Drummond Capital Partners

Market Insights – August 2026

What's The Warsh That Can Happen?

Key Points:

- *Kevin Warsh has now chaired two FOMC meetings, both ending with rates on hold at 3.50-3.75%. He has also sharply reduced the Fed's forward guidance.*
- *Markets now have to interpret the Fed for themselves for the first time since the Financial Crisis, and have demanded higher risk premiums as a result.*
- *The result has been a steeper curve and a rising term premium, with the 30-year yield reaching its highest level in around two decades.*
- *We remain underweight government bonds. The Fed's communication shift is not the reason, but it adds to sticky inflation, high deficits and an elevated political risk premium as reasons not to lend to government.*

The Chair of the US Federal Reserve (Fed) is arguably the most important person to global financial markets. They set the tone for US and, to a large extent, global interest rates. Although decisions are made by committee, the Chair has a dominant role, not least through controlling the branch of the Federal Reserve system which produces staff forecasts for future inflation and other key macro variables. Although other Federal Reserve officials and senior members of staff give speeches and speak to the media, the Chair carries the voice of the room. So, what happens when that voice is confusing? It is clear from his first two FOMC meetings as Chair that Kevin Warsh doesn't view providing forward guidance to markets as favourably as his predecessors. Markets have been left with a task they haven't faced since the Financial Crisis, trying to interpret the Fed's view on the outlook for inflation and interest rates. In this month's Market Insight, we review how markets have initially digested this change, and what it means going forward.

