CAPITOL ANALYSTS NETWORK, INC.
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TRUMP'S FED PICKS PLUS THE NUCLEAR OPTION = LOW RATES, FOR LONGER?

When Senate Democrats invoked the nuclear option in 2013, it meant that the Senate could confirm any Presidential appointee subject to Senate confirmation by simple majority vote if it chose, except for Supreme Court nominees. Senate Republicans swept this exception away two weeks ago and used it to seat Neal Gorsuch as the replacement for Justice Scalia. One huge unintended consequence of invoking the nuclear option is that next year it could give Donald Trump control over monetary policy. The last President to have such power was FDR. Trump won't just shape the Supreme Court for a decade. He may do the same thing with the Fed.

The longstanding protocol has been for Presidents to nominate Board Governors and Board Chairmen who are acceptable to the Senate leadership of both parties. In the past, the nominations of potential Fed nominees and Fed Chairmen have been discussed confidentially with the Chairmen and ranking Members of the Senate Banking Committee, which must confirm them first before they can be considered by the full Senate. If either Committee leader seriously objected during the quiet consultation periods, nominees would be withdrawn silently. There was no point in putting hotly contested Fed nominations forward: they would be blocked by the majority party directly, or indirectly by the minority party by filibuster. Consequently, Presidents have nominated formally only candidates acceptable to both parties. As a result, Fed appointees often have been respected technocrats with impressive prior experience inside the Fed system or distinguished professors of economics. Political operatives were not considered eligible.

Presidents also have been deterred from making highly partisan choices because they would do them little good, even if one or two somehow made it onto the seven-member Board. One or two couldn't sway the majority of seven Fed Governors, many of whom had been appointed by a previous President because Board Governors have 14 year terms. Some are even reappointed and serve far longer. For example, Menc Szymczak served for 28 years.

In addition to the Senate filibuster and recalcitrant Board holdovers from past presidents, there is a third obstacle to the White House dominating monetary policy by partisan appointees: the inability to secure a durable majority of the Federal Open Market Committee. It is the FOMC that decides the direction of monetary policy. Its twelve voting members consist of the seven Board Governors, the president of the NY Fed Bank, plus four other rotating Fed regional Banks presidents. The White House would need seven of these twelve votes to form a narrow 7-5 FOMC majority. The five regional bank presidents are not presidential appointees, and they owe their loyalties mostly to bank leaders in their regions that gave them their positions. Any president would need at least five Governors' votes to feel confident he could get the remaining two votes from the pool of five bank presidents. Past presidents haven't had the opportunity to try until late in their second terms. Some haven't, even then. If you ever wondered why Bill Clinton reappointed Chairman Alan Greenspan or Barack Obama reappointed Chairman Ben Bernanke, both Republicans, it is possible they saw little reason to try to install partisan loyalists with Senate Republicans blocking the way.

Trump may try because he has an excellent chance to succeed if he does. With the resignation of Daniel Tarullo two weeks ago, there are now three vacancies on the Board. But that is just the beginning. It is the custom for Fed Chairmen who are not reappointed to resign, rather than take back bench roles as just other members of the Board. Only Chairman Marriner S. Eccles decided to stick around from 1948 to 1951as just a regular board member. If Trump doesn't renominate Yellen when her current chairmanship ends this February, she will quit early next year. That is Trump's FOMC seat number four. Fed Vice Chairman Stanley Fischer is widely viewed as a Yellen loyalist. He also is expected to follow Yellen out the door, although he could wait until his vice-chairmanship ends later in the year. That would be Governor pick number five.

Now you are talking. It would be an inept Administration that could not find another two votes out of seven remaining possibilities on the FOMC. True, two are Obama holdovers, Fed Governors Lael Brainard and Jerome Powell. But Powell is a *Republican*. His approval was paired with the approval of a Democrat, Fed Governor Jeremy Stein, as part of a consensus partisan trade in June 2012, before the nuclear option exploded. Powell is GOP supporter number six, out of seven Fed Governors. Won't at least one of the five regional bank presidents likely to be Republican? Yes. Trump will have his mostly handpicked FOMC majority by the end of his second year in office, if not sooner.

		FEDERAL OPEN MARKET COMMITTEE
FEDERAL RESERVE BOARD OF GOVERNORS		
1	Janet Yellen	TRUMP TO CHOOSE BY FEB 2018?? -Chairwoman
2	Stanley Fischer	TRUMP TO CHOOSE BY FEB 2018?? - Vice Chairman
3	**VACANT**	**TRUMP TO CHOOSE, Governor, Vice-Chairman for Regulation**
4	**VACANT**	**TRUMP TO CHOOSE**
5	**VACANT**	**TRUMP TO CHOOSE**
6	**Jerome Powell**	**Obama Appointee, REPUBLICAN**
7	Lael Brainard	Obama Appointee, Democrat
Voting Bank Presidents-Class of 2017		
8	William Dudley	NY Fed Bank President
9	Charles Evans	Chicago
10	Robert Kaplan	Dallas
11	Neel Kashkari	Minneapolis
12	Patrick Harker	Philadelphia
Class of 2018		
8	William Dudley	NY Fed Bank President
9	Loretta Mester	Cleveland
10	Raphael Bostic	Atlanta
11	John Williams	San Francisco
12	Vacant	Richmond

Only FDR had the same opportunity. FDR got his chance because Congressional Democrats overhauled the Federal Reserve Act of 1914 in 1935, giving the FOMC its current structure. After the modern FOMC was so created, FDR "packed the Fed" in 1936 because he could. Democrats controlled the Senate, 71-25, with only 64 needed to end nomination filibusters. Five Board Governors nominated by FDR were approved by the Senate in just four months in 1936! Other presidents have had to make bipartisan deals on Fed Governor appointments because of threatened Senate filibusters. No longer.

