FROM THE

FOUNDER

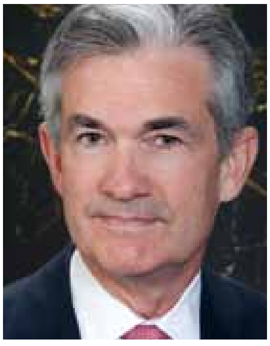
The Cunning of a Currency Trader

And the talent of Laurence Olivier.

As Jerome Powell, President Trump's nominee to become Federal Reserve Chairman, prepares for his Senate confirmation, he should be awed by some of the challenges facing his institution. This has not been an easy decade for the Fed. True, the institution includes some extraordinary talent and remains one of the few islands of civility in the Washington partisan cesspool. But for central bankers, the world has changed. In coming years, Mr. Powell and the rest of the Fed need to be more realistic about the institution's loss of power *vis-à-vis* the financial markets. They cannot be the generals fighting the last war.

In the run-up to his nomination, Mr. Powell was described as the "status quo" choice. On the surface, preserving the status quo would seem to make sense. The economy is growing. Equity markets are at all-time highs. Labor markets have tightened. For some reason, inflation remains dormant. There is a calmness in the air. Both the markets and the economy seem to be in an unusual sweet spot.

But a number of perplexing things are also going on in the economy. This is no time for status quo thinking, no matter how calm financial markets seem. Remember, the stock market crash of 1987 came at a time when the economy's fundamentals seemed fine. Stock market exuberance fed on itself until…boom!



Federal Reserve Chair nominee **Jerome Powell:** *He'll need a fierce intellectual curiosity and uncommon flexibility.*

What's needed now is more critical forward thinking about the many things that could go wrong. Mr. Powell is taking over at a time when the world's public and private debt is approaching 300 percent of GDP. Central bank balance sheets are a horror show and the Chinese economy remains a mystery. In the United States, bloated corporate and "junk" debt markets remain vulnerable to a sudden shrinking of liquidity. So do emerging market debt markets. If this happens in today's interconnected financial world, other markets will also be at risk. This includes today's robust equity markets. Mr. Powell shouldn't forget: Since Harry Truman was president, nine out of the last ten economic dips happened under Republican administrations.

Today's soaring asset prices have become the U.S. economy's powerful engine, but as financial market strategist Mohamed El-Erian puts it: "We are close to exhausting the asset channel as the principal vehicle for promoting growth." The problem is not merely low volatility and high asset prices, he argues. Traders have developed almost an addiction to buying equities at every dip. Why? They believe central banks have pretty well telegraphed that they will step in to support the market at every drop by driving down long-term interest rates. (In both China and Japan, the central banks directly purchase stocks to stabilize the markets.) El-Erian argues that the markets end up essentially "front-running" the central banks.

As chairman, Mr. Powell's first challenge will be to answer this question: Why is the VIX, the popular fear gauge measurement of the implied volatility of S&P 500 index options, still at rock-bottom levels? The world today is a cauldron of global political uncertainty. From Brexit

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to Donald Trump to North Korea, the potential for upheaval appears to never have been greater. Yet the VIX remains at an historic low. Is the calmness really a troubling complacency?

Some analysts argue the VIX is low because markets believe the world is simply doing better than the pundits think. Others argue that historically, geopolitical risk has had little market impact.

The most interesting explanation, and the one that the incoming chairman should be most worried about, comes from Scott Bessent, who for years was chief investment officer at Soros Fund Management. Bessent argues that the answer to the VIX puzzle may be quite simple: When central banks push real rates below zero, as they have done for nearly a decade, financial volatility freezes. States Bessent: "Just as the nature of water changes when the temperature drops below zero degrees Celsius, so too does the nature of financial markets when real interest rates become negative." But volatility will quickly return when real interest rates return to normal.

Bessent points to the research on pro-cyclical market behavior conducted by Tobias Adrian and Hyun Shin and presented in a paper published by the New York Federal Reserve: "The growth rate of financial institutions' balance sheets is directly related to the degree of ease in monetary policy. When policy is loose, balance sheets grow rapidly and with this so does financial market liquidity. In contrast, when monetary policy is tight, balance sheet growth is slowed and financial market liquidity declines." He adds: "Low interest rates spur a reflexive feedback loop in which more rapid balance sheet growth generates increased financial market liquidity, thus raising asset prices and dampening measured volatility, allowing for further balance sheet growth."

And here's the potential problem: While such feedback loops can be pleasurable on the way up, they are likely to be miserable on the way down. If a hint of inflation appears, higher interest rates will result in weaker balance sheet growth, less market liquidity, greater volatility, and plummeting asset prices.

The big question is whether Fed policymakers understand the degree to which their world has changed in the last decade or so. Particularly in the midst of a crisis, the power of the Fed's monetary tool (after an initial period of stabilization) in the medium to long term is likely not going to be what it once was.

The first sign of that change came in 2004. Then-Chairman Alan Greenspan began a lengthy series of short-term interest rate hikes. To his surprise, long-term rates, which usually rose and fell largely in sync with the Fed's short-term rates, barely budged.

From that point on, the central bank was transformed from a kind of storehouse of economic data into more of a kind of global theater. With their reserves shrinking relative to the ballooning size of the world's financial markets, central bankers worldwide were forced to become more like actors. They performed, but they knew markets more and more were in control of the show.

Many of the tried-and-true rules under which the Fed had operated for decades (including the Phillips Curve which suggested a trade-off between inflation and unemployment) were suddenly no longer working as predictably. The Fed has become what it describes as "data driven," which is another way of saying "not in control." And to make matters worse, the Fed's job has become even more complicated by the interconnectedness of the global financial system. Even as the Fed trims its balance sheet and cuts back on its creation of liquidity, global influences can affect U.S. interest rates in the opposite direction. The European Central Bank and the Bank of Japan still have their fire hoses of liquidity pumping. This has the potential to affect the performance of U.S. interest rates as global investors search for yield in the U.S. markets.

In this environment, the new chairman's best personal attribute may be that he is not a Ph.D. economist, beholden to the theoretical underpinnings of some thesis written decades ago. Running the Fed has evolved to an aggressive and unpredictable global game of multi-level chess. Look at how large parts of the world, led by Russia and China, already resent the dollar's role as the world's reserve currency and are quietly working to undermine the greenback's unique position. They want a less dollar-centered (read: less transparent) global financial system.

Like no Fed chair before him, Jay Powell will be forced to live by his wits. He'll need a New York Fed president with real world experience at crisis management. The new chairman needs to start off by demonstrating to the world that he has a nimble, flexible, and creative mind with fierce intellectual curiosity. He'll need to demonstrate the cunning of a global currency trader. And if things go wrong, he'll need the acting skills of Laurence Olivier.

—David M. Smick

Mr. Smick is founder, editor, and publisher of The International Economy *and author of the* New York Times *bestseller* The Great Equalizer: How Main Street Capitalism Can Create an Economy for Everyone *(PublicAffairs, 2017).*