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The radicalism of a Warshian Fed

- **Markets are starting to recognize the radicalism of a Warshian Fed**
- **But they are pricing its impact too narrowly**
- **The key involves understanding the link between balance sheet, rates, and affordability**

It's pretty clear what Warsh would like to do at the Fed. It's exactly what he has written in op eds, and Stephen Miran reiterated last Friday: shrink the balance sheet aggressively, and offset the impact with rate cuts.¹

More debatable is the extent to which he would be able to achieve this, and the impact it might have on markets and the economy. But as so often when it comes to questions of balance sheet policy, we think much of the confusion stems from the shibboleths of trained economists. This piece argues the impact would be just as radical and yet considerably broader than markets are pricing to date.

From debasement to rebasement?

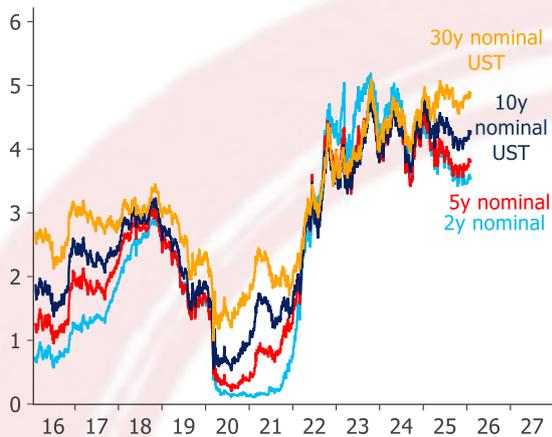
Much of the exciting price action over the past ten days seems to have been catalysed, if not actually caused, by the nomination of Kevin Warsh to chair the Fed. So far markets seem to think he would be good for the dollar, drive a modest bear steepening of the yield curve, have a limited impact on risk assets, and be bad for precious metals. A vote of confidence, then – albeit one slightly at odds with the condemnation from some parts of the economics profession?²

¹ ["Warsh Return Renews Tension on Fed \\$6.6 Trillion QE Hangover"](#), *Bloomberg*, 1 Feb.

² ["A Bad Heir Day at the Fed"](#), P. Krugman, 30 Jan.

A modest backup and steepening

UST yields, %



Source: Macrobond, Satori Insights.

Warshian rebasement?

Gold vs silver prices



Source: LBMA, Bloomberg, Satori Insights.

This price action constitutes a pretty much perfect, if mostly modest, reversal of what most economists think of as the textbook effects of QE. Fed QE, they would say, both drove and was designed to drive a compression of term premia and fall in long-term yields, with \$ weakness as an ancillary benefit, and spillover support for risk assets came largely as a consequence of those interest rate and FX moves. Flight into precious metals on fears of debasement has been a side effect. It is therefore unsurprising that the nomination of a candidate for Fed Chair who has been vocal about his desire to reverse the Fed's balance sheet unwind³ should spark a partial reversal.

So far, so logical. But there are three problems with this narrative. First, there is the viciousness of both the run-up and the retrenchment in many assets – which points to momentum-chasing and herding more than mere interest rate-driven effects. Is this mere coincidence – or do monetary or other factors have the potential to create a cascade of unwinds across assets?⁴ Second, balance sheet reduction is only the first half of the Warshian policy proposal: it needs to be considered alongside extreme rate cuts. Third, as seems clear to everyone except trained economists,⁵ the primary impact of QE over the last fifteen years was an enormous rally in risk assets, and associated decline in what it has become popular to describe as “affordability”. It was the impact on term premia, curve steepness and yield levels which was always ambiguous.

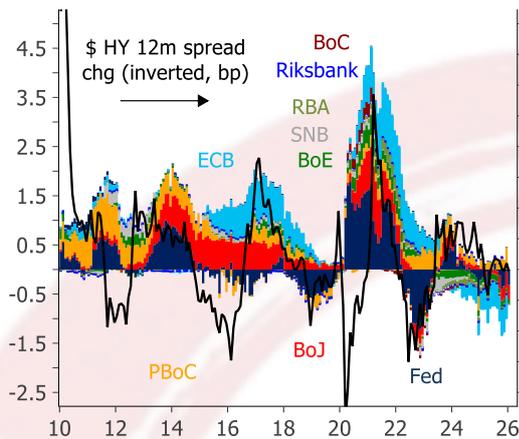
³ For a concise (and we think persuasive) articulation, see “[Commanding Heights: Central Banks at a Crossroads](#)”, K. Warsh, Apr25. Those condemning his proposals might like to ponder his enthusiastic endorsement by Mark Carney and Raghuram Rajan.

⁴ “[Michael Burry Warns of Cascading Effects From Bitcoin Plunge](#)”, *Bloomberg*, 3 Feb.

⁵ The trouble with economics – in contrast with other, more properly social, sciences – is that it tends to study individuals as they *ought* to behave, so as to make them more easily modellable, rather than start from how they actually do. For an amusing book full of counterexamples from the advertising world, see *Alchemy*, R. Sutherland.

QE's link with risk assets is clear

