

From QE to Discipline: Market Under a Warsh Fed

Executive Summary

Kevin Warsh's nomination as Fed Chair follows a politicised process that forced the White House to prioritise "confirmable independence" over pure loyalty. The DOJ probe into alleged Fed renovation overruns hardened Senate resistance, Kevin Hassett fell out of favour, and Warsh emerged as the compromise candidate with credible Fed and market experience.

For investors, the key takeaway is a likely shift in how monetary policy is implemented rather than a wholesale change in objectives. Warsh's framework combines limited easing at the front end of the curve—justified by a supply-side, productivity-driven disinflation narrative—with a multi-year effort to reduce the Fed's balance sheet through steady QT and targeted regulatory adjustments. The intention is to rely less on balance-sheet expansion and asset-price reflation as a transmission mechanism, and more on conventional interest-rate policy to support households and small businesses. By shrinking the Fed's footprint in financial markets, Warsh also aims to reinforce market discipline and reduce the perception that monetary policy has drifted into quasi-fiscal territory.

Our central case is a "productivity-driven soft landing," in which the Fed delivers a moderate easing cycle of roughly 50–75bps while continuing balance-sheet runoff in a measured, non-disruptive manner. In rates, this configuration is likely to produce a two-phase adjustment: an initial period in which long-dated yields remain relatively elevated as term premia are supported by Treasury supply and QT, followed by a gradual flattening of the curve if disinflation continues and policy credibility is reinforced.

In equities, the implication is a late-cycle broadening of market leadership. Mid-cap stocks and select cyclical sectors—particularly financials and industrials—stand to benefit from improved credit transmission and resilient domestic activity, while highly valued, long-duration growth stocks remain constrained by structurally higher real yields. Favour equally-weighted over cap-weighted indices.

The principal risk to this baseline is a loss of policy credibility, whereby rate cuts occur into still-sticky inflation or balance-sheet normalization is slowed under political pressure. In such a scenario, term premia would likely reprice higher, pushing long-end yields up and generating a bear-steepening of the curve. A more adverse tail risk is policy over-tightening or an exogenous shock that disrupts liquidity and credit transmission, leading to a recessionary outcome in which duration once again becomes the primary portfolio hedge. We recommend keeping fixed income duration neutral until we gather more information on the most probably scenario to unfold. Steer away from richly priced credit.

While this framework provides a useful starting point, it remains early in the policy cycle. We expect further information on Warsh's approach to rates, balance-sheet policy, and communication to emerge, and we may update our views as the policy landscape evolves.

Introduction and Context

The nomination of Kevin Warsh as the next Federal Reserve Chair follows an unusually politicised selection process, marked by a sharp deterioration in relations between the White House and Chair Powell. Tensions culminated when the Trump administration initiated a DOJ criminal investigation into alleged cost overruns tied to the Fed's headquarters renovation. The episode triggered an immediate institutional backlash: several Republican senators framed the move as a threat to Fed independence and signalled they would delay confirmations until the probe was resolved. In practice, it raised the confirmation hurdle for any nominee perceived to be primarily a "loyalist," forcing the administration to pivot toward a candidate with greater establishment credibility.

Against that backdrop, Kevin Hassett—Trump's long-time economic advisor and early frontrunner—lost momentum. While his credentials were solid (former CEA Chair; NEC Director), the same proximity to the president that initially made him attractive became a liability. With the Senate effectively reasserting its role as gatekeeper of central bank independence, a Hassett nomination risked being blocked by members of Trump's own party.

Attention then shifted to other names on the shortlist, notably Rick Rieder, BlackRock’s fixed income CIO. Rieder’s candidacy gained traction as markets looked for a technically credible, market-literate chair. However, his profile proved politically misaligned. He lacked government experience and crucially, had a history of bipartisan or Democratic-leaning leanings.

Warsh ultimately emerged as the consensus choice precisely because he sits at the intersection of credibility and alignment. He combines establishment Republican pedigree (Bush-era alumnus), direct Fed experience (former Governor), and Wall Street fluency—reducing “rookie risk” while offering a coherent critique of the post-GFC Fed. Importantly, he has also been one of the more vocal public critics of the Fed’s expanded mandate and balance sheet-era policies, a stance that resonates with Trump’s advisers pushing for a regime shift. The political calculus is straightforward: Warsh offers enough perceived independence to pass the Senate filter, while still enabling a meaningful reorientation of policy framework and institutional scope.

On January 30, Trump formally announced Kevin Warsh as his nominee for Fed Chair. The stage was set for a potential sea change at the Federal Reserve.

Who Is Kevin Warsh?

Kevin M. Warsh brings an intriguing resume to the table, combining high-level experience in government, finance, and policy circles. Now 55 years old, Warsh began his career on Wall Street after earning a law degree from Harvard. He worked as a vice president at Morgan Stanley, gaining a banker’s perspective on capital markets. He later moved into government, serving under President George W. Bush at the White House National Economic Council (NEC), advising on financial and macro policy.

His big break came in 2006, when at just 35 years old Warsh was appointed to the Federal Reserve Board of Governors, becoming the youngest Fed governor in history. Warsh served on the Board from 2006 until 2011, a tumultuous period that spanned the housing bubble, the 2008 Global Financial Crisis (GFC), and the Fed’s first experiments with extraordinary easing. The period matters: he observed the emergency response from inside the institution, but also became increasingly sceptical of the post-crisis shift toward persistent balance sheet activism and broad mandate interpretation. His stance during the GFC era also explains his current reputation: he was consistently focused on the inflationary risks of easy money, including at moments when the labour market was weak. This steadfast focus on inflation, despite slack in the economy, illustrated Warsh’s fundamental divergence from the Keynesian Phillips Curve worldview. He resigned in 2011, broadly seen as uncomfortable with the direction of policy (QE2 and the normalization of balance sheet intervention).

Since leaving the Fed, Warsh has remained close to both policy and markets. He has been affiliated with Stanford/Hoover as a senior fellow and has operated within high-level investment circles (including advising Stanley Druckenmiller), while also sitting on corporate boards.

Hawkishness & Sound Money

Warsh is regarded as an “inflation hawk,” firmly believing that loose money and fiscal excess cause inflation. Warsh has vehemently opposed the Fed’s post-2008 balance sheet expansion, arguing that the \$9 trillion of assets it amassed distorted markets and would inevitably fuel inequality and price pressures. He sees the Fed’s massive holdings as “bloated” and “a material part of the inequality story” by propping up financial asset prices. Warsh’s recommended cure has been tight monetary policy and normalization of the Fed’s footprint – even if painful in the short run.

