Weekly Relative Value

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Warsh Wobbles

"This is one consequence of ending forward guidance, but Warsh should be careful that the tail does not wag the dog — and that the market does not push the Fed into a policy error." — George Catrambone, Head of Fixed Income, DWS Americas

As expected, the Fed held rates steady at 3.5%-3.75% last week, but the vote was 9-3. Three members voted to raise rates instead, the most dissents in favor of a hike since September 2016.

No pressure, then.

But never mind that the Fed left rates unchanged at last week's Federal Open Market Committee (FOMC) meeting. The real story was that, for the first time since the Fed began issuing press releases in 1994, not one word changed. Apparently, copy-and-paste is now a policy framework. Logan, Hammack and Kashkari all dissented in favor of a rate hike. Big deal. It was the same gang of three hawks who dissented at Powell's last meeting on April 29. Beyond generating a few headlines, they have roughly the same influence as a weather forecast from last week.

In any event, the Warsh press conference ranks among the worst I have seen, and that is not a low bar. The Fed chairman offered the usual buffet of cliches, but true to form for this central bank, supplied no explanations, no analysis and no discernible framework. In a word, inept. Warsh said Inflation will get to 2.0%. Thank you for stating the obvious.

THIS WEEK

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Meanwhile, he never mentioned that core inflation excluding shelter — and nobody actually writes a check for Consumer Price Index (CPI) rent or Owners' Equivalent Rent — is already very nearly at 2.0%. His only real comment on the economy was a 20%+ growth figure tied to the artificial intelligence (AI) spending boom, as if the other 93% of gross domestic product (GDP) matters not. Indeed, some solid economy: The Q2 real GDP is now 1.5%, down from the 4% expected just two months ago. (See more below.)

"If you look broadly at market prices, they are certainly not saying all clear, but they are working in concert to keep us on our toes. And they have tightened financial conditions in this intra-meeting period. And that has given us — that has provided us some comfort that we've got the ability and capability to deliver."

I must admit that I could not make any sense out of that comment. If the market was keeping the Fed on its toes, then it should have tightened because that is what the front end of the curve was telling the central bank to do the other day.

"What I can offer as assurance is that the Fed's on the case. That this Fed chairman feels better about this board and this committee's ability to deliver than I did when I showed up here on the first day."

Why on earth would he say that? He didn't have as much confidence in his colleagues six weeks earlier.

"As I mentioned in the prepared remarks, we've seen a material tightening not just in nominal rates but in real rates too, and we're observing it. We're trying to stay out of that because, you know, many of you might be interested in our reaction function. We're interested in the reaction of financial markets."

If he is interested in the reaction of the markets, again, why didn't he vote for a hike?

"I was comforted that markets in the intermeeting period weren't reacting to us. They weren't reacting to dots or to speeches."

But the markets were reacting to the Fed. Maybe not him, but they were responding to the hawkish commentary from the folks who dissented. On June 17, the date of the prior meeting when the Fed changed its dot plots to show a hike, the 10-year Treasury yield jumped by +6 basis points to 4.49%, and the 2-year had a heart attack, soaring by +15 basis points to 4.20%. That comment above is simply not true.

The Fed doesn't even have a price anchor to base a policy decision on — so why make a move at all? And knowing that there is no datapoint that the brass at the Fed trusts (if it did, why create these task forces), why did the three dissenters want to hike? The Fed has already said it was rudderless. Warsh openly admitted that he can't separate out the noise from the signal. So you are tightening, or threatening to tighten (as per the latest median dot plot), for what reason exactly?

"So we'll be watching inflation data over the period ahead. But I also don't want you to leave with the misimpression that we're sort of breathlessly waiting that. <u>I've called for a task force to revisit both the private and public data we use to make our decision-making</u>. That task force is out doing their work. I'll be checking back in with them the next couple of weeks. But I wouldn't say we overly relied on any one piece of data, including that data which surprised some a couple of weeks ago."

