

Research

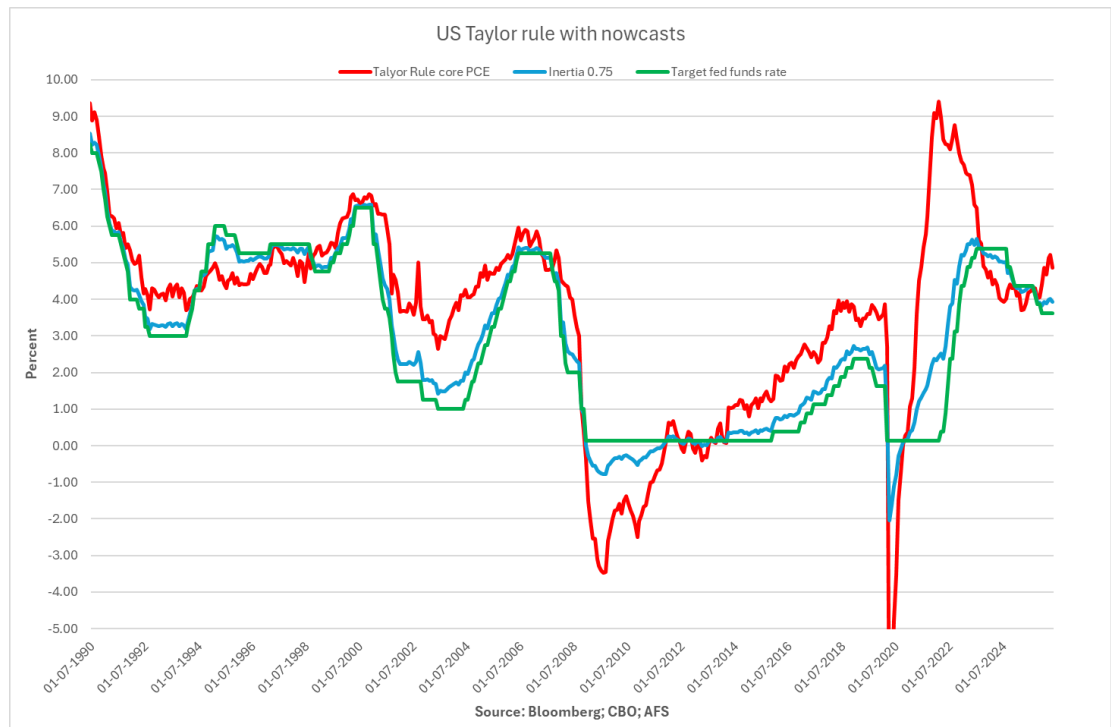
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The operational changes at the Fed are a diversion

- **How will Fed Chairman Kevin Warsh’ first meeting since taking the helm at Fed play out?** I see three scenarios: hawk, dove, and middle of the road. Markets lean towards the middle of the road scenario, which is the path of the least resistance. That is: Warsh paying lip service to the Fed’s inflation mandate but not moving the dial compared to his predecessor, Jerome Powell, who never got inflation back at target. Inflation will remain likely problematically elevated for the rest of the decade. For a while, Warsh will likely try to mask the inflation failure by announcing operational changes with much fanfare. But the changes will be cosmetic in nature. Hence, the window-dressing reference in the title of this note.
- **The lip service part refers to obviously restating the two percent target.** And removing the dovish bias from the April FOMC statement, which was former Chairman Powell’s parting shot. But restating the target and tweaking the statements hawkishly are easy wins. They require no skin in the game.
- **Fed funds futures and OIS are priced to perfection with regards to the Warsh ‘revolution’.** But at the same time, pricing is completely wrong when you think about it. One 25bps hike is fully priced in. Which is bang in line with the output of my simple Taylor rule with high inertia (inertia is a factor for giving greater weight to past interest rate decisions).

