FRIDAY – JULY 31, 2026

Well, hello, and welcome to this Friday's Dividend Cafe. I'm your host, David Bahnsen. We're going to be talking about the Fed today, but it's going to be fun. It's not going to be a regular monetary policy discussion where I lose you with the minutiae and boredom of Federal Open Market operations and other such things. I want to get into what happened this week with the Fed, explain why I chose to write about it this week, and lay out some concrete thoughts about both the very short-term future with the Fed and the longer-term picture. I think it's an incredibly important topic right now.

The reason I basically chose this topic at the very beginning of the week was that I was very open to the possibility—although it was not my base case, and I had expressed a great deal of skepticism that it would happen—that the Fed might surprise markets. It was one of the first Fed meetings I can remember in a long time where there was a part of me that wondered whether I might be surprised. You can't exactly say you expected to be surprised, because that doesn't make any sense. But while I predominantly expected the Fed to do exactly what they ended up doing, I remained open to the possibility that I was wrong because there were people I hold in extremely high regard who were genuinely convinced the Fed was going to do something much more surprising—namely, hike rates when it wasn't really priced into markets. A quarter-point hike would have been a surprise, with futures implying roughly a 30% probability. Thirty percent is certainly not zero, but it's obviously not the majority case. Several respected observers even believed we could see 50 basis points of tightening, and that would have been extraordinarily surprising. Their argument was not merely why they thought the Fed should do it, but why they believed the Fed actually would. While it wasn't my view, and as it turned out it certainly wasn't what happened, I want to walk through the reasoning because I think it helps explain why we are entering a very different period in Federal Reserve history.

As someone who has followed the Fed closely throughout my entire adult life—and really long before that—I believe we are at a point where there is an opportunity for a fundamentally different relationship between the Fed, the markets, and the economy. The basic case for a rate hike this week was fairly simple. The Fed says its inflation target is 2%. Inflation has remained above 2% for years. Therefore, rates should go higher. It's a logical syllogism. Of course, there are reasons one could challenge that logic. Someone could argue inflation is already headed back toward 2% without additional tightening. Others could argue the factors keeping inflation elevated are not particularly responsive to higher interest rates. Still others could say the economic costs of additional tightening—higher unemployment or weaker growth—would outweigh the benefits. Whether those arguments are correct or not, they illustrate why the case for higher rates contains more nuance than the simple headline suggests.

What fascinates me is that we are living through a period where people often arrive at the same conclusion for entirely different reasons. Sometimes people have the right conclusion but the wrong reasoning, or perhaps simply different reasoning. The reasons matter tremendously. One of my frustrations over roughly the last eighteen years has been that the Fed has often fostered public debates based on explanations that I never believed represented its real motivations. For example, I spent much of that period arguing against the wisdom of a zero-interest-rate policy. If the Fed publicly justified those policies by saying they were primarily concerned about unemployment, then debates naturally centered on unemployment. But what if the real concerns were global dollar liquidity, the government's cost of borrowing, housing market recovery, or other issues that were never fully articulated? Those may or may not have been valid concerns, but they weren't the ones publicly emphasized. As a result, much of the public debate became somewhat disingenuous because people were debating stated reasons rather than actual motivations.

This week felt very different. Whether you agree with the Fed or not, I believe they were remarkably transparent about why they did what they did and why they chose not to do what they didn't do. That honesty allows us to have a much more meaningful discussion. Interestingly, I actually believe there are compelling arguments for not raising rates right now, but they are not quite the same arguments the Fed itself emphasized. One common argument is that inflation expectations are already moving toward the target. We'll put up the chart showing Treasury Inflation-Protected Securities spreads, which represent market-based inflation expectations. Across the two-year, five-year, and ten-year maturities, expectations have moved steadily lower and are now approaching 2%. These are market prices reflecting trillions of dollars of collective judgment. That naturally leads many people to ask why additional monetary medicine should be administered if the patient is already improving.

Chairman Warsh, however, made a somewhat different argument. His point was that financial conditions have already tightened without the Fed needing to tighten policy directly. Yields across the curve—both real and nominal—have risen meaningfully since the previous meeting. In other words, markets have already done part of the Fed's work. That has become a consistent theme under Chairman Warsh: he appears to place much greater emphasis on market signals than on theoretical projections. The second element, which he only briefly referenced but which I believe sits at the core of his thinking, involves the balance sheet. If the Fed truly wants tighter monetary conditions while simultaneously expanding its balance sheet by another $200 to $250 billion this year, perhaps the first step is simply to stop adding liquidity before reaching for higher interest rates. It's a perfectly legitimate argument. He didn't elaborate extensively because he has appointed a task force to review the balance sheet, and I suspect he believes it would be inappropriate to prejudge that process publicly.

