Northern Trust

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- **The speculation about Fed leadership has gone too far**
- **Eurozone growth should be placed in perspective**
- **The velocity of money may turn around soon**

This week, I am going to do something that I promised myself I would not do before summer is over: talk about the succession situation at the Federal Reserve.

It's not that the decision about who will follow Ben Bernanke isn't important. But I've been reluctant to comment on the derby for several reasons.

1. Chairman Bernanke has nearly six months left to serve. All of this talk about who will take his place threatens to make him a lame duck and undermine his ability to lead the Federal Open Market Committee (FOMC) in its management of the economy.
2. The decision-making process has been altogether too public. The president made an unfortunate slip when speaking with journalist Charlie Rose in June, suggesting that Bernanke had stayed "longer than he was supposed to." One potential candidate seems to be conducting a campaign for the post through some key placements in the media. I am not alone in thinking this seems a little tawdry and does not reflect well on the spirit of independence that the Fed is supposed to maintain.
3. Trying to pick a favorite is sheer speculation, with potentially more gossip value than fundamental value.
4. I am not sure that the choice of a new chair will dramatically alter the course of U.S. monetary policy.

Nonetheless, questions about the situation are top of mind among investors and are filling copious numbers of column inches in public and private commentary. So while I reserve the right to share more definitive observations later in the year, here are some thoughts on how the leadership of the Federal Reserve may evolve over the next six months.

FOMC Turnover

Governor	Term Ends
Bernanke	Chair: Jan 2014 Term: 2020
Yellen	Vice Chair: Oct 2014 Term: 2024
Tarullo	2022
Powell	Jan 2014
Stein	2018
Duke	Leaving August 31
Raskin	Nominated to become Deputy Treasury Secretary

2014 Voter Rotation

Cycling Off:
- Evans (Chicago)
- Rosengren (Boston)
- George (Kansas City)
- Bullard (St. Louis)

Cycling On:
- Pianalto (Cleveland)
- Plosser (Philadelphia)
- Fisher (Dallas)
- Kocherlakota (Minneapolis)

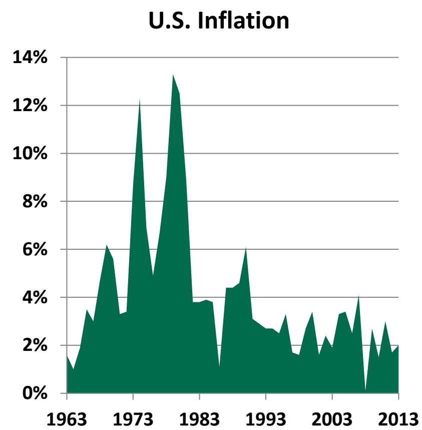
There is a multitude of strong voices at the Fed, not just one.

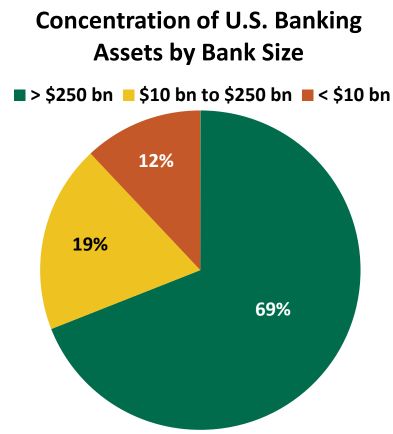
At the outset, it is important to note that the chair is not the only seat on the FOMC that soon will change hands. Of seven slots on the Fed's Board of Governors, two are currently open; Bernanke's departure will make a third. A fourth governor's term expires early next year. In addition, the annual rotation of Reserve Bank presidents will bring in four new voters whose leanings may differ from those who having been raising their hands this year.

The FOMC is much more of a democracy than it was 10 years ago. Chairman Bernanke has said that he'd like credibility vested in the institution, not any particular person. By all accounts, dialog and debate at the Fed has increased during Bernanke's tenure. While some have been distressed or distracted by the plurality of opinion expressed publicly by various Fed officials, accommodating a divergence of views is a strong management practice, not a weak one.

So as we try to divine how U.S. monetary strategy might change next year, we cannot end our contemplation at the head of the table. It seems very unlikely that the incoming chair will be able to impose his or her will on the process in the manner that some suggest Alan Greenspan did during his tenure. Regardless of who is selected, monetary policy may not change that much.

Beyond the table itself, the Fed's staff is tremendously capable and influential. The institution's memory of runaway inflation in the 1970s and financial instability five years ago serves as a powerful check against overly expeditious monetary policy.





