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SCOTIA FLASH

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The Apprenticeship of Kevin Warsh

- **The policy target rate was unchanged at 3.75%**
- **Balance sheet policies stayed the course**
- **Implied guidance seeks answers that will take longer to arrive than markets are pricing**
- **US Ts steepened as markets doubted the FOMC's resolve to fight inflation**
- **History shows Warsh's deference to bond markets can be exceptionally unwise**

The FOMC met our expectations by keeping the fed funds policy rate unchanged at 3.75% and driving a relatively less hawkish market reaction. Guidance offered nothing to reaffirm market pricing for fairly aggressive tightening into year-end which was disappointing to the hiking bias that markets had baked in before the communications.

As such, US 2-year Treasury yield rallied by about 9 bps in the aftermath and closed 4–5bps lower. The 10s yield increased 6–7bps and the 30s yield jumped by about 10bps. In my view, the FOMC did the right thing, but the curve clearly signalled more concern about the FOMC failing to deliver on all of its verbiage about achieving price stability as pushing the short-end yields lower and longer-end higher.

Advice to receive July and September OIS pricing paid off. September OIS pricing was slashed from over 25bps to about 15bps of a 25bps hike priced at present. Cumulative pricing for the remaining three meetings this year was reduced to about +33bps.

I think the main takeaway from today's communications is that the FOMC is still some way from having answers to key questions that will take months to obtain which at a minimum makes nearer-term hike pricing premature if not entirely offside.

What follows summarizes statement changes and the press conference, and then offers my views.

STATEMENT CHANGES

Simply put, there were no meaningful **statement** changes except for the dissenters. Otherwise, every single other part of the statement was a carbon copy of the prior statement in June as shown in the appendix.

There were three dissenting hawks who preferred a hike that this meeting. They included Minneapolis President Kashkari, Dallas President Logan, and Cleveland President Hammack. Each of these regional presidents vote for three more times this year and then take a back seat as nonvoters starting in January.

PRESS CONFERENCE TRANSCRIPT

Chair Warsh began his press conference with a few statements before turning to Q&A.

He said "the economy is showing impressive resilience" which was slightly upgraded from the statement's "solid pace". He reinforced inflation concerns, saying there is no soft inflation target above 2%, it is 2% period. Warsh emphasized that 5 years of above target inflation cannot be cured in 9 weeks. He also emphasized that nominal and real yields are materially higher across the Treasury curve than they were into the June meeting while sounding at ease toward market gyrations, indicating a bias toward allowing markets to do their work while the Fed observes which lessens market dependence upon the Fed.

Warsh also pointed to strong growth of business investment and the surge of cap-ex but stated this doesn't necessarily make the Fed's job any easier as the precise timing and magnitude of the effects on the supply side remain hard to predict.

Warsh noted that the two-day FOMC meeting addressed four main questions:

1. What are the implications of the past five years of high inflation on the current policy conjuncture?

2. The economic shocks of recent years were considered including the pandemic, military conflict, energy shocks, AI surge and tariffs. Do they differ in their effects?

3. We took up the issue of changes in prices and whether they are generalized or narrow.

4. We focused upon monetary policy strategies to achieve price stability.

Expect deeper discussion of these four questions in the FOMC minutes three weeks hence including the likely continued use of language that infers the degree of plurality around the opinions. The rather open-ended nature of these questions and the uncertainty that surrounds them sounds to me like an FOMC that is buying time even if to the disappointment of the three impatient regional hawks who have three more meetings to make an impression upon actionable policy before fading away.

What follows is an attempt at providing a transcript of the Q&A.

Q1. What message are you getting from the markets as to where policy should be right now?

A1. The message from markets is the message from markets. We're aiming to get an unfiltered message from markets. Then judging for ourselves how are we doing on that remit? This is a good thing as I mentioned we have seen a material tightening in nominal and real rates.

Q2. If markets are talking to you, what do you hear them saying? If real rates are higher, that would suggest where the funds rate should go.

A2. Interpreting markets is difficult. First, the economy is solid. Cap-ex and productivity are strong. Labour markets are solid, steady. The bond market seems to be saying that as well. That's why we're seeing a tightening in nominal and real.

Q3. Could you characterize the arguments that were put forward by the dissenters and why you weren't persuaded?

A3. We had a family fight and that's the way to get the policy rate. There was nothing inertial about that discussion. It was an active discussion about what we can do in the period ahead. The path to central bank heaven means delivering on price stability. That doesn't happen this quickly.

Q4. How much do you think holding in July was due to June CPI?

A4. Not much. The historic problem with data dependence is the data and the dependence. We care about trends in the data.

Q5. Markets think you'll tighten eventually and a Taylor Rule says the policy rate should be higher. Why not tighten today?

A5. Yields have moved higher. We have tried to step back from that judgement. We don't take them dictation but we are observing them. It's a mischaracterization that markets haven't reacted just because we haven't raised. Monetary policy matters not just by what we say or do but by how it impacts the real economy.

Q6. Was it a close call on holding versus tightening?

A6. The vote was 9–3. There was a lot of agreement on the core questions. There was commonality on the questions but difference leanings on the answers. This is a period of watchful thinking no watchful waiting.