The only thing worse than Warsh's answers were the questions he was asked by the media. Almost all the questions from the press were geared towards the Fed falling further away from its +2.0% target, and the long end of the curve seems to share the same concerns (maybe also due to the sudden re-escalation of Middle East hostilities and the bounce-back in the oil price).

There were so many questions about the three dissenters who have been expressing their hawkish view for months but nothing about why the other nine FOMC voters went the other way. Talk about playing little-league ball.

Warsh, who took over in May, has made a point of not signaling where the Fed is heading, wary of leaving himself boxed in if economic conditions change. And on Wednesday, he indicated the recent jump in long-term bond market rates may be doing some of the central bank's work for it by pushing up borrowing costs and, in turn, tapping the brakes on the economy.

But even as the bond market on Thursday steadied from the selloff he unleashed, Wall Street notes showed that Warsh's explanations have left plenty of doubts about the Fed's priorities and where monetary policy is headed. Given Warsh's history and his public commitment to lowering annual CPI to 2%, the issue is not just that his actions don't match his words, but why he is so afraid to act. Investors should be very concerned about what Warsh is so worried about that he can't even discuss it!

The only real takeaway is that this Fed has no interest in spoon-feeding the market. Forward guidance, at least the kind meant to move asset prices, appears to be dead. What is priced into futures before a meeting will not be treated as some sacred instruction manual for meeting-day policy. If anything, the Fed now seems more inclined to treat market prices as an input — not an order. Warsh, for his part, sounded perfectly comfortable with the tightening in financial conditions over the past six weeks.

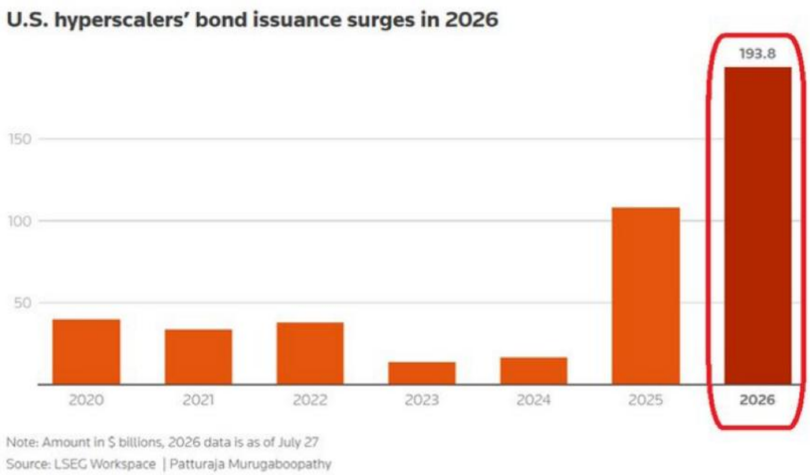
"Rates are higher today than they were 42 days ago. Markets have made decisions because we stepped back in part from trying to influence those. Market judgements have moved up. We are observing them. ***So I think it's a mischaracterization to say the markets haven't reacted because we didn't move today.*** *We will continue to monitor the markets and see how they react and that can help our decision making when we meet in 7 or 8 weeks. … This is a period of watchful thinking, not watchful waiting". — Fed Chair Kevin Warsh*

That probably helps explain why the long bond and equities took it on the chin. Uncertainty is not exactly a love language for long-duration assets. Equities tumbled and the long end of the Treasury curve sold off hard with the 10-year Treasury yield rising to 4.7%.

The long bond soared to 5.24% — a nearly 20-year high.

These two numbers set the price of borrowing for the entire U.S. economy. Your mortgage, your car loan, your credit card and every corporate bond issued this year all get more expensive when these yields rise.

Four things are pushing yields higher at the same time. The Fed's credibility, the Iran war and elevated oil prices, the U.S. government running deficits that force the Treasury to sell more bonds and hyperscalers borrowing at an unprecedented pace to fund the AI buildout. Amazon, Alphabet, Meta and Oracle have issued ~$194 BILLION of bonds so far in 2026 through July 27, surpassing the ~$108 billion issued in all of 2025. That 2025 total was itself up +535%, or ~$91 billion, from just ~$17 billion issued in 2024.



