CLARITY

Kevin Warsh takes the helm

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EXECUTIVE SUMMARY

- Kevin Warsh was confirmed as the next Federal Reserve Chair (effective May 18), assuming leadership just weeks before the June FOMC meeting, amid a more complex backdrop than anticipated—characterized by evolving inflation dynamics, elevated geopolitical risks, and broader institutional challenges.
- Despite early expectations of a more dovish policy path, persistent inflation, rising energy prices, and geopolitical uncertainty have driven a sharp shift in market expectations, resulting in higher long-term yields and renewed pricing of future rate hikes.
- With inflation still near 4% and the labor market holding steady, near-term rate cuts are unlikely, and significant policy shifts are not expected. Instead, Warsh is likely to focus on process and institutional reform—particularly around Fed communications and forecasting—while maintaining a data-dependent path for any future balance sheet adjustments or rate changes.
- From a portfolio management standpoint, we encourage clients to resist the temptation to treat Warsh's confirmation as a standalone signal. Policy will remain driven by the Fed's committee, incoming data, and geopolitics.

Kevin Warsh was confirmed by the Senate on Wednesday, May 13, as the next Chair of the Federal Reserve (Fed), officially succeeding Jerome Powell when his term as Chair expires May 15. Warsh will formally assume the role on Monday, May 18, giving him just weeks to prepare for his first Federal Open Market Committee (FOMC) meeting on June 17. The meeting will include a new set of economic forecasts. In addition, Fed Chair Warsh will hold his first post-meeting press conference as Chair, which will likely provide more insights into his views on monetary policy and how he intends to oversee it. While the nomination itself generated considerable market anticipation—with investors initially positioning for a more dovish policy trajectory—the environment Warsh is stepping into is considerably more complicated than the one many had envisioned when he was first nominated. The inflation landscape has shifted, geopolitical tensions remain elevated, and the Fed itself faces meaningful internal and institutional questions. In short, the new Chair inherits a central bank at a crossroads.

A more challenging backdrop than expected

When Warsh's nomination was first announced, markets quickly coalesced around what became known as the "Warsh trade"—a bet on a steeper yield curve, driven by expectations that an incoming chair sympathetic to rate cuts would deliver meaningful monetary easing. That trade has largely unwound, even as some investors continue to view Warsh as someone who believes that advancements in artificial intelligence (AI) will drive prices lower in the medium to long term. 30-year Treasury yields are now approaching 5%, and futures markets are pricing an approximate 67% chance of a Fed rate *hike* by April 2027—a dramatic reversal from late February, when markets were fully pricing in two rate cuts before year-end.

The catalyst for this shift has been inflation. April Consumer Price Index (CPI)[1] came in at 3.8% year-over-year, the fastest pace since 2023, while Producer Price Index (PPI)[2] surged 6% annually—its fastest pace since 2022—driven in large part by war-related energy price increases. Core Personal Consumption Expenditures (PCE)[3] inflation is estimated to have run at an annualized rate of roughly 3.8% over the first four months of the year, materially above the Fed's 2% target. Perhaps more concerning is the speed of passthrough: transportation, trade services, and other categories that historically took months to absorb energy cost increases are already reflecting those pressures. Core inflation, which excludes more volatile items like food and energy, has not yet accelerated to the same degree, but the risk of further passthrough into May data is real.

Compounding the inflation picture is an unsettled geopolitical landscape. The conflict in the Middle East continues to drive energy prices higher, with retail gasoline now exceeding $4.50 per gallon nationally. President Trump is currently in Beijing for high-level discussions with President Xi, a visit with potentially significant implications for energy markets—including whether China will back the U.S. in pressing Iran on the Strait of Hormuz. That development, if it materializes, could represent a meaningful positive for energy prices and the broader inflation outlook. For now, however, the oil shock remains a live inflationary variable, and the trajectory of U.S.-China relations introduces additional uncertainty into the global outlook.

What Warsh is likely to focus on first

Given near-4% CPI inflation and a stabilizing labor market, rate cuts are effectively off the table in the near term. Three FOMC members dissented from the implicit easing bias in the most recent statement, and above-trend payroll data have further reinforced a patient stance across the committee. With that in mind, it is unlikely that Warsh's early tenure will be defined by dramatic policy rate moves in either direction.

Instead, we expect Warsh to focus on process and institutional reform in the early months of his chairmanship. Having served at the Fed in the late 1990s and early 2000s, Warsh is well-acquainted with how the institution used to operate—in particular, how the FOMC and staff interacted—and is likely to revisit changes made since then that may have complicated rather than enhanced the Fed's ability to achieve its dual mandate in balancing low and stable inflation with a healthy labor market. Changes to the Summary of Economic Projections (SEP, or the "dot plot") and broader communications frameworks are likely coming, though they will take time to implement. For the June meeting specifically, we anticipate that the easing bias will be removed from the post-meeting statement and that the June SEP will feature a zero-cut median projection for 2026.

