed chair.

The other candidate that we believe has a high chance of being selected is Jerome Powell. Powell joined the board of governors in 2012 and was a partner at Carlyle Group, a leading private-equity firm. He served in President George H.W. Bush’s Treasury Department, where he has an extensive amount of experience in crisis management. To his credit, he has both a government and business background.

More recently, he has openly mentioned how he would like to ease some of the rules in Dodd-Frank, soften annual stress tests on big banks and believes in eliminating the Volcker rule. Powell has been vocal that the post-crisis crackdown on financials “has gone too far”. This type of de-regulation is music to the ears of both President Trump and hundreds of financial entities. The overall market will love these comments.

#### **Others:**

We have heard John Allison’s name get mentioned and he certainly has an impressive resume. He was the former chief execution of BB&T Corp and has a strong business background. He has previously mentioned for a return to the gold standard and an abolition of the Fed. These controversial thoughts are not what the market wants to hear. His choice would be an absolute “curve ball” and President Trump does not want to stop the steady march higher of the stock market.

Lastly, there is chatter that John Taylor will get the nod. Professor Taylor teaches at Stanford University and is a well-respected and distinguished academic economist. He has been a vocal critic of QE (mentioned above) and how low-interest rates have boosted other asset and stock valuations. Taylor has developed the “Taylor Rule”, which uses mathematics to set and influence interest rates. Many believe he would look to significantly raise interest rates, which might stop the “Trump Bump” that we hear about on Twitter (ex: The Dow is up 25% since President Trump took office).

#### **Conclusion:**

Uncertainty in the equity markets exists, but it always has. President Trump’s choice to lead the Fed is uncertain today, but we should have more clarity over the next 3 to 4 weeks. In fact, we won’t be surprised if the choice is announced via Twitter. We believe Yellen is not Trump’s choice and that he will choose between Warsh and Powell. There is much more to come out on all of the candidates and who ultimately gets selected will have a formidable job in front of him/her.

We are forecasting an environment of heightened volatility over the next year. We expect more shocks in 2018, similar to the sharp market drop experienced in August of 2015, early January of 2016 or possibly even another European election surprise. Strategas Research Partners recently noted that the S&P 500 suffered drops of at least 10% in 5 of the last 7 years, with the two exceptions being 2013 (drop of 6%) and 2014 (drop of 7%). In 2017, the biggest drop has only been 3%. While it seems like we are overdue for some sort of correction, we cannot ignore the positive, underlying fundamentals of the global economy. When a correction comes, and it will come, we will assess the situation and attempt to frame the opportunity. Whomever sits at the Fed will have a difficult environment to navigate. We wish that individual the best because the entire global economy rests on their shoulders (and decisions). That’s all....

No discussion on the Fed would be complete without analyzing QE, the balance sheet reduction program or our expectations for interest rates. In our 4<sup>th</sup> quarter newsletter ([which can be viewed here](#)), we discuss many of these issues. At the time of this writing, the market is expecting a 88% chance of raising interest rates by 25 basis points in December of 2017. Using the Fed’s dot plots, 12 of 16 central bank officials expect to see 3 interest rate hikes next year. We are not expecting this to occur to occur and we are placing less and less emphasis on the dot plots. Why? The Fed is about to see massive leadership change and we anticipate significant volatility next year.



The US Federal Reserve  
*October 2017*

**Manole Capital Management**

Commerce Club at Oxford Exchange

E-Mail: [warren@manolecapital.com](mailto:warren@manolecapital.com)

Website: [www.manolecapital.com](http://www.manolecapital.com)

**Disclaimer:**

**Firm:** Manole Capital Management LLC is a registered investment adviser. The firm is defined to include all accounts managed by Manole Capital Management LLC. **In general:** This disclaimer applies to this document and the verbal or written comments of any person representing it. The information presented is available for client or potential client use only. This summary, which has been furnished on a confidential basis to the recipient, does not constitute an offer of any securities or investment advisory services, which may be made only by means of a private placement memorandum or similar materials which contain a description of material terms and risks. This summary is intended exclusively for the use of the person it has been delivered to by Warren Fisher and it is not to be reproduced or redistributed to any other person without the prior consent of Warren Fisher. **Past Performance:** Past performance generally is not, and should not be construed as, an indication of future results. The information provided should not be relied upon as the basis for making any investment decisions or for selecting The Firm. Past portfolio characteristics are not necessarily indicative of future portfolio characteristics and can be changed. Past strategy allocations are not necessarily indicative of future allocations. Strategy allocations are based on the capital used for the strategy mentioned. This document may contain forward-looking statements and projections that are based on current beliefs and assumptions and on information currently available. **Risk of Loss:** An investment involves a high degree of risk, including the possibility of a total loss thereof. Any investment or strategy managed by The Firm is speculative in nature and there can be no assurance that the investment objective(s) will be achieved. Investors must be prepared to bear the risk of a total loss of their investment. **Distribution:** Manole Capital expressly prohibits any reproduction, in hard copy, electronic or any other form, or any re-distribution of this presentation to any third party without the prior written consent of Manole. This presentation is not intended for distribution to, or use by, any person or entity in any jurisdiction or country where such distribution or use is contrary to local law or regulation. **Additional information:** Prospective investors are urged to carefully read the applicable memorandums in its entirety. All information is believed to be reasonable, but involve risks, uncertainties and assumptions and prospective investors may not put undue reliance on any of these statements. Information provided herein is presented as of December 2015 (unless otherwise noted) and is derived from sources Warren Fisher considers reliable, but it cannot guarantee its complete accuracy. Any information may be changed or updated without notice to the recipient. **Tax, legal or accounting advice:** This presentation is not intended to provide, and should not be relied upon for, accounting, legal or tax advice or investment recommendations. Any statements of the US federal tax consequences contained in this presentation were not intended to be used and cannot be used to avoid penalties under the US Internal Revenue Code or to promote, market or recommend to another party any tax related matters addressed herein.