In the written Dividend Cafe, I compared it to installing an elaborate home security system before you've even bothered closing or locking your front door. Sometimes the lower-hanging fruit is staring you right in the face. I don't believe Chairman Warsh is either a dove or a hawk in the traditional sense. I think both labels miss the point. He seems to be governing from a coherent set of principles, one of which is that the Fed should not be encouraging economic actors to spend all their time trying to anticipate what the Fed itself will do. His objective appears to be getting businesses and investors focused back on actual economic activity rather than monetary speculation. If you look at the balance sheet chart, it's entirely plausible that had the balance sheet remained flat rather than expanding over the last several months, he might have supported a rate hike this week. Instead, he seems to be saying that if tightening is the goal, perhaps reducing balance sheet expansion should come first.

So we now have several different schools of thought. Some believe rates should rise because inflation remains above target. Others believe no additional tightening is needed because inflation is already moving lower. Chairman Warsh's position seems to be that financial conditions have already tightened through market action and that balance sheet policy offers a more appropriate first tool than interest rate increases. Whether one agrees or disagrees, I find it to be an intellectually coherent framework.

The broader question for investors is what this new regime actually looks like. I've heard people dismiss Chairman Warsh after only six weeks by saying he's turning out to be just another Fed chair. I disagree completely. His repeated phrase about "playing the ball, not the referee" strikes me as enormously important. I have lived through decades in which tremendous amounts of financial activity were devoted not to producing goods and services or creating value, but simply to guessing what the Fed might do next. That is not productive capital allocation. It is essentially a zero-sum exercise. Chairman Warsh seems genuinely committed to redirecting attention back toward productive investment, innovation, and business activity. That philosophical commitment feels very different from what we've seen for many years.

One of the most revealing exchanges this week came when Wall Street Journal Fed reporter Nick Timiraos asked Chairman Warsh about balancing price stability with full employment. Warsh responded, "Price stability and full employment are not at war." He rejected the idea that inflation control and labor markets inherently conflict. Instead, he argued that inflation itself often inflicts the greatest damage on employment because price instability discourages hiring, investment, risk-taking, and wage growth. That is an economic philosophy I've believed for much of my career, so hearing it expressed directly by the Fed chair represents, in my view, a significant paradigm shift.

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Markets responded accordingly. Expectations for future rate hikes declined meaningfully after this week's meeting. Futures still assign a majority probability to another rate increase later this year, but those odds have fallen substantially. They may ultimately prove correct. But if incoming data show weaker labor markets or continued moderation in inflation, I remain skeptical that another hike actually occurs. Importantly, I don't interpret that skepticism as evidence of excessive dovishness. Chairman Warsh certainly could have shocked markets with a large rate hike to demonstrate independence from political pressure. That would have made a statement, but it would also have carried significant costs. Instead, he appears to be pursuing reform through incremental institutional changes rather than dramatic one-time actions. His task forces reviewing data, the balance sheet, and the Fed's reaction function suggest someone interested in durable reform rather than headline-grabbing moves.

I also don't believe any of this has much to do with President Trump. In fact, Chairman Warsh explicitly acknowledged that tariffs and higher oil prices have contributed to inflationary pressures. Those are not exactly flattering observations about current policy. I don't think he is acting to please the administration, nor do I think he is acting to oppose it. He appears to be acting independently, which is precisely what we ought to expect from a central bank.

In conclusion, I think it's a good thing that we don't have a revolutionary Fed chair. I think it's good that we have a measured one. There are legitimate arguments for raising rates, and there are equally legitimate arguments for holding steady. Of the reasons for holding steady, I find Chairman Warsh's emphasis on market tightening, market function, and the priority of balance sheet policy especially compelling. There is still much more ahead. The Fed will have to evaluate future inflation data, oil price volatility, TIP spreads, and the dual mandate of price stability and full employment. But Chairman Warsh is approaching all of this with a governing philosophy that does not view prices and employment as inherently conflicting, and with a belief that the Fed itself should not become the center of economic decision-making. He wants markets focused on the game, not the referee.

If it sounds like I'm being a Warsh cheerleader, it's because I've simply been calling it as I see it so far. I assure you, if he disappoints me, it won't be the first time someone in public policy has done so, and I won't hesitate to say so. But at the moment, I remain cautiously optimistic that we have the right governing framework within the Fed, and I believe investors may ultimately benefit from reforms that prove both meaningful and constructive.

I'm going to leave it there. Thanks, as always, for watching, listening, and reading The Dividend Cafe. I hope you have a wonderful weekend. I'll be with you, as always, on Monday to recap the different categories we cover each week. Reach out anytime. Thanks so much for being a part of The Dividend Cafe.