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The Fed is a Soap Opera?

Who would have thought the Federal Reserve could rival a soap opera for drama? Chairman Powell, first appointed in 2018, has already faced a pandemic, the sharpest recession in decades, and the highest inflation since the 1970s. Now, political attacks from President Trump have made the Fed's independence a front-page story.

Congress gave the Fed a dual mandate, to ensure price stability and full employment. However, this was granted with substantial discretion to transact. Without congressional support, the Fed's ability to credibly execute its dual mandate could be at risk. Independence has never been absolute - Presidents have always preferred easier money – but today's pressure campaign is unusually public. History shows the danger when the Fed bends to politics. In the 1970s, President Nixon pressured Fed Chairman Burns for easy money to juice the economy before reelection. Burns later wrote that President Nixon's pressure was "startling and even frightening." When Burns acquiesced Nixon's demands, the result was double-digit inflation.

The Fed's independence has never truly been absolute, as it exists and serves "at the pleasure of Congress." It's convenient to say the Fed is independent, but it operates within the political system. Politicians and officials are always looking to get elected, and it is obviously much easier in a booming economy than a recession. As former Fed Chairman Alan Greenspan once said, "I cannot remember many calls from presidents or Capitol Hill for the Fed to raise interest rates."

How the Fed Sets Interest Rates:

The Fed Funds rate - the short end of the yield curve - is set by the Fed. This is the central bank's most consequential decision, spurring or hindering bank lending and determining whether the economy to expands or contracts. The Federal Open Market Committee (FOMC) - 12 members who meet 8x a year – sets this rate. The rest of the yield curve is determined by market forces. Regional Fed banks act like quasi-private institutions, but fall under 12 governors appointed by the President and confirmed by Senate.

The chair sets the agenda for FOMC meetings, and leads the institution, but cannot force policy decisions on the committee. Turmoil could ensue if the Chair loses majority support. While the Fed has traditionally spoken with one voice, cracks are appearing. We wonder what would happen, if the FOMC had large disagreements with its existing chair. Is this the start of a schism? In an organization that prides itself on consensus, where disagreements are rare, the last FOMC vote had two dissenters – its first since 1993. While this was just two dissenting votes, could other governors begin to voice a differing opinion?

In early August, Fed governor Adriana Kugler resigned ahead of schedule, giving President Trump an immediate appointment. Kugler did not give a reason for her early departure, other than saying she plans on teaching at Georgetown University. Then, on August 26th, President Trump demanded Fed Governor Lisa Cook resign over alleged mortgage fraud, or face removal. While the Federal Reserve Act allows removal 'for cause,' the law doesn't define exactly what that means, leaving it to judicial interpretation. Lawsuits – and possibly the Supreme Court – will likely settle this dispute. Is this just one step in President Trump's desire to restructure the entire Fed? This might be the beginning of a broader executive branch interference program to control the Fed's operations.

We expect a more unpredictable Fed, which means more volatility (which would certainly help volumes on our exchanges). We never want to see financial markets get riled up, but we expect additional uncertainty, potentially some institutional instability, and heightened volatility. Markets so far remain calm, but sustained political pressure could erode confidence in the Fed's independence. For now, it feels like Wall Street's version of popcorn theatre - but the implications are serious.

What Change on the Fed Could Look Like:

Since his 2024 re-election, President Trump has been demanding lower rates. He repeatedly mocks Chairman Powell as "Too Late," a "numbskull," and even a "stubborn MORON." Steering monetary policy while receiving verbal attacks from the White House, probably wasn't what Powell envisioned when he joined the Fed. Powell's term ends on May 15th, 2026, and given tensions, we question if he'll last that long.

One of the first shifts at the Fed could be messaging and communication. The current Fed avoids surprises, holding press conferences, publishing forecasts, and regularly signaling its thinking. Economists once complained that the Fed made decisions "behind the curtain," but now critics argue it telegraphs too much, making it easier for markets to game its moves. As the World Bank President said in June, "Today's Fed is effectively the world's biggest hedge fund." Under President Trump, expect more abrupt economic announcements, perhaps even via Truth Social, X.com, Instagram and Facebook.

The Potential Candidates for Fed Chairman:

Now, let's highlight some of the potential candidates President Trump will choose from for Powell's successor. Yes, you can finally legally bet on important things, like will the Miami Dolphins winning Super Bowl 60, in Santa Clara, California on February 8th, 2026 (currently at 10,000:1 on DraftKings) or who will be the next Fed Chairman.

