Agincourt Capital Management, LLC

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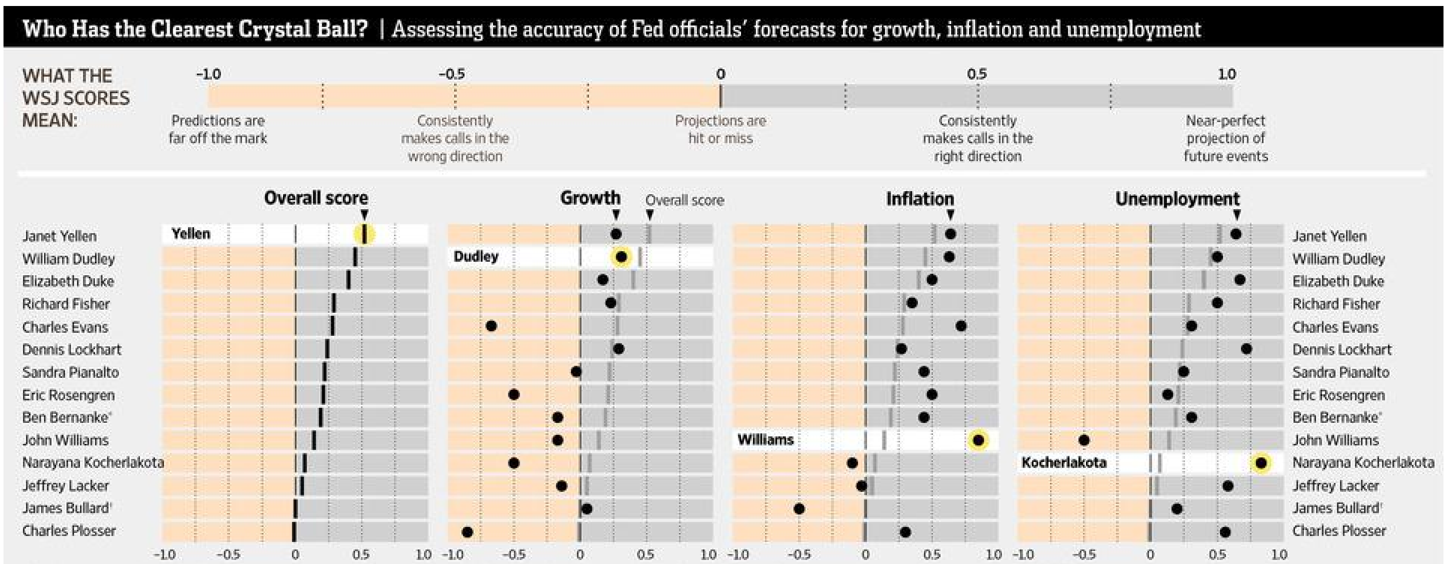
INVESTMENT UPDATE

Barring some unforeseen event, in early 2014 Janet Yellen will become the Chairman of the Federal Reserve System. But just who is Janet Yellen and what are her policies likely to be?

Yellen is a lifelong academic who has, with increasing frequency over the decades, stepped into the role of public servant. She served as the Chair of President Clinton's Council of Economic Advisors, she was a Federal Reserve Governor, and she served for nearly six years as the President and CEO of the Federal Reserve Bank of San Francisco. In 2010, she was named the Vice Chairman of the Federal Reserve System, succeeding Don Kohn, a Fed lifer who was passed over by President G.W. Bush as Fed Chairman in favor of Ben Bernanke. Unlike Kohn, and every other Vice Chairman before her, Yellen will take the place of the Chairman she's been working with.

Yellen's nomination last month did not arrive without controversy. As it became clear over the summer that Bernanke wouldn't be re-appointed, two names were immediately put forward by Fed-watchers as to who the next Chairman might be: Yellen and Lawrence Summers. Their respective reputations preceded each—Summers, the former Treasury Secretary under President Clinton, was seen as more of an inflation "hawk" who would tend to pursue policies focused on controlling consumer prices, while Yellen was viewed as more of a "dove" and therefore likely to favor policies that stressed economic growth. You will recall that "price stability" and "full employment" are the Fed's dual, often-times conflicting, policy mandates.

The markets were already undergoing a nervous patch during the summer, as the discussion both inside and outside the Fed turned to the timetable for the "tapering" of the Fed's bond buying program, which has been purchasing $85 billion every month since early 2013. The fact that Summers might be named Chair spooked investors, as they expected a Summers-led Fed would wind the program down much more rapidly than one headed by Yellen; this was made obvious when Yellen was announced as the nominee, with the stock and bond markets both immediately posting strong "relief rallies," believing that Yellen would keep the liquidity taps open full blast for a little while longer.