Prescribed rate	4.85
Inertia	3.93
Prior rate	3.62
Neutral rate	1
Core PCE	3.3
Unemployment	4.3
NAIRU	4.2
α	0.5
β	0.5
Okun factor	2

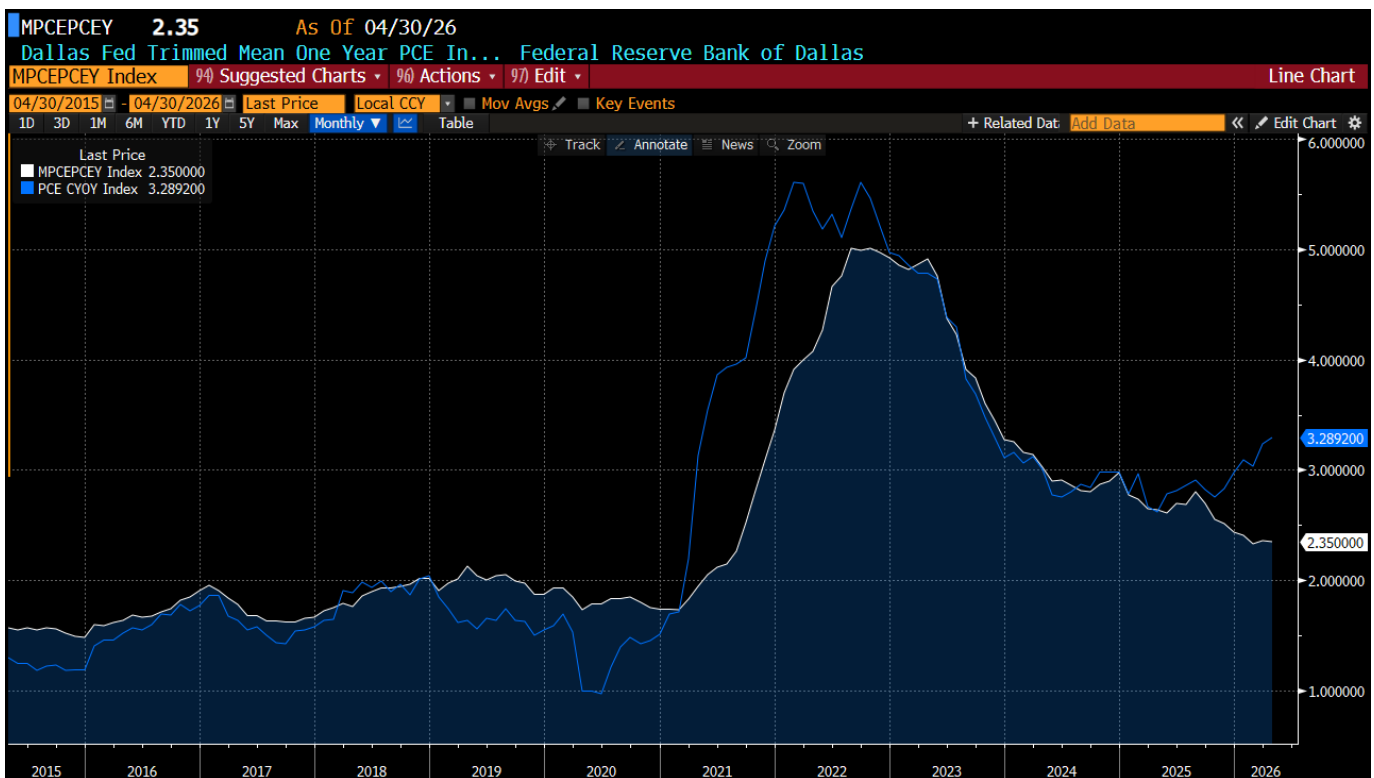
- **Be aware that the model with high inertia has the best historical fit for the fed funds rate:**



- **The neutral real rate estimate of one percent is sourced from the NY Fed’s ubiquitous neutral rate model. In nominal terms, it translates to a three percent neutral rate.** Which is bang in line with the FOMC median – the message being that the Powell Fed believed that its policy was slightly restrictive. Which I find hard to square with relative solid payrolls growth this year and core inflation which already had gotten stuck at three percent in the months before the start of the Iran war. Not to mention the unstoppable AI-driven investment boom/bubble
- **While a single rate hike might look great on paper (re the Taylor rule), it makes zero sense.** When was the last time the Fed pulled a ‘one and done’ hike? Decades ago. More importantly, inflation has been above target every year since 2021. Core has risen further north of three percent in the wake of the Iran war. What good is one quarter point hike going to do?
- **Now remember, Warsh sold himself to President Trump and Congress as the guy who is going to change the Fed.** Yes, Warsh will likely do some housecleaning. He hates the ‘dot plot’ (FOMC forecasts) and could simply drop them. Then again, how does dropping the dot plot square with his preference for forecasts over data when setting policy? He could cut the number of press conferences to four from eight. He might say that he will communicate less and stop doing the central banker ritual that is offering forward guidance. That’s taking a leaf out of the ECB’s playbook. Remember: Lagarde & Co are resolutely sticking to the line that “rates are not on a preset path.” But how has the ‘no forward guidance, forward guidance’ method worked out for the ECB? If rates aren’t on a preset path, why bother mentioning rates with a reference to the future? Alas, as an ECB-watcher, I can tell you that ECB-speakers can’t help themselves. They speak incessantly along the lines of giving forward guidance. And they leak to the press with almost equal vigor;
- **Then there is Warsh’s smaller balance sheet fetishism.** As a money market purist, of course my preference is for a small central bank balance sheet. But that would require a lower concentration of reserves at the biggest banks.

