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Investors Prepare for a New Fed

Markets are calm despite concerns about the central bank's independence

BY SAM GOLDFARB

Investors are preparing for a very different Federal Reserve in the year ahead.

President Trump has signaled that he is closing in on a pick to be the next centralbank chair. He has also doubled down on his demand for lower interest rates and recently told The Wall Street Journal that he expects the new leader to be on board with his agenda.

So far, markets have shown few signs of significant concern that the Fed would completely surrender its independence. But investors are still bracing for a central bank marked by unusual division, a potentially weaker chair and the lingering threat of more radical change.

Analysts warn that a less independent Fed would pose a major threat to the economy and markets.

Note

Although the Fed controls short-term interest rates, borrowing costs in the U.S. are heavily influenced by yields on longer- term U.S. government bonds. And those are determined by investors' expectations for short-term rates in the future, rather than where they are now. If the central bank cuts rates aggressively when the economy is still in decent shape, worries about inflation and higher rates could drive yields and borrowing costs up rather than down. A sharp climb in yields could also rattle stocks.

Note

Moves have been muted so far. One reason: Fed chairs have historically wielded outsize influence over the 12person Federal Open Market Committee that votes on interest rates, but they don't have the power to set rates on their own. So a lot would be required for Trump to gain clear control over the central bank.

Note

Some on Wall Street still see that as possible. The FOMC consists of seven Fed governors appointed by the president and five regional

bank presidents selected by the boards of those banks and confirmed by the Fed governors. A Trump-appointed majority could try to dismiss any Fed president seen as standing in the way of rate cuts.

Right now, three Fed governors are Trump appointees, including two from his first term, when Trump wasn't as committed to finding loyalists. Earlier this month, all three joined the other governors in unanimously reappointing Fed presidents.

Trump, though, could have more opportunities to pick governors in the coming months, potentially altering the central bank's balance of power.

Note

One would come if Jerome Powell resigns from the Fed after his term as chair expires in May—a move that would follow historical precedent, even if it isn't required (his term as governor extends into 2028). Another would arrive if the Supreme Court rules in Trump's favor and allows him to push out Fed governor Lisa Cook, whom the administration has accused of lying in mortgage paperwork—a charge she denies.

At that point, three governors would be second-term Trump appointees—on top of the two from his first term— and the chances of removing Fed presidents would go up enough to likely spook markets, said Blake Gwinn, head of U.S. rates strategy at RBC Capital Markets.

If Trump could replace both Powell and Cook, “that gets a lot more interesting,” he said.

Even if that doesn’t play out, many investors warn that a more divided Fed would be enough to cause problems in markets. Some even expect situations whereby the central- bank chair is pushing for lower rates, yet getting outvoted by other officials.

In some other countries, including the U.K., a centralbank leader dissenting from an interest-rate decision isn’t unheard of. But it would mark a major change in the U.S.

The views of each FOMC member would carry more weight, potentially creating more uncertainty about the path of rates and therefore more volatility in the bond market, said John Briggs, head of U.S. rates strategy at Natixis Corporate and Investment Banking.

That in turn could lead to higher Treasury yields, because “if you’re adding volatility uncertainty, you should be able to receive more yield,” he said.

In recent weeks, the gap between yields on short-term and long-term Treasurys has increased. Some view that as a sign that investors are growing more worried about the Fed’s independence, because it suggests they expect rates to be lower in the short term, but not necessarily over the longer run.

Many investors, though, say they already expect the Fed to keep cutting rates early next year, even before the arrival of a new chair.

Stocks have betrayed little concern, with the prospect of more rate cuts buoying sectors that could benefit most, including banks and industrial companies.

One popular view on Wall Street holds that a weaker economy will mitigate divisions at the central bank and create consensus for additional cuts.

Note

The Fed, over the course of 15 months, has already lowered its benchmark federalfunds rate to 3.5% to 3.75% from 5.25% to 5.5%.

Although Trump has said that he thinks rates should be 1% or lower a year from now, many investors are confident that a new Fed chair can get away politically with more modest cuts, ones justified by the economic data.

“By the time that person’s in the seat and they start to have their first meeting, they’re going to have a lot more information [and] probably more backing to lower the rate,” said Bryan Whalen, chief investment officer of TCW’s fixed-income group.

Some argue that style also matters: Investors will be less unnerved by a Fed chair who can make a reasonable economic case for much lower rates than one who just echoes Trump’s arguments, even if the target is the same.

