2 Gray Beards Week 161 - Extended Summary

January 31, 2026

Introduction: A Month of Clarity

Nick opens by noting that January has been a long month, but there's finally clarity on who will be the next Fed Chair: Kevin Warsh. Rather than taking immediate action based on speculation about what Warsh might do in four months, Nick and Andy focus on understanding why he was selected and what his eventual policy goals might be.

Nick's Initial Assessment: The Warsh Agenda

Regulatory Reform and Balance Sheet Hawkishness

Nick identifies two primary policy directions he expects from Warsh:

1. Financial Market Regulation Reform Warsh is expected to reform regulations around how banks handle treasuries on their balance sheets, including requirements for reserves. This represents a fundamental shift in how the financial system operates and could have significant implications for bank behavior and treasury demand.

2. Fed Balance Sheet Reduction Warsh will likely be hawkish about eventually reducing the size of the Fed's balance sheet. This contrasts sharply with the current institutional bias toward maintaining or growing the balance sheet.

The Key Market Implication

The most important takeaway Nick identifies: Warsh will try to incentivize the financial system to hold more treasuries by giving them more carry. This means creating better risk-adjusted returns for banks that hold longer-duration treasury securities. While Nick doesn't plan immediate portfolio changes, this consideration will inform his thinking as he adjusts positions over the coming months.

The Druckenmiller Connection

Nick notes an interesting relationship: both Warsh (incoming Fed Chair) and Bessent (Treasury Secretary) have worked closely with Stanley Druckenmiller. This common link suggests the possibility of coordinated, competent economic policy. Nick expresses confidence based on his personal experience with Druckenmiller in the 1980s, though he acknowledges this may reflect personal bias.

Waiting for Confirmation

Nick emphasizes the importance of hearing directly from Warsh during the confirmation process over the next three months. These hearings and statements will provide crucial clues about specific policy intentions and the timeline for implementation.

Andy's Perspective: Qualification, Politics, and Institutional Challenges

The Selection Process

Andy begins by affirming that Warsh is qualified for the role, expressing serious doubts about some other candidates who were interviewed, particularly Kevin Hassett, who had been the long-running frontrunner. Andy's preferred candidate was Waller, though he didn't expect him to get the position. The other viable choices—Waller, Warsh, and Rick Rieder (a late consideration)—were all acceptable candidates.

The Powell Question and Fed Independence

Andy raises an important historical parallel. Jerome Powell could stay on as a governor after his term as Fed Chair ends, though Andy initially thought this was unlikely until the subpoenas emerged. Now Powell faces a difficult decision.

The last Fed Chair who didn't resign his governorship was Marriner Eccles in the 1940s. Eccles spent three years after leaving the Chair role aggressively defending the Fed's independence during President Truman's attacks on the Fed. Truman, like all presidents, wanted lower interest rates and easier policy. The Fed building was eventually named after Eccles in recognition of his defense of Fed independence.

On a "checkerboard" level of analysis (as Andy puts it, distinguishing from more complex strategic thinking), choosing Warsh represents less of a threat to Fed independence than choosing Hassett would have been. However, Andy gives no one credit for this, noting that markets had moved past Hassett as a serious candidate long ago.

The Three Voices Shaping Fed Policy

Andy identifies three key voices from the administration commenting on monetary policy, which likely influenced the Fed Chair selection:

1. President Trump Consistently and single-handedly advocates for lower interest rates across the board and wants the Fed to cut rates significantly. While everyone prefers lower rates when possible, Trump's position is clear and unwavering. As the person who made the selection, his influence cannot be understated.

2. Treasury Secretary Bessent Extremely consistent in his rhetoric: he wants long-term bond yields lower, believes short-term bond yields are too high, and has been highly critical of the prior administration and the Fed regarding balance sheet size and the treasury issuance process. Bessent talks about being hawkish on the balance sheet and dovish on the front end, but has taken no action yet. The quarterly refunding announcement (expected this week) provides another opportunity to act on "terming out" the debt, but Andy expects no change—just more talk.

3. Myron Scholes Scholes authored the first paper (crediting Andy's work) on using the balance sheet to manage financial conditions. He's hawkish on the balance sheet but in a very specific way consistent with Nick's analysis. Scholes argues that reserves aren't the critical factor—the regulatory framework is. He believes deregulation can dramatically reduce the amount of reserves needed in the system, thus allowing balance sheet reduction without disrupting markets. On interest rates, Scholes couldn't be more dovish: he consistently dissents at FOMC meetings with a dot showing a terminal rate 100 basis points lower than the median.

The Likely Policy Direction

Given these three influential voices, Andy concludes the new Fed Chair will likely:

- Cut interest rates aggressively
- Pursue deregulation to reduce the importance of reserve management
- Shrink the Fed's balance sheet

This represents a coordinated approach: hawkish on balance sheet, dovish on rates.

