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Registered Investment Advisor

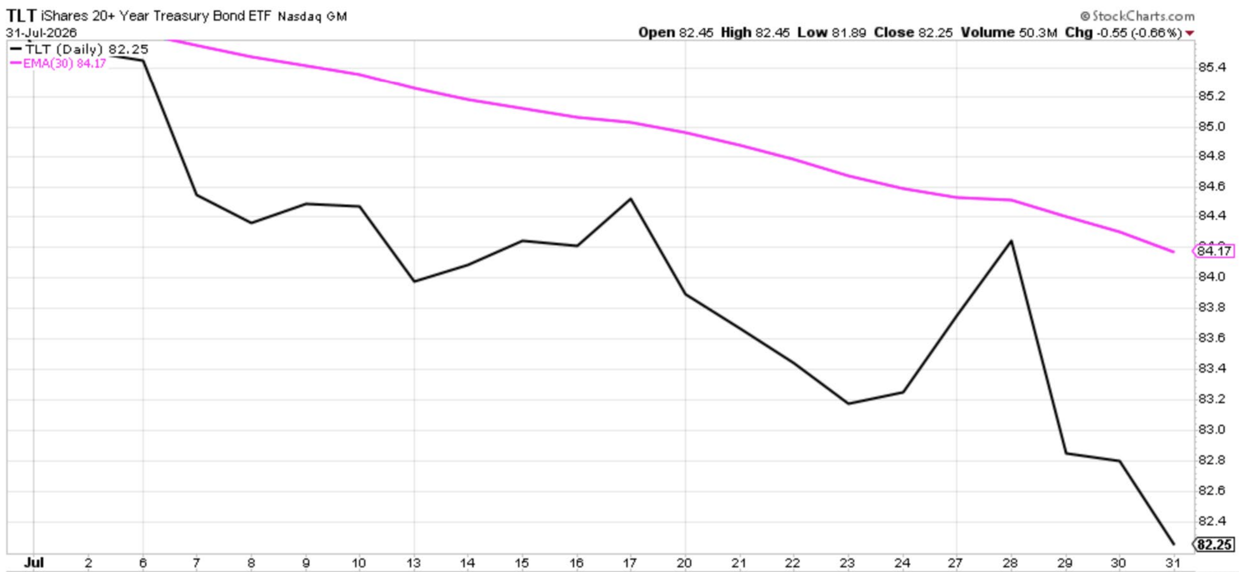
FCM Weekly Market Notes

The Fed as a Volatility Multiplier

Most of the time, you need not really care what the Fed is doing as an average investor. But at rate cycle inflections—where the interest rate cycle turns up, down, or flat from recent trends—uncertainty rises and the Fed can provide a roadmap to limit market volatility. This enhances investor confidence and ultimately the probability of a smooth path of investment returns.

Then there are the "tails"—events like the Great Financial Crisis or Covid—where the Fed MUST lead. A Fed that raises the odds that it will not quickly communicate that it recognizes such an event in real time or respond appropriately raises the risks of investing in general. That is the Fed framework that follows from less communication, and the new Fed chair is all in on this approach.

What we saw this week is the bond market pricing this in. Just another reason we believe bonds are a very poor investment choice in this era.