Source: Bloomberg, Federal Reserve

Further, financial regulation is absorbing a much bigger fraction of the Fed's time since the 2008 financial crisis. A lot of attention has been paid to the monetary philosophies of prospective leaders, but the handling of the financial services industry may be just as influential to the pace of economic growth.

In the aftermath of the financial crisis, banking has become even more concentrated, with just 12 institutions accounting for more than two-thirds of industry assets. Limiting systemic risk will require "macroprudential" policies that prevent these firms from becoming victims of, or transmission mechanisms for, financial contagion.

It is also worth remembering that U.S. presidential nominations are no longer sure things. The Senate must confirm candidates to join the Federal Reserve's Board of Governors; given the state of politics in the upper chamber, this could become a protracted and contentious process. The more strident the candidate, the more likely that he or she will be a victim of the procedural hold so often used to impede progress.

From 2006 until last year, the Fed Board operated with only five of its seven members because Senators repeatedly put roadblocks in front of nominees. (One candidate, a Nobel Prize winner, was derided as lacking necessary experience.) Ultimately, the logjam was broken when a set of candidates from varying backgrounds was proposed and confirmed.

Those who want to restructure the Federal Reserve could color hearings on the nominee.

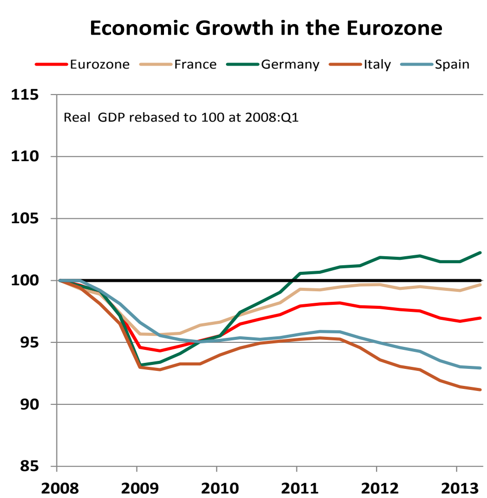
There are some in the U.S. Congress who would like to reopen the question of whether the Federal Reserve should have a dual mandate. They might choose confirmation hearings to press their case for dropping the objective of full employment. This would undoubtedly draw some very sharp battle lines between the parties. The markets would view very negatively any delay in seating a new Fed leader, not so much because policy would grind to a halt (it wouldn't) but because this would be yet another sign of deep political dysfunction.

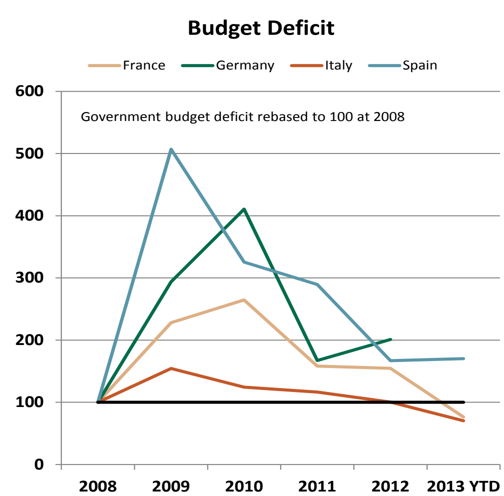
So those are my thoughts. Note that I have not commented here on the qualifications of those whose names are bandied about as the possible new chair; check back with me when the leaves begin to change color.

Has the Eurozone Weathered the Storm?

Real gross domestic product (GDP) of the eurozone rose 0.3% in the second quarter, the first increase after five declines in the last six quarters. This is good news but not enough to say the glass is half-full.

Performance across countries remains very uneven. Real GDP advanced in Germany (+0.7%) and France (+0.5%), the first and second largest economies, respectively, in the eurozone. Real GDP fell in Italy, Spain and the Netherlands, the remaining three of the big five markets. Europe still appears to have a two-track economy, with the North moving ahead and the South stagnating.





Source: Haver Analytics

The headwind of austerity is moderating but still present. Most of the world's major economies, including eurozone members, ran massive budget deficits to support economic activity after the 2008 financial crisis.

Fiscal rules in the Stability and Growth Pact were reformed during 2011. Brussels and Berlin were determined to enforce fiscal austerity even at the cost of economic setback. Budget deficits were slashed indiscriminately (see chart above), and major eurozone economies now operate with budget deficits comparable to the levels seen in 2008.

It is premature for European policy makers to open champagne bottles.