Rejection of Phillips Curve dogma

Warsh does not subscribe to the traditional Phillips Curve dogma that a tight labour market mechanically causes inflation. Instead, he argues the Fed’s inflation framework has been empirically inconsistent, with policymakers repeatedly shifting the metric they emphasize, ranging from core PCE to services inflation or wage growth, without anchoring policy to a stable, testable theory of the inflation process. In his words: *“they don’t seem to have a serious theory of inflation that’s theoretical and empirical. It’s not obvious that they acknowledge what their role is in prices. Instead, it has something to do with wars and pandemics.”*¹

¹ CNBC interview, October 2024

The practical implication is a different reaction function: less mechanical tightening into labour strength, more emphasis on the interaction between wages, productivity, and fiscal stance.

Balance sheet reduction as the signature policy lever

Warsh's most consistent policy through-line is his preference for a materially smaller Fed balance sheet and a return toward a scarce-reserves operating regime. His critique is not only about "size," but about institutional scope: a large, duration-heavy portfolio (and particularly MBS holdings) blurs the line between monetary policy and quasi-fiscal allocation. He has floated the idea of a "Treasury-Fed accord" to normalize the balance sheet over time, potentially shifting the Fed's holdings toward shorter-duration assets and coordinating with Treasury issuance so markets can absorb the transition more smoothly.

Pro-competition banking stance

Warsh has increasingly emphasized distributional outcomes and financial-sector structure. He argues post-2008 reforms may have increased complexity and concentration without reliably preventing failures (SVB being the obvious modern case), while reducing credit creation for SMEs and interest-rate-sensitive sectors. The policy direction implied push to redirect capital from Wall Street to Main Street – through deregulation of smaller banks, and by shrinking the Fed's role so that private banks and markets intermediate more credit.

The U.S. Economic and Fiscal Backdrop

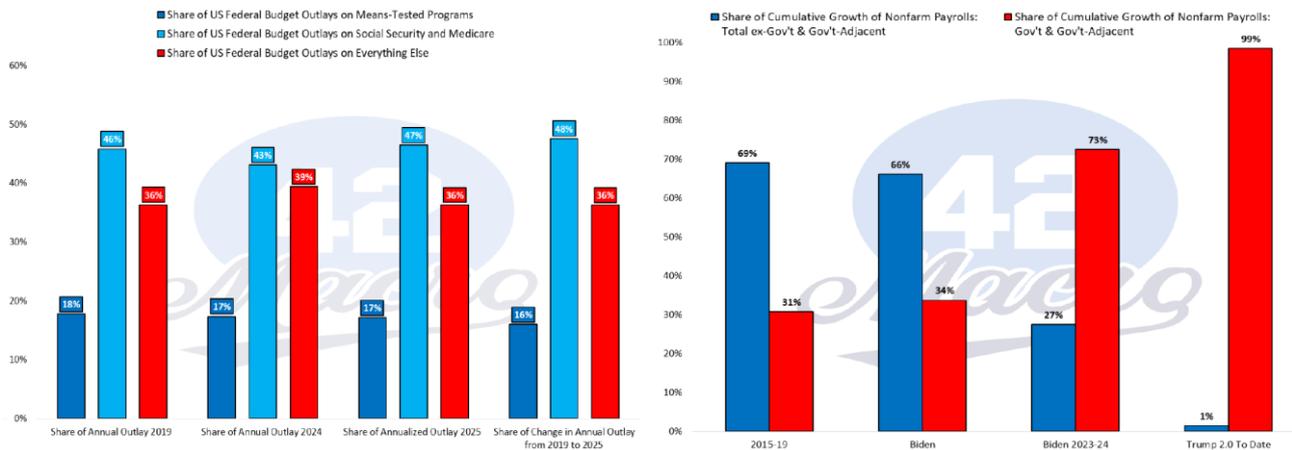
To understand Warsh's likely policy direction, one must first grasp the economic context in which this nomination occurs. The United States in early 2026 is grappling with the aftermath of a K-shaped economic cycle and persistent inflationary pressures – dynamics largely traceable to the unprecedented fiscal and monetary responses of the past few years.

A K-Shaped Crisis Fuelled by Fiscal Largesse

The K-shaped economy captures the divergence between asset-rich households and sectors that benefited from policy support (top of the "K"), versus rate-sensitive consumers and smaller firms facing higher living costs and restricted credit (bottom of the "K"). Fiscal largesse sits at the core of this divergence: revenues remain broadly stable as a share of GDP (~17%), while expenditures are structurally elevated, (23% of GDP vs 20% long-term mean) implying persistent deficits and heavier Treasury financing needs. Two transmission channels matter:

1. **Cantillon Effect:** The flood of government money has disproportionately benefited entities and individuals close to the government. Washington currently spends more than twice as much "everything else" that it does on means-tested programs (**Exhibit 1, LHS**). This is a classic Cantillon effect, where newly created money benefits the first recipients (government contractors, subsidized sectors, higher-income groups with asset exposure) at the expense of later ones.
2. **Crowding Out of Private Sector:** The U.S. Treasury's financing needs have been colossal. Net treasury debt issuance now soaks up an estimated 40% of global savings, nearly double the long-run average. Domestically, Treasury supply is 228% of total U.S. savings, vs ~117% historically. In practice, this means the government is consuming a huge share of available capital, leaving relatively less for private investment. The impact is evident in employment trends. In the two years of the Biden administration (2021–2022), roughly 72% of nonfarm payroll growth came from government and government-adjacent sectors (public sector, healthcare, education). Under the first year of Trump 2.0, that share rose to ~99%, implying a near-zero contribution from the "true" private sector (**Exhibit 1, RHS**).