Bottom line: Anyone with a mortgage, car payment or a credit card balance is paying more to borrow. Businesses pay more too. The four big tech companies committed $720 to $745 billion in capital expenditures (capex) this week, much of it bond-funded, and the cost of that debt just rose. But this goes well beyond tech. Every company, municipality and homebuyer who needs to borrow does it at rates the market hasn't seen in almost two decades.

CREDIBILITY ON THE LINE

“Are you going to be the president's human sock puppet?" — Senator John Kennedy
"Absolutely not." — Kevin Warsh

There was no specific moment during the press conference where long rates jumped higher. There were several instances when Warsh said something hawkish where rates began to go down. Rates went up more after the press conference was over than during the press conference.

This pattern reveals something important about what's driving the market reaction to Fedspeak, including the steepening of the yield curve.

One interpretation of what happened is that markets understand the Fed’s commitment to 2% inflation, but with no forward guidance, the market does not understand how the Fed will get to 2% inflation.

Is the way to 2% inflation through higher rates, a smaller balance sheet or tighter financial conditions?
The answer to this has significant implications for the yield curve and how and when we will achieve 2% inflation. The lack of clarity about how to get there is what's pushing yields higher because there is now a risk that it may take longer or involve a policy mistake.

Imagine saying: “I will take you from Maine to Sarasota, but I'm not telling you how quickly, what it will cost or how you'll get there."

By not explaining these important elements, you may question if we are actually getting to Sarasota.

The risk with abandoning forward guidance is a steeper yield curve with investors asking more questions about the journey ahead, which is what we have seen since the statement came out.

As a reminder, in last week's *WRV*, "Reality Check," I had discussed that Fed Chairs often face an early crisis.

"Finally, with a new Fed chair at the helm, history is worth remembering: New chairs almost never get a quiet opening act. Markets tend to test them early, and the pattern goes back to Eccles in the 1930s."

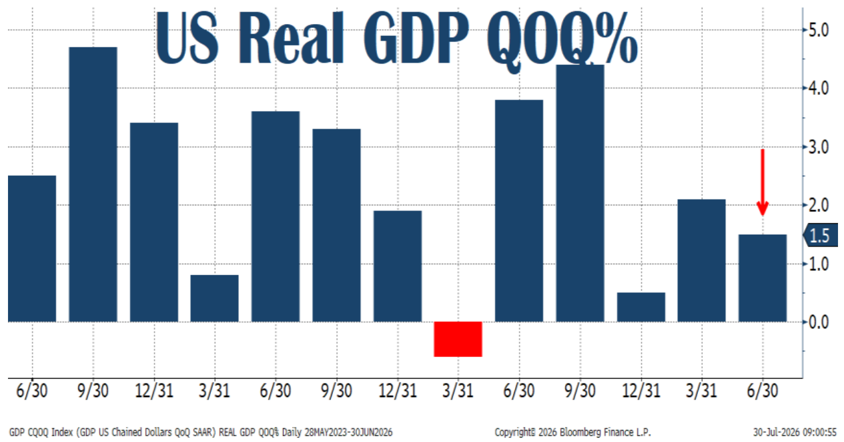
"Maybe new Fed leaders feel compelled to flash their anti-inflation credentials. Maybe markets simply test the rookie. Either way, the first move has usually been a hike — even Janet Yellen started that way in 2015 before quickly abandoning the tightening script."

"Greenspan had just tried to show he was the new Volcker by hiking early. Markets offered a rather blunt review".

Bottom line: An important part of the Fed's credibility is not just to say that it has certain goals but also to explain how it will achieve those goals.

GOOD NEWS FOR BOND BULLS

The bond market could not have asked for a cleaner setup, at least in theory. In practice. Real GDP growth missed the mark, rising at a +1.5% annualized rate in Q2 versus expectations for +2.0%.