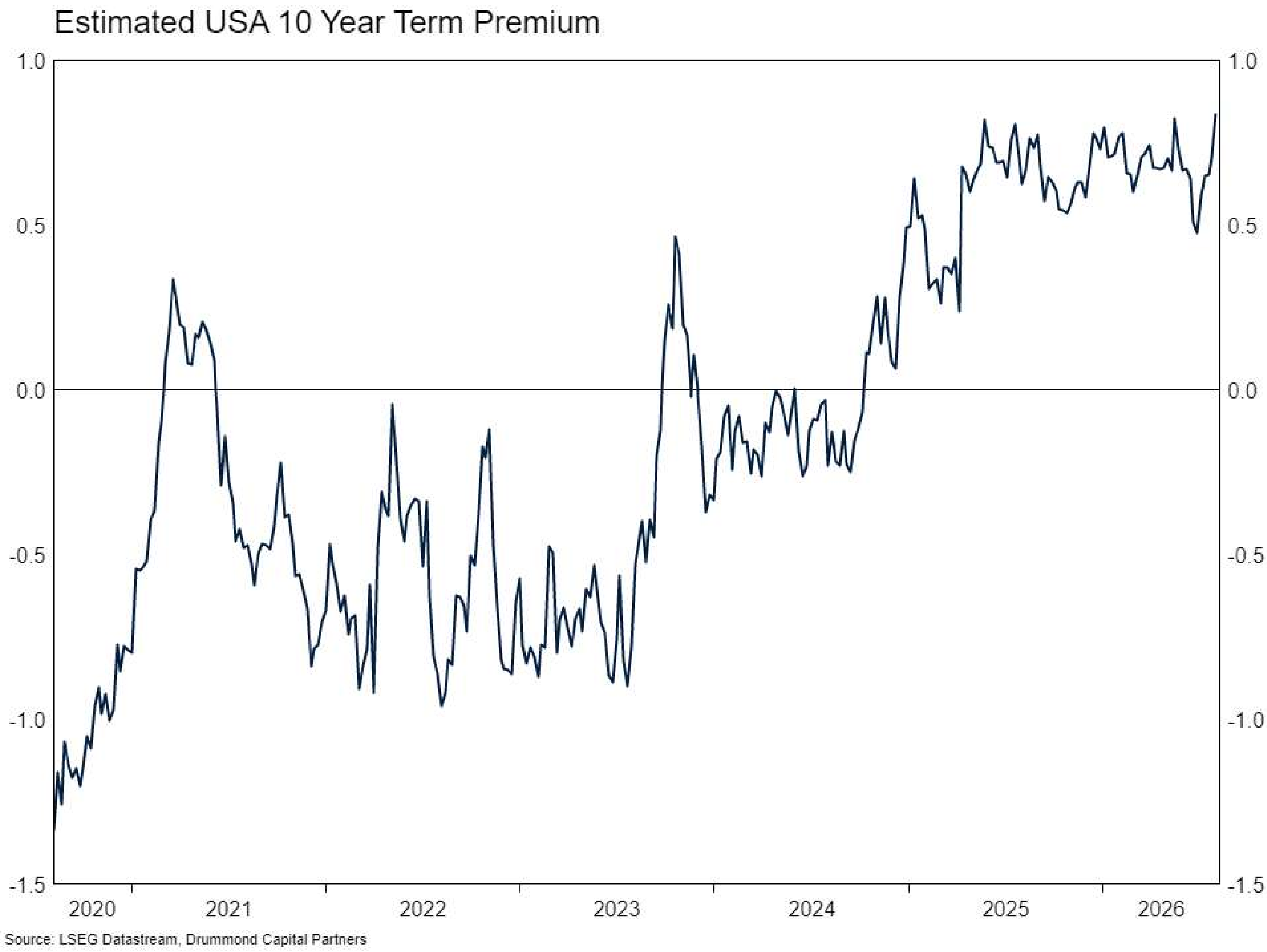
The Song Remains the Same

Kevin Warsh has now chaired two FOMC meetings, and both ended with rates on hold at 3.50-3.75%. In June, the committee was unanimous in holding rates steady. The median participant forecast implied around half a 25bp hike this year, with nine of the eighteen participants projecting higher rates (six of them by 50bp or more), but Warsh conspicuously declined to submit his own projection. This marked the beginning of a planned reduction in forward guidance – effectively the Fed communicating to markets what it thinks will happen in the next few years. At the July meeting, while rates were again left on hold, there was significant dissent in the committee, with three members calling for a rate hike. Warsh himself, notably, voted with the majority to hold, only six weeks after markets had read him as firmly hawkish (in favour of rate rises). Warsh's message throughout has been a flat commitment that the Fed "will deliver price stability", without any indication of how or when.

The contrast between the two meetings is the clearest evidence of what removing guidance costs. June was read as hawkish and rates rose across the curve, but in July a near-identical statement with inconsistent messaging, was read as dovish (in favour of rate decreases) and near term rates fell but breakeven inflation rose and long-term bond yields rose. Both meetings also produced equity selloffs despite no change in policy..

Additionally, five task forces have been set up by Warsh, with one including the Fed's inflation framework. In July, Warsh said that while PCE inflation is the Fed's stated target, he looks at a broad set of data to ascertain if that objective will be achieved. He also indicated that while PCE is the targeted inflation index now, the task force on that topic may recommend changing that, and that change could happen in next January's Statement on Longer-Run Goals and Strategy. The market interpreted this as a dovish signal.

This uncertainty comes alongside a general rise in the estimated US 10-year bond term premium (the excess return investors demand to hold long-term bonds versus short-term bonds due to inflation risk and general uncertainty).