Exhibit 1: Share of U.S. Federal Budget Outlays and Cumulative Payroll Growth by Sector

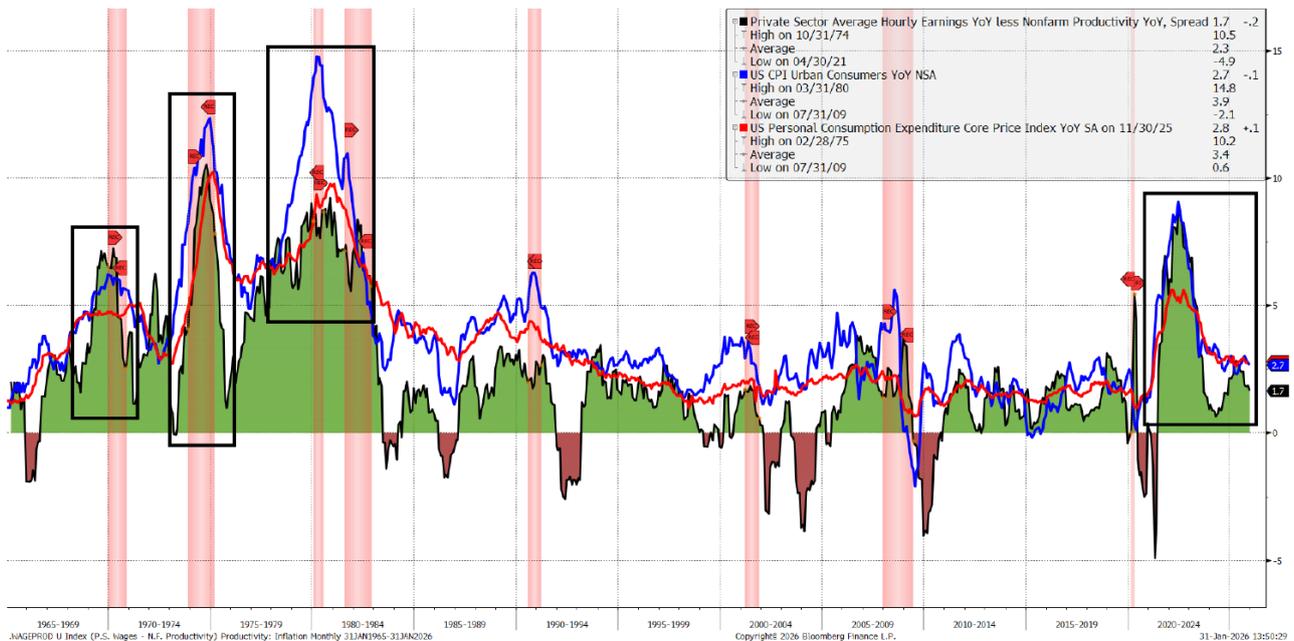


Source. MAM Research, 42 Macro

Inflation: wages are not the framework; productivity is

The U.S. is coming off the highest inflation in four decades and has struggled to return to a stable 2% regime. Warsh’s critique is that the Fed has leaned on shifting narratives (supply chains, wars, “supercore”, etc.) rather than a stable empirical model of inflation causality. 42 Macro’s key claim is more specific: wage growth is not inherently inflationary; wage growth becomes inflationary when it outpaces productivity. When compensation rises faster than output per hour, unit labour costs surge and firms pass through price increases, particularly in an environment already boosted by fiscal stimulus. This was the case in 2021-2022: government stimulus bolstered incomes and labour bargaining power despite output not fully recovering, yielding a surge in unproductive wage growth. (Exhibit 2). Conversely, higher productivity growth tends to lower the equilibrium inflation rate by expanding capacity and compressing unit costs. This distinction matters because it directly undermines a simplistic Phillips Curve reaction function (tight labour market = inevitable inflation) and instead suggests policy should track the interaction of wages, productivity, and fiscal impulse.

Exhibit 2: Unproductive Wage Growth Causes Inflation



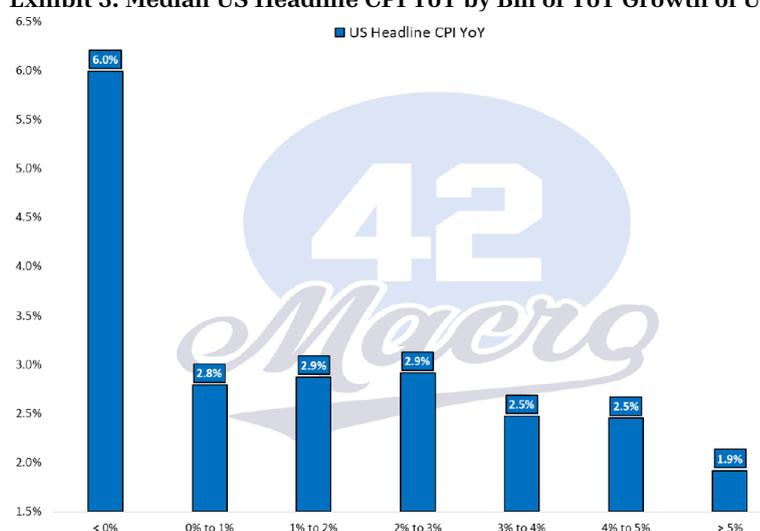
Source. MAM Research, 42 Macro

Productivity & AI: A Potential Disinflationary Silver Lining:

The potential offset to these late-cycle pressures is a structural productivity upturn, increasingly associated with AI capex and diffusion. From an inflation perspective, higher productivity is the holy grail: it allows faster growth without commensurate price increases, effectively expanding economic capacity. Warsh's policy stance leans on the optimistic variant: if the U.S. is transitioning from a ~2% trend productivity economy toward ~3%, the Fed can maintain easier front-end policy without reigniting inflation, because supply growth is structurally stronger. 42 Macro formalizes the same intuition: higher productivity bins are associated with materially lower median inflation outcomes (**Exhibit 3**). In fact, this is the crux of how Warsh plans to square his hawkish reputation with Trump's push for lower rates. Warsh posits that AI advancements raise the economy's structural growth rate and r-star (neutral interest rate), meaning the Fed can cut the policy rate somewhat (from current levels) without fuelling inflation, as long as productivity gains are coming through.

The risk, however, is sequencing: AI diffusion can raise measured productivity with a lag, while fiscal impulse operates contemporaneously. If fiscal remains expansionary and productivity gains prove uneven, inflation could remain sticky despite "good" growth.

Exhibit 3: Median US Headline CPI YoY by Bin of YoY Growth of US Nonfarm Productivity



Source. MAM Research, 42 Macro

Phillips Curve unreliability

The upshot of the above points is that the classic Phillips Curve may be an unreliable guide in the current environment. It assumes a stable mapping from labour tightness to inflation. Yet when employment gains are heavily concentrated in government and government-adjacent sectors, the unemployment rate is a weaker signal of underlying private-sector capacity constraints. Moreover, a Phillips Curve model that ignores fiscal stance misses a primary driver of demand shocks in this cycle.

