Weekly Commentary with Professor Jeremy J. Siegel

Warsh Gets an A: Re-focused Fed on the Right Key Principles

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Kevin Warsh's Jackson Hole speech was notably hawkish. But I came away from the speech even more confident in Warsh and thought it was one of the best speeches I've heard from a Federal Reserve chair. Most importantly, Warsh is refocusing on factors missing from the Fed's framework for years: an explicit recognition that money supply and bank credit matter for the Fed's inflation outlook. Jerome Powell failed miserably on this feature during a critical and unprecedented surge in money supply with the Fed and the government's pandemic response.

Warsh made clear that the Fed needs to look at a broad range of indicators in addition to the money supply, such as commodity prices, domestic private demand, and credit spreads, while recognizing much of the official economic data arrive with a substantial backward lag. This is exactly the right approach. Monetary policy should not be conducted by looking only at rear-view mirror inflation and employment statistics. Money and credit conditions and commodity prices tell us what is happening in the economy before many of the traditional economic reports do.

I was also encouraged by his discussion of the relative importance of interest rates versus quantitative easing (QE). QE can be extremely important during a financial crisis when liquidity is scarce, but in a normal environment the level of short-term interest rates is far more consequential. The size of the Fed's balance sheet is not, by itself, a good measure of whether monetary policy is tight or easy. Warsh also correctly questioned the importance of forward guidance now that we are no longer at the zero lower bound. Forward guidance was powerful when short-term rates were pinned at zero and the Fed needed to influence longer-term rates by promising to remain easy. That mechanism is much less important with rates well above zero.

The most important point for markets is that Warsh does not believe current policy is particularly restrictive. The federal funds rate is around 3.6%, and bank credit is expanding at roughly a 7%–8% annual rate. That is hardly consistent with a monetary policy crushing demand.

Warsh noted inflation expectations currently appear well anchored, but he did not take that stability for granted. That is exactly right. Inflation expectations often look stable until suddenly they do not. As Hemingway famously put it when asked how someone goes bankrupt, "gradually, then suddenly!" The same can happen with inflation expectations, which is why the Fed cannot simply assume that today's stability will persist.

Beyond the Fed, we continue to see a very strong fundamental backdrop from the AI story powering the equity market. Nvidia delivered results that pushed back against concerns that the AI investment cycle was losing momentum. Jensen Huang's confidence in the durability of AI demand helped propel the market. Salesforce's results and their partnership with Anthropic helped shift the bearish narrative that all software would be replaced by AI and led to a thrust in software stocks.

Overall, the market continues to demonstrate considerable resilience and I remain constructive. We are coming off extraordinarily strong earnings growth, so some deceleration is inevitable, but that does not mean the earnings outlook is deteriorating. The biggest question? Can Warsh hike before the mid-term elections or will he wait until December.

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