And that came with a better tone to the consumer, where personal consumption accelerated to a +3.2% annualized rate in real terms from +0.5% in Q1 (consensus was +2.3%), but keep in mind that this past quarter contained the One Big Beautiful Bill tax goodies, the World Cup and the earlier timing of Amazon Prime Day. One can reasonably expect a big deceleration for this quarter and likely Q4 as well, with the sharp but brief sources of support fading away.

Frankly, if not for the fact that households, some of which feel a lot wealthier, have been willing to spend at a pace far above their income, we would have practically seen no growth in real consumer spending over the past year. That is not income-led consumption. That is raiding the cookie jar. Question is — can a four-year-low personal savings rate at a mere 2.7%, far below the long-run norm of 8% (back to 1970), be sustained?

Without households spending well above cash flow, real consumer spending over the past year would have been nearly flat. For all the AI hype, the wealth effect has been the bigger stimulus.

Business tech spending remained the shiny object, rising at a +9.3% annual rate — the third straight double-digit or near-double-digit gain. AI capex is still doing real work. The question is how much of the rest of the economy is just watching it lift the furniture.

Bottom line: Real GDP, the entire pie, came in at a +1.5% annual rate, which is very weak and undercut the consensus forecast of +2.0%. The average of the past decade is closer to +2.5%, so this is well below trend. And the fact that this was the best we could do in a quarter that had so many tailwinds is not a good harbinger for what lies ahead, unless President Trump is able to double down on tax cuts or FIFA wants to hold another World Cup event quickly.

As for the business sector, the sharp rise in certificates of deposit and credit spreads speaks to a bond investor universe that is seeing wider risks, and the attendant impact on financial conditions could well make 2026, and not 2027, the peak for the AI capex boom.

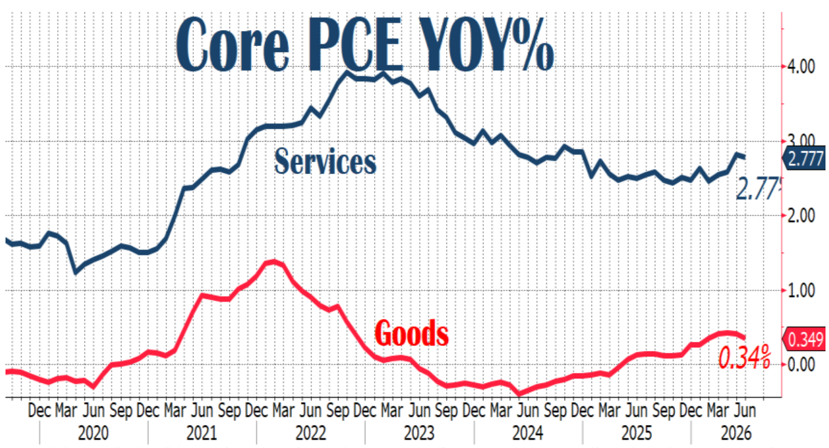
There is also a somber message that has surfaced of late in that investors are punishing the stocks of the mega-cap AI companies that have been boosting their capex guidance. Another reason why I highly doubt the economy (and inflation) will give the Fed the proverbial "green light" to start tightening policy. The front end of the Treasury curve is starting to sniff this out.

BETTER THAN EXPECTED

The headline Personal Consumption Expenditures (PCE) saw 0.1% month-over-month drop in June, its first "deflationary" print since April 2020 (the pandemic). And after three months of significant acceleration in prices, the Fed's favorite inflation indicator — core PCE (a measure of price changes in consumer goods and services that excludes volatile food and energy costs price changes in consumer goods and was expected to slow in June data released) — did more than expected. Core PCE rose 0.1% month over month (below the 0.2% month over month expected) pulling the year-over-year rise down from +3.4% to +3.3%.

The key number for bonds was the light June core PCE print. The old "Powell Supercore" — services excluding energy and shelter — rose just +0.1% for the second time in three months. That matters because it signals whether labor slack is building. Despite the tidy U-3 unemployment rate, the answer increasingly looks like yes.

