Trend Macrolytics, LLC
Donald Luskin, Chief Investment Officer
David Gitlitz, Chief Economist
Thomas Demas, Managing Director

POLITICAL PULSE

America's Next Top Fed Model

Monday, July 27, 2009

Donald Luskin

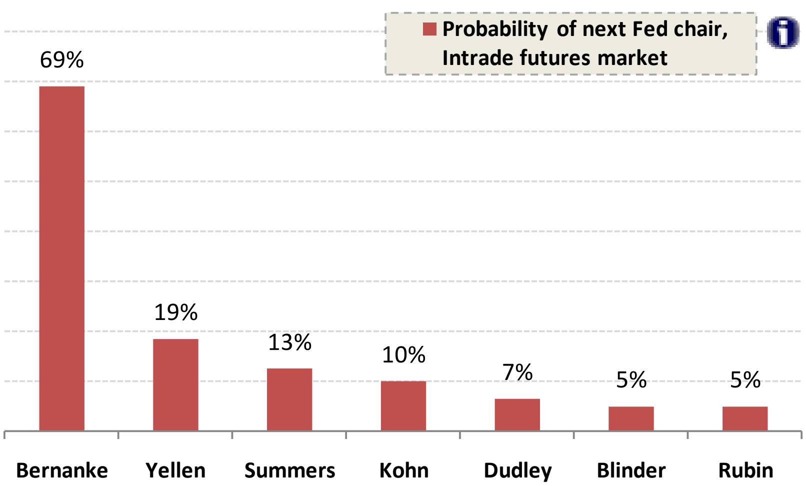
Markets rightly expect Bernanke to stay, and Summers would be a destabilizing surprise.

In a meeting last week with a highly placed Fed official, we were asked, "How long before the markets start demanding that Obama say whether or not he's going to reappoint Ben Bernanke?" What he meant was, with the Fed having already done so much to restore calm to markets, the last thing the central bank needs is for the president to roil things up by creating uncertainty about its future leadership. We've seen how well markets react to continuity of policy leadership during a crisis -- recall the explosive upside reaction to the nomination of Tim Geithner for Treasury secretary last November (see "Another Rescue, A New Rescue Ranger" November 24, 2008). We would expect markets to react well to Bernanke's reappointment now -- but not extremely so, considering both that his reappointment is fully expected, and that the crisis atmosphere is far less intense than it was in November.

Update to strategic view

US STOCKS, US FINANCIAL STOCKS, US BONDS, US MACRO: The consensus strongly favors the reappointment of Ben Bernanke as Fed chair, so a disappointment could be destabilizing, especially if the appointee is the unpredictable Larry Summers. We expect Bernanke to be reappointed, but if he is not, we doubt it will be Summers.

[see Investment Strategy Dashboard]



Bernanke wants the job. According to sources, he didn't last year (all he wanted then was a good night's sleep). But now he sees it as his public duty, and a way to finish what he started. He's clearly campaigning for it, as he creates a demand effect by raising his public profile through media appearances, including this week's series on the PBS News Hour, drawn from his unprecedented "town hall meeting" in Kansas City

http://www.trendmacro.com
don@trendmacro.com
dgitlitz@trendmacro.com
tdemas@trendmacro.com

Offices:
Menlo Park CA
Parsippany NJ
Charlotte NC

Phone:
650 429 2112
973 335 5079
704 552 3625

on Sunday.

The online political futures market has Bernanke a strong favorite for reappointment (see the chart on the previous page). Based on what we hear from our sources in the Fed and the White House, we don't disagree. It stands to reason that unless there were some strong motive to appoint someone else, Obama would surely recognize the benefit of continuity. Yes, Bernanke is a Republican and a Bush appointee, but he's not a partisan. And Obama did reappoint Bush-appointee Sheila Bair to run the FDIC. But there's more to it than that.