The Institutional Challenge: The Repo Traders

Four Key Personnel Driving Current Policy

Andy identifies a critical institutional problem. Four people currently dominate Fed thinking about reserve management and short-term rate control:

1. **Lori Logan** - Federal Reserve official
2. **Robert Purley** - SOMA (System Open Market Account) manager

3. **An unnamed official** - Previously at the New York Federal Reserve Board, worked on SOMA portfolio
4. **Beth Hammack** - Spent entire career at Goldman Sachs trading the repo book and short-term interest rates

The Narrow Focus Problem

Andy makes a striking observation: if you've ever met a repo trader, they are "narrow and deep" more than any other person in the financial business. They focus exclusively on the overnight rate and the small movements around it. Even minor volatility in the repo market causes them to raise red flags about impending financial crises.

While there have been some legitimate "doom events" associated with the repo market (2019 is cited as an example), these four individuals sound alarms even during normal end-of-month occurrences. Last month, they threw up their hands enough to force the Fed to buy $40 billion of T-bills per month.

The Reserve Management Philosophy

These four people have collectively decided that:

- The only way to manage the short-term interest rate is to have all banks full of reserves
- The only way to keep all banks full of reserves is to grow the balance sheet
- They caused QT (quantitative tightening) to slow, then taper, then end entirely
- They are the trusted voices within the Federal Reserve institution on reserve management
- They initiated reserve management operations in December

Market Impact of December Reserve Injection

After the Fed plowed reserves into the system starting in December, several markets responded predictably:

- Silver price doubled
- Gold price improved 25%
- Dollar cracked/weakened
- Asset prices generally supported (though less clear connection)

These movements are all consistent with excess reserves being blown into the system—exactly what happens when money floods the financial system.

The Coming Conflict

The institutional Fed is dominated by these reserve-focused individuals, but they are "completely out of line with the new management." This creates a fundamental conflict: current Fed personnel operate under one philosophy while new leadership operates under an opposite philosophy.

The question becomes: can new management overcome this entrenched institutional thinking?

Market Implications and Trading Considerations

Current Market Pricing

Andy analyzes what markets currently expect versus what the new policy regime might deliver:

Current Expectations:

- Terminal rate fewer than two cuts away (very few rate cuts)
- Reserves expected to grow rapidly through April
- Modest reserve growth thereafter
- Fed balance sheet expected to grow
- Relatively flat yield curve
- Tremendous treasury issuance from budget deficit

New Management Direction:

- Much more aggressive rate cuts
- Balance sheet decline rather than growth
- Deregulation to reduce reserve importance

The Conventional Wisdom Challenge

Traditional thinking suggests:

- QE (quantitative easing) is good for equities
- QT (quantitative tightening) is not good for equities
- Cutting rates is good for equities
- Hiking rates (or pausing cuts) is bad for equities

But the new policy mix combines aggressive cuts WITH balance sheet reduction, creating an unusual dynamic that might offset and result in minimal net impact on equities. Or it might not—the details matter enormously.

Headline Risk

Andy emphasizes that headlines drive market reactions:

- If the headline reads "10-year yields rise to 4.75%," stocks will be down
- If the headline emphasizes Fed funds cuts from 4.33% to 2.63%, stocks will likely be up
- A hawkish balance sheet causing yield increases will be negative for stocks

The Volatility Trade

The policy shift represents "an event that the market's not prepared for." This suggests significant volatility ahead. Current option pricing doesn't reflect this uncertainty:

- Out-of-the-money calls are cheap across multiple month expirations (in case it's a bullish outcome)
- Puts aren't expensive either in bond, stock, and currency markets

Andy's recommendations:

- **For long-only investors:** Maintain plenty of cash and willingness to fade selling on volatile moves
- **For option traders:** Own out-of-the-money calls and puts as protection/opportunity

The Curve Steepening Trade

Both Nick and Andy agree: if the policy shift begins impacting markets, the most natural outcome is a steeper yield curve. However, the specifics matter:

- Will it be a "twist" (long end up, short end down)?
- Will it be a "bull steepener" (long end down more than short end)?
- How much backend duration will banks be willing to buy?
- At what yield levels will they become buyers?

Nick emphasizes there is "absolutely no reason to short the two-year note." The only question is how far yields fall and how fast.

The Waller Dissent: A Warning on Employment

An Unusual Public Statement

At this week's Fed meeting, Fed Governor Christopher Waller not only dissented but wrote an actual dissent statement—an unusual move that signals the importance of his concern.

Waller's Warning (Paraphrased by Nick)

The job market is significantly weaker than official data suggests. When the labor market cracks—and Waller believes it will—the deterioration will be far worse than current expectations.

This Week's Critical Data

This week provides every conceivable piece of employment data:

- JOLTS (Job Openings and Labor Turnover Survey)
- ADP private sector employment
- Weekly unemployment claims (again)
- Non-Farm Payrolls (NFP)

Nick notes the data is still catching up from the government shutdown, but this represents the first real opportunity to test Waller's thesis.

The Trading Signal

Nick identifies a clear catalyst: "The first time we get a weak employment number—high unemployment—everyone is going to jump on the bandwagon and say 'Waller's right, and here we go.'"

That moment represents the optimal time to:

- Be maximum long the short end of the bond market (two-year notes, etc.)
- Be short the dollar

This would be Nick's signal to position aggressively for the coming rate cut cycle.