Digging through the details, the Fed should take some comfort in how broad the disinflation was across both goods and services.



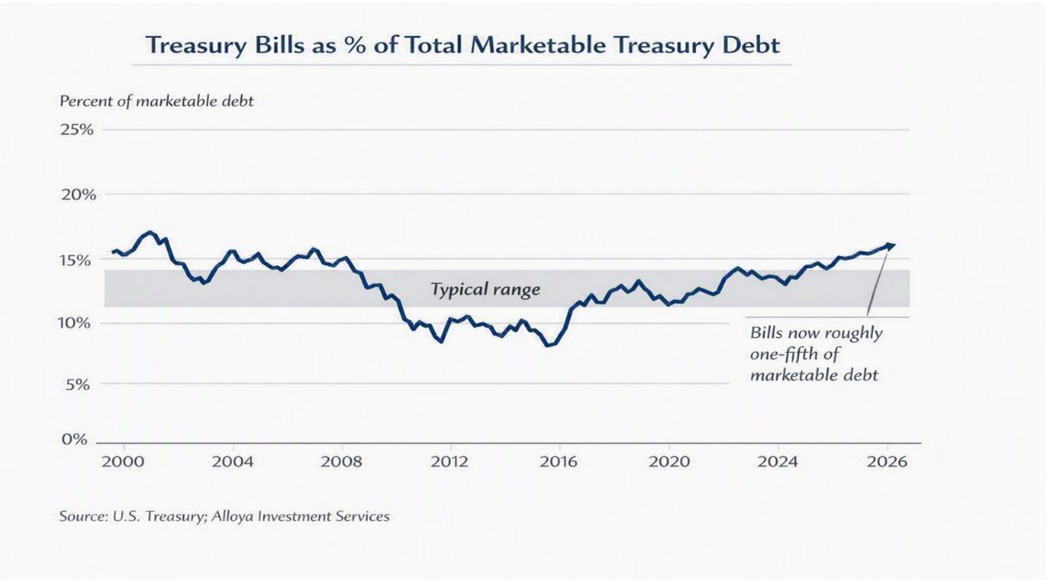
THE FED MUST RAISE RATES?

"Fed Chairman Kevin Warsh didn't sound as hawkish as I'd expected….the Fed has to raise rates at some point in the not-too-distant future." — Roger Ferguson, Former Vice Chair of the Federal Reserve

Former Fed Vice-Chairman Roger Ferguson was on CNBC last week and made it pretty clear that he believes the Fed must raise rates. Jeff Gundlach pretty well said the same thing after the FOMC meeting on Wednesday, and, in fact, virtually everyone coming on these TV shows is saying the exact same thing. And while the front end of the curve has rallied of late, nearly two rate hikes are still priced in.

And we know that when the Fed shifts its stance, in either direction, it is never a case of one-and-done. The first move typically begins a new cycle. This may be why the long end of the curve has been behaving so poorly — because Fed rate maneuvers and the fiscal deficit have never before been so tightly linked. And that is because the Treasury has consistently been funding the huge budget gap in the bill market.

