ASPIRIANT

Market Perspective

March 2018

THE FEDERAL RESERVE: NEW CHAIR, SAME RESULT

Changing of the guard

The Federal Reserve's Board of Governors is entering a new era. Jerome "Jay" Powell was sworn in as chairman in early February, replacing Janet Yellen. While much attention has been focused on the transition at the top, many more upcoming changes are likely at the Fed. In fact, President Donald Trump has an unprecedented opportunity to deeply influence the rest of the organization for many years to come by nominating as many as five of the seven board members during his presidency. How successful Trump ultimately is at getting those governors nominated and confirmed remains to be seen. What seems clearer to us is that the Fed under Powell won't look dramatically different from the Fed under Yellen.

Impact of the Fed's actions

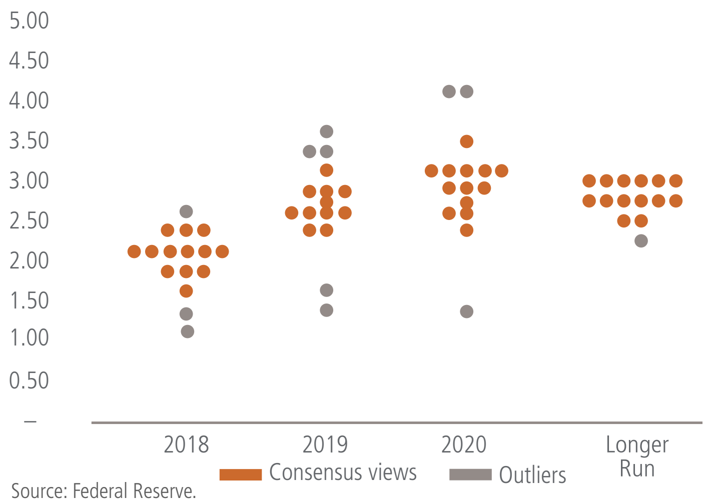
From our perspective, the Fed should be commended for the extraordinary actions it began taking in 2008 to stabilize an economy in free fall and inject liquidity into financial markets. These measures included lowering the fed funds rate to zero percent and Quantitative Easing, which involves the purchase of government bonds and mortgage-backed securities to add additional liquidity and, importantly, pull down long-term interest rates. These purchases grew the Fed's assets from under $1 trillion in 2008 to $4.5 trillion by the end of 2014. The Fed has carried that amount on its books by reinvesting proceeds from maturities back into purchases of additional bonds.

Over the last few years, as unemployment has fallen, there has been significant debate surrounding the Fed's efforts to normalize monetary policy by increasing short-term interest rates and reducing the size of its balance sheet. This process started in December 2015 with the first interest rate increase since 2006. A year passed before we saw another rate hike in December 2016, followed by three more hikes in 2017. In total, the Fed has raised rates five times, or 1.25%, over the previous 24 months.

Fed fund's rate and balance sheet

The Fed regularly provides guidance on future expectations of interest rates and reductions in the balance sheet after each meeting of the Federal Open Market Committee (FOMC). The December rate increase moved the target range for the federal funds rate to 1.25% to 1.50%. Meanwhile, the Fed's average long-term expectation for the fed funds rate is 2.75% to 3.00%; much lower than the historical norm. The dot chart below shows each FOMC meeting participant's view on rates for the end of 2018 through 2020 and the long-term average expectation.

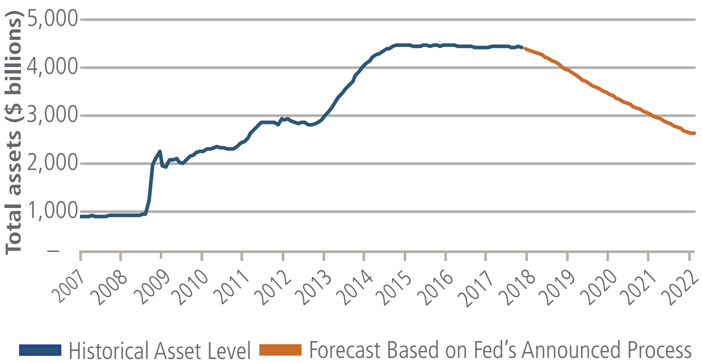
FOMC Target Values of Federal Funds Rate
December 13, 2017



Source: Federal Reserve.

Last year, the Fed provided guidance on future reductions in the balance sheet. It announced a plan in June to gradually shrink the balance by about $10 billion per month, increasing this by $10 billion on a quarterly basis until the aggregate monthly reduction reaches $50 billion per month. This equates to a planned reduction of approximately $300 billion in the first year and $600 billion in future years until the balance sheet is restored to a reasonable amount. At this pace, it would take until 2021 to bring the balance down to $3 trillion. The Fed has been careful not to announce an expected size of debt holdings going forward, but the market anticipates a significantly higher level of assets than before the Global Financial Crisis. The gradual nature of this plan is expected to impact long-term rates only a little, but any deviation (either faster or slower changes) could impact future rates.

