



Warsh An Excellent Choice for Fed Chair

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Last week began with a quiet Fed meeting, but markets quickly received a new catalyst with Trump announcing Kevin Warsh was Trump's choice to be the next Federal Reserve chair. Warsh was always my first choice. I expect the Senate to confirm him. His qualifications are superb, and most importantly, he brings genuine independent minded thoughts back to the Fed—something that was too often lacking in recent years. In contrast to critics who think Warsh is subservient to Trump's wishes to lower rates, I believe Warsh is a decisive upgrade to Powell.

Bond markets initially sold off modestly as the odds of Warsh's appointment firmed. Investors reflexively framed Warsh as overly "hawkish." I disagree. A Fed that is credibly tough on inflation is ultimately positive for bonds and the dollar. Artificially low rates are inflationary, and inflation is the true enemy of fixed income. The modest backup in yields reflects cross-currents, not fundamentals.

Warsh's skepticism toward later rounds of quantitative easing (QE) were well-founded. His support for a gradual balance-sheet reduction does not entail dumping securities too quickly on the market. Warsh will want to continue to reduce the Fed's ownership of mortgage-backed securities, and the administration recently announced a program for Fannie and Freddie to buy these same bonds.

An important signal for the Fed continues to come from the money supply. M2 growth over the last year is running around 4.5%. I would like to see M2 growing closer to 5–5.5% and the sluggishness argues for another 25–50 basis points of rate cuts.

A brief money supply refresher as it relates to Warsh fears during the QE era. Warsh and other economists worried QE would lead to inflation. These economists missed that QE never fed directly into the money supply (deposits)—bond buys just translated to higher excess reserves in banks. Government spending in that QE-era did not funnel into consumers checking accounts and M2. By contrast, during the pandemic under Powell, M2 exploded over 40% in a very short period from 2020–2021, the greatest two-year surge in Fed history. Powell directly monetized the government spending and inflated borrowing.

Warsh was right to support QE1 in a crisis. In another true Lehman-style crisis, I have no doubt Warsh would again support aggressive action. But even I share questions about how stimulative QE was for the economy beyond what was achieved by lowering short-term rates to zero.

On inflation, we did get a slightly hot PPI print, but I am not alarmed. A portion of this is clearly tariff-related, and even in the worst case, the remaining pass-through is modest—perhaps another third of a percentage point on prices. When inflation is already running near the 2–3% range, that is not macro-defining. Powell himself acknowledged that most tariff effects have already been absorbed. Unless there is a renewed and aggressive tariff escalation—which remains a political risk, not a base case—this story fades.

Growth remains solid despite noise. The widening trade deficit knocked Q4 GDP estimates down from the fives into the low fours, and perhaps even the high threes, but that is still strong growth, especially given the distortions from the government shutdown. Jobless claims have edged up toward 210,000—hardly a sign of labor market stress, but enough to confirm that conditions are no longer overheating. This is exactly the environment in which modest rate cuts can support small and mid-sized businesses that rely on bank credit rather than capital markets.

Equity markets continue to rotate sharply. We saw dramatic dispersion within the Magnificent 7—Meta a winner and Microsoft a loser—a clear sign investors are reassessing AI valuations and capital expenditures. My central view remains that this is shaping up to be the year of the AI user, not the AI producer. Capital spending will continue, but returns will increasingly accrue to firms that deploy AI to boost productivity rather than those merely selling the picks and shovels.

Put it together, and the picture is constructive. Two major uncertainties—the Fed leadership transition and the risk of a government shutdown—have diminished. Tariffs remain a wildcard, but not a dominant risk. Warsh at the helm is a net positive for both bonds and equities, and I remain optimistic about the medium-term outlook.

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