INVESTMENT UPDATE

The bond market received some surprise news earlier this month from a source that has been trying to do its best to not surprise anyone: The Federal Reserve Board. Stanley Fischer, the Board's vice chair and Janet Yellen's trusted colleague, announced that he would be resigning in October, with less than one year left on his term. Interesting guy, Stanley Fischer. Born in Northern Rhodesia (now Zambia), educated at the London School of Economics and MIT, with dual US and Israeli citizenship, Fischer is arguably the Fed's most prominent macroeconomist, with decades of experience both here and abroad. After a career in academia, Fischer worked for The World Bank, the IMF and Citigroup. Before being appointed governor and vice chair of the Federal Reserve Board in 2014, Fischer headed Israel's central bank for eight years, guiding the Israeli economy through the global financial crisis.

In announcing his early retirement, Fischer cited "personal reasons." There is speculation about his health (he is 73), but it's likely that he just wants a change of scenery. This is a man who clearly likes a challenge and it's worth noting that he resigned from the Bank of Israel halfway through his second term, so this retirement announcement is not without precedent.

Name	Title	FOMC Term Ends
Janet Yellen	Board of Governors, FOMC Chair	Feb 2018
Stanley Fischer	Board of Governors	Oct 2017 (Retire)
Lael Brainard	Board of Governors	Jan 2026
Jerome Powell	Board of Governors	Jan 2028
Vacant	Board of Governors	
Vacant	Board of Governors	
Vacant	Board of Governors	
William Dudley	President, NY Fed, FOMC Vice Chair	Permanent
Patrick Harker	President, Philadelphia Fed	Dec 2017
Robert Kaplan	President, Dallas Fed	Dec 2017
Neel Kashkari	President, Minneapolis Fed	Dec 2017
Charles Evans	President, Chicago Fed	Dec 2017

Fischer is one of the more "hawkish" governors at the Fed, favoring a more rapid normalization of monetary policy—including raising the overnight Fed funds rate and reducing the size of the Fed's balance sheet—than most other members of the Fed's Open Market Committee (FOMC). In this respect, Fischer is decidedly old school; he strongly believes that macroeconomic models play an important part in directing monetary policy. This belief extends even to those models that don't appear to work very well, which is a hot topic of debate within the FOMC right now, as there is an undeniable break in the Phillips curve link between the labor market and inflation.

As we wrote about (at length) in our June *Investment Update*, despite the US unemployment rate falling into the low-4% range, we have not seen a measurable uptick in wages or inflation, which is contrary to what a Phillips curve model would have predicted. Fischer has been one of the leading voices in downplaying this disconnect over recent months, attributing the lack of upward pressure on inflation to temporary factors (e.g., mobile phone companies offering cheaper monthly plans). Critics have pointed out that temporary factors are, by definition, transitory, and over time wash out, having no real impact on core inflation trends. Theses "doves" argue that there is something far more fundamental and structural going on that's keeping inflation low.

The loss of Fischer comes at a time when the Fed is dealing not just with theoretical issues, but existential ones, too. The policy-setting FOMC is comprised of all seven members of the Federal Reserve's Board of Governors and five of the 12 regional Federal Reserve Bank presidents (although all 12 presidents attend and participate in Committee discussions, only five have votes). But when Fischer's retirement becomes effective in a few weeks, there will be only two sitting governors besides Yellen, as there are already three open slots that are currently waiting to be filled.

This has created an unprecedented situation where the voting regional presidents now outnumber Board members on the FOMC (the table shows the current members of the FOMC). That's not the way the system was designed to work, as the Board tends to be more insular, and attuned to the research (notably, the "tealbook") that the Board's economic staff prepares for each of the eight meetings the FOMC has every year. The Reserve Bank presidents have their own separate economic staffs, and are often more concerned with the specific economic conditions in their particular region of the country. Unlike the regional Reserve Bank presidents (who are nominated and approved by each regional bank's board of directors) the governors are appointed by the President of the United States. Another important distinction: The governors serve very long terms (14 years) on the FOMC, while the regional presidents rotate off the FOMC every 12 months (except the president of the New York Fed, who is, by rule, a permanent member of the FOMC and the committee's vice chair).

With five FOMC appointments to be made between now and February (including the decision whether to re-appoint Dr.

Yellen as chair), President Trump has the ability to virtually transform the makeup of the Board of Governors at the Fed. And while we're loath to engage in a heated political debate, it's not particularly controversial to note that Mr. Trump has no particular affinity for the way things are normally done in Washington, so predictions about who he might pick to fill these slots are especially difficult. The White House's chief economic advisor, Gary Cohn, had been the apparent front-runner to replace Yellen as chair, but he fell out of favor after criticizing Mr. Trump's comments regarding the violent protests in Charlottesville last month.