The U.S. enters 2026 with a policy mix that has supported headline resilience but generated distortions: fiscal-driven growth, private-sector crowding out, and an inflation process more sensitive to productivity than to wage growth alone. This backdrop creates fertile ground for a "Warsh Fed" narrative: restore discipline via balance-sheet normalization and a narrower mandate, while leaning on AI-led productivity as the non-inflationary growth engine.

Warsh's likely policy agenda

Lean into AI-driven productivity to justify lower front-end rates

Warsh's most "dovish" lever is a supply-side one: if the U.S. is entering an AI-led productivity upcycle, then the economy can sustain stronger real growth without rekindling inflation. The policy implication is straightforward: he can argue for earlier or deeper policy-rate cuts than a Phillips Curve framework would normally allow, because productivity expands capacity and reduces the inflationary impulse from tight labour markets.

In practice, Warsh is likely to emphasize indicators such as business investment in information-processing equipment, diffusion of AI across sectors, and realized productivity trends as evidence that the inflation process is improving structurally. This is also the key bridge to the Trump agenda: the administration wants lower rates; Warsh can deliver cuts while claiming they are consistent with price stability, provided inflation expectations remain anchored.

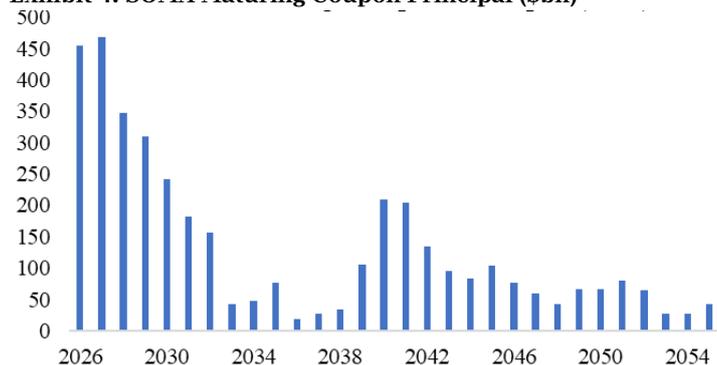
A realistic baseline is that Warsh supports at least the easing already embedded in the Fed's late-2025 projections (two 25bp cuts) and would likely remain open to additional cuts if inflation expectations remain well behaved. The constraint is credibility: any renewed inflation scare would raise long yields and mortgage rates via term premia and inflation risk premia, offsetting the growth benefits of lower policy rates. This is why Warsh's framework should be understood as a conditional easing bias, not a blanket dovish pivot.

Balance sheet reduction as the primary tightening tool

The most consequential change under Warsh is likely to be persistent QT and a structurally smaller Fed balance sheet, i.e., a return toward a scarce reserves operating regime more akin to the pre-2008 architecture, when the balance sheet was only ~5% of GDP (versus ~25% today).

Operationally, how might this unfold? Mechanically, the Fed can shrink its balance sheet through passive runoff (allowing Treasuries and MBS to mature without reinvestment). The near-term feasibility is high because the Fed's Treasury holdings have meaningful maturities in the coming years, allowing large runoff without immediate asset sales (**Exhibit 4**). The market implication, however, is not neutral: as the Fed reduces its structural bid for duration, the private sector must absorb more risk, typically requiring a higher term premium, at least initially.

Exhibit 4: SOMA Maturing Coupon Principal (\$bn)



Source. MAM Research, Federal Reserve Bank of New York, Joseph Wang

Warsh's core argument is that QT can substitute for some rate tightening. He has argued that a smaller balance sheet is "trillions larger than it needs to be" and that, if markets knew the Fed's objective was a smaller, riskless balance sheet pursued through a deliberate strategy, the economy could ultimately sustain lower interest rates with a less politicized Fed footprint. The intended trade-off is explicit: reduce the wealth-effect channel and excess financial leverage created by QE-style policy, while enabling lower short rates that support households and SMEs through more conventional credit channels.

Two implementation constraints matter for investors:

1. Treasury issuance strategy. A key mitigation is for Treasury to lean more heavily on bill issuance (short duration) rather than flooding the long end with coupons. This limits the amount of duration private investors must absorb at any one time and provides a near-cash substitute as reserves decline. Treasury has already increased the T-bill share of issuance to around historical norms (~22% of debt) and could go higher.
2. Money-market plumbing and bank balance sheets. A successful shift to scarce reserves requires the private banking system to intermediate more Treasury financing and repo activity. This is where regulatory reform becomes complementary to QT: if banks face binding leverage and liquidity constraints, they will not step in, increasing the risk of funding-market stress. Warsh will push for a

regulatory environment that facilitates this handoff. In fact, SLR reform² and other de-regulatory signals have already been expedited in anticipation of Warsh.

Overhaul bank regulation to shift credit back to the real economy

Another pillar of Warsh’s approach will be a major shift in regulatory focus: easing the burdens on small and medium-sized banks while rebalancing the financial system away from over-reliance on megabanks and shadow banking. We expect a Warsh-led Fed (in coordination with other regulators via the Treasury) to pursue a “tailored” regulatory agenda that reduces one-size-fits-all rules and encourages greater credit intermediation by community and regional banks. Policy actions likely include:

1. Revisiting leverage and liquidity constraints that penalize low-risk balance sheet usage (e.g., Treasury market intermediation and repo). The Supplementary Leverage Ratio (SLR) is central here: easing SLR increases banks’ ability to hold Treasuries and extend repo without disproportionate capital costs, which becomes critical under QT. This aligns with the plumbing objective: ensure the private sector can finance Treasury supply as the Fed steps back.
2. Opposing Basel III “Endgame” capital reforms and tilting toward a U.S.-centric framework. The Basel III “Endgame” refers to the final package of post-Global Financial Crisis banking regulations designed to standardize and increase capital requirements across banks globally. Its core objective is to limit banks’ ability to use internal risk models, raise capital charges for trading, operational, and market risks, and ensure banks hold more equity against a broader range of activities—particularly those involving market and balance-sheet complexity. Warsh has explicitly criticized the Basel endgame approach, arguing it is misaligned with U.S. objectives.