*Bernanke score includes forward-looking comments made during congressional testimony, when he often speaks for the collective view of the Federal Open Market Committee; excluding congressional testimony, his score is 0.29.
†Mr. Bullard often gives PowerPoint presentations without prepared text. Scores based on press releases with those presentations.
Source: WSJ analysis of more than 700 Federal Reserve officials' speeches and testimony from June 2009 through December 2012
Jon Hilsenrath and Kristina Peterson (analysis); Pat Minczeski and Erik Brynildsen (graphic)/The Wall Street Journal

But painting Janet Yellen as a one-trick pony is a mistake. Her record, while not perfect (she's an economist, after all) shows a strong analytical background and a pretty solid predictive record. In fact, in a recent *Wall Street Journal* review of more than 700 predictions made by 14 Fed policymakers in speeches and congressional testimony over the three-year period ending in 2012, Yellen came out on top (see chart). Over this period, she has been pretty consistently correct in predicting the persistence of the slow-growth, low-inflation environment that we've seen over the past few years.

Yellen has also gained some notoriety as someone who correctly foresaw serious danger in the US housing market, having spoken out about the "bubble element" in an October 2005 speech in Salt Lake City where she stated, "I think it's obvious that a substantial cooling off of the housing sector represents a downside risk to the outlook for [economic] growth." Certainly, as head of the Federal Reserve Bank of San Francisco from 2004 to 2010, she was located at Ground Zero for some of the worst excesses of the US housing market, where two of the rottenest eggs among US mortgage lenders, Golden West and Countrywide, fell under the purview of the San Francisco Fed. Clearly, the jettisoning of lending standards and the proliferation of subprime, low-doc, and other "affordable" mortgage products does not, in retrospect, reflect positively on the San Francisco Fed's regulatory supervision.

Yellen later told the Financial Crisis Inquiry Commission that she relied too much on Washington, including the Federal Reserve's Open Market Committee, to tackle the housing bubble, and that she believed that she lacked the authority to act unilaterally. She also admits that she underestimated the size and scope of the problem, "I did not see and did not appreciate what the risks were with securitization, the credit ratings agencies, the shadow banking system, the S.I.V.'s — I didn't see any of that coming until it happened."

While we can appreciate that last quote—we know of nobody who foresaw the level of global wealth destruction that came about when the dominoes all fell once home prices tanked—Yellen did have responsibilities as President of a regional Federal Reserve Bank to monitor and report on improper lending practices in her region of the country. We can find no record of her raising such concerns. Further, in that same October 2005 speech, she spoke out against the Fed using its policy tools to mitigate the obvious housing bubble that had formed, saying, "My bottom line is that monetary policy should react to rising prices for houses or other assets only insofar as they affect the central bank's goal variables—output, employment, and inflation." Again, with the full benefit of hindsight, it's easy to see that she, and essentially every other policymaker, got this episode wrong. We bring these points up not to single her out, only to show that her predictive prowess is not above reproach.

Janet Yellen's first job at the helm of the Federal Reserve will be to ensure continuity and quell the global markets' collective unease that comes with any change at the helm of the world's most powerful and influential central bank. Clear communication of policy goals has been a hallmark of Bernanke's Fed, and it appears that Yellen intends to keep this emphasis in place. In her confirmation hearings she stated, "I have strongly supported this commitment to openness and transparency, and will continue to do so if I am confirmed and serve as Chair."

Ben Bernanke is a guy who spent much of his pre-Fed career studying both the Great Depression and the more recent Japanese "lost decade," analyzing how mistakes in policy made both of these crises far worse than they should have been. In this respect, he was almost the perfect man for the times, a guy who, within a year of taking over the Fed, had to start dealing with the worst financial crisis the world had seen in 80 years. Because of his background, he was able to pull tools from his toolbag that no previous Chairman had used, for better or worse (mostly better, in our opinion). Yellen will be responsible for unwinding the last of these tools, the large-scale bond buying program. She has made it clear, as has Bernanke, that the timing of the tapering of this program is dependent on the overall health of the economy, and most importantly, the strength of the US labor markets.

If Bernanke was the right man to tackle the unique problems of financial crises, Yellen might just be as well-suited to address the current issues surrounding the labor markets, having spent much of her academic effort—and years in public service—studying this topic. In fact, she and her Nobel Prize-winning husband George Akerlof have co-authored more than a dozen research papers on the labor markets, with a particular focus on long-term unemployment. Fed-watchers believe that the central bank's current use of the unemployment rate as a benchmark for the timing of tapering the bond buying program is attributable, to a large extent, to Yellen's influential role as Vice Chair.

Clearly, the Fed continues to pursue a highly stimulative monetary policy, with the Fed funds rate at near-zero and a bond purchase program that's keeping interest rates lower than they would be without the "artificial demand" of the Fed. Normally, at this point in the cycle, with unemployment down more than 3% from its cyclical highs, with seven million jobs added since the cyclical low point, and with wages on a slow but steady upward trajectory, we would see the Fed begin to withdraw that accommodation. That's why we (and so many others) were surprised to see the Fed back away from their earlier comments that the purchase program would be tapered as unemployment neared 7%. The fact that they distanced themselves from that benchmark (and have privately suggested that the new benchmark might be 6.5% or even 6.0%) around the same time that Yellen was announced as the nominee signals that there's already been a *de facto* handoff of power at the Fed.

The new Fed Chairman, leaning on her academic work which highlights the structural problems caused by millions of US workers who remain classified as "long-term unemployed," will take a slightly different tack than her current boss. Yellen seems content to keep the monetary dials "turned up to 11," even if that means that at some point down the road she might have to deal with something her predecessor never encountered: rising consumer price inflation.