What does the Warsh era mean for Fed policy?

UBS House View Briefcase

Andrew Dubinsky, US Economist, UBS Financial Services Inc. (UBS FS); **Vincent Heaney**, Strategist, UBS AG London Branch; **Alison Parums**, Strategist, UBS Switzerland AG

Key message

The Federal Reserve left interest rates unchanged in July and Chair Kevin Warsh indicated that policymakers were in a period of "watchful thinking." Although the Fed remains vigilant on inflation risks, we believe it will keep rates on hold in the second half of the year as disinflation trends reemerge. With yields currently elevated, we see an appealing risk-reward outlook for short- and medium-duration quality bonds.

01 The Fed left policy rates unchanged in July.

- The FOMC kept the federal funds rate unchanged at 3.50-3.75% in July, though three hawkish dissents highlighted ongoing US inflation concerns.
- Chair Warsh signaled that the central bank is in a period of "watchful thinking."
- Structural changes to Fed communications and the launch of multiple task forces suggest a cautious policy approach in the near term.

02 We expect rates to stay on hold as "watchful thinking" prevails.

- The combination of a new chair regime and a wide dispersion of views among FOMC members implies a higher bar for near-term action in either direction.
- US inflation data moderated in June, reinforcing our view that the peak impact of tariffs has passed.
- We expect the Fed to keep rates on hold for the remainder of the year. Likely slower economic growth trends and disinflation in the US in the second half should support a pivot toward lower policy rates in 2027.

03 We continue to like short- and medium-duration quality bonds.

- Current market conviction around Fed rate hikes over the coming year appears somewhat too aggressive, in our view.
- We believe yields on short- to medium-duration quality bonds are appealing. Investors looking to enhance or diversify portfolio income can consider complementing this with higher-yielding credit and equity income and yield-generating strategies.
- We believe Fed policy overall will remain supportive for US equities, and we favor a balanced and diversified approach to the asset class.

New this week

Headline and core US consumer price inflation moderated as expected in July, with the annual core rate at 2.5% compared with 2.6% in June. Monthly inflation data remain consistent with gradual disinflation, supporting a Fed hold in the near term.

One liner

We believe the Fed is likely to keep policy rates on hold as disinflation resumes and "watchful thinking" prevails.

Did you know?

- The FOMC removed forward guidance from its statement in June and has shortened the statement significantly, now offering only a high-level assessment of economic conditions.
- Chair Warsh has not submitted rate projections, consistent with his earlier criticism of the dot-plot framework. This partial participation highlights growing skepticism of the dot-plot framework and raises questions about its role over time.
- Cash tends to underperform other assets over time: Stocks have outperformed cash in 86% of all 10-year periods and 100% of all 20-year periods since 1926.

Investment view

We believe elevated yields on short- and medium-duration quality bonds offer an opportunity to lock in a durable source of portfolio income. We also expect Fed policy to remain broadly supportive for US equities.

Non-Traditional Assets

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