NEWPERSPECTIVES

Commentary from New Century Advisors
November 2017

Powell New Fed Chair

- **Status quo on monetary policy but focused on deregulation of financial institutions**
- **Fed still trending hawkish**
- **Market underpricing Fed hikes through 2018**
- **Powell nomination suggests further curve flattening and should bode well for bank stocks**

What's Really Changed?

President Trump announced the nomination of Fed Governor Jerome Powell as the next Fed Chair earlier today. The political optics are that the President lives up to a campaign promise by 'shaking things up' at the Fed, appointing a new, Republican Fed Chair. Powell, having served on the Board since 2012, largely represents the Fed status quo. As such, he is unlikely to veer from the current slow pace of accommodative policy removal. He is also expected to be substantially more dovish than John Taylor, the man seen as the runner-up in the President's deliberations. That said, markets should be wary of overreacting to perceived Fed dovishness going forward. The Fed is still shifting more hawkishly, if just not as sharply as it might have under Taylor. In addition, Powell's stated preference to roll back some of the regulations on financial institutions, a factor which no doubt endeared him to the President, represents additional upside economic potential which should put further pressure on the removal of policy accommodation and could favor banks.

First, looking at the Fed Hawk/Dove chart below (1 = Extreme Dove; 5 = Extreme Hawk), there are a few noteworthy trends as the Fed transitions into 2018 under Chair Powell:

- Regional Fed Presidents tend to be more hawkish than Board Governors
- Regional President rotation shifts hawkishly from 2017 into 2018
- Regional Presidents carry greater relative weight given Board vacancies (5/12 votes with a fully staffed Board; 5/9 this year; 5/8 next year) until the President nominates more Governors
- Additional nominations bring a potential further shift in the hawkish direction, particularly should the President look to appease conservatives

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Federal Reserve Dove/Hawk Scale

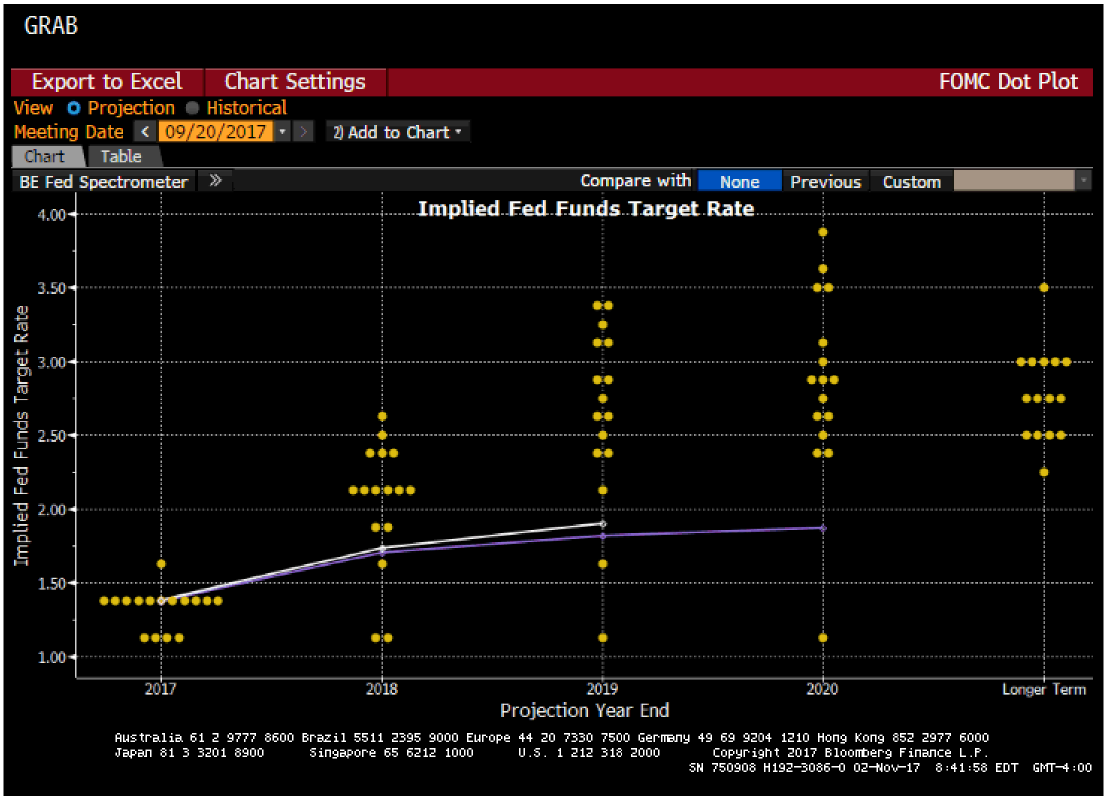
Group	Member	1 (Dove)	2	3 (Neutral)	4	5 (Hawk)	
Board of Governors	Janet Yellen, Chair		X				Voting in 2017
	Lael Brainard	X					
	Jay Powell		X				
	Randal Quarles			X			
Regional Presidents	Bill Dudley, FOMC Vice Chair*		X				
	Charles Evans**	X					
	Patrick Harker				X		
Total 2017 Voting Avg: 2.0	Robert Kaplan		X				
	Neel Kashkari	X					
Board of Governors	Jay Powell, Chair		X				Voting in 2018
	Lael Brainard	X					
	Randal Quarles			X			
	???		<-----	?	----->		
	???		<-----	?	----->		
	???		<-----	?	----->		
	???		<-----	?	----->		
Regional Presidents	Bill Dudley, FOMC Vice Chair*		X				
	Loretta Mester**				X		
	Raphael Bostic		X				
Total 2018 Voting Avg: 2.6	Mark Mullinex (interim)				X		
	John Williams			X			
Additional Regional Presidents	Esther George					X	2019
	Eric Rosengren				X		
	James Bullard	X					