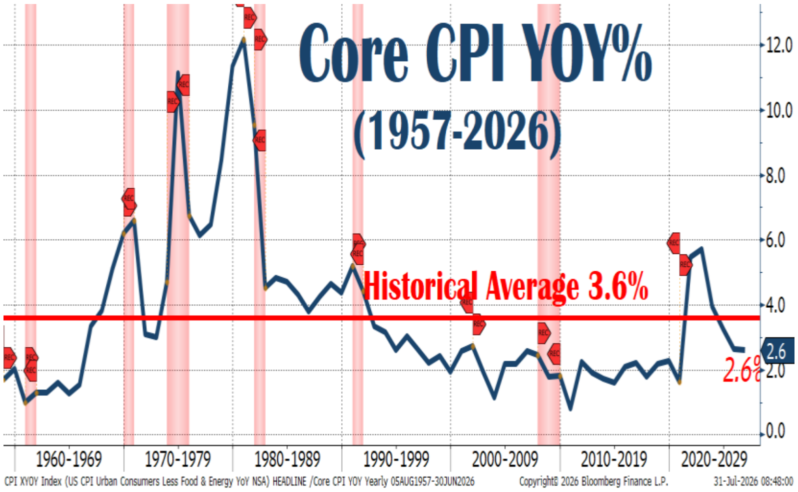
Here's the thing. T-bills now account for over 20% of marketable debt. Four-week bills have averaged $101 billion per auction so far in 2026 — more than double what we saw a decade ago, making this maturity the single largest security that Treasury offers — larger than any note or bond auction. This extreme reliance on short-term funding leaves the government's fiscal position in an even more precarious position if the Fed embarks on a cycle of rate increases — and the long end may well be concerned that this will mean more supply out the curve and a time when the AI debt binge has yet to hit the wall.



Bottom line: Running roughly a fifth of a very large debt pile at the front end means the fiscal cost is indexed to the funds rate. Every hike reprices several trillion dollars of bills within months. If September delivers a +25 basis point hike that flows into interest outlays almost immediately rather than over a decade. It also makes the Treasury secretary's and the Fed chair's incentives diverge in a way that is sure to become politically visible very fast (as was the case with Jay Powell).

IS INFLATION REALLY TOO HIGH?

I keep hearing about how U.S. inflation is far too high. Yet, at a 3.5% headline inflation rate, it is spot on the post-WWII average. As for the core rate of inflation, at 2.6%, going back the past seven decades, it actually is over a full percentage point below the historical norm. Is this really a problem? The bond market and consensus of economists seem to believe so.



When Paul Volcker, the legendary inflation dragon slayer, left the Fed in August 1987, the inflation rate was 4.3%. The core was 4.2%. When he resigned, he was widely viewed as having been an enormous success. His legacy lives on to this very day. Inflation, headline and core, are measurably below the levels at the time Paul Volcker stepped down, and yet in his second meeting, the markets and the media have totally taken Kevin Warsh to the woodshed (not to excuse his inept responses at the podium on Wednesday — you can't say that you love the bond market selloff and view that as a replacement for adjusting policy, which was totally weird).

Bottom line: I ask once again… is the graph above really a big problem?

MARKET OUTLOOK AND PORTFOLIO STRATEGY

"The U.S. economy has demonstrated notable resiliency this year, with stronger business investment and hiring. This strength is being supported by several tailwinds, including AI-driven capital investment, fiscal stimulus and the benefits of more efficient regulation. However, several risks are shifting below the surface like tectonic plates, including geopolitical tensions and wars, sticky inflation, large global fiscal deficits and elevated asset prices. We cannot predict how these forces will ultimately play out. They may remain manageable, but they could also cause meaningful disruptions when they shift or collide." — Jamie Dimon, Chairman and CEO, JPMorgan Chase, July 14, 2026

Real GDP limped in at just 1.5% annualized in Q2 after 2.1% in Q1. That is not exactly an economy pounding the table for another rate hike.

Core CPI excluding shelter is already sitting right around 2.0%, and housing inflation is finally rolling over. Yes, the Fed has things to worry about — energy prices and the Trump tariff file could still find their way into core inflation. But that argues for staying moderately restrictive, not grabbing the policy hammer and looking for another nail. This is not 2021 or 2022. The real policy rate is roughly +100 basis points, not negative 4.5%.

Looking forward, the main event this week is Friday's July payrolls report, which should show modest hiring and contained wage growth — not exactly an overheating labor market.

Consensus expects payrolls to rise 85,000, up from 57,000 in June, though that would merely match the first-half average. Even that may be generous, as weekly ADP data have softened since mid-June, pointing to downside risk.

Wage growth is expected to hold at 3.5% year over year, while unemployment stays at 4.2%. Participation may tick up to 61.6%, but it remains well below last year's level, helping explain why unemployment has not risen more clearly.