Warsh’s intellectual case often echoes the Richard Werner-style view that many smaller local banks can create more productive, distributed credit than a small number of megabanks, which tend to lend to large corporates and financial activities. The portfolio implication is not just for banks: if successful, it could shift the growth mix toward SME investment and capex, supporting breadth in the real economy.

Reject Phillips Curve Orthodoxy and Forward Guidance Dependency

One of the more philosophical but impactful changes under Warsh will be a reorientation of how the Fed makes and communicates policy. Warsh is likely to reject a purely Phillips Curve-centric reaction function. His critique being that inflation is not mechanically driven by wage growth alone, and that policy errors often stem from using unstable models and shifting narrative anchors.

Practically, a Warsh Fed would likely: (i) place more weight on productivity, fiscal stance, and financial conditions, (ii) be less reliant on “open mouth operations” and precise forward rate-path guidance, and (iii) accept that reduced guidance may increase rate volatility, but view that as preferable to embedding false precision in the reaction function.

From an investor standpoint, the implication is a regime with higher distribution of outcomes around the path of rates: fewer explicit commitments, more sensitivity to real-time inflation expectations and market-based measures of financial conditions.

Putting it together: the likely “Nash equilibrium”

The political-economy equilibrium can be summarised succinctly: Trump wants lower rates and growth; Treasury Secretary Bessent wants a stable dollar and lower long-term funding costs; Warsh wants a smaller Fed footprint that promotes disinflationary real growth. The implied policy package is: front-end easing justified by productivity, prolonged balance-sheet runoff, and regulatory changes that push credit intermediation back toward banks—especially smaller ones.

This is a meaningful regime shift. It does not guarantee lower long-term yields or mortgage rates in the near term (QT and higher term premia can keep long-end rates sticky) but it does change the medium-term direction of travel: away from balance-sheet-driven asset reflation and toward a policy mix that attempts to restore market discipline, contain inflation risk premia, and broaden the real-economy transmission of credit.

² Reuters, “Fed kicks off effort to ease bank leverage rules,” June 25, 2025.

Asset-Class Implications: Scenarios for a Warsh Fed

Given the significant uncertainties around how Kevin Warsh’s policy experiment will unfold, it’s useful to frame the outlook in terms of scenarios. We outline three scenarios. They are not point forecasts; they describe plausible regimes and the asset-market mapping.

Scenario 1: “Productivity Boom Soft Landing” (Base Case, 65% probability)

In this base case, Warsh successfully implements a balanced version of his agenda. AI-driven productivity gains materialize sufficiently to help disinflation continue, even as growth remains positive. Warsh delivers a modest easing cycle (50-75bps) while maintaining a steady, non-disruptive QT path. Treasury issuance tilts further toward bills, and regulatory tweaks (e.g., leverage constraints) support the plumbing, preventing a sharp liquidity crunch. This is broadly consistent with the “Nash equilibrium” laid out previously: rate cuts on the front end, a flattening yield curve through QT, and credit flowing to the real economy via smaller banks.

U.S. Equities. The broad index likely performs constructively, but leadership rotates. Lower short rates support cyclicals and domestic breadth, while QT keeps long real yields and term premia from collapsing, capping the upside for long-duration growth. This setup is consistent with the “late-cycle broadening” dynamic we have highlighted: mid-caps can sit in the sweet spot (domestic exposure, more cyclical than mega-caps, generally better quality than small caps) and may benefit as policy becomes more supportive at the margin and concentration fades. Sectorally, financials (especially regionals) benefit from: (i) a more favourable regulatory stance, and (ii) better credit formation for SMEs if the re-intermediation story gains traction. Industrials and select energy can participate through a capex and productivity lens. By contrast, bond proxies (utilities/REITs) face a relative headwind from structurally higher real yields. Expect a more balanced market with leadership rotating to sectors that benefit from capital spending, productivity, and rising real activity (industrials, energy, small/mid banks) while highly valued growth stocks face a valuation ceiling from higher discount rates.

Rates. Expect a two-stage dynamic:

1. Initial steepening pressure (or at least “sticky long-end”) as QT shifts duration back to the private sector and term premia stays supported by supply. We might see the 10-year Treasury yield remain elevated in the near term, potentially increase to 4.50%-4.75% on aggressive QT signals.
2. Second-order flattening if inflation expectations compress and the market assigns credibility to the new regime. the 10-year yield could settle back or even dip below the 4%. Meanwhile the 2-year yield falls more significantly if the Fed cuts towards ~3%. In our base case, as Warsh proves his anti-inflation credibility, the long-end “sticky inflation premium” abates, allowing flattening as a second-order effect.

U.S. Dollar (USD). Near-term USD support is plausible via relatively higher real yields and reduced inflation tail risk. Over time, the USD can become more range-bound as global growth stabilises, and risk appetite rotates into higher beta FX. So, the dollar might peak early in Warsh’s term and then settle. Warsh’s focus on a stable dollar (Treasury Sec Bessent also wants a stable dollar) implies they won’t mind a firm currency as it helps combat inflation. Politically, however, Trump prefers a weaker dollar for export competitiveness; the Nash equilibrium likely means tolerating a moderately strong USD in the short run while pushing other pro-growth levers.

Precious Metals. QT and higher real yields are headwinds (especially for gold), but a structural bid (reserve diversification) likely keeps a floor under prices—consistent with our broader commodities framing where central-bank demand remains a core pillar even when tactical positioning becomes extended.

We assign a 65% probability to this scenario.

Scenario 2: “Credibility Slip” (25% probability)

The strategy’s internal contradiction becomes dominant: Warsh cuts rates into sticky core inflation and/or slows QT under political pressure. Markets conclude the Fed is prioritizing growth and the political agenda over a stable inflation anchor. Inflation expectations rise, term premia re-prices higher, and the “policy risk premium” returns. This is the regime in which the Fed loses the benefit of the doubt and long-end yields become the adjustment valve. In effect, the worst fears about installing a Trump-friendly chair materialize –

Warsh, despite his hawkish past, is seen as acquiescing to political desires for stimulus at the cost of the Fed's independence. Probability is medium, as Warsh's instincts are hawkish, but the pressures are real: Trump publicly wants near-zero rates, and a mid-2020s supply shock or wage push could test Warsh's resolve.

