

2 Gray Beards Week 161 Summary

Key Topic: New Fed Chair Kevin Warsh - Policy Implications

Nick's Initial Assessment: Warsh expected to reform financial market regulations, particularly around bank treasury holdings and reserve requirements. He'll likely be hawkish on reducing the Fed's balance sheet while incentivizing the financial system to hold more treasuries through increased carry. The common link between Warsh (Fed Chair) and Bessent (Treasury Secretary) is Stanley Druckenmiller, suggesting competent leadership ahead.

Andy's Analysis: Warsh is qualified, though Waller was Andy's preference. The choice represents less threat to Fed independence than Kevin Hassett would have been. Three key voices influencing monetary policy: Trump (wants all rates lower), Bessent (wants long-term yields down, critical of prior balance sheet management), and Myron Scholes (hawkish on balance sheet but very dovish on front-end rates). The new Fed chair is expected to cut rates aggressively, deregulate to reduce reserve importance, and shrink the balance sheet.

Current Fed Institutional Challenge: Four key Fed personnel (Lori Logan, Robert Purley, and others) are narrow repo market specialists who believe the only way to manage short-term rates is keeping banks full of reserves, requiring balance sheet growth. They caused QT to slow/end and initiated \$40B/month T-bill purchases in December. This institutional view conflicts with new management's philosophy. Since December's reserve injection, silver doubled, gold rose 25%, and the dollar weakened - all consistent with excess reserves.

Market Implications: Current expectations: fewer than two rate cuts and growing Fed balance sheet through April. New management suggests opposite: aggressive cuts and balance sheet reduction. This policy shift is not priced in and represents a significant volatility event. The curve would likely steepen substantially, though the direction depends on deregulation details and bank appetite for duration. No reason to short the two-year note.

Waller's Dissent: Fed Governor Waller wrote an unusual dissent stating the job market is weaker than data suggests and will crack badly when it does. This week provides multiple employment data points (JOLTS, ADP, weekly claims, NFP) to test his thesis. A weak employment number would trigger maximum long positioning in short-end bonds and dollar shorts.

Personnel Changes Signal: If current Fed personnel focused on reserve management are fired or moved, it will signal the new administration is serious about policy changes.

Gold/Silver Volatility: Silver fell 35% in one day but recovered to levels from nine days prior. Andy trimmed gold and commodity exposure on January 20th but would have achieved better prices waiting. Volatility noted but trend remains intact. Strategy: trim on sharp moves, expect grinding process forward.

Other Notes: Quarterly refunding announcement expected to show no change in Treasury issuance strategy. Most earnings disappointed except Meta. Dollar strengthened late week. Continuing transition from US dollar assets to rest-of-world assets as opportunities arise.

Bottom Line: All discussion focused on future policy implications - no immediate portfolio changes recommended. Watching for confirmation through personnel changes, employment data, and policy rhetoric over coming months.

