First Trust
Monday Morning OUTLOOK

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Warsh Has the Fed Right Where He Wants It

We're back to reading tea leaves! Hooray! Next week the Federal Reserve will have its second meeting since Kevin Warsh officially took the helm. And, at this point, the outcome is far from certain, which is unusual given that ever since Ben Bernanke instituted "forward guidance" the market usually knew what to expect.

Warsh does not think "forward guidance" is a good idea, therefore the market needs to read the tea leaves like in the old days. Second, Powell won't leave and appears to be quietly leading an opposition force. And third, the inflation data are murky at best, with a few months of what appears to be a war-induced bump in inflation, and last month, the reverse.

A rate "cut" would be a huge surprise, and even though the futures market is pricing in about a 10-20% chance of a "hike," we think this is highly unlikely.

So why do markets think a hike is possible? In part because Warsh has not gotten rid of the "dot plot" yet and at the last Fed meeting (in mid-June) out of nineteen members of the Board plus the bank presidents, three predicted one hike this year, five expect two hikes, and one policymaker is looking for three hikes.

In addition, Warsh said in Congressional testimony that, under him, the Fed has "no tolerance" for inflation above a 2% target. He voted for no rate change in his first meeting in spite of many expecting him to push for rate cuts in response to pressure from President Trump.

However, President Trump appears to be bowing to the reality of both data and the Fed's factions. Trump said "I want him to be totally independent" – a sign that Warsh (and likely Bessent) have convinced the president that pushing for a rate cut may backfire and undermine Warsh's leadership. He needs time to consolidate the Board.

It's been more than five years since inflation has been at or below 2.0%. So, if the Fed doesn't want to get there soon, then when does it want to get there? A year from now? Two years from now? Five? Never? Warsh claims he wants to get to 2.0% inflation, just like Powell did, but sooner or later (preferably sooner) the Fed must deliver 2.0% inflation or its credibility with the markets may diminish.

Another reason for a rate hike is that although the central estimate among Fed policymakers is that the federal funds rate will average about 3.00 – 3.25% range in the long run, which is lower than the current 3.625%, the Fed may need to bump that long-term estimate higher.

Over long periods of time, the yield on the 10-year Treasury Note tends to hover around the growth rate of nominal GDP (real GDP growth plus inflation). Nominal GDP has grown at a 5.4% annual rate in the past two years and at a 6.1% annual rate since the pre-COVID business-cycle peak at the end of 2019, which suggests a possible move upward in the ten-year yield in the years ahead.

In turn, in the past 50 years the federal funds rate has averaged about 1.15 percentage points below the 10-year yield. This means a higher average 10-year yield would suggest a higher federal funds rate than 3.1% and maybe even higher than the current 3.625%.

However, there are also reasons why the Fed can be patient. For one, when we compare regular Treasury securities to inflation-indexed securities, the five-year forward "breakeven" inflation rate remains about 2.4%.

Yes, inflation remains stubbornly high, but we think official measures of inflation would already be lower were it not for the Iran War, and the ongoing Russia-Ukraine conflict, which have raised oil prices and cut global refinery capacity.

Also, while nominal GDP growth is a good target for interest rates, it can also mislead. In the late 1990s, dot.com investment lifted GDP. In the mid-2000s, home-building did the same thing. And, today, data center building is making GDP growth appear stronger than it really is. Without data centers, GDP growth is weaker, which would argue for lower rates.

Moreover, in reading the tea leaves, Warsh told Congress recently that the Fed has other "tools" to fight inflation rather than just interest rates. What he is referring to is the Fed's balance sheet and Quantitative Tightening. Trimming the Fed's balance sheet would reduce liquidity in the banking system, which in turn would help hold down growth in the money supply.

The M2 measure of the money supply is up at only a modest 4.7% annual rate in the past twenty-four months. And ultimately, unless money supply growth picks up, we think inflation will diminish.

Housing inflation is much more subdued than it was a few years ago and housing makes up a large chunk of inflation measures. In addition, Warsh has shown interest in the Fed focusing more on "trimmed-mean" inflation rates, which tend to mute the effect of the most volatile prices. Basically, they throw out outliers in inflation data on both the high and the low side and look at what prices in the middle are doing.

Put it all together and we think Warsh's goal is to find a way to hold off the hawks on the Fed (what we will call the Powell faction) and avoid rate hikes altogether. For now, he appears to be winning in this endeavor and it certainly looks like he has both the arguments and the support to play the long game and remain patient. He has the Fed right where he wants it.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
7-23 / 7:30 am	Initial Claims – Jul 18	211K	**211K**		208K
7-24 / 9:00 am	New Home Sales – Jun	0.606 Mil	**NA**		0.580 Mil