Some relief was offered recently. France and Portugal were awarded more time to bring down their budget deficits to 3% of GDP. But those countries in charge of Europe's purse strings are anxious to keep up pressure to reduce structural deficits (created by excessive government employment, for example) while offering some latitude on more cyclical elements. Separating the two sometimes is not easy.

While Germany has weathered the storm best, the current situation is not sustainable. A large part of German growth derives from exports to eurozone members, reducing the ability of the German economic engine to pull the rest of the regional bloc. A definitive assessment of GDP numbers will follow when all members publish details. If they show inventories were a significant driver of growth, the outlook will be less certain.

In addition, the eurozone's unemployment rate is alarmingly high, and banks are focused on meeting capital requirements and not on lending. Credit conditions are tight, and loan rates in the weaker economies are comparatively high versus Germany's rates even though the European Central Bank's policy is low and identical for all eurozone members.

On the positive side, it is better to be growing than contracting. Angela Merkel's likely victory in impending German elections is expected to allow for growth-oriented policies and more flexibility about meeting fiscal goals. Sovereign debt stress remains muted.

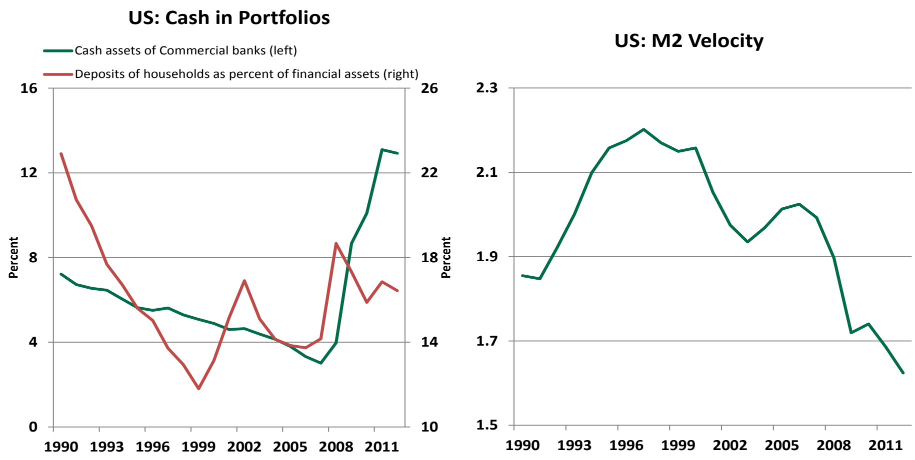
But it may be some time before Europe establishes a sustainable, broad-based economic recovery. In this case, one number truly does not make a trend.

Cash Preferences Drive Velocity of Money

Portfolio choices of U.S. households and banks between liquid assets and longer-term investments are not fixed. Risk assets with higher returns are favored over lower yielding alternatives during periods of economic expansions and vice versa. This has a pronounced effect on the velocity of money and, by inference, the possibility of inflation.

Changes in risk aversion are visible in consolidated balance sheet data of households. Deposits at banks made up roughly 23% of financial assets of households in 1990 but stood at only 12% when equity prices peaked during the dot-com bubble. Following a sharp drop in equity prices in 2000, the share of bank deposits of households climbed to nearly 17%.

There were similar swings in bank deposits and non-bank assets during the period surrounding the financial crisis; household deposits still stand at elevated levels five years after the Great Recession began.



Source: Federal Reserve Board, Haver Analytics

Cash assets of commercial banks show a similar behavioral trend. After trending down for nearly two decades, commercial bank cash assets reversed sharply following the 2008 crisis and are holding at an elevated level. Instead of acquiring assets or extending loans, commercial banks hold a significant part of the Fed's financial accommodation in reserves.

These changes in preferences for cash and near-cash assets influence the velocity of money. Velocity is the frequency with which money turns over in the economy. A preference for holding cash relative to other assets reduces the velocity of money. Therefore, it should not be surprising that a sharp drop in velocity of money occurred as business conditions deteriorated after 2008.

As we discussed earlier this year, low velocity limits the growth rate of the money supply, and thereby the potential for inflation.

Recently, households and commercial banks have lowered their preference for cash slightly. Velocity of money should reverse its downward trend if the U.S. economy gathers steam and cash in portfolios becomes less important for banks and households. This eventuality could then initiate a genuine concern about inflation.

This has led some to suspect that the Federal Reserve will seek to keep in place some of the excess bank reserves by offering higher rates of interest on them. The interest rate on excess reserves is a new tool in the Fed's kit that may be used more liberally in the coming years. Following the cash will be critical to anticipating inflation and monetary policy in the coming year.