

**Will a New Fed Chairman Derail the Stock Market Rally?**

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Over the past two years, investor exuberance has poured over $150 billion into equity funds. The perception of market risk has been sharply lowered over the past years by the central bank’s supportive activities in the capital markets and the high octane fuel of near zero interest rates. Meanwhile, Bernanke’s buyback of treasury and mortgage back securities is at a pace of moving the Fed’s balance sheet to over $4 trillion. The questions that Wall Street has is what policies will any new Fed Chairman have and what promises will be made during a confirmation hearing about reducing the Fed’s balance sheet? Mortgage rates have already recently soared on speculation the Fed’s purchases may ebb and bonds have lost value with the expectation of interest rate hikes in 2014.

Ben Bernanke’s second term as Federal Reserve Chairman comes to an end in January of 2014, and most insiders look for a change in the guard with Bernanke forgoing (or more likely not reappointed for) another term and Obama choosing instead to usher in a fresh new Chairman of the Federal Reserve. Starting in early 2013,Bernanke has made subtle indications of his reign coming to a close. For example, in a March press conference, he stated “*I don’t think that I’m the only person in the world who can manage the exit*.” He also gave guidance about the President’s position, “*(I have) spoken to the president a bit*” and ‘*(he) feels no personal responsibility in regards to asking for a third term in office*.’ Ultimately, the decision will rest with President Obama, who has shown his hand a bit for his own chosen appointment, and not sticking with a throwback from the Bush era. Indeed, Obama told Rose in a PBS interview in June that “*Ben Bernanke’s a little bit like Bob Mueller, the head of the FBI – where he’s already stayed a lot longer than he wanted or he was supposed to.*”

While Bernanke’s departure is not written in stone given he is eligible for another term, President Barack Obama is expected to name a new chairman of the Federal Reserve this fall and the comments have been growing toward Bernanke’s departure. Perhaps a good part of the subtleties in guidance is that the capital markets don’t want a lame duck Chairman for the tail end of the central bank’s policy direction.

Fortunately there was no bombshell in Bernanke testimony at the recent House Financial Services Committee, as Bernanke pronounced that “we intend to maintain highly accommodative monetary policy for the foreseeable future.” However, arguably the most revealing of the Chairman’s [prepared remarks](http://www.federalreserve.gov/newsevents/testimony/bernanke20130717a.htm) to the House Committee was Bernanke’s statement “*I emphasize that, because our asset purchases depend on economic and financial developments, they are by no means on a preset course*.” The delivered message is that the central bank could decelerate the tapering of bond purchases should the economy remain stable or slightly improve.

Bernanke said the funds rate likely would stay near zero well after the unemployment rate drops to 6.5%, as long as the annual inflation outlook is below 2.5%. However, Bernanke explained that Quantitative Easing (“QE”) and the Fed’s zero-interest-rate policy are distinctly different tools. QE’s asset purchases of treasuries and mortgage-backed securities are short term boosts, or as Bernanke states, “*increase near-term economic momentum*”.

The pervasive and more resoundingly influential factor in all this is how the capital markets view any newly elected Fed Chairman and what economic policies will be maintained, or revised? The new Chairman will inherit an unprecedented asset purchase program, which have expanded the Fed’s balance sheet to a record $3.4 trillion and this new Chairman will likely have the complex job of having to unload some of the inventory during their term.

There are many top contenders qualified for the job of Chairman, but there are less than a handful of candidates that fit the short list. The current Federal Reserve's powerful vice chair, Janet Yellen, is the hands on favorite. A recent Reuters poll has the Yale educated PhD as the pick by 40 of 44 economists polled. The former president of the San Francisco Federal Reserve Bank is considered dovish and expected to follow the current Bernanke blueprint should she take over for her boss in February 2014. Her appointment would also be consistent with the diversity agenda of President Obama, who would be first President to nominate a female Fed Chairman. Others viewed as top candidates for the chief role are former Treasury Secretaries Tim Geithner and another old insider hand, Larry Summers. All three potential Presidential picks would likely not rattle the capital markets given they have shown to be accommodating and not leery of bolstering the balance sheet in times of economic upheaval.

As for the hands-on favorite of Janet Yellen, there is a potential policy change difference toward a more acute focus on inflation as a more prominent factor for central bank polices. She was an early proponent of the 2% target inflation rate and helped move the Fed’s eventual 2% target adoption. Yellen has historically shown more concern for the under 2% than over 2% inflation and was a proponent of convincing the markets that the lower interest rate path is innocuous as long as price stability is maintained.

At the 2013 National Association for Business Economics Policy Conference, Washington, D.C., Yellen made several statements that intimated a future policy of ‘staying the course’ and this stance is consistent with Wall Street’s expectation. Some key excerpts included:

*“I view the Committee's current rate guidance as embodying exactly such a ‘lower for longer’ commitment.”*

*“…Committing to keep the federal funds rate lower for longer helps bring down longer-term interest rates immediately and thereby helps compensate for the inability of policymakers to lower short-term rates as much as simple rules would call for.”*

*“At present, I view the balance of risks as still calling for a highly accommodative monetary* *policy to support a stronger recovery and more-rapid growth in employment.”*

Though these statements are clearly in support of the Fed accommodative stance, these views may come back to haunt Janet Yellen should she face confirmation hearings. A major hurdle for her will be Capital Hill’s concern over the Fed’s balance sheet, which would likely dominate the Republican dialogue. Committee fiscal conservatives will seek clarification on the risks of the current Fed balance sheet, how to reduce the debt load and what are the long-term implications for the economy, capital markets and consumers. The discussions on reducing the Fed’s economic support and its balance sheet could quickly upset the capital markets and lead to market volatility in equities.

In conclusion, both Economist and Wall Street contingencies don’t anticipate any hawkish shift in the Federal Reserve and that prevailing accommodating policies should be incrementally adjusted downward as economic conditions further stabilize. However, to what extent can a new Fed Chairman deliver ‘more of the same’ as the Fed’s balance sheet approaches $4 trillion and rates are already near zero? With one foot already out the door, Bernanke has already started the saber rattling of headwinds at a press conference in Washington, “*If the incoming data are broadly consistent with this forecast, the committee currently anticipates that it would be appropriate to moderate the pace of purchases later this year.*”

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