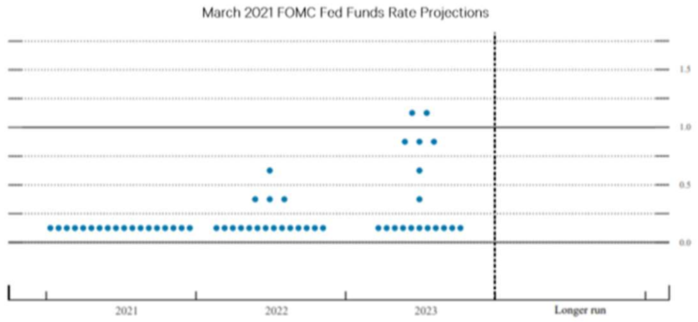


Communication Breakdown

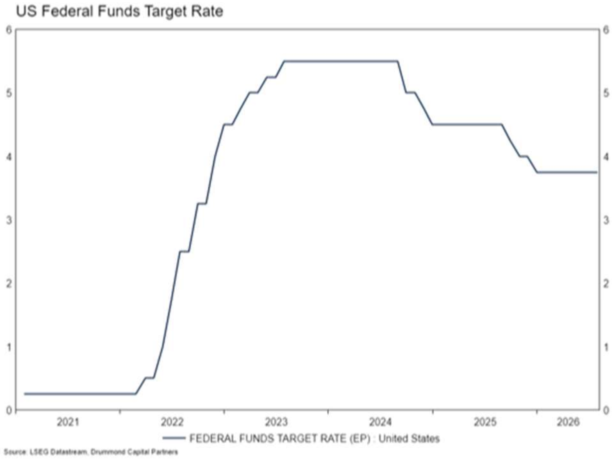
The removal of forward guidance represents the Fed almost travelling full circle with respect to its communication strategy over the past couple of decades. Around the time of the Financial Crisis, then Chair Bernanke was convinced that a high level of transparency improved the policy transmission mechanism. Although there were significant misfires during the Crisis (who will they save, who will they let fail), beyond that period a key policy mechanism was effectively telling markets that rates would stay at zero for many years, until the economy recovered from the damage caused by the Crisis. In 2011, the Fed started doing press conferences (allowing the media to ask questions) and in 2012 the Fed started publishing its "Dot Plot", a forecast of where policymakers thought rates would go over the next few years, alongside an estimate of the neutral interest rate.

Since then, things have moved the other way. Powell's later years were an explicit walk-back to data dependence with repeated warnings not to read the dots as a plan, and the 2025 framework review scrapped flexible average inflation targeting (overshooting following undershoots) for flexible inflation targeting while adding a pledge to act forcefully on expectations. Warsh has continued that trend by offering no guidance, terse statements, no chair dot, and a task force to rethink communication outright.

Perhaps this is the correct strategy. Forward guidance, stating rates will be around zero indefinitely, makes sense when a central bank is stuck at the zero lower bound and desperately trying to stimulate growth with few options. Now, with deflation no longer a problem, it makes sense to leave the Fed's options open and allow the market to do some of the work for them. Indeed, Warsh noted in the last meeting that the rise in real interest rates, likely due to the lack of communication, has effectively tightened policy a little, lowering the Fed's need to hike rates in response to still sticky inflation. Aside from that, in an uncertain world, long-term forecasts for inflation and interest rates are basically meaningless. The FOMC's late 2021 forecasts for interest rates were for rates to stay around zero through 2023, which was clearly incorrect (see below).



