First Trust
Monday Morning OUTLOOK

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August 31, 2026

Fedspeak's Back, And Warsh Is A Breath of Fresh Air

Federal Reserve Chairman Kevin Warsh used his Jackson Hole speech last week to lay out what he thinks of monetary policy. Two things jumped off the pages of his speech.

First, "Fedspeak" may be making a comeback. Former Fed Chairman Alan Greenspan became famous for phrases like "irrational exuberance." One section of Warsh's speech, titled "Preparing for Future Policy Conjunctures," felt like a throwback. "Conjunctures," really? Greenspan would be proud.

Second, the narrative about Warsh is that he will get rid of forward guidance and make the Fed more circumspect. Many thought that would give them less to talk about. But compared to Jerome Powell, Warsh is much more focused on the monetary side of monetary policy. Powell wouldn't answer questions about abundant reserves or money supply. His press conferences became all about interest rates and tariffs, while Warsh talks about commodity prices and M2.

Warsh laid out seven principles. The fifth of which was that "short-term interest rates are the predominant tool" for achieving the Federal Reserve's mandate.

We completely disagree. If interest rates are the predominant tool, then why did inflation remain stable when Bernanke held rates near zero for seven years, but Powell got 9% inflation after just two years of zero rates? And why has inflation remained stubbornly high even after the rate hikes of recent years?

Interest rates used to signal monetary policy under the "scarce reserve" regime prior to 2008. Banks traded federal funds, and changes in the supply of reserves helped move short-term rates. Today, banks are flooded with reserves and no longer trade them. The federal funds rate is rate fixing by the Fed, with little market input. Money and rates are no longer connected.

That is why Warsh's sixth principle was so encouraging: "money matters." What a breath of fresh air for us Friedmanites who think this was the mistake Powell made, ignoring the 40%+ surge in M2 during the pandemic, causing the highest inflation in 40 years.

There is an interesting tension between his fifth and sixth principles. If money matters, why should short-term interest rates be viewed as the predominant tool of monetary policy? We would reverse the emphasis. Policy should be judged first and foremost by what is happening to the quantity of money, rather than simply where policymakers set an overnight rate. The Fed's balance sheet, bank reserves, credit creation, and the Treasury General Account matter as well, particularly to the extent they influence the money supply.

Warsh also bashed "forward guidance." Forward guidance moves markets. The Fed says, "this is what we are going to do with rates" and the market moves there. Then analysts say, "the markets think the Fed should do this, or that." But the markets are just responding to the forward guidance. Warsh calls this a "hall of mirrors" with the markets reflecting the Fed, and then the Fed reflecting the markets. He is absolutely right.

However, if Warsh really does think that interest rates are the predominant tool of monetary policy, then forward guidance is part of that process. So, we think he is being a little inconsistent. Hopefully, he knows this and is just moving the Fed slowly but surely back to a money-focused institution.

He also said the Fed should take responsibility for 65 months of elevated inflation. It took the Fed nearly 30 years to admit it caused the inflation of the 1970s. To admit it in just 65 months is a miracle. What a breath of fresh air in DC.

Finally, his comments leaned hawkish on rates. Markets price a 65% chance of a September hike. We agree and expect that probability to rise. We welcome this new Fed leadership, and a return to more transparent monetary policy.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
9-1 / 9:00 am	ISM Index – Aug	55.2	**55.2**		55.6
9:00 am	Construction Spending – Jul	0.0%	**-0.2%**		-0.1%
afternoon	Total Car/Truck Sales – Aug	16.3 Mil	**16.4 Mil**		16.3 Mil
9-2 / 9:00 am	Factory Orders – Jul	+0.7%	**+0.4%**		-0.1%
9-3 / 7:30 am	Initial Claims – Aug 29	205K	**204K**		206K
7:30 am	Int'l Trade Balance – Jul	-$90.1 Bil	**-$90.6 Bil**		-$73.3 Bil
9:00 am	ISM Non Mfg Index – Aug	54.1	**54.3**		54.1
9-4 / 7:30 am	Non-Farm Payrolls – Aug	55K	**52K**		-23K
7:30 am	Private Payrolls – Aug	50K	**47K**		30K
7:30 am	Manufacturing Payrolls – Aug	5K	**5K**		5K
7:30 am	Unemployment Rate – Aug	4.1%	**4.1%**		4.1%
7:30 am	Average Hourly Earnings – Aug	+0.3%	**+0.3%**		+0.1%
7:30 am	Average Weekly Hours – Aug	34.3	**34.3**		34.3