Personnel Changes as a Leading Indicator

The Litmus Test

Nick raises an important question: How will we know if the new Fed leadership is serious about changing policy?

Answer: Watch for personnel changes.

The administration has stated multiple times that "the personnel at the Fed needs to change." Nick believes they're very conscious of the institutional resistance Andy described. If the four key personnel focused on reserve management get fired or moved to different positions, it signals the new leadership is serious and willing to overcome institutional inertia.

Andy's Consideration

Andy finds this an interesting angle. While the three governors and presidents Andy mentioned can't be directly fired, they could potentially be moved to different roles. The SOMA manager at the New York Fed could certainly be replaced.

If the new administration's philosophy is that reserves are not the right tool for managing short-term rates, and they look at a Fed that focuses only on reserves, they would naturally want to make changes.

The Equity Market Risk

Nick asks: What would be the effect of such personnel changes on equity markets?

This is Nick's fear—that the transition process itself creates volatility and uncertainty that impacts stocks negatively, at least initially. The question remains somewhat open, as the impact would depend on how the changes are communicated and what policy specifics emerge.

Gold and Silver Volatility

The Dramatic Move

This week saw enormous volatility in precious metals, with silver falling 30% in a single day—an abnormal reaction even for the notoriously volatile silver market.

Nick's Positioning

Nick stated immediately upon seeing the volatility that there was no way he'd catch the exact top, and he didn't—he was about three days and 5% away from the peak.

The Cause: Technical or Fundamental?

Nick asks whether the volatility was purely technical or whether people were worried about Warsh and the possibility of a lower Fed balance sheet (which would be negative for precious metals as it removes liquidity).

Andy's Trade Experience

Andy shared his recent gold and commodity positioning:

- On January 20th, he did a podcast with Jack Farley announcing he was reducing from overweight to neutral in both gold and commodities
- In the prior week's episode, they agreed to lower gold holdings
- He sold some commodity exposure (which includes heavy metal components like silver, gold, and other high-flying metals) back to neutral
- He also sold some gold exposure

The result: None of those trades have made money yet. He would have been better off waiting until Friday to sell, even with silver down 35%, and would have gotten better prices.

The Bigger Picture

Andy points out a remarkable fact: Silver fell 35% and recovered to its level from just nine days ago. In other words, despite the dramatic volatility, silver is still significantly higher than it was less than two weeks prior.

Conclusion: The volatility is notable, but it's not yet a significant reversal. The uptrend remains intact.

Strategy Going Forward

Andy's approach: Owning gold is an important part of every portfolio. Trimming exposure when you have sharp moves is the best strategy. He expects "a grinding process from here on both gold and silver"—meaning continued volatility but no dramatic sustained moves in either direction immediately.

The key is position sizing and willingness to trade around a core position rather than trying to perfectly time entries and exits.

Other Market Observations

Earnings Season Disappointments

Andy briefly notes that earnings came in this week, and with the exception of Meta, most stocks performed poorly after their earnings events. This is worth noting as it suggests:

- Market expectations were too high heading into earnings
- Forward guidance may have disappointed
- Valuations may have been stretched

Dollar Strength

The dollar strengthened somewhat toward the end of the week. This provides better entry points for the strategy both Nick and Andy have discussed: continuing to transition from US dollar assets into rest-of-world assets.

Andy notes: "If we get further better prices, maybe we do a little bit more." This reflects their opportunistic approach to the dollar weakness trade—not forcing it, but taking advantage when prices improve.

Conclusion: A Wait-and-See Approach

No Immediate Action Required

Nick summarizes: Everything discussed is about the future. Nothing requires immediate portfolio changes. The key is to:

- Understand the policy direction and conflicts
- Watch for confirming signals (personnel changes, Warsh's confirmation testimony, employment data)
- Be prepared to act when catalysts emerge
- Maintain flexibility with adequate cash positions

The Timeline

With months before Warsh officially takes over, there's time to gather more information. The confirmation process will reveal more about specific policy intentions. Employment data over the coming weeks will test Waller's thesis about labor market weakness. The quarterly refunding announcement will show whether Bessent's rhetoric translates into action.

Positioning for Volatility

The overarching theme: a major policy shift is coming that markets haven't priced in. Rather than trying to predict the exact outcome, the prudent approach is:

- Maintain optionality through cash and options positions
- Watch for clear catalysts before making large directional bets
- Be ready to fade panic selling if volatility emerges
- Focus on asymmetric opportunities (cheap out-of-the-money options)

Final Thoughts

This episode represents a transition point in the podcast's analysis. The focus shifts from analyzing the current Fed policy to anticipating a new regime with fundamentally different priorities. The institutional resistance to change adds complexity and creates the potential for volatility. Both Nick and Andy emphasize patience and preparation over premature action, while remaining alert for signals that the transition is actually beginning to impact markets.

The coming weeks and months will reveal whether the new Fed leadership can overcome institutional inertia, whether employment data vinifies Waller's concerns, and whether the curve steepening trade becomes the dominant theme of 2026.