

Inflation and the Fed: new Fed Chair Warsh's big plans amid rising price pressures



Image source: Bloomberg/Graeme Sloan

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- ▶ **The latest CPI and PPI data make near-term rate cuts again more unlikely.** Stronger core inflation besides the expected higher food and energy prices, firmer underlying inflationary pressures (think of the trimmed-mean CPI) and broadening producer-price pressures that spill over to services, all point to rising core inflation risks. We adjust our view and expect now no further rate cuts until the end of the year, even if our baseline scenario of a rather swift relaxation of the Middle East conflict will lower energy prices towards USD 90 per barrel during Q2.
- ▶ The (almost certain) **new Fed chair, Kevin Warsh, will have to grapple** with these new figures, and even his preferred indicator of underlying inflation trends picked up in April. **Any additional fiscal stimulus**, like the idea of a national gasoline tax holiday floated by President Trump some days ago, would add to the inflationary pressures as long as domestic demand remains so strong.
- ▶ In a Senate hearing, **Warsh stated to prioritise inflation credibility.** His communication also suggests less reliance on detailed forward guidance, and more open debate within the FOMC, even if he also recognises that some recent price pressure may be energy- or tariff-related.
- ▶ **A smaller Fed balance sheet** is likely to become a central policy objective. Warsh has long argued that the balance sheet is too large, pointing to a possible mix of continued quantitative tightening, easier bank regulation and, eventually, lower policy rates.
- ▶ **Powell's continued presence on the Board still matters.** As long as he remains a governor, the Board's balance of power limits a rapid shift toward deregulation or a more dovish policy stance, even under a Warsh chairmanship.
- ▶ **If Powell eventually steps down, the regulatory agenda could shift** more clearly. A new Trump-appointed governor could give Warsh a Board majority, which would matter particularly for banking regulation and the Fed's ability to reduce its balance sheet.
- ▶ **Investors should expect patience rather than immediate policy change.** The Fed is likely to keep rates unchanged in June and may drop its easing bias, while broader Warsh-led reforms would take time and require careful handling to avoid destabilising markets and form a majority at the Fed committees.

Based on the latest news on US inflation and other economic figures and the almost certain final confirmation of Kevin Warsh as the new Fed Chair (at the time of writing), we updated our key rate expectations and sharpened our views on what could change in a new era of Kevin Warsh at the top of the Federal Reserve.

What is likely to change under new Fed Chair Kevin Warsh?

First will come inflation credibility. Warsh has made clear that restoring confidence in the Fed's inflation mandate is his top priority, openly criticising past policy mistakes. His remarks had both dovish and hawkish elements: he downplayed tariff-driven inflation and pointed to improving trimmed and median inflation measures, both of which were below the usual Fed inflation measure (PCE). He also emphasised that inflation remains above target and that the Fed must take responsibility for restoring price stability. Interestingly, Warsh mentioned inflation much more than the labour market part of the dual Fed mandate.

Less forward guidance, more internal debate. He favours reduced reliance on detailed forward guidance and is comfortable with more open disagreement at the FOMC, moving away from the highly scripted communication style of recent years. He argued that rate projections can lock policymakers into suboptimal decisions.

Smaller balance sheet over time. Warsh has long argued that the Fed's balance sheet remains too large and supports continued quantitative tightening, even if rate cuts eventually resume. This potentially points to a policy mix of lower rates, looser banking regulation, but tighter liquidity. This could, at some point, steepen the yield curve.

Independence under scrutiny, but intact. Despite political noise around his nomination, Warsh has explicitly stressed his independence from the administration. Also, with Jerome Powell remaining on the Board for now, the three "Trump-leaning" governors—Warsh, Bowman, Waller—remain in the minority against the four others: Powell, Cook, Jefferson and Barr. As such, institutional checks from the Board of Governors remain strong.

Jerome Powell will stay on the Board of Governors for now – does it matter?

At the last FOMC press conference, Jerome Powell, the former Chair, stated that he will remain on the Board of Governors until the investigations concerning him fully conclude. This remains unchanged even after the US Department of Justice dropped its criminal investigation into Powell and referred the matter to the Office of Inspector General for further review of the multibillion-dollar renovation of the Fed's headquarters in Washington.

Powell said his decisions "will continue to be guided entirely by what I believe is in the best interest of the institution and the people we serve", after his term as Chair ends on 15 May, adding that he will continue to serve as governor for a period still to be determined. Powell can remain on the Board until his governor term officially ends in early 2028.

This matters because it affects the balance of power on the Board of Governors. If Powell stays, there would be four more traditional central bankers — Barr, Jefferson, Cook and Powell — who are less inclined toward deregulation. On the other side, Chair Warsh, Waller and Bowman are likely to support a more dovish monetary policy stance and greater financial-sector deregulation, broadly aligned with President Trump’s agenda.

What if Powell were to eventually step down from the Board of Governors?