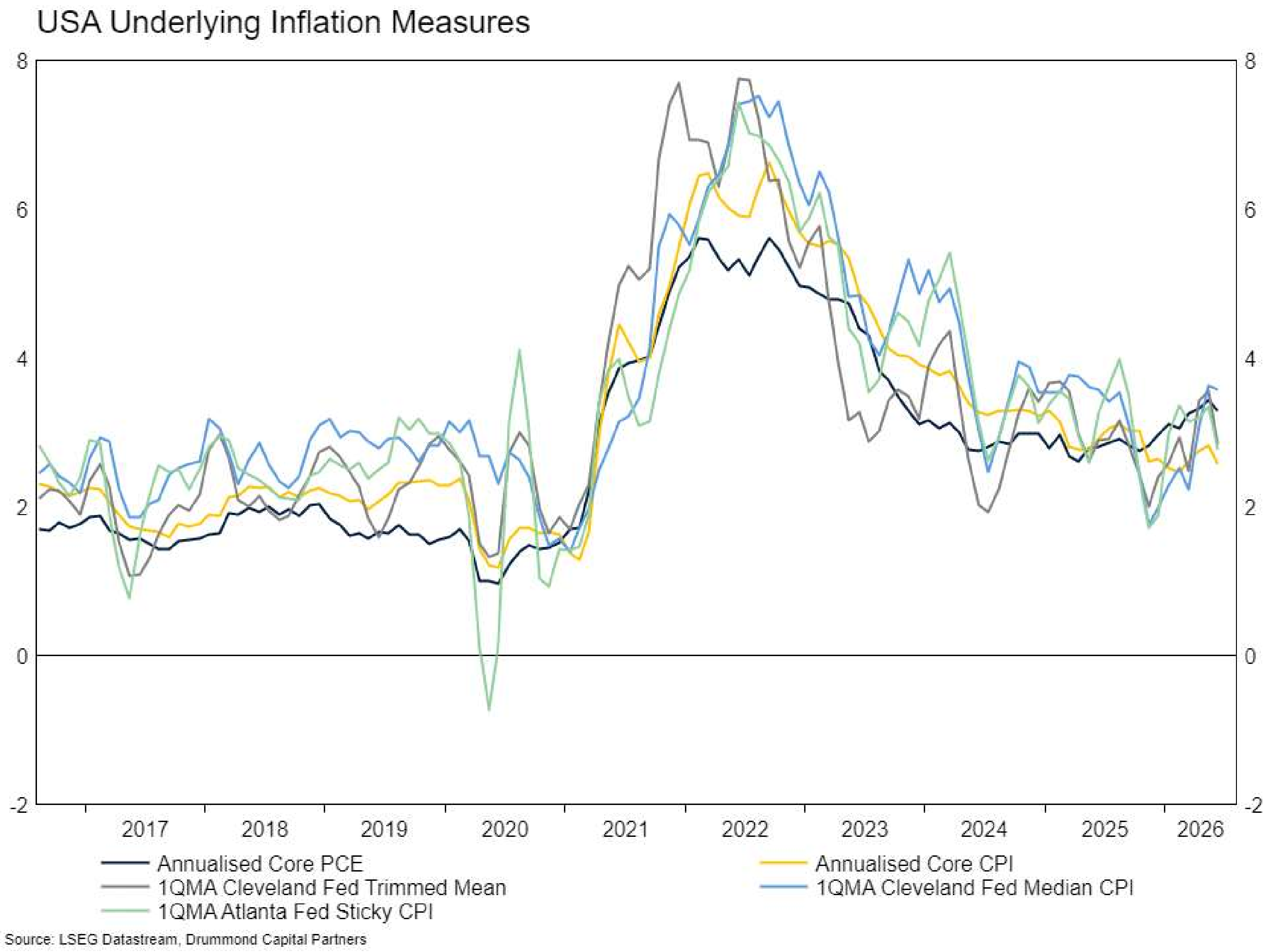
Source: FOMC



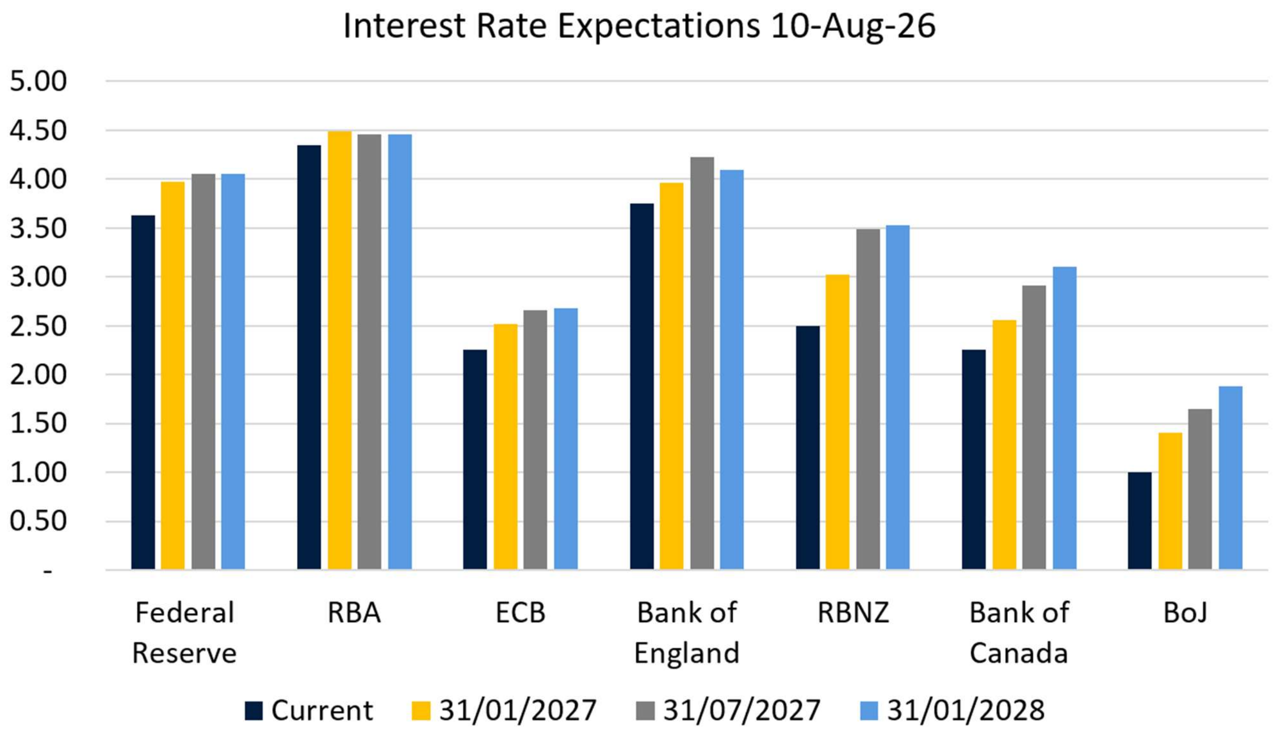
The gap between rhetoric and action is the other source of discomfort. Warsh talks tough on inflation: “there is no soft inflation target, there is no soft implicit target, not on this Committee’s watch. There is only a target, and it is 2 per cent,” while simultaneously voting to hold against three dissents and indicating that the target will be assessed against an undefined broader set of measures.

In Through the Out Door

So where does that leave markets and Market Insight drafters from here on out? Well, we now have a job to do, and can no longer rely on Fed guidance for the future of interest rates. It does look like core inflation in the US has accelerated a little in recent months, following a period of stabilisation a bit above target. That feels sticky by anyone’s definition. The dark blue line in the chart below is the Fed’s current preferred measure, and it’s plain to see why Warsh was seen as dovish when he referred to other measures – they are all currently lower. Core PCE has flipped from being reliably the lowest of the major inflation measures to the highest. Core PCE has a higher weighting to software and portfolio management fees. The latter are typically charged as a percentage of assets and so rise with market returns. Software is being pushed higher by the AI capex boom.



With economic growth in the US still solid, likely boosted by tariff refunds, it's not hard to see why futures markets are pricing 1-2 rate hikes again in the US (see below). If this occurs, it would see the US join a number of other central banks, including the RBA and ECB, in a hiking cycle. The new communication regime has led to a wider than normal dispersion of Fed forecasts by economists. Some expect multiple hikes in the next 12 months, some expect multiple cuts.



Our portfolios are currently underweight government bonds. This isn't because of the change in the Fed's communication strategy, though that doesn't hurt the case at the margin. Ultimately, inflation is still sticky across a number of economies and government deficits and levels of debt are uncomfortably high. Any notion of fiscal consolidation is seemingly off the table everywhere and therefore the political risk premium is elevated. There isn't a lot to suggest lending to governments is a good idea at the moment and we think the tendency will be for longer-dated interest rates to drift higher as investors demand to be compensated for this risk and as governments continue to drop significant bond supply on the market. There is a Fed-specific version of that political risk premium worth naming. Warsh was confirmed by the narrowest margin since Senate approval was first required in 1977, and was asked at his confirmation hearing whether he would be a "sock puppet" for the President, to which he answered "absolutely not". In early August it was reported that the President has periodically telephoned him to ask about his forecasts and opinions. Nothing improper has been alleged. But a central bank that has stopped explaining its reaction function, at a time when its independence is being tested, is one investors will reasonably demand more compensation to lend against.

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