

FOMC: What to Watch Out For



Not “Warshing” Out Volatility: **Kevin Warsh** floating *inflation “regime change”* and “*narrower lanes*” whilst doubling down on *independence* and *price stability will not wash out the Fed’s policy dilemma* and **multi-dimensional/sided risks** that square with *a bumpy rates path subject to two-way volatility*.

Iran is Bigger than Warsh: **Between now and the September FOMC**, we expect **a terse hold as Iran risks trap the Fed** between *diametrically opposed* (inflation and demand destruction) risks. This is an outcome that is, to a large extent, **agnostic to the prevailing Fed Chair**.

Fed Forced “Behind the Curve”: This uncomfortable hold amid **mounting two-sided risks, bound to morph into one more dominant risk** (rather than benignly negate one another) *down the line*, **inevitably knock the Fed behind the curve**.

Consequent Binary Risk: The unavoidable instinct for “catch-up”/“catch-down”, depending on **sets the stage for binary** (policy) risks.

Acute Path-Dependence: Trouble is, there is **simply no visibility** (much less clarity) **on whether inflation or demand destruction eventually prevail** *given acute, path-dependent divergences* in inflation-demand outcomes.

Concealed & Close, Cut(?): So, the appropriate **policy risks** are **currently concealed**. And *as the fog of war persists*, the **associated variability in the policy calculus** imposes **extremely close call** on rate decisions.

Tilting to a Cut: Our inclination is to **lean gently on the side of rate cuts** resuming. Possibly with modest urgency – quick succession of 50bp of cuts into Q4 2026/early-2027.

Hawkish Talk ...: Admittedly, **Kevin Warsh sounded somewhat hawkish** in terms of his *strident inflation focus* (rather than jobs risk) at his Senate hearing.

- Most conspicuously from his allusions to the *importance of “ahead-of-the-curve” price stability* pursuit **stressing on the high cost associated with belatedly trying to rein in inflation**.
- But equally, his **refrain from counter-balancing** inflation risks with **underlying dis-inflation dynamics**.
- Especially, **in the context of a K-shaped economy** – which he stressed on – **which may be hiding demand dampening** (from price shocks) **in plain sight**.
- And above all. his conspicuous lack of reference to AI-driven (and wider capacity-building) structural disinflation, which he had previously featured.

...But Dovish Goalpost Shift: *Nonetheless*, **beneath the hawkish façade** was a **dovish shift of the Fed goalposts**.

Trimmed Inflation & Tail Risks: Notably, in terms of **shifting the benchmark for inflation gauge to** (Warsh’s preferred) **“trimmed averages ... (that) take out the tail risks”**. And positioning this an **enhanced gauges for assessing “underlying inflation”**.

“Warshing” Out Inflation Risks: In so doing, the **Fed may materially downgrade inflation risks** (by some 30-60bps depending on specifics), **effectively washing out inflation-side policy** (calculus) **barriers to further easing**..

Lowering Rates, Not Optimism: Arguably, this **could provide the Fed with scope to cut, as is** (And all else equal), **without downside risks to growth/jobs undermining optimism**. 60bps depending on specifics).

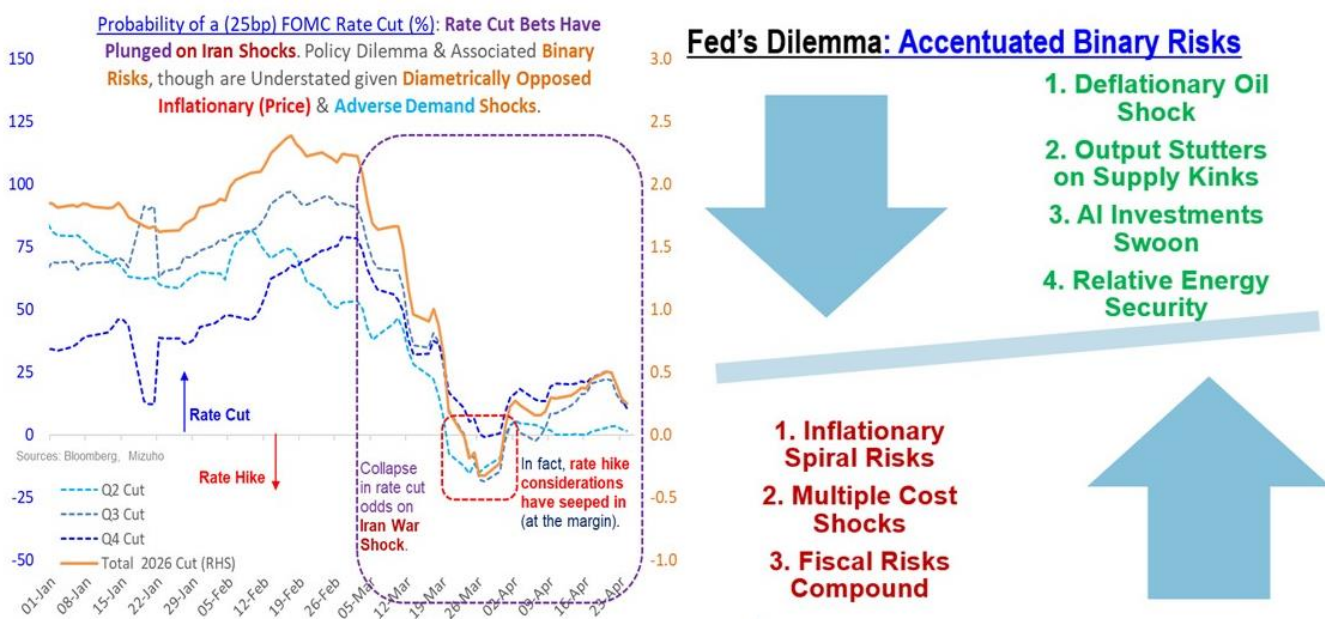
Interim Bear Flattener to Bull Steepner: Insofar that these (goal-post) **shifts under Warsh take place gradually**, bias for an *interim bear flattening* bias (as rate cut bets are suppressed (if not flipped into increased rate hike probabilities) may *precede a late-2026 bull flattening* (as rate cuts re-emerge as the mainstream bet).

Albeit Prone to Fiscal Risks Lifting Long-End: But the *long-end will be prone to revived upside risks into mid-2027* on a confluence of US fiscal risks (and associated long-end led sell-off) being revived.

Exacerbated by “Smaller Balance Sheet”: A dynamic that may be **compounded by Warsh’s desire for shrinking the balance sheet** (albeit sequenced after the cuts).

But Reticence & Non-Linear Risks Accentuate Uncertainty/Volatility: What’s more, *Warsh throwing shade on “forward guidance”*, accentuate **policy uncertainty** and **attendant** (latent) **volatility**. Which exacerbates already compromised visibility of the Fed policy path due to *non-linear, two-sided oil shocks*.

- a. Oil is a major moving part in what could change the calculus. In particular, **how high** it goes, **how long it remains high** and enduring **price volatility** can **all have significant** and **highly consequential, albeit non-linear, impact on the Fed/US rates**.
- b. Moreover, **AI-driven growth multipliers** - which can abruptly turn from demand-shock dampener to amplifier – have the **potential to exacerbate notoriously non-linear adverse demand shocks risks** from **oil shocks – therefore featuring as a potential “swing factor” for Fed policy**.



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