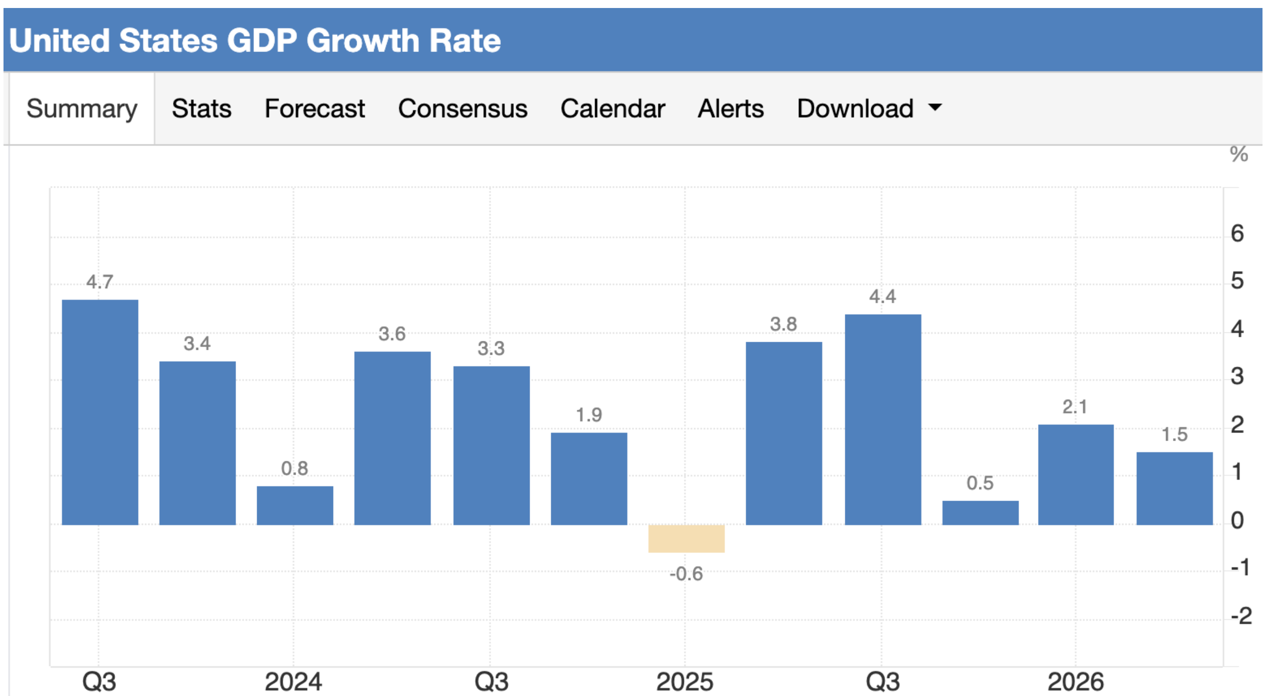


New Fed chair Warsh said at this week's meeting that there was a new sheriff in town for inflation fighting, the target was really 2%--never mind the 63 straight months above 2%--and that target would be achieved. Except the Fed did nothing. And Warsh continues to muse about altering how we measure inflation, which completely derails the "tough on inflation" theme if you are potentially moving the goalposts.

On Friday, a trial balloon was released that suggested Warsh was considering having Fed meetings less often than the decades long practice of eight times a year—doubling down on the view that less is more in Fed communication. All of this combines to make investing in fixed income more fraught.

The ascension of the uber-confident Warsh comes as a host of structural inflation issues continue to stir in the background for both investors and the economy. The return of tariffs as a blunt tool will increase the odds of at least temporarily higher inflation. The ongoing Middle East conflict will guarantee higher oil prices for longer. Getting to a 2% inflation rate under these conditions would clearly require some pain be felt on the growth front and likely in markets as well.

And the growth story is also shaky. This week's preliminary report of 1.5% growth in Q2 is the latest in a string of average to uninspiring numbers. The massive tsunami of AI spending by big tech is showing signs of nearing a peak as the market continually reasserts its anxiety about spending at that level without signs of an appropriate return.



And the last issue looming is the massive US pile of debt. No one can know when this issue becomes front and center, but it at least appears to be one factor behind fewer international holdings of US debt. That debt load will likely begin to influence Fed policy before the term of the new chair is over. This chart shows why:

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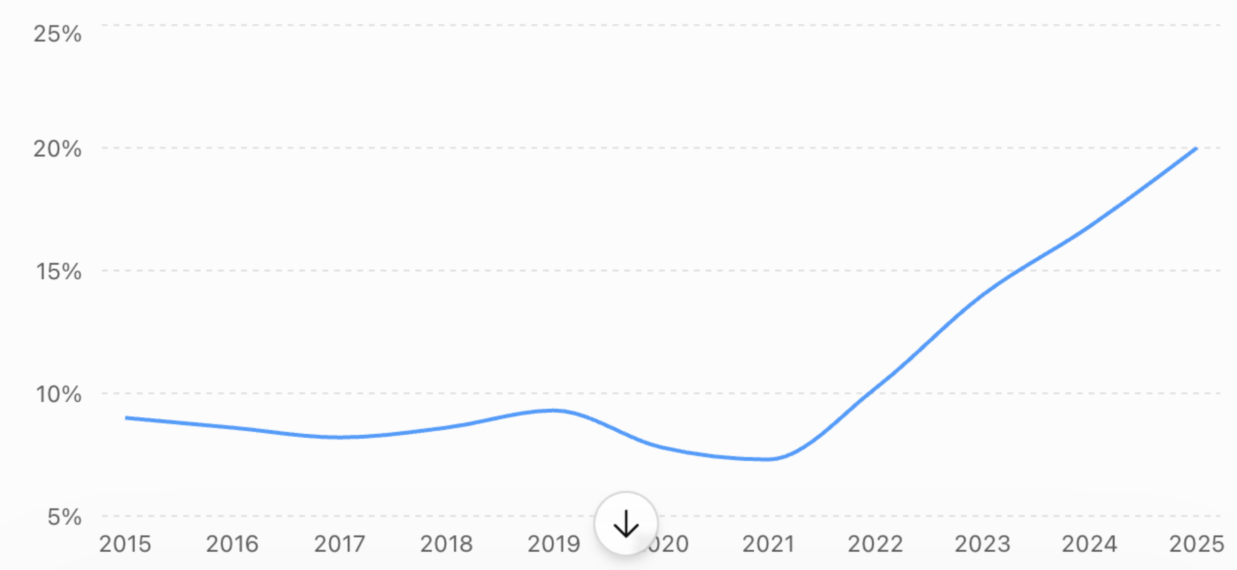
U.S. federal interest expense as a share of tax revenue

Annual federal net interest outlays divided by total federal receipts (approximate historical values based on OMB historical tables).



How high can interest rates go as we approach a staggering quarter of tax revenue being spent simply to service existing debt?

And of course, the $40 trillion-ish debt level question will be what happens when yields must be suppressed to continue financing the debt, and ultimately, when inflation has to be allowed to reduce the real stock of debt to levels financial markets can live with?

The odds are high that Kevin Warsh is going to be the guy to answer those questions. Just don't count on him communicating his answer to you, at least until markets have forced him to do so at great cost to investors.

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