U.S. Equities. Initially, a dovish tilt – Warsh cutting rates faster or more than expected – would spur risk-on enthusiasm in equities, with high-duration growth and speculative beta outperforming initially. However, as the credibility issue becomes apparent, the euphoria flips to concern. The scenario evolves toward an “inflation trade”: earnings may hold up nominally, but rising yields and risk premiums compress valuation multiples. Volatility increases. If inflation expectations drift higher, energy/materials can outperform as implicit inflation hedges, while financials become ambiguous (a steeper curve helps NIMs, but policy uncertainty and credit risk typically dominate). Overall, a regime of un-anchored inflation tends to compress equity valuations. One possible outcome: equities rally on stimulus, but by mi-2027 face a reckoning as inflation remains sticky, forcing a harsher tightening then – leading to a sharper equity drawdown.

Rates. A bear steepener becomes the base dynamic: the front end reflects the Fed's cuts, while the long end sells off on inflation risk premia, fiscal worries and diminished credibility. This is consistent with our view that persistent deficits and supply can become self-fulfilling drivers of higher rates; with credibility loss accelerating that process. The practical outcome is higher rate volatility and a higher probability of disorderly repricing episodes in long bonds. Under this scenario, Warsh's Fed might inadvertently replicate the stop-start pattern of the 1970s: ease policy, inflation expectations worsen, market forces long rates up, eventually Fed is forced to hike abruptly later.

U.S. Dollar. Initially softer on rate differentials, but the path becomes unstable: higher long yields can offer nominal support, yet the erosion of institutional credibility and rising inflation risk premium reduce safe-haven appeal. In our own work, the dollar's valuation premium is increasingly difficult to justify when fiscal optics deteriorate and policy volatility rises; this scenario accelerates that pressure. We could see increased interest in alternatives to USD for reserves – e.g. gold or even other fiat like the euro/yuan – at the margin, which weighs on the dollar.

Precious Metals. This is the scenario in which gold can reassert upside. Gold would benefit from the “inflation is a choice” misstep – as Warsh ironically becomes the person who doesn't fully enforce that mantra. A weaker real-rate anchor and rising policy risk premia drive demand for hedges. The key risk is sequencing: if credibility loss ultimately forces a Volcker-like response later, precious metals can overshoot and then retrace.

We assign a 25% probability to this scenario.

The most relevant indicators to monitor are:

- 5y5y forward breakeven inflation as the market's cleanest gauge of longer-run inflation expectations (**Appendix I**)
- Inflation expectations, particularly the 5y series as a proxy for household-level anchoring (**Appendix II**), and
- The trend in core PCE inflation, ideally assessed on short-run annualised measures to detect stalling disinflation (**Appendix III**).
- On the cost side, unit labour costs provide a direct read-through on whether wage growth is running ahead of productivity (**Appendix IV**).
- In rates, confirmation would come through a sustained bear steepening (long-end yields rising relative to the front end), consistent with higher term premia and/or inflation risk premia.
- Cross-asset confirmation would be gold and oil trending higher alongside rising breakevens, which would reinforce the interpretation that markets are hedging a weakening inflation anchor rather than merely repricing growth.

Scenario 3: “Hawkish Overreach and Recession” (Tail Risk, 10% probability)

In this adverse scenario, policy tightening proves either excessive or poorly timed, or is compounded by an external shock, leading to a material slowdown in economic activity. Accelerated balance-sheet runoff and

regulatory adjustment could strain market liquidity or credit transmission, increasing the risk of a broader downturn. Alternatively, a strict commitment to restoring price stability may result in policy remaining restrictive even as growth deteriorates, particularly if productivity gains disappoint or lag expectations. Another variant is that Warsh's deregulation backfires quickly – e.g. a relaxation of bank rules leads to a bank taking on too much interest-rate risk or leverage, precipitating a crisis of confidence in the banking sector. Warsh may be willing to tolerate near-term pain to re-anchor discipline, but markets force a pivot once stress becomes systemic.

U.S. Equities. Risk-off. Equity multiples compress and earnings expectations roll over. Cyclical and small caps underperform materially due to credit sensitivity, refinancing risk and weaker demand. Financials can suffer despite deregulation intentions: liquidity accidents and rising defaults dominate. In our own equity framework, high starting valuations and a late-cycle macro setup magnify drawdown risk when growth disappoints. Overall, this scenario would be risk-off until Warsh eventually capitulates.

Rates. A classic recession pattern: curve initially re-inverts (front-end held high while the long end rallies on growth fears), followed by bull steepening once the Fed pivots and the front-end collapses. Long-duration Treasuries become the key hedge again, while credit spreads widen sharply and defaults rise. This is consistent with our repeated caution that credit offers poor asymmetry when spreads are tight and fundamentals deteriorate; in a hard landing, spread products underperform sovereign duration.

U.S. Dollar. The USD initially strengthens on global risk aversion and funding demand (classic crisis dynamics), then weakens as the Fed pivots aggressively and U.S. growth underperforms. However, if the U.S. is epicentre of a financial crisis (say a U.S. bank issue), USD could weaken versus other safe havens like the yen or Swiss franc. Additionally, if Warsh's overreach undermines confidence in U.S. assets generally, there could be some diversification away from the dollar after the immediate panic.

Precious metals. Two-phase response: near-term pressure from higher real yields and a stronger USD; later upside if the policy response reverts to balance-sheet expansion, real yields collapse, or the crisis triggers renewed reserve diversification as the Fed credibility is tarnished.

In summary, this scenario represents a hard-landing outcome. While low probability—requiring multiple adverse developments without timely policy adjustment—its potential impact on portfolios would be material. As such, it remains a relevant tail risk, particularly given the Fed's pursuit of an untested policy mix.

We assign a 10% probability to this scenario.

The most relevant indicators to monitor are:

- SOFR volatility, a practical proxy for funding stress and reserve scarcity (**Appendix V**)
- Bank CDS spreads widening, particularly among regional banks as the most balance-sheet and deposit-sensitive cohort, and
- A material tightening in bank lending standards (SLOOS), especially for C&I and CRE credit (**Appendix VI**)
- In market-based credit, the most direct signal would be high yield and investment grade spreads widening sharply (**Appendix VII**), ideally accompanied by deteriorating credit performance such as rising delinquencies.
- On the macro side, the earliest labour-market warning tends to be an uptrend in initial jobless claims (**Appendix VIII**), while cyclical demand softness would be reflected in ISM new orders / PMI deterioration. A sustained co-movement across these variables would increase the probability that the economy is transitioning from a managed tightening to a credit-driven downturn, in which duration resumes its traditional hedging role.