Warsh's longer-term policy agenda—balance sheet reduction paired with eventual rate cuts—has not changed, but the sequencing and timing will be dictated by data, not ideology. If CPI remains near 3.5% by September, conversations about productivity-driven disinflation will be difficult to sustain publicly.

Two scenarios for the path forward

From a market perspective, the path forward can be framed through two key scenarios:

- **Scenario 1** — Inflation remains sticky, policy stays restrictive: If energy prices remain elevated and passthrough into broader services inflation becomes more evident in the May and subsequent CPI and PPI reports, the Fed will likely remain on hold well into 2027. In this environment, rate hike pricing may continue to build at the margin, longer-dated Treasury yields could stay elevated or drift higher, and Warsh's ability to advance his rate-cutting agenda will be severely constrained regardless of his personal preferences. FOMC consensus will prove difficult to build for easing, and Warsh's first year could look more like continuity than change.

- **Scenario 2** — Labor market softens, easing window opens: Elevated interest rates are already exerting pressure on consumer and housing costs. If the consumer begins to pull back meaningfully and hiring slows with unemployment drifting higher, the calculus shifts. In this scenario, Warsh would have both the economic cover and likely the FOMC majority needed to begin cutting rates. This would represent the "Warsh trade redux"—a scenario that some investors are already positioning for through short-term Treasury exposure, viewing current elevated yields as a buying opportunity.

The critical variable separating these two scenarios is the energy complex. A diplomatic resolution that reopens global energy flows would remove the primary inflationary impulse and tilt the balance meaningfully toward Scenario 2. The near-term result of the Beijing discussions between Presidents Trump and Xi may prove more consequential for Fed policy than anything Warsh says at his first press conference.

Internal dynamics and the FOMC composition question

Beyond the macro backdrop, the composition of the FOMC itself remains an important variable. Warsh cannot move policy unilaterally—rate decisions require a simple majority of the twelve-member committee—and the current board includes voices that have resisted dramatic policy shifts, as evidenced by the recent unanimous vote to resume asset purchases to maintain adequate bank reserves. Jerome Powell, notably, remains on the Board as a Governor through January 2028 and is expected to continue serving, adding an institutionalist counterweight.

The ongoing investigation into Governor Lisa Cook and the potential for additional Board vacancies could shift the balance of the committee meaningfully if two or more seats open up in the second half of the year. Any such changes would significantly alter the internal dynamics Warsh must navigate. For now, the risk of a unilateral pivot toward cuts remains low.

What this means for investors and client portfolios

The key takeaway for investors is that the Fed's policy path over the next twelve months is genuinely uncertain—more so than at almost any point in recent memory. The dual mandate itself is under stress: inflation argues for patience or even tightening, while the risk of a consumer-led growth slowdown and the medium-to-long term impact of AI argues for eventual easing. Which side ultimately drives policy will depend largely on how energy prices evolve and whether inflationary pressures broaden into core services.

From a portfolio positioning standpoint, a few high-level considerations are worth keeping in mind. In fixed income, the risk of further yield curve volatility is elevated, and investors should be thoughtful about duration positioning given the possibility of continued upward pressure on longer-dated yields. The removal of the Fed's easing bias, likely at the June meeting, could serve as a near-term catalyst for additional rate repricing. For equities, the relationship between the macro environment and policy is less linear, but a sustained rise in the term premium[4]—and the attendant tightening of financial conditions—would represent a headwind for valuations, particularly in rate-sensitive sectors. The dollar outlook remains tied closely to whether Fed independence is perceived to be intact; at the margin, Warsh's perceived alignment with the administration's preference for lower rates keeps downside risks to the dollar in view, though it bears repeating that monetary policy decisions are made by committee. Notably, markets are currently pricing just over a 50% probability of a rate hike by March 2027—a far cry from the rate-cut expectations that prevailed at the start of the year, and a dynamic that investors should weigh carefully when considering positioning across asset classes.

Above all, we would encourage clients to resist the temptation to treat Warsh's confirmation as a singular policy signal. The Fed remains a committee, the economy remains data-dependent, and the geopolitical environment will likely have as much to say about monetary policy over the next year as the new Chair himself.

Endnotes:

1 CPI (Consumer Price Index): Measures the average change in prices paid by consumers for a basket of goods and services, commonly used to gauge overall inflation.

2 PPI (Producer Price Index): Measures the average change in prices received by producers for goods and services, often seen as an early indicator of inflation.

3 PCE (Personal Consumption Expenditures): Tracks changes in prices for goods and services consumed by households and is the Federal Reserve's preferred measure of inflation.

4 Term premium is the extra yield investors demand to hold longer-term bonds instead of rolling short-term bonds.

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