FEDERAL RESERVE BANK *of* NEW YORK

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Minutes of the Investor Advisory Committee on Financial Markets

June 29, 2017

Federal Reserve Bank of New York

Committee attendees:

William A. Ackman, Pershing Square
James Chanos, Kynikos Associates
Ray Dalio, Bridgewater Associates, LP
Vicki Fuller, Office of the New York State Comptroller
Joshua Harris, Apollo Management
Bob Jain, Millennium Management
Scott Minerd, Guggenheim Partners
Rebecca Patterson, Bessemer Trust
Rick Rieder, BlackRock, Inc.
John W. Rogers, Jr., Ariel Investments
David Tepper, Appaloosa Management L.P.

FRBNY and Federal Reserve Board attendees:

William Dudley, Chair
Sarah Bell
David DeCarlo
James Egelhof
Ibrahim Gassambe
Michael Held
Beverly Hirtle
Thomas Kennedy
Sandra Lee
Meg McConnell
Michael Nelson
Rania Perry
Simon Potter
Michael Schetzel
Kevin Stiroh
Michael Strine
Benedict Wensley
Beth Anne Wilson

Domestic Developments

Several Committee attendees pointed out that recent inflation data was weak and, in their view, did not support an increase in the target range for the federal funds rate at the June FOMC meeting. On the other hand, some Committee attendees suggested that the FOMC's decision in June was consistent with expectations for inflation to rise from current levels. Regarding the outlook for future target rate increases, some Committee attendees said that market participants remain skeptical that the FOMC will hike at the pace implied by the median projections for the federal funds rate in the Summary of Economic Projections. With respect to the outlook for inflation, many Committee attendees agreed that structural "cost-push" forces are likely to put downward pressure on prices. These forces include ongoing substitution of capital for labor, rapid growth in online retailing, and technological changes that have increased the utilization of household goods.

Committee attendees generally stated that they believe the FOMC will announce a change in September or December to the pace of reinvestments for maturing securities from the Federal Reserve's balance sheet. Several Committee attendees suggested that changes to balance sheet policy could have material implications for market pricing of Treasuries and mortgage-backed securities; however, they indicated it was difficult to estimate the potential impact. They also said that changes in market pricing after recent announcements concerning the balance sheet have been surprisingly small. Finally, some Committee attendees suggested that, if changes in balance sheet policy cause long-term interest rates to increase materially, then, market participants believe, the FOMC might raise the policy rate more gradually.

Committee attendees also discussed their expectations for fiscal, trade, immigration, and regulatory policies in the U.S., and the consequences of potential changes in these policies for financial markets. Several Committee attendees indicated that they expect a shift in policy towards deregulation will buoy business sentiment and improve economic growth somewhat. A few Committee attendees suggested that a small corporate tax cut may occur, but major tax reforms or infrastructure spending are unlikely.

Committee attendees next discussed their assessments of U.S. Treasury, equity, and corporate credit valuations. Committee attendees generally agreed that several possible explanations could account for the low and declining levels of long-term Treasury yields, including the following: first, market participants' expectations for the neutral level of the federal funds rate may have declined; second, market participants may have lowered their estimates for the long-run level of inflation; third, ongoing asset purchase programs by advanced economy central banks abroad may be suppressing term premiums. Committee attendees also suggested that low interest rates support relatively high equity valuations. Some Committee attendees opined that returns on high-yield corporate credit, compared to risk-free rates and accounting for expected credit losses, are not sufficiently high to provide adequate premium for bearing credit risk.

Global Developments

Several Committee attendees highlighted the following chain of vulnerabilities in the Chinese economy and financial markets. First, financial engineering of so-called "wealth management products" has created significant liquidity risk because of the mismatch between long-term assets versus short-term liabilities. Second, the real estate and local government sectors are highly leveraged, and they have become particularly dependent upon such wealth management products for funding. Third, some mid-size Chinese banks have become systemically important in their provision of credit to these sectors. Finally, real estate assets represent a significant share of Chinese households' total wealth. In light of these vulnerabilities, Committee attendees discussed the risk that some unknown event could trigger runs on Chinese financial institutions, with the effects propagating through the Chinese financial system. Several Committee attendees pointed out that Chinese policymakers are now reducing the growth of credit, primarily through macro-prudential measures, but also by tightening monetary policy. They suggested that the government could support a deleveraging of the private sector and local governments, by providing capital to financial institutions or guarantees to limit losses on financial products.

Financial Landscape

Committee attendees discussed factors contributing to multi-decade low levels of realized and implied volatility in financial markets, and they generally agreed on the following: first, macroeconomic growth has improved, and the variance of macroeconomic data, such as U.S. GDP and non-farm payrolls growth, has declined; second, accommodative monetary policies from central banks have supported market prices and boosted investor risk appetite; third, investor behavior has changed, as seen in the growth of passive investing and quantitative strategies. Committee attendees discussed whether the growth of passive investing tends to reduce volatility, since passive investors' trading flows are more predictable and their asset holdings are stickier compared to other investors. They also discussed whether quantitative strategies, such as statistical arbitrage, could dampen volatility. Committee attendees pointed out that risk premium strategies, which attempt to capture the spread between implied and realized volatility, have also become increasingly popular and have thereby suppressed implied volatility. Finally, Committee attendees discussed whether these investor behaviors may ultimately increase market fragility.