Q7. If inflation is not coming down is the best remedy to raise rates as the dominant remedy?

A7. It could be part of that solution but I wouldn't say it's the only one. There was a misimpression that central bankers set a 2% inflation target but they were comfortable being higher. We will deliver the 2% inflation target. One way, absent he tools you referenced, is to ensure expectations are centered around the right number.

Q8. How do you consider the fact that a large portion of the inflation shock is supply shock driven?

A8. A lot of our focus is upon understanding underlying drivers including shocks. We're trying to understand to what extent are these shocks broadening in their impact. Our goal is to have growth that is broadening and inflation is more limited.

Q9. What specifically would be your argument for a pause today?

A9. I wouldn't characterize what we did today as a pause. I would characterize it as a rigorous review of the big hard questions and our own homework.

Q10. How do you look at the speech coming up at Jackson Hole?

A10. I look at it as a blank sheet of paper. Historically it would be sort of a setting up speech of what was going to be happening in the Fall. I haven't made any judgements on that. I'd also like to frame the big questions. What's happened with productivity? Demographics? Shocks? I haven't decided is it a big picture speech of a set up of all the action we'll have between September and December. Also indicated he may or may not have early thoughts on progress by the task forces.

Q11. Question on the balance between the dual mandate goals.

A11. The two parts are equally important. I've been talking mostly on price stability but we've been doing pretty well on full employment but less well on price stability. Different tools work through different channels. We're trying to get supply and demand in broad order. We've got a reasonable sense of aggregate demand but we're inferring what is happening to aggregate supply and in the period ahead we're going to try to do just that.

Q12. Where was the main disagreement today? The inflation forecast? Risks? Tactics?

A12. The judgements as to how best to achieve price stability was the question we're trying to answer. The best move, the best strategy. When do we need to make those harder calls. I was comforted that markets were not reacting to us but were reacting to real time events. They are gauging themselves how restrictive the Treasury curve should be.

Q13. Is there a point at which you would not want to surprise the markets on a particularly decision?

A13. Surprise is not the objective function. We're getting views of a very accomplished economist: markets. We're getting their own judgement. Surprises are not the objective but we didn't come into this meeting feeling constrained by the options we faced.

Q14. How concerned are you that you are ceding control of the narrative (by not given guidance)?

A14. Not very.

Q15. What measure are you relying on for the 2% inflation target?

A15. Some version of the Lucas critique or Goodhart's law should remind us that if we remind markets what our objectives are then delivering on our objectives is more difficult. To achieve our goals we are looking at a broader set of data than PCE inflation to get at the underlying generalized change in prices. [ed. so, central tendency measures? Trimmed mean? Weighted median? Warsh said that in his Senate testimony but then poured cold water on such a view in his June presser].

Q16. You've said your goal is to bring down prices. The market says you're not there yet because they've raised rates. All you've spoken about here today is talking about it. What are you waiting for today?

A16. Today's press conference is not the only thing I've done today. The discussion was far more robust and our thinking about how to achieve that target is becoming much more advance and will become more advanced in coming months. If I look at markets, they are saying this Committee does own it, has the ability to deliver it, and that we will but it isn't something we can carry our in days or weeks.

Q17. What vetting did you do of the people you added to the Task Forces such as one member that lobbied heavily on AI?

A17. I selected 15 subject matter experts to tackle 5 of the most important questions. We're the decision makers. We will be the consumers of the outputs of 5 different committees. The judgements will be informed by these outside groups but not determined by them. We aimed for a divergence of views on the Committees.

Q18. You've said you have no tolerance for above target inflation but we are seeing this and said if underlying inflation is rising then you might need to tighten which is what we have been seeing except for this most recent print. What do you mean by no tolerance for above target inflation?

A18. I hear this impatience from many. Tighten already. The impatience that households and businesses have has been in place for 63 months. We want to disabuse people of the view we can do this in weeks or months. As we resolve those questions we'll deliver on the remit. You don't have to take my word on it, look broadly at market prices. They have tightened financial conditions in the intermeeting period.

Q19. If markets see 100% chance of a rate hike how does that feed into your decision making?

A19. We're not going to be constrained by market prices. Markets can be a very good source of information. If we take a useful source of market information and fog it up with our guidance then we'll be less able to land the plane successfully.

Q20. For the average household what was the news today?

A20. Between now and year-end we are committing to press conferences. I can offer as assurance that the Fed is on the case.

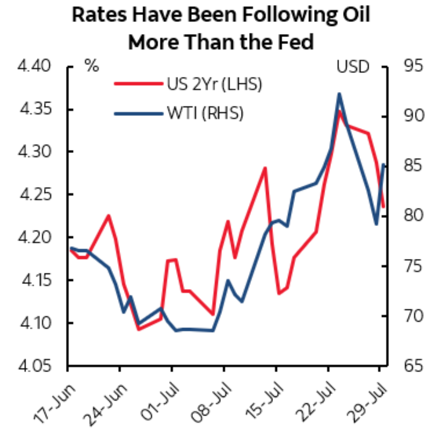
MY TAKE—LEARNING THE ROPES

I'm puzzled as to why Chair Warsh offered repeated messaging around a willingness to step back from markets and be guided but not straight jacketed by what they are telling the Fed. Two problems arise. One is that had the Fed taken largely to heart what markets thought in the past then it may have been inclined to tighten policy right out of the GFC when markets were of the belief that inflation was the biggest risk, or to slash the policy rate around the time of SVB's failure as just two examples of the folly behind Warsh's claim that the best economist is the market. We may never had escaped the GFC and would have added to inflation risk coming out of the regional banking crisis had the Fed done what markets signalled as the correct path.