If Powell leaves, President Trump could nominate another governor and shift the Board majority in his favour, four to three. However, while this would be important for banking regulation, it matters less for monetary policy. Interest-rate decisions are made by the twelve-member FOMC, comprising of seven Fed governors and five voting regional Fed presidents. One additional dovish governor, even the Chair, cannot directly influence rate decisions.

However, as Kevin Warsh aims to reduce the balance sheet, the power balance within the Board of Governors could become increasingly important. Assuming the US government is unlikely to begin consolidating its public spending, finding an additional marginal buyer for US Treasuries may prove challenging unless interest rates adjust higher, all else equal. As a result, easing banking regulation could become important in enabling US banks to absorb more government debt onto their balance sheets. Last year, a research paper by the Federal Reserve Bank of Boston empirically showed how during the temporary relaxation of certain regulation during the pandemic in 2020 enabled US banks to increase their Treasury holdings. A recent Fed paper argues that their current balance sheet could be reduced by USD 1.2–2.1 trillion through a range of regulatory, supervisory, and operational changes to the Fed’s framework. Such changes must be approved by the Board of Governors, and that is why the power balance in the board can play a crucial role in the new Chair Warsh’s aim to lower the balance sheet.

Regardless of regulatory issues, the notion to conduct key rate cuts to balance out the lowering of the balance sheet is a delicate mission. The balance sheet reduction alone, in isolation, will naturally reduce the liquidity in the markets and negatively affect financial conditions, which the lower key rates—through easier refinancing costs—could balance out. It is important to keep in mind that the biggest position in the FED’s balance sheet has a duration of 10 years and more, i.e. sits at the long-end, and the key rates are the anchor on the front end. So, the manoeuvre to balance out the reduction of the balance sheet by lowering the key rate is not an easy undertaking.

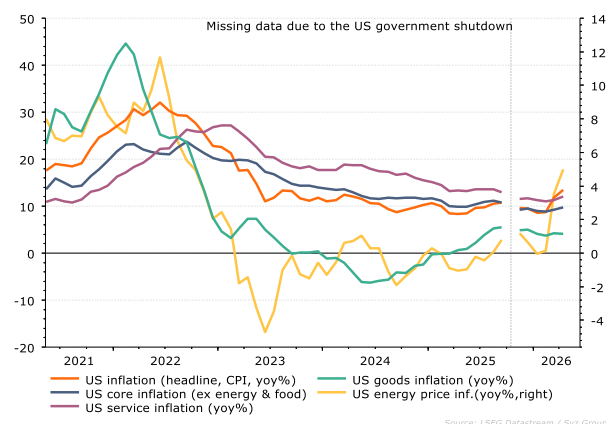
The latest CPI print is not a support for Warsh and lower key rates ...

The April CPI figures were not reassuring for anyone hoping to see the Fed cutting rates. Particularly for new Fed Chair Kevin Warsh, some details of the reports were worrying. But one thing at a time: the headline inflation rose by 0.6% compared with March, which was in line with expectations. On a year-on-year basis, inflation increased to 3.8%, slightly above the expected 3.7%.

The more important point is that core inflation, which excludes volatile food and energy prices, came in a tad stronger than expected. It rose by 0.4% month-on-month, compared with expectations of 0.3%, and by 2.8% year-on-year, slightly above the expected 2.7%. This is significant because core

inflation – particularly at a time of high energy prices caused by the conflict in the Middle East – provides a better indication of underlying price pressures.

The CPI is grinding higher in April – but also when excluding energy and food

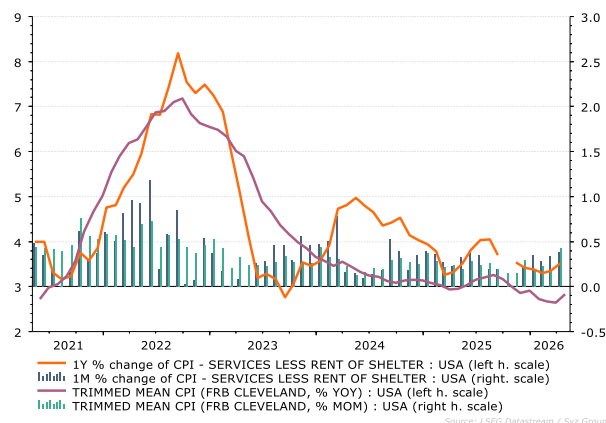


Some of the details of the report were also uncomfortable for the “doves” – i.e. anyone that aims for a loose monetary policy. The conflict in the Middle East has obviously pushed up prices in areas such as energy, airfares, and delivery services. Food costs were another concern, with grocery prices posting their strongest monthly increase since 2022.

Another important signal came from the Federal reserve of Cleveland’s trimmed mean CPI, which removes the components of the CPI with the most extreme price moves and provides a clearer view of underlying inflation trends. This measure rose by 0.43% in April, its strongest monthly increase since January 2024. Similarly, a kind of super-core measure, the Services CPI excluding rent of shelter prices rebounded higher.

