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Have they forgotten how to price risk without the Fed guiding them?

Warsh Makes Markets Do Their Job

REVIEW & OUTLOOK

Memo to Wall Street: Quit whining about the Federal Reserve. Your clients are paying you (a lot) to make judgments about risks and returns in real time, and it's embarrassing when you complain now that Daddy Fed isn't telling you how to do it.

We're sorry for any ruffled feathers, but someone has to say this after the outpouring of scorn directed at Fed Chairman Kevin Warsh this week. The second Federal Open Market Committee meeting he led in his still-new tenure on Wednesday left the overnight Fed funds rate target range unchanged, though with three dissenting votes in favor of an increase.

In his press conference following the meeting, Mr. Warsh delivered a strong statement that the Fed aims for 2% inflation and not 2%plus-what-we-think-we-can-get-away-with. But he otherwise stuck to his determination to deprive markets of "forward guidance" on future rate moves. Cue a freak-out on Wall Street, on bond desks—and among the journalists these folks talk to.

This distills to two complaints that we can see. The first is that Mr. Warsh is blowing his credibility by not raising interest rates to tamp down stubborn inflation, especially with a new Middle East energy-price shock looming. This crowd argues that rising bond yields since Wednesday, especially at the long end of the curve, signal that investors doubt Mr. Warsh will bring inflation under control.

Maybe, and maybe not. Even after this week's rise, rates aren't high by historical standards. The 10-year Treasury at about 4.74% is lower than it was for most of the 1990s and the entirety of the '80s. Ditto the 30-year at 5.28%. As of Thursday, the average annual inflation rate investors anticipate over the next decade, as measured by the 10-year breakeven on inflation- protected bonds, was 2.27%. That's above the Fed's target, but less than the 2.5% inflation priced in May.

An alternative explanation for the recent rise in long rates could be anticipated economic growth as investors continue to digest the artificial intelligence boom. Friday's rising yields were accompanied by good days for equities around the world. Enthusiasm for stock investments seems to have drawn capital into those markets and pushed up bond yields to compensate. It all sounds so old-fashioned, and also, dare we say, normal.

We don't know which of these factors—agita surrounding Mr. Warsh's credibility and inflation, economic growth, or something else—is driving markets now. Neither, we'd venture, do many market pundits. Which leads us to the other complaint about Mr. Warsh—that he isn't telling investors what to do. This leaves them to figure it out for themselves. This encompasses several whinges. One is that by abandoning the Fed's prior practice of sending strong signals about its future rate intentions, Mr. Warsh is losing control of the longer end of the bond yield curve. Never mind that this was never something the Fed aspired to dictate before the Ben Bernanke era. Mr. Warsh has said this loss of control is a feature, not a bug, of his method. He wants market participants to "play the ball and not the referee."

Whining about the lack of guidance is an odd complaint from the same people who worry markets are sending an important signal about Mr. Warsh's policy choices (see above). Would they prefer he use forward guidance to headfake markets into covering his tracks?

A related complaint is that the Fed is too important to be this quiet. This is more true than it used to be after repeated rounds of quantitative easing made the Fed a major participant in the Treasury market. But the Fed's guidance often has been wrong and damaging—incorrectly forecasting inflation, and trapping itself in policy errors. Especially because it's the 800pound gorilla in markets, better a gorilla that sits quietly for a change.

Much of this may not be about economics. One undertone to this debate is that many of Mr. Warsh's critics want to goad him into a rate increase that would antagonize President Trump. The Fed press corps would love nothing better, after feuds between Mr. Trump and Mr. Warsh's predecessor Jerome Powell made for rare compelling copy about a central bank.

There's also the awkward question of whether Wall Street knows how to do the riskpricing Mr. Warsh now asks of it. Not since 2008 have trading desks had to make decisions on bond deals without reference to a cheatsheet from the Eccles Building. That's roughly a generation if not two, as measured by the career span of a bond trader.

Mr. Warsh knows his reputation is on the line concerning his ability to deliver price stability. And it's been all of two meetings and 71 days since he took on the job. The freak-out is premature, and it reflects worse on Wall Street than it does on Mr. Warsh.
