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Kevin Warsh, the Federal Reserve, and the Current Policy Challenge

Kevin Warsh was confirmed as Chairman of the Federal Reserve in May of this year. He appears exceptionally qualified for the role, with degrees from Stanford University and Harvard Law School, as well as prior experience serving on the Federal Reserve Board of Governors from 2006 to 2011.

While Chairman Warsh is only a few months into the position, investors have struggled with the Federal Reserve's messaging, or lack thereof, under the new leadership. At last week's FOMC press conference, markets were unsettled when Mr. Warsh stated that there was "no magic wand" to lower inflation after the Committee elected to leave interest rates unchanged. Faced with hawkish rhetoric but no policy action, bond investors took matters into their own hands. The yield on the 30-year Treasury bond rose from 5.10% to 5.23%, reaching its highest level since 2007.

By choosing not to raise rates, or at least make a stronger case for future tightening in the face of persistent inflationary pressures, the Federal Reserve left investors questioning the rationale behind its decision to stand pat. As a result, some market participants began to doubt the central bank's commitment to returning inflation to its 2% target. While Chairman Warsh reaffirmed the Fed's dedication to price stability, he offered little clarity regarding the path to achieving that objective, leaving bond investors uneasy.

At its July 28-29 meeting, the Federal Reserve maintained the target range for the federal funds rate at 3.50% to 3.75%. Notably, three FOMC members, all Federal Reserve Bank presidents who have voiced concerns about the persistence of inflation, dissented in favor of a 25-basis-point rate increase. Those dissents highlight the growing pressure within the Committee to respond to inflation that has remained above the Fed's 2% target for five years. The policy statement was largely unchanged from the June meeting and again concluded with the emphatic declaration: "The Committee will deliver price stability."

The outcome of last week's meeting was among the most difficult to predict in many years. One reason is the significant influence that oil prices continue to have on inflation data. Another is the growing uncertainty surrounding the conflict with Iran and its potential economic consequences. Complicating matters further, Chairman Warsh has abandoned the practice of providing forward guidance, preferring not to signal likely future policy moves. Combined with unusually wide disagreement among Committee members regarding the appropriate policy path, this has made it increasingly difficult for markets to anticipate the Federal Reserve's next step.

During the post-meeting press conference, Chairman Warsh was asked directly, "What are you waiting for?" With commodity prices and Treasury yields continuing to rise and inflation remaining in the 3% to 4% range, the question reflected growing investor frustration. In response, Mr. Warsh emphasized that the Committee had undertaken a rigorous review of current economic conditions, seeking to better understand the forces driving both economic growth and elevated inflation. Particular attention is being paid to supply-side shocks, including oil prices and tariffs, and their potential impact on inflation in the months ahead.

Our view has been that the Federal Reserve could afford to remain patient, given that the inflationary impact of higher oil prices would likely prove temporary if the conflict with Iran were resolved, the Strait of Hormuz reopened fully, and disruptions to global energy supplies eased. However, as we noted previously, uncertainty surrounding the conflict has increased over the past month rather than diminished. Continued delays in reaching a resolution would likely sustain upward pressure on oil prices and increase the probability of one or more Fed rate hikes before year-end.

The Federal Reserve now faces the difficult task of threading the policy needle. Tightening monetary policy will not directly lower oil prices caused by a supply shock. However, higher interest rates can restrain aggregate demand, moderate employment growth, and reduce broader inflationary pressures over time. At the same time, rising Treasury yields over the past several months have already pushed borrowing costs higher across the economy, from mortgages to auto loans. In effect, financial conditions have tightened even while the Federal Reserve has left policy rates unchanged.

The futures market for federal funds currently implies a 67% probability of a rate hike at the September 15-16 FOMC meeting. Meanwhile, the yield on the two-year Treasury note, at 4.30%, stands approximately 67 basis points above the midpoint of the current federal funds target range. Taken together, these market signals suggest investors are pricing on more than two rate hikes over the next year.

We wish Chairman Warsh the very best. He inherits a challenging environment shaped by persistent inflation, geopolitical uncertainty, and increasingly skeptical markets. Restoring confidence in the Federal Reserve's commitment to price stability while navigating these crosscurrents will be no easy task.

Sincerely,

The Private Capital Management Team

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