Either through a revival of the interbank market or another money market avenue that more equally disperses reserves. Yes, US regulators eased the burden on US systemic banks by lowering their capital buffer. But the easing of US onshore money market conditions (read: SOFR and fed funds falling relative to the Fed’s administered rates) this year I attribute to the Fed’s T-bill purchases, not regulatory relief. Warsh will be confronted with the same problem as his predecessor. The moment the Fed lets reserves drop by a few hundred billion dollars from current levels, money market rates will soar relative to the Fed’s administrative rates. Is Warsh prepared to live with greater money market volatility and even run the risk of a complete seizure? I think not.

- **To conclude: Warsh would walk down the path of mostly cosmetic changes: with regards to interest rate policy, communication, and money markets.** Lean a bit hawkish but not commit to hikes. Talk less in public and tell his colleagues to do the same. Finally, lob off a few hundred billion dollars from the balance sheet. Claim mission accomplished.
- **Other options would be: Trump’s stooge.** Or Miran 2.0 – Stephan Miran was the Trump-appointed Governor who missed no opportunity to vote for rate cuts. Or a hawkish surprise. The former is straightforward. He cherry-picks the most benign measure of underlying inflation (trimmed mean) and steers the ship towards a rate cut later this year. Just in time for the November elections.
- **The chart below shows trimmed mean inflation versus PCE core, the informal target inflation gauge.** Both have been right and wrong. The former was royally late in picking up the pandemic inflation. The latter knee-jerked lower early in the pandemic.



- **I think a dovish coup is hard to pull off though, given the composition of the FOMC.** I suspect that Powell – back to being a Governor – is hanging around

just to make Warsh's life miserable. I know for a fact that there's no lost love between Governor Waller – who coveted the Chairmanship job – and Warsh. And Waller is pessimistic about inflation to boot. Then there's Governor Cook, who the Trump administration targeted with lawfare. I am sure Cook will return the favor by voting against any dovish hare-brained schemes from Warsh. The other Governors aren't doves by design. As a matter of fact: Trump's point man on the Board, Miran, has returned to his job at the Hudson Bay hedge fund.

- **What about the regional Fed Presidents?** We have a pretty hawkish roster of voters this year: Kashkari, Logan, and Hammack lean hawkish, citing inflation worries.
- **Bottom line, for a dovish stunt, Warsh needs to get lucky with the data.** Or magically convince his new colleagues that his forecast-based way of doing things will deliver price stability.
- **In the case of a hawkish surprise, he will heap blame on Powell (who is sitting at the same table remember) for losing sight of the inflation target.** The message being that he's priming markets for a string of hikes. Given the inflation situation, it is my preferred pick for policy. But then I ask myself: how long will it take Trump to figure out that Warsh is uncontrollable and going against his wishes for easier policy? Yes, I know that the administration will give Warsh some 'honeymoon period' slack as to allow him to gain the market's confidence. But at some point, before the elections, Trump's patience will run out if he doesn't deliver the goods: rate cuts.
- **So, is Warsh really going to be the guy who stands up to Trump?** Trump 2.0 values loyalty above all else. Have you seen Trump nominees who have fallen from grace and then getting on the President's bad side? No, they have all stayed silent. Not to mention that compared to Trump 1.0, Trump's cabinet is remarkably stable – in the broadest sense of the word. This time there isn't the endless coming and going of new appointees. So, if Warsh fits the mold, it's hard to see him go rogue and turn full-blown hawk.
- **To conclude, I don't have either cuts or hikes on my radar in the next twelve months.** If Warsh is going to hike, which is where I think the risks are, it will be more than just one hike. And I do hope that Warsh raises rates for the right reason: by turning on Trump and to get inflation down on his own volition. And not because the market forces him to.

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