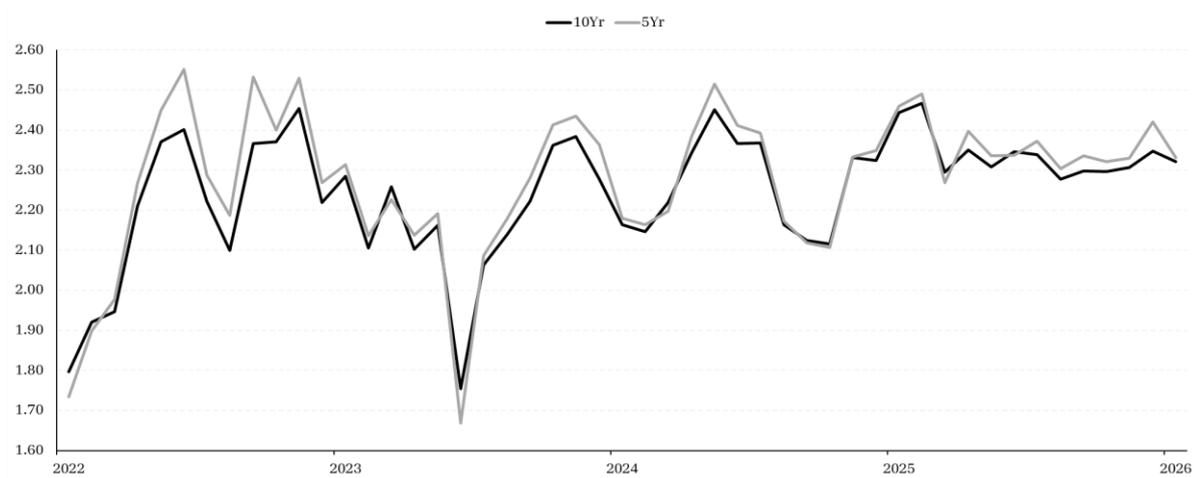
From QE to Discipline: Market Under a Warsh Fed

Appendix I - U.S. 5yr 5yr Forward Breakeven



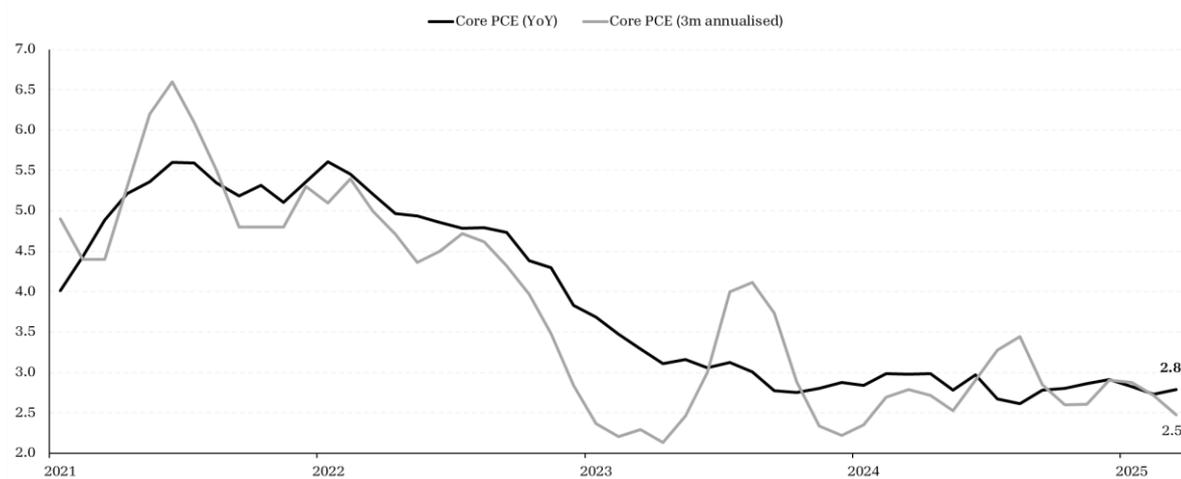
Source. MAM Research, Bloomberg

Appendix II – University of Michigan Inflation Expectation



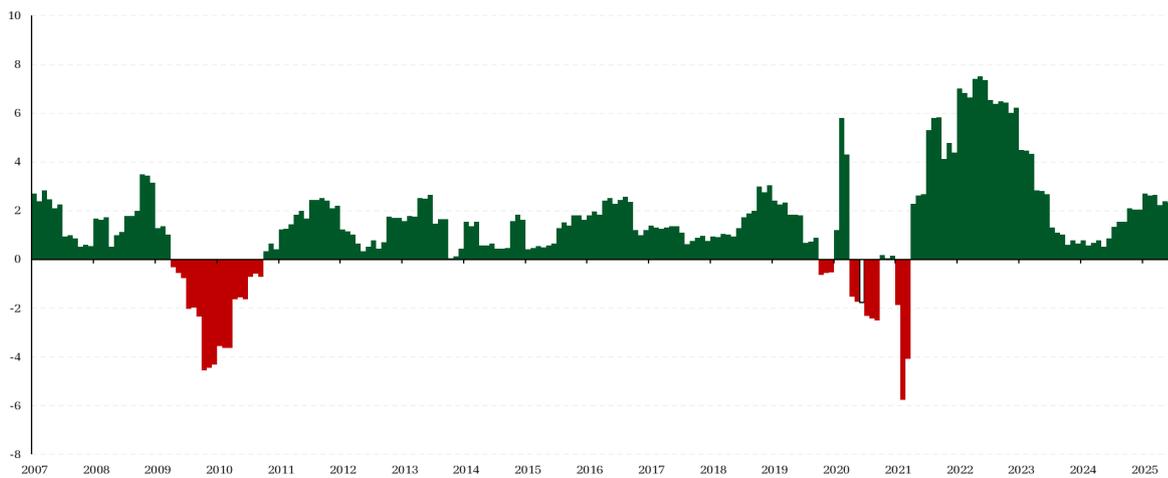
Source. MAM Research, Federal Reserve Bank of St. Louis's Federal Reserve Economic Data (FRED)

Appendix III – US Personal Consumption Expenditure Core Price Index (YoY & 3m annualised)



Source. MAM Research, Bloomberg

Appendix IV – US Avg Hourly Earnings Total Private YoY Minus US Nonfarm Productivity YoY