Federal Reserve - Total Assets



Source: Bloomberg, Federal Reserve, Aspiriant. Assets held as of January 1 of each year.

Continuity with some interesting differences

Powell's appointment should provide some measure of continuity as his outlook on the U.S. economy and monetary policy is very similar to Yellen's. In fact, he has never dissented in a monetary policy vote during his five-year tenure. In general, he believes the U.S. economy is in fairly good shape and expects a modest increase in inflation pressures. Accordingly, he has supported the current measured approach to monetary tightening, along with a plan to gradually normalize the Fed's balance sheet.

> "The healthy state of our economy and favorable outlook suggest that the FOMC should continue the process of normalizing monetary policy. The Committee has been patient in raising rates, and that patience has paid dividends. While the recent performance of the labor market might warrant a faster pace of tightening, inflation has been below target for five years and has moved up only slowly toward 2 percent, which argues for continued patience, especially if that progress slows or stalls. If the economy performs about as expected, I would view it as appropriate to continue to gradually raise rates."
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> "Thoughts on the Normalization of Monetary Policy" speech by Governor Jerome Powell Economic Club of New York, June 1, 2017.

The upshot is we are not anticipating any major surprises. From a policy perspective, the differences between Powell and Yellen lie at the margin. Powell seems more supportive of deregulation in the financial sector and has shown more willingness to consider broader financial stability as a policy input. Deregulation is seen as a positive for capital markets and financial firms as Powell is inclined to reduce some of the more onerous constraints imposed by the Volcker Rule, especially for smaller or more mid-sized banks for whom the legislation is proving costly. Including financial stability in the economic forecast could prompt more pre-emptive tightening in situations where market excesses appear to be building in the economy or, more controversially, in the capital markets.

Who is Jay Powell?

Unlike previous Fed chairs who held doctorates in economics, Powell was originally trained as a lawyer. He's also held posts within both the public and private sectors, which is a bit different from the more academic and public-sector-focused experience of recent Fed chairs.

Early in his career, Powell worked in the investment banking industry and for the U.S. Department of Treasury. After spending several more years in investment banking, private equity and venture capital, he had an entrepreneurial turn as co-founder of a specialty finance business. Finally, he spent time as a visiting scholar at the Bipartisan Policy Center, a D.C.-based think tank, where he focused on federal and state fiscal issues. In 2012, he was appointed to the Fed Board of Governors by President Barack Obama.

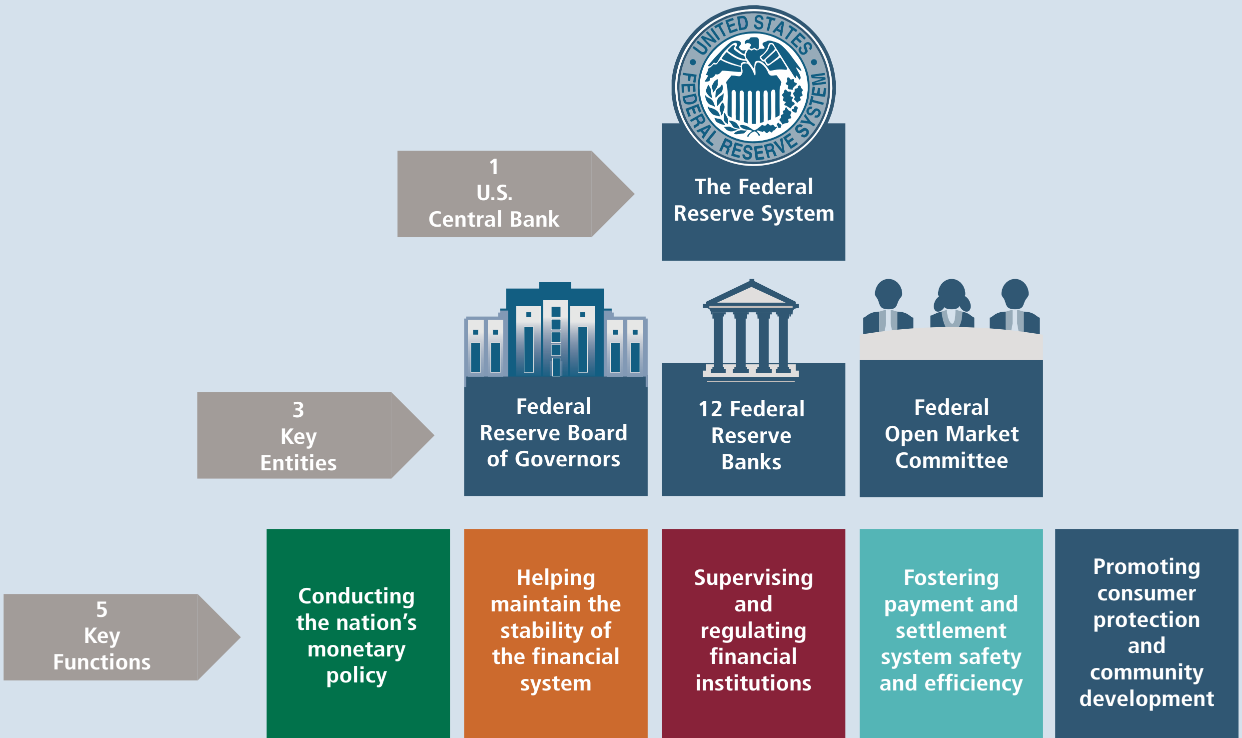
Given the Fed's uniqueness as an independent arm of the government comprised of both public- and private-sector members, we think his diverse business experiences should serve him well in a leadership role at the Fed and in building consensus on the FOMC. Also, his hands-on, small business experience should provide some helpful insights into crafting monetary policy given the small business nature of the U.S. economy.