President (time in office)	FED Governor Appointments	FED Chairperson	Years Served
Woodrow Wilson (1913-1921)	14	Charles Sumner Hamlin William P.G. Harding	1914 – 1916 1916 - 1922
Warren Harding (1921-1923)	2		
Calvin Coolidge (1923-1929)	9	Daniel R. Crissinger Roy Young	1923-1927 1927-1930
Herbert Hoover (1929-1933)	3	Eugene Meyer	1930-1933
F. Roosevelt (1933-1945)	**14-filibuster proof**	Eugene Robert Black Marriner S. Eccles	1933-1934 1934-1945
H. Truman (1945-1953)	8	" Thomas B. McCabe William M. Martin	1945-1948 1948-1951 1951-1953
D. Eisenhower (1953-1961)	4	"	1953-1961
John Kennedy (1961-1963)	1	"	1961-1963
Lyndon Johnson (1963-1969)	4	"	1963-1970
Richard Nixon (1969-1974)	4	Arthur F. Burns	1970-1978
Gerald Ford (1974-1977)	6	"	
Jimmy Carter (1977-1981)	6	G. William Miller Paul Volcker	1978-1979 1979-1980
Ronald Reagan (1981-1989)	8	" Alan Greenspan	1980-1987 1987-1988
George H. Bush (1989-1993)	3	"	1988-1992
Bill Clinton (1993-2001)	7	"	1992-2000
George W. Bush (2001-2009)	6	" Ben Bernanke	2000-2006 2006-2009
Barrack Obama (2009-2017)	7	" Janet Yellen	2009-2014 2014-2018?
Donald Trump (2017-20__)	**5 if he wants, filibuster proof**	?	2018-?

It has been argued that the FOMC is legally independent of the President, but that it nevertheless often "gives the president the monetary policy he wants." Often, the Fed Chairman has routine contact with the Secretary of the Treasury. The Fed has good reason to do this. It does not act in a vacuum, and it needs to know the direction of fiscal policy to inform its own deliberations. How much influence does an Administration have on the Fed? It depends on the individual loyalties of those sitting on the FOMC and how big the Administration's "ask" is. Fed watchers since the 1930s have rarely had to think along these terms in assessing the direction of monetary policy because the FMOC was not loyal to the president. Starting in 2018, they will.

In the meantime, watch carefully to see when the Trump Administration fills the three vacant Board Governorships and who they appoint. If they move too fast and fill the Board by June with three appointees hostile to Janet Yellen, then Fed policy afterward could become unpredictable if Yellen calculates that her days are numbered, and she owes Trump nothing.

- The first appointee is rumored to be Randy Quarles, a former Treasury Undersecretary for Domestic Affairs in George W. Bush's Administration. If the rumor is true, he will become the Fed Vice Chairman for Regulation, a key position in its own right, and the likely lead player to reform Dodd-Frank. Quarles currently is a managing director of the private equity firm Cynosure Investments.
- If Trump wants an explicit takeover of the Fed, he could appoint Gary Cohn to another vacant seat late this year and announce that Cohn is his pick to replace Janet Yellen. Reportedly, this is under consideration. Cohn currently is the head of the president's National Economic Council. Previously, he was president of Goldman Sachs. Currently, Cohn and Treasury Secretary Mnuchin are the key players in the development of the Trump Administration's tax package. Cohn would be free to take the helm of the Fed after the tax fight concludes later this year. The timing would be perfect.
- A second possible future Fed Chairman nominee is John Taylor. Like Quarles, Taylor was an Undersecretary of the Treasury during the Bush Administration. Furthermore, Taylor is expected to receive a Nobel Prize in economics someday. His theoretical monetary policy work has been highly praised by both Ben Bernanke, who called it profound, and Janet Yellen, who stated ten years ago that Taylor's research had changed how central banks conduct monetary policy. Taylor is the leading theoretician of rational expectations and its application to monetary policy. His appointment would signal that Trump is NOT interested in having political control of the Fed. As Chairman of the Fed, Taylor, no doubt, would follow the "Taylor Rule," a mechanical approach to monetary policy guided by data, not by the political preferences of the White House.

What Does Trump Want from the Fed?

Two weeks ago he told us in an interview with the Wall Street Journal, "I do like a low-interest rate policy, I must be honest with you." From a political viewpoint, this makes sense. To win re-election, Trump has to maintain faith with the rust pail Democrats in Michigan, Ohio, Pennsylvania, and Wisconsin who provided his margin of victory. There is little doubt that disaffected middle class whites are net borrowers, not savers. They benefit from low interest rates. More broadly, Trump sees a vibrant economy in 2020 as his best chance to be re-elected. Lower rates make it more likely that companies will be profitable, and therefore invest and hire.

The interesting question is whether Janet Yellen, widely seen as dovish, might keep her job after all. During the campaign, Trump said he "most likely would not reappoint" Yellen. But in the recent WSJ interview Trump said he has spoken with Yellen in the Oval Office, he likes and respects her, and regarding her reappointment, "It's early."

Expectations are high that Yellen's Fed will deliver two more rates increases this year and afterward start selling off the Fed's massive bond portfolio. Selling bonds into the public markets could send materially rates higher across the yield curve, depending on which bonds are sold, how many are sold, and the appetite in the bond market for more Treasury debt. Could Yellen lose her job to a Trump loyalist... because she is not dovish enough?

For investors, the best bet is that Trump will do what he needs to do to keep interest rates low through 2020, and that he will use his appointment powers to the Board of Governors, plus a filibuster-proof Senate at least through 2018, to make this happen.

For investors, that would imply lower interest rates, for longer, and that the consensus forecast for monetary policy next year is wrong.

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