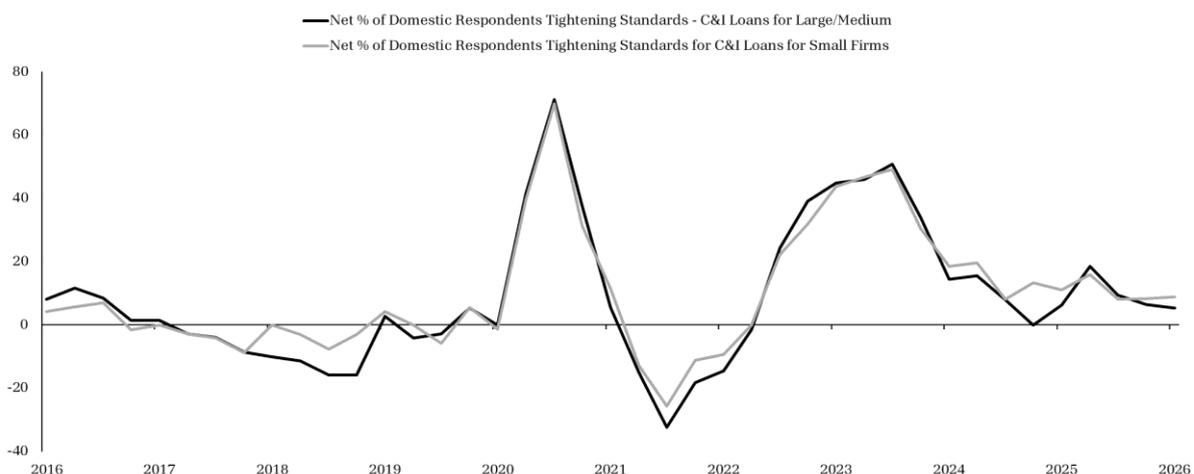
Source. MAM Research, Bloomberg

Appendix V – US SOFR Minus US Federal Reserve Interest on Reserve Balances (IORB)



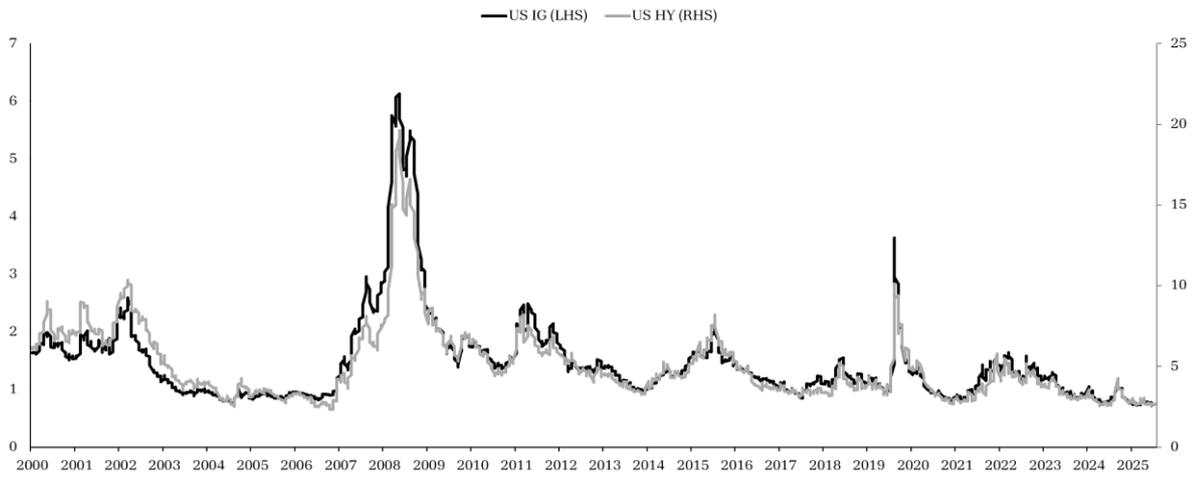
Source. MAM Research, Bloomberg

Appendix VI – US Net % of Domestic Respondents Tightening Standards - C&I Loans



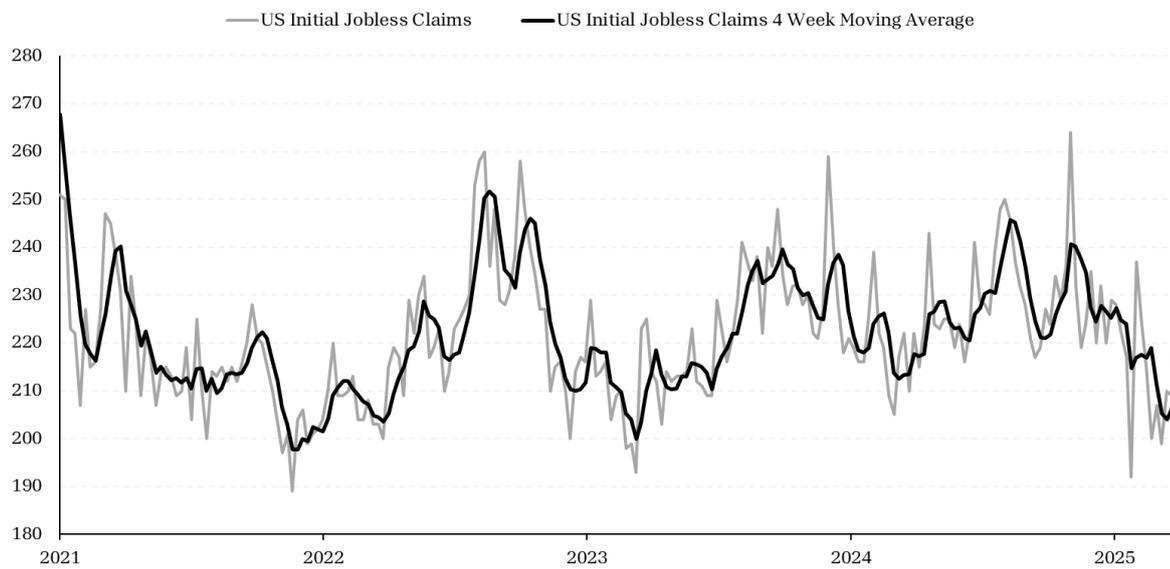
Source. MAM Research, Bloomberg

Appendix VII – US Credit Spreads



Source. MAM Research, Bloomberg

Appendix VIII – US Initial Jobless Claims



Source. MAM Research, Bloomberg