It is important to note, however, that the strong services-sector print was meaningfully supported by both the expected recovery in rents following last October’s government shutdown – which had disrupted data collection – and the positive impact of airfares and delivery services on the core index.

New Fed Chair Warsh will not like to see his favoured measure of underlying inflation – the trimmed mean – trending higher in April



Overall, the report suggests that there are currently significant doubts as to whether the underlying inflation trend is continuing to point downwards. While one month does not make a trend, the combination of stronger core inflation, rising food prices, and a firmer trimmed-mean measure makes it harder to argue that inflation pressures are fading gradually.

... and the PPI print neither: the measure rose with the fastest pace since 2022

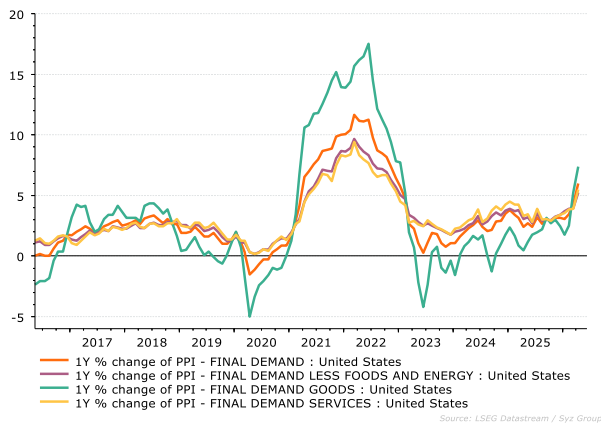
US Producer Price Inflation greatly accelerated in April, adding to concerns that price pressures are broadening again. The US Producer Price Index (PPI) rose by 6.0% year-on-year (YOY), the fastest pace since 2022 and above all economist estimates in the Bloomberg survey. The monthly increase was also the strongest since 2022 and with 1.4% much hotter than the average expectations of 0.5%.

The rise was not limited to volatile components. Core producer prices, excluding food and energy, increased by 5.2% YOY, the largest gain in more than three years and also exceeding expectations of 4.3% substantially. This suggests that the recent inflation pressure is not only an energy story.

Energy prices remained the main driver. They rose by 7.8% in April, following an even larger increase in March. Goods prices, which include fuel, also posted their strongest increase since 2022.

More concerning for the inflation outlook is the fact that higher energy costs are now feeding into services. Services prices rose by 1.2% on the month, the largest increase in four years. Transportation and warehousing services were particularly affected, with prices up 5.0%, driven by higher freight trucking costs and wider margins at fuel retailers. Even when excluding trade, transport and warehousing, the service component rose more than 1.5 pp compared to the March.

The latest CPI and PPI prints also increase the expectations for the upcoming PCE release as two of the three main categories that feed from the PPI into the PCE showed price increases. The core PCE is the data the US central bank usually focuses on.



Given this inflation news, what should investors expect from the upcoming Fed decisions under the new Fed Chair Warsh?

Recent price developments, together with a stronger-than-expected labour market, are likely to lead the **Federal Reserve to drop its “easing bias”** from the statement at its next meeting in June. We do not expect the Fed to change rates as early as the meeting on 17 June. However, policymakers — and investors — will closely watch the next inflation releases before the meeting, notably PCE inflation on 28 May and May CPI on 10 June, alongside the employment report on 5 June.

Over the medium term, we no longer expect a rate cut towards the end of the year, even under our baseline scenario of a relatively rapid easing of the Middle East conflict and a decline in energy prices, with Brent crude oil gradually moving back towards USD 90. Underlying inflationary pressures, beyond the direct impact of higher energy prices, remain stronger than the Fed — and likely the new Fed Chair — would like to see. Combined with solid labour market data and stronger-than-expected US consumption, this makes a rate cut unlikely for the foreseeable future.

That said, **uncertainty remains elevated** given the ongoing conflict in the Middle East. A rapid resolution, followed by a sharp decline in energy and potentially other commodity prices, could still bring inflation lower and allow the Fed to cut rates in the second half of the year. Conversely, a scenario of persistently high energy prices, coupled with broader spillovers into non-energy components of inflation, could force the Fed to consider new rate hikes. Also, more fiscal stimulus, in form of a tax holiday for energy products, as President Trump floated this week, would potentially add to more upward pressures on inflation, as long as the US consumers do not freeze spending due to the higher prices.

Finally, we believe that **any broader changes at the Fed**, as suggested by incoming Chair Kevin Warsh — such as reducing the balance sheet, easing banking regulation, and potentially combining this with rate cuts — would likely take time to announce and implement. Warsh would first need to build sufficient support around his objectives in the Committees and design a strategy that does not undermine financial stability or his stated goal of restoring credibility to the Fed’s inflation mandate. This is particularly relevant given that US inflation has remained above the Fed’s 2% target for the past five years.

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