Our expectations

While there are some cyclical pressures on inflation and interest rates developing from an improving economy, expansionary fiscal policy, higher commodity prices and a weaker U.S. dollar, we believe these pressures are more transitory than durable and will be offset in the long run by structural forces that are fundamentally deflationary in nature. These include demographic trends, technological disruption, automation and a persistent global savings glut, all of which are likely to keep growth, inflation and interest rates generally lower for longer.

The Federal Reserve System

The Federal Reserve System was created in 1913 to provide stability to a banking system that saw a series of financial panics in the early 1900s. Given our nation's distrust of centralized power, the Federal Reserve Act of 1913 created 12 districts, with each district bank operating independently from each other. Along with the regional banks, the Federal Reserve Board of Governors was created as the governing body of the Fed. Problems with the system in the 1930s brought changes as the Federal Reserve Act of 1933 and 1935 created the modern-day Federal Open Market Committee. The intended objectives of the Federal Reserve Act, and the purpose of today's central bank, is to maximize employment, stabilize prices and temper interest rate fluctuations.



Source: Federal Reserve.

Historically, the Fed has used three tools to achieve these monetary policy goals:

- The discount rate — The borrowing rate available to member institutions to access short-term funds directly from the Fed
- The reserve requirement — The minimum amount of reserves, usually expressed as a percent of deposit liabilities, held by member institutions
- Open market operations

The FOMC is the committee within the Fed that manages open market operations. The committee principally influences monetary policy by targeting short-term interest rates through the federal funds rate, an overnight loan rate between depository institutions for reserves balances (to be held at the Fed). The FOMC members include the seven members of the Federal Reserve Board of Governors, the president of the New York Fed, and, on a rotating basis, four of the other 11 regional Federal Reserve Bank presidents.

The Federal Reserve Board is where the power of the presidency is most evident within the Fed. The president nominates members to the board to serve a single 14-year term (exceptions apply for chairman and vice chairman).

Near term, we expect interest rates to move gradually higher with continued yield curve flattening. Short-term rates will rise. Long-term rates may also rise, but not as much, which is a typical outcome in periods of tightening. If history serves as any guide, the average duration and magnitude of a tightening cycle tends to be approximately 14 months, with an average increase of roughly 3% in the fed funds rate. The current cycle is already longer in duration, but perhaps, it may be somewhat shallower in magnitude.

One risk to expectations that rates will remain lower than historical averages is fiscal policy. It is unusual to have rising government deficits and significant fiscal stimulus this late in an economic cycle. The risk of higher rates could become more acute if fiscal policy (e.g. significant tax cuts and infrastructure spending) begins to spur inflation. This does not change the longer term expectation of low rates, but we could see a period of time where interest rates go higher than current market expectations.

Investment strategy implications

Long-term fixed income investors should feel more happy than worried over higher rates, but that's not often the message you hear when it comes to rising rates and bond portfolios. The reality is rising interest rates are actually good for long-term bond investors. While there may be some initial price weakness, the ability to reinvest income at higher rates ultimately means higher long-term returns.

Nevertheless, our bond portfolios remain well-positioned to manage rising rate pressures as we've built an intentional yield advantage into our positioning. This extra income should help cushion any initial price weakness related to higher rates. Additionally, the majority of our bond exposure is actively managed, which we believe tends to deliver better performance than passive bond portfolios in rising-rate environments.

While much focus is directed toward the outcome for bonds, it is also important to recognize the potential headwinds to equities from rising interest rates. This concern finally came to the forefront of the market during the first week of February. Higher interest rates put pressure on equity valuations and help bonds become a more attractive investment. Further, corporate profit margins may be negatively impacted by a higher cost of debt. Combined with high valuations, this environment causes us to focus portfolios on higher quality, more defensive equity investments versus more highly leveraged businesses. Our increasing exposure to quality and defensive equities has been an important strategy initiative over the last few years.

Importantly, it is vital to remember monetary policy can be altered by the political environment. This is especially true given the fiscal policy changes we are seeing ranging from tax reform to potential increases in infrastructure spending. It will be important to watch whether the stimulative impact of tax cuts and other fiscal policies proves inflationary or produces real economic growth. The coming months will be interesting to monitor for this interplay between monetary and fiscal policy. What fiscal policy might giveth, the Fed may taketh away.

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