Other labor data should reinforce the same message: Companies are hesitant to hire but not yet eager to fire, and workers are staying put. Job Openings and Labor Turnover Survey openings are expected to fall to 7.25 million, with the hiring and quits rates more important than the headline openings number.

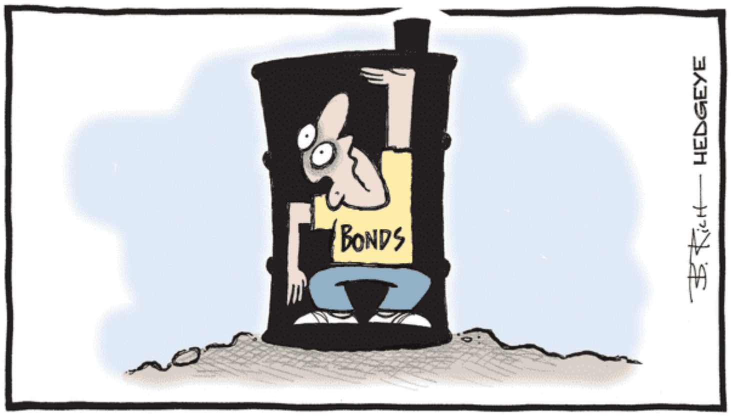
The Institute for Supply Management surveys should show activity still firm and price pressures slowly cooling. Manufacturing is expected to rise to 54.0, while services edges up to 54.3, with both prices-paid indexes easing but still elevated.

Moving on. There are three FOMC meetings left this year: September 16, October 28, and December 9. The market is fully priced for a September rate hike and about 80% priced for two hikes by year-end. At the start of July, before the U.S.-Iran ceasefire fell apart, the odds of two hikes were closer to 72%. In other words, the market has taken a fragile growth backdrop, sprinkled in some geopolitical anxiety, and somehow decided the correct answer is tighter money.

We are now approaching near-unanimity that inflation is about to run wild and yields are headed straight through the ceiling. Funny how that works. The last bond bull has apparently been escorted from the building. I have always preferred selling what everyone loves and buying what everyone hates. Right now, bonds are wearing the dunce cap.

A little bond math, since apparently, we still need it: Remember 2022, when long Treasuries got taken behind the woodshed? Those bonds had microscopic coupons, which meant massive duration and maximum pain when rates rose. A 5% coupon long bond is a different animal. The duration is shorter, the convexity profile is better, and the risk is nowhere near what it was four years ago. Details matter. Occasionally, so does math.

A word on bonds and war: Bonds do not like war because war smells like inflation. Fair enough. But if the war starts denting confidence, slowing activity or tightening financial conditions, bonds will rally — not sell off. We may be getting uncomfortably close to that point.



Bottom line: For all the geopolitical and economic fog, bonds still offer an attractive risk/reward tradeoff at these levels. Inflation looks less durable than advertised, the economy looks weaker than markets want to admit, and the Fed risks tightening into a slowdown driven more by supply shocks, oil headlines and speculative excess than by genuine demand-led inflation. That is not usually the backdrop where one wants to be short duration.

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For more information about credit union investment strategy, portfolio allocation and security selection, please contact the author at **tom.slefinger@alloyacorp.org** or (630) 276-2753.

As Alloya's Market Strategist, **Tom Slefinger** leverages nearly 40 years of investment strategy expertise to deliver insightful commentary on the economy and market events to optimize balance sheet performance at the credit union level. With thousands of subscribers, Tom's daily and weekly publications are widely read amongst credit union executives.

Prior to becoming the corporate's Market Strategist, Tom served as the Senior Vice President of Institutional Fixed Income Sales at Alloya Investment Services, a division of Alloya Solutions, LLC. In this role, Tom developed and managed operations associated with institutional fixed income sales in addition to developing investment portfolio strategies, identifying appropriate sectors and securities, and optimizing portfolio performance at the credit union level.

Tom holds a B.S. in business administration from the University of Maine. In addition, he holds a Series 7 and 63 through ISI.