Recommended reading
["Oh, the Economics You'll Find in Dr. Seuss!"] Ben Miller and Michael Watts, Purdue University, March 12, 2009
[Recommended Reading home]

Obama has a warm and trusting personal relationship with Bernanke. During the presidential campaign last year Obama visited the Fed several times, and this pair of Ivy-educated intellectuals made a deep connection with each other. Obama asked to be educated on the basics of monetary economics, and Bernanke -- who is a gifted explainer of economics in laymen's terms -- obliged him in a humble and non-partisan way. Bernanke became Obama's "guru" on the subject, his benchmark, the source of basic learnings to which all future ideas will have to be adapted.

Contrast that to the way Obama might regard Larry Summers, the most frequently cited alternative to Bernanke. It may seem at first glance that Obama would want to install a Democratic operative like Summers at the Fed, to assure that the central bank would do the White House's bidding. But according to sources, within the White House Summers is respected and feared, but he is neither liked nor trusted. Obama probably feels no real assurance that Summers would, in fact, do his bidding once installed in a tenured position at a proudly independent agency. Oddly, Obama may feel he can rely more on Republican Bernanke than he can on Democrat Summers. Also, Summers' approval process in the Senate might be very uncomfortable for the White House -- while he would probably prevail, he would be attacked from the right in any event, but also from the far-left based on the politically incorrect circumstances under which he left the presidency of Harvard University. Summers very much wants the job, we hear. And his Machiavellian political skills may be enough to get it. But we don't rate him as the most likely Bernanke alternative.

A more likely alternative is Janet Yellen, former Fed governor, former CEA chair in the Clinton White House, and now president of the San Francisco Fed. She is in almost every sense the Democratic version of Ben Bernanke. She is liberal, but not partisan. She is a serious and rigorous scholar. And she is outspoken and persuasive -- according to sources, she is one of only four FOMC members who consistently shape the policy debate in meetings. There are two factors that prevent her from being a shoo-in for the job. First, there is likely no overriding reason why Obama couldn't stick with the incumbent Bernanke. But second, according to sources, the White House is concerned with whether Yellen has the physical stature to be credible in the job -- she is petite in the extreme, a 4'11" white-haired lady. We can say from our meetings with her that her intellectual power is so tremendous that one comes away with the impression that she is ten feet tall. But television is another matter, and it is problematic to visualize her testifying before Congress, getting grilled by the likes of Barney Frank. Nevertheless, the online political futures make Yellen the number two possibility, and we think that's right.

Other more remote candidates include Fed vice chair Donald Kohn, and New York Fed president William Dudley. Kohn, a Democrat, was considered a top alternative to Bernanke four years ago. He can't be ruled out, but he seems to be doing nothing to promote himself for the position. Dudley, also a Democrat, was recently appointed to the New York Fed after heavy lobbying on his behalf by Geithner, his predecessor in the position. We think the former Goldman Sachs economist has thrown his hat in the ring with his public comments that the Fed as a "systemic risk regulator" ought to be able to detect and prevent "bubbles" before they happen (see "A Deflationary Correction" July 9, 2009). But his Goldman connection is problematic for his Senate approval. And according to sources, he is not well respected by the Board of Governors (one official told us that if Dudley were to join the economics staff in Washington, "he'd be middle-level at best").

To answer the question from the Fed official with which we began, since Bernanke's reappointment is expected, the markets will probably not put a great deal of pressure on Obama simply to affirm what they already think they know. And when he *is* reappointed, the reaction will be muted. But that means the *failure* to reappoint Bernanke could draw a large negative reaction. There is already a great deal of uncertainty about what Bernanke himself will do with the Fed's enormous balance sheet (see "Check the Exit" July 22, 2009) -- that would only be made worse by putting someone else in charge of it. All the more so if the appointment is an unpredictable Machiavellian like Summers.

BOTTOM LINE: The consensus strongly favors the reappointment of Ben Bernanke as Fed chair, so a disappointment could be destabilizing, especially if the appointee is the unpredictable Larry Summers. We expect Bernanke to be reappointed, but if he is not, we doubt it will be Summers.