Secondly, since markets reacted dovishly to today's communications, does this mean he would think that the FOMC should pivot more dovishly as well? He defers to markets to a high degree, so why not? What markets basically implied today is that they think Chair Warsh is a frustrated dove with hawkish aspirations.

Warsh took comfort in markets behaving somewhat hawkishly since the June FOMC by raising the odds of tightening in the nearer-term and seemed to believe this was because markets understood the Fed's message. Yet that could just as well have been markets reacting to oil's gyrations—and imo incorrect tightening as a response—as war between the US and Iran escalated once more (chart 1).

Chart 1



Sources: Scotiabank Economics, Bloomberg.

For another, Warsh appeared to be a fan of less communication during the courtship phase for his job, but is no less verbose than his predecessors thus far. He took 45 minutes in today's press conference to do nothing and to say little while pre-committing to the next three press conferences!

As previously argued, I think Warsh is focused upon fighting the last fight while downplaying the forecasting business. His constant references to the past five years of inflation remains confusing in that it almost implies a desire to target price levels in a p-level targeting sense which could be very damaging to the US economy. I think he's still focused upon the inflation rate, but it should be expressed in forward looking fashion, not lamenting the past five years. I could almost quip that it would be like my employer saying it's ok to never try to forecast anything again and to dwell on the past!

I've long advocated receiving July. September was too richly priced going in and remains so as is the rest of the year. I think markets have gone too far given data, given the range of Committee opinions and dots, given wobbly risk appetite, given guidance to be patient as the five taskforces do their work, given my views on the outlook, given fiscal policy is turning toward tightening, given lagging influences of monpol into highly uncertain AI influences with markets questioning high spending with little return, etc.

As for oil, the first-round inflationary effects are more likely to present second-round disinflationary effects as it's more like a relative price shock that crimps real wages and purchasing power this time than generalized inflation like the last burst which had more evidence of a demand surge and more pervasive supply-side shocks amid looser monetary policy. The US economy does not generate the same second round effects as, say, Europe, or Canada, with labour markets much less driven by collective bargaining in the US for example. I also don't think the terms of trade influences of high commodities on the US economy are anywhere nearly as beneficial as elsewhere.

Recent data has given them breathing room notwithstanding their excessive dependency on recent data. Payrolls at +57k with negative revisions and soft core CPI and PPI components that point to a soft core PCE reading tomorrow are among them. So is tracking of Q2 GDP growth as an indirect influence on the dual mandate. AI and fiscal have been the dominant drivers of US growth including spillover effects and both are looking like they're at a turning point.

Anyway, to me, the main takeaway is the ongoing signal that Warsh wants fundamental answers from the task forces and debates among FOMC members before deciding to do anything and that's not likely by now, September, probably not October, maybe not even December by the time we get into implementation mode at which point the direction of the next move remains uncertain, let along magnitudes.

RELEASE DATE: July 29, 2026

The Federal Open Market Committee approved the following statement for release by a ***9 – 3 vote:***

The Committee decided to maintain the target range for the federal funds rate at 3-1/2 to 3-3/4 percent, in support of the Federal Reserve's dual mandate. The Committee ***is continuing*** its policy of maintaining ample reserves in the banking system.

Economic activity is expanding at a solid pace despite elevated uncertainty that owes, in part, to the conflict in the Middle East. Productivity growth and capital investment are strong. Job gains have kept pace with the workforce, and the unemployment rate has changed little.

Inflation remains elevated relative to the Committee's 2 percent goal, in part reflecting supply shocks that have driven price increases in certain sectors, including energy. The Committee will deliver price stability.

Voting against the monetary policy action were Beth M. Hammack, Neel Kashkari, and Lorie K. Logan, who preferred to raise the target range for the federal funds rate by 1/4 percentage point at this meeting

RELEASE DATE: June 17, 2026

The Federal Open Market Committee approved the following statement for release by a ***12 – 0 vote:***

The Committee decided to maintain the target range for the federal funds rate at 3-1/2 to 3-3/4 percent, in support of the Federal Reserve's dual mandate. The Committee ***reaffirmed*** its policy of maintaining ample reserves in the banking system.

Economic activity is expanding at a solid pace despite elevated uncertainty that owes, in part, to the conflict in the Middle East. Productivity growth and capital investment are strong. Job gains have kept pace with the workforce, and the unemployment rate has changed little.

Inflation remains elevated relative to the Committee's 2 percent goal, in part reflecting supply shocks that have driven price increases in certain sectors, including energy. The Committee will deliver price stability.