Permanent voter*
Vote rotates every other year**

Source: New Century Advisors

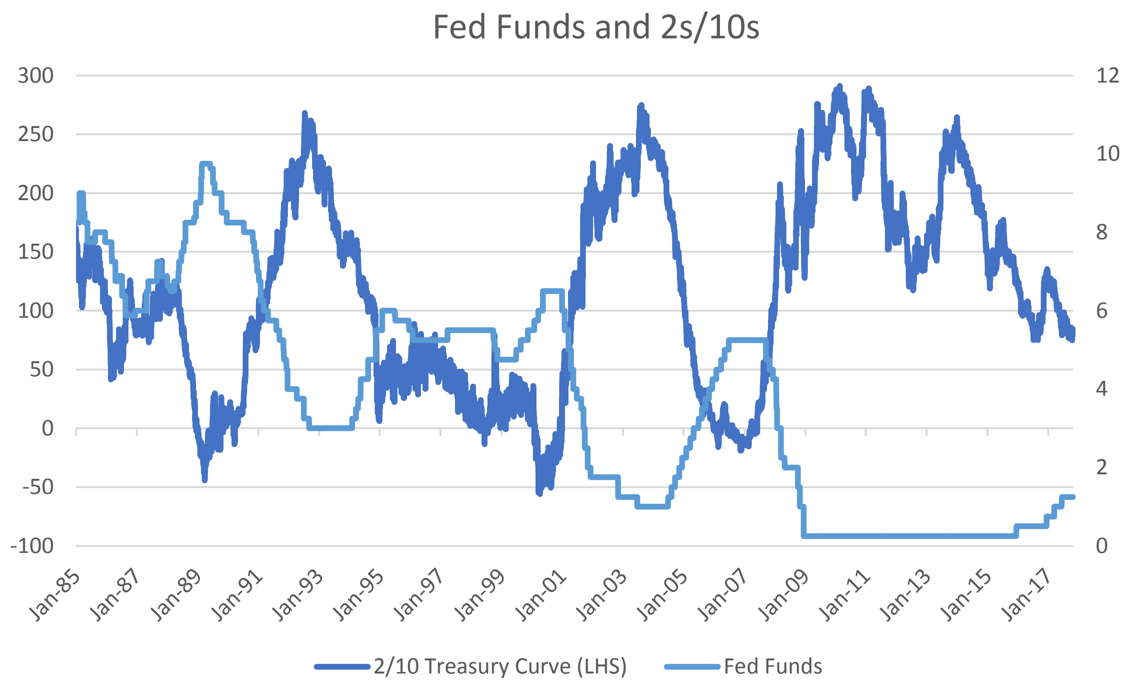
Further Flattening Ahead

In addition, based on the Fed's Dot Plot in the September Summary of Economic Projections (SEP, below), the current Fed already anticipates hiking rates four times between now and the end of 2018 (once this December and three times next year). Based on Fed Funds futures, however, the market is pricing in roughly two-and-a-half rate hikes over the same period. Given our forecast for supportive Q2 base effects to push inflation higher next year, we see a risk that the market is already underpricing rate hikes, even before taking into account the potential shift to a more hawkish Fed discussed above.



Source: Bloomberg

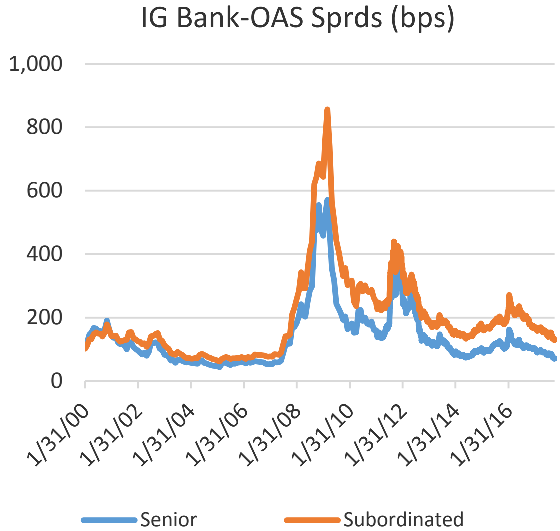
In light of the above, there are a couple of trades we like in response to today's announcement. One is for the Treasury yield curve to flatten further. Simply put, yields flatten as the Fed tightens. While the curve is already the flattest it's been since the crisis, prompting many investors to fade the move, we look at how much further the Fed could tighten and see room for the curve to flatten further.

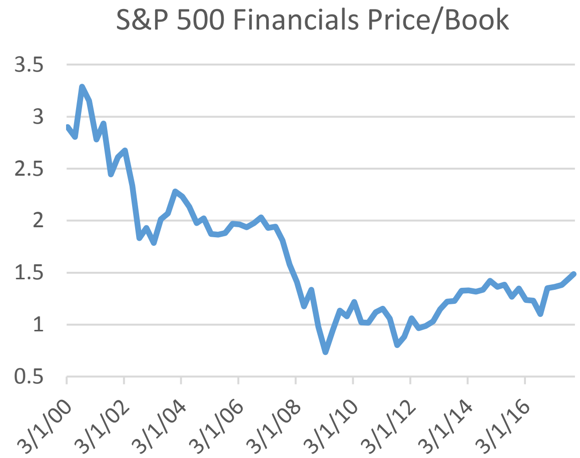


Source: New Century Advisors and Bloomberg

Favor Bank Stocks over Bank Debt

In addition, we think the Powell appointment will be a net positive for bank equities. Prior to the financial crisis, price-to-book ratios for the major U.S. banks traded at 2x to 3x, primarily based on their earnings coming from the pre-existing higher leverage ratios.





Source: New Century Advisors and Bloomberg

Once the leverage ratios were reduced following the financial crisis, we saw an opportunity for bank debt to outperform. Deleveraging and increased regulation reduced bank profitability but increased their safety. In time, that led bank debt to tighten significantly to Treasury rates. Now, with Fed Chair Powell and recently confirmed Vice Chair of Bank Supervision Randal Quarles at the Fed, both of whom have spoken about the need to roll back over-burdensome bank regulation, we look for bank profitability to improve, and for price-to-book ratios to follow suit. Thus, a rotation from bank debt to bank equity makes sense.

For more information on any of the data, trends, or trading strategies in this piece, or to discuss how New Century Advisors might help you to manage your inflation risk, please contact Leigh Talbot, CFA, Director of Client Relations at 240-395-0012 and ltalbot@ncallc.com

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