According to prediction market Kalshi, the best candidates are:

- **31% Christopher Waller**, Fed Governor, nominated by President Trump in 2020
- **21% Kevin Warsh,** a former Fed Governor from 2006 to 2011, and now an active investor
- **18% Kevin Hassett**, National Economic Council Director and macroeconomist specializing in taxes
- **10% David Zervos**, Jefferies Chief Marketing Strategist
- **4% Scott Bessent,** Current Treasury Secretary, has asked to be removed from consideration
- **2% Michele Bowman,** Fed Vice Chair of Supervision

We correctly predicted Powell back in October 2017 (see here), and our view is that Kevin Warsh seems like President Trump's most likely choice. He was considered for in 2018, has the credentials, and is echoing many of President Trump's critiques. On CNBC in July, Warsh argued "We need regime change at the Fed. It's not just about a person. It's about an approach to economics. We need to change how we're thinking about inflation, how we're conducting policy, how we're supervising and regulating banks, and how we're communicating." Warsh has been blunt; he said the current Fed "isn't working," and he advocates for "breaking some heads" at the central bank. At a conference in April, he quipped, "There's only two problems with data dependence, the data and the dependence." Clearly, this is not the language of past, cautious central bankers.

One thing is certain: whoever takes over next year will push for rate cuts and a major overhaul. The administration insists the Fed misunderstand inflation's drivers and has mishandled policy. Expect a radically different framework for inflation and interest rates.

The Fed has evolved from a rate-setting body into an institution that shapes fiscal policy and influences the global economy. Today's Fed is driven by a profound sense of caution. Tighten too quickly and you could hinder potential growth; tighten too late and inflation accelerates. Could a new-look Fed alter its fundamental mission altogether? Might it begin to resemble the political divisions of the Supreme Court? Regardless of who leads, change is coming – either in how the Fed defines inflation, conducts policy, or communicates with markets. The Fed was a creation of the political system, and it can be altered and changed by it. That change is coming in the next few months and quarters.

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The Current Macro Picture:

After Chairman Powell's 14-minute Jackson Hole speech, markets rallied (the S&P 500 rose +1.5% and the Russell 2000 increased by +3.7%) on hopes for a September 25-bps cut. But when Treasury Secretary Scott Bessent floated a 50-bps cut, speculation spiked further. Is the Fed acting in the economy's best interest, or bowing to political pressure?

Investors must remember that the Fed often follows the data rather than leads it. Cuts typically reflect existing conditions, not create them. Several risks remain for the "data dependent" Fed. First, tariffs could hit consumers and producers harder than expected, and cutting too aggressively risks fueling inflation – especially with the S&P 500 at record highs.

Inflation has cooled from its 2022 peak of +9.1%, but with Core CPI above 3% and producer prices rising (highest monthly increase in 3 years), pressures remain. Meanwhile, unemployment has edged up to 4.2%. While not alarming, the trend is creeping higher and higher. When the BLS (Bureau of Labor Statistics) reported this uptick, President Trump questioned its accuracy and promptly replaced its Commissioner – Erika McEntarfer. So much for "don't fire the messenger."

The current Fed sees itself as institutionally nimble and intellectually flexible. Critics see it as bloated, backward looking, and outdated. Powell must steer the Fed through 9-months political hostility while convincing markets the Fed remains data-driven, not politically driven. As former Chairman Bernanke said, "The Fed's credibility - its perceived willingness to make hard decisions based on data and nonpartisan analysis - is an important national asset." That credibility is now being tested more at any point in the last 50 years.

Conclusion:

According to the CMEs FedWatch tool (a favorite resource of ours), markets see an 86% chance of a 25-bp rate cut in September and nearly a 50% chance of another in December. While the bond market may worry about the implications, equity markets, IPOs, and M&A activity typically welcome a lower-rate environment.

Still, the upcoming cut is no surprise. Markets have already priced it in, which means the Fed's decision is unlikely to spark a major move. History shows rate cuts rarely change the market cycle's direction. In 2001 and 2007, they couldn't stop bear markets, with stocks falling (40%) before bottoming. In 1974 and 1990, by contrast, they happened to coincide with the start of new bull markets. On average, after Fed easing cycles, equities rose +7% over six months and +12% over twelve months. While stocks have often risen after initial cuts, the true driver has always been the economic and earnings cycle. Lower rates help, but fundamentals, not Fed decisions, drive sustainable rallies.

That is why we focus on fundamentals, not Fed drama. A small and well-telegraphed cut may steepen the yield curve slightly, but it won't alter the long-term trend. In the current environment, we largely see a resilient US economy, even as some signs of slowing are starting to show. Market performance ultimately depends on earnings growth, consumer resilience, and global demand, not a quarter-point move.

As investors, our job is to look past the noise, whether it's central bank theatrics or controversial political headlines. We stay disciplined, patient and focused on cash flows, and fundamentals. That approach has served us well, and we believe it will continue to deliver value in the years ahead.

Warren Fisher, CFA
Founder & CEO of Manole Capital Management

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