Weighing in on Warsh

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Key Takeaways

- Kevin Warsh's nomination for Fed Chairman initially reassured bond markets by offering a known, crisis-tested Fed veteran with a reputation as an inflation hawk, reducing uncertainty at a critical juncture for monetary policy.
- A Warsh-led Fed would likely focus on shrinking the balance sheet and potentially dialing back forward guidance—a shift that could alter funding markets and raise bond market volatility even if rate cuts remain on the table.
- Despite political noise around Fed appointments, policy outcomes will still be driven by the FOMC's data-dependent framework, suggesting investors should focus more on rates, liquidity and duration positioning than headline risk.

After much fanfare, we now have a nominee to become the next Fed Chairman, Kevin Warsh. While this announcement certainly created its fair share of headlines and market reactions, now that the dust has settled a bit, I thought it would be useful to offer some insights, and perhaps more importantly, perspective on what a Warsh-led Fed would potentially mean.

In prior episodes of naming a new Fed Chairman, the bond market always preferred 'known' quantities (uncertainty is a big negative), especially those who may have had prior monetary policy decision-making experience, and Warsh checks those boxes (see below).

Background

For those of you not familiar with Warsh's Fed background, he served as a Fed Governor from 2006-2011. As you can see, this period coincided with the Financial Crisis and Great Recession. In other words, Warsh had experiences with monetary policy in both normal times and in times of emergency.

For the markets, this past experience and his prior reputation as being more of an inflation 'hawk' in terms of policy, were both viewed as desirable traits to lead the Fed. In addition, it is believed that Warsh understands fully the importance of the perception of Fed independence.

The Trump Fed?

Is the Fed in any danger of becoming Trump's Fed? In order to become Chairman, Warsh needs to become a Fed Governor. Presently, it would appear as if expiring Fed Governor Miran's seat would fit the bill. Current

Fed Chairman Powell's term as Chairman ends in May, but if he stays on as Fed Governor, unlikely but not necessarily a zero chance, Trump won't have another Fed nominee...yet. Conversely, if Powell does exit, the President will get another crack at a Fed Governor nominee.

Keep in mind that monetary policy is set by the Federal Open Market Committee, where each of the twelve members has a vote, including Biden- and Trump-appointed governors as well as bank presidents. Four Fed bank presidents rotate on the FOMC every calendar year, and with the exception of Atlanta Fed President Bostic who is retiring, every other regional president was just re-upped for another five-year term.

Potential Bond Market Impacts

The major area of focus in a Warsh-led Fed could presumably be the Fed's balance sheet, where the nominee's stance regarding a smaller 'footprint' has been well documented. However, it's not as simple as reducing the Fed's holdings of Treasuries and MBS. Other important impacts on the funding markets also need to be considered, as we have witnessed during past and recent episodes of balance sheet reduction.

Another interesting aspect could be the Fed's 'communication function' where a reduced presence or guidance could be a goal of a Chairman Warsh. While grizzled veterans such as myself remember a day when the Fed didn't even announce the outcome of their FOMC convocations on actual 'meeting day', a whole generation of investors are well accustomed to FOMC policy statements, Summary of Economic Projections, and of course dot-plots. Could this increase the bond market's volatility quotient?

While Warsh has more recently talked about lower rates, it comes against the framework of reducing the Fed's balance sheet.

What's Next?

While Sen. Tillis (Senate Banking Committee) has said he won't consider any nominees until the 'Powell subpoena' situation is resolved, it will 'go away' and Warsh should clear through the confirmation process.

Conclusion

I've been following the Fed for decades, and 'past is really never prologue'. For future Fed policy, I would argue that Warsh, just like prior Fed Chairmans, will follow the data.