The one nomination Mr. Trump has made already gives us a general idea of what direction he may take: Randal Quarles was formally nominated in July to the Fed's Board, and more specifically, to take on the newly created position of Vice Chairman for Supervision. Mr. Quarles' background is in investment banking, and at his recent Senate hearing he called for "refinements" in the level and scope of banking regulations passed in the wake of the financial crisis. There has been some speculation that Fischer's retirement may have been hastened by Quarles' nomination, as both Fischer and Yellen are staunch proponents of tough regulation for banks and their affiliates. We know virtually nothing about Mr. Quarles' positions on monetary policy, but indications are that he will be more tilted towards the "hawkish" side of the ledger.

We also know that there will be four new voting members of the FOMC in 2018 coming from the regional Reserve banks; the presidents of the Philadelphia, Dallas, Minneapolis and Chicago banks will be rotating off, to be replaced by their counterparts from Cleveland, San Francisco, Richmond and Atlanta.

There will be some shifting of power as a result of these rotations. In particular, Neel Kashkari of the Minneapolis Fed, who will be rotating off, is a noted dove on the FOMC. He has dissented from the past two votes to raise the overnight funds rates while urging his colleagues to take a slow and deliberate path to policy normalization. He has formed a strong tie with Governor Lael Brainerd, the heavyweight economist who has taken the leading role in encouraging the FOMC to carefully examine their biases and faith in econometric models.

Gaining a vote in 2018 will be Loretta Mester, from the Cleveland Fed. She will join with other known hawks and traditionalists favoring Yellen's current prescription for continuing the current pace of policy normalization. She will be losing the like minded Fischer but is likely to be joined by the aforementioned Quarles in supporting a rules-based Fed, where models predominate actual data. Also getting a vote in 2018 is San Francisco's John Williams, a moderate who has backed the idea of fighting persistently low interest rates by not raising the Fed funds rate aggressively during an expansion, which would allow the economy to "run hot" and boost inflation above the 2% target for a period of time. His position on this doesn't appear to be rock-solid, though, as his most recent speech on the topic seemed to direct most of the policy onus on lawmakers, calling for fiscal stimulus instead of monetary solutions.

As for the other two new voting members rotating on in 2018, we are practically flying blind. The Richmond Fed is without a president right now, since well-known hawk Jeffrey Lacker resigned earlier this year after admitting to having leaked proprietary information. While a search for Lacker's replacement is ongoing, stepping in for him as a voting member of the FOMC is First Vice President Mark Mullinix, whose background is in operations—currency and accounting and risk management—not monetary policy. It's pure speculation who Lacker's permanent replacement will be, but given that the Richmond Fed's board is pretty conservative, our best guess is someone who is fairly hawkish.

Meanwhile, the Atlanta Fed's new president, Raphael Bostic, has only been on the job since June. Bostic's hiring was historic, as he is the first African-American to head a Reserve Bank, and the first openly gay Federal Reserve bank president. He replaces Dennis Lockhart, a moderate who leaned towards the dovish side of the ledger. Bostic was an economist for the Board in the 1990's and has a background in public policy (specifically, affordable housing), having served as assistant secretary for policy development and research at HUD under President Obama. His views on monetary policy are unknown, but in an interview with the *Atlanta Journal-Constitution* shortly after taking office, Bostic addressed the Phillips Curve dilemma by saying, "My approach is going to be, just take the data as it comes. I am not wedded to any policy pathway. I will allow myself to be informed by what the data show us." That sounds a lot like someone who won't be wedded to the Fed's hawkish/model-driven faction.

Where does that leave the FOMC in 2018? Well, there will still be three open Board seats, assuming that Fischer is out and nominee Quarles is in. Let's also assume that the Richmond Fed hires a hawk and that Bostic in Atlanta sides with the doves. That leaves the known voting members relatively balanced between the hawks, led by Loretta Mester, and the doves, led by Lael Brainerd, fighting it out on either end of the spectrum. Holding down the middle with Chair Yellen are Bill Dudley from the New York Fed and known centrist Governor Jerome Powell, both of whom have sided with Yellen and the current "normalization" theme.

But we expect that the balanced FOMC that stands today could change markedly in the coming months. One would assume that a Republican President would favor inflation-fighting hawks, but we cannot be sure that's the way it will play out this time. We're looking at an uncertain future for the FOMC and its policies, and uncertainty is one thing that markets don't like.