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Friend or Foe? Wall Street Can't Decide

Warsh has recently advocated for lower rates, but a smaller Fed balance sheet

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Wall Street is unsure whether Kevin Warsh will be a friend or foe.

Investors are optimistic that Warsh will preserve the Federal Reserve's cherished independence. They are also concerned he might be far from the easy--money chair that President Trump has demanded, noting Warsh's enthusiasm for reducing the central bank's bondholdings.

The conflicting views were reflected Friday by falling stocks, steady bond yields, a rallying dollar and the worst day for gold and silver in more than four decades.

A Fed governor from 2006 to 2011, Warsh earned a reputation as an inflation hawk, having argued for years that low interest rates and expansive bond purchases would fuel rising prices. Note

More recently, he has said the Fed should cut interest rates faster. But he has also continued to argue that the central bank should shrink a balance sheet stuffed with U.S. Treasurys—a move that some investors believe could mitigate the impact of rate cuts. Note

Some leading investors cheered the pick. They say Warsh will likely prove more independent than other potential choices, and that investors will become more comfortable with the choice. Warsh's background working with investor Stanley Druckenmiller is another reason to believe he might not prove hostile to markets, some say.

"Warsh is a pragmatist," said Rob Arnott, founder of Research Affiliates. "He'll be a voice of reason, and that will be calming and soothing to the markets."

Hedge-fund manager Paul Tudor Jones praised Warsh as "very market savvy."

"With debt/GDP over 100% and a budget deficit of 6%, he is the perfect person to navigate what will potentially be challenging times," Jones said.

Still, stocks fell, with the S&P 500 losing 0.4%. The Russell 2000 index, which tracks smaller stocks that could be more vulnerable to tighter monetary policy and a slowdown in economic growth, dropped 1.5%. Prices of longer-term Treasurys slipped, nudging the yield on the 10-year note up to around 4.24%, while the WSJ Dollar Index jumped 0.9%.

"People are responding to his comments that the balance sheet should be smaller," said Priya Misra, a fixed-income portfolio manager at J.P. Morgan Asset Management. "That would have a really big impact on risk assets."

Price moves were most dramatic for metals, which have roared to all-time highs. Gold futures fell 11%, their largest one-day decline since January 1980. Silver plunged 31% in its worst one-day loss since March 1980.

Some investors have said that the recent run-up in gold reflected a dwindling faith in U.S. assets such as the dollar. The dollar's rise on Friday, coupled with falling metals prices, suggested investors were pulling back on that so-called debasement trade.

Some investors noted that Warsh's stated views wouldn't necessarily translate to any near-term policy changes. While Fed chairs have historically wielded outsize influence at the central bank, they lack power to make policy on their own. The Fed, with the approval of Trump-appointed officials, just started expanding its balance sheet again by buying short-term Treasurys in an effort to relieve pressure in overnight lending markets.

For investors, a major concern has been that whomever Trump picked would be a less independent figure than previous chairs, thanks to Trump's repeated demands for much larger rate cuts. His administration has also pressured the central bank with criminal probes.

Investors and economists have argued that a Fed free from political influence is critical to keeping inflation stable, which is itself a cornerstone of healthy markets.

"The market will be comfortable with the pick," said Dan Ivascyn, chief investment officer of bond-powerhouse Pimco. "He will exhibit sufficient independence."

In some other countries, including the U.K., a central-bank leader dissenting from an interest- rate decision isn't unheard of. But it would mark a major change in the U.S., and some investors argue that a shift in that direction could weigh on markets by creating more uncertainty about the Fed's future decisions.

Peter Boockvar, chief investment officer at OnePoint BFG Wealth Partners, said Warsh's complicated history makes it hard to immediately discern his likely policies as Fed chair.

"Will the real Kevin Warsh please stand up?" he asked.

