

Will Kevin Warsh Fix the Fed?

President Trump finally made his pick for Fed Chair and it is Kevin Warsh. A Wall Street Journal editorial said Warsh has been “the leading voice in public life for reforming the Fed.” Apparently, the WSJ ignores First Trust, because we have been more than vocal, for more than a decade, about Quantitative Easing, abundant reserves, mission creep, and the fact that the Fed is now losing money every day.

By contrast, Warsh was a Fed Governor in 2008 and voted to start Quantitative Easing. He later changed his views. The question is whether he can alter the course of the Fed without getting on the wrong side of President Trump, who wants much lower interest rates and an easier monetary policy.

But to discuss this fully we need to back up a bit. As most of our readers know, we believe support for the current system of QE and abundant reserves is built on a myth. QE did not save the economy in the Great Financial Crisis. QE started in September 2008, but the S&P 500 fell another 40% between then and March 2009. It was the end of mark-to-market accounting that marked the end of the crisis.

Warsh, technically, supported the very early use of QE (when he voted for it), but criticized its continued use after 2011 and again during COVID...because that ended up creating the first major surge in inflation in 40 years.

This is unfortunate. The entire experiment in monetary policy needs to end. QE and abundant reserves have made the world less stable, not more. But, like so many things in Washington DC, admitting that an entire policy experiment was a mistake is virtually impossible for those who supported it. To do a 180 on a policy you supported is a sign of weakness.

Let's list some of the many problems QE has created.

1) A 40-year high in inflation and more inequality; tripling the money supply in eighteen years created a huge gap between those who owned assets and those who didn't.

2) Overreaching bank regulation.

3) The financing of huge growth in government spending at artificially low interest rates.

4) Losses on the Fed's balance sheet and at banks which total over \$1.5 trillion, at least 3-times bigger than the original subprime loan losses that led to QE.

5) Annual losses from operations because the Fed is paying private banks to hold reserves, boosting the federal deficit.

Most sober observers think the Fed ought to shrink its balance sheet. Kevin Warsh is apparently one of them. However, policy makers and many market participants are worried that shrinking the Fed's balance sheet and pushing those bonds into the private sector will lead to higher interest rates and market destabilization. We would argue that not doing this will lead to even less stability in markets over time.

In 2011, Kevin Warsh wrote: “The path to prosperity requires taking the long road. It requires policy reforms that make the economy less reliant on the preferences of government and more responsive to the market. That means prioritizing long-term growth over fleeting market stability...temporary stimulus and market manipulation.”

Long-term prosperity cannot be created by running the printing press. That's QE. It should have never been instituted; it is supported by a myth. It did not save the economy in 2008/09.

In the near term, we expect Powell will keep rate cuts on pause through his departure in May, but that Warsh will restart rate cuts when he takes over. Warsh has sounded hawkish at times in the past, but that was back when most Republicans liked hawkish rhetoric, so it might have been part of his long campaign for the Fed job.

We would like to see Warsh quickly shift the Fed against abundant reserves and QE as well as against paying banks interest on reserves. Unfortunately, investors should expect any moves to unwind these policies will arrive gradually. But at least Warsh will put those changes on the table.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
2-2 / 9:00 am	ISM Index – Jan	48.5	48.5	52.6	47.9
2-3 / afternoon	Total Car/Truck Sales – Jan	15.3 Mil	15.2 Mil		16.0 Mil
afternoon	Domestic Car/Truck Sales – Jan	12.7 Mil	12.1 Mil		12.7 Mil
2-4 / 9:00 am	ISM Non Mfg Index – Jan	53.5	53.3		53.8
2-5 / 7:30 am	Initial Claims – Jan 31	212K	208K		209K
2-6 / 7:30 am	Non-Farm Payrolls – Jan	65K	105K		50K
7:30 am	Private Payrolls – Jan	75K	100K		37K
7:30 am	Manufacturing Payrolls – Jan	-7K	-7K		-8K
7:30 am	Unemployment Rate – Jan	4.4%	4.4%		4.4%
7:30 am	Average Hourly Earnings – Jan	+0.3%	+0.3%		+0.3%
7:30 am	Average Weekly Hours – Jan	34.2	34.3		34.2

This report was prepared by First Trust Advisors L.P. and reflects the current opinion of the authors. First Trust Advisors L.P. is an affiliate of FT Portfolios Canada Co. This report is based upon sources and data believed to be accurate and reliable. Opinions and forward-looking statements expressed are subject to change without notice. This information does not constitute a solicitation or an offer to buy or sell any security. Actual results may differ materially from the results anticipated in these forward-looking statements. We do not undertake, and specifically disclaim, any obligation to update or revise any forward-looking information, whether as a result of new information, future developments or otherwise. This information does not constitute a solicitation or an offer to buy or sell any security. Commissions, management fees and expenses all may be associated with ETF investments. Read the prospectus before investing. ETFs are not guaranteed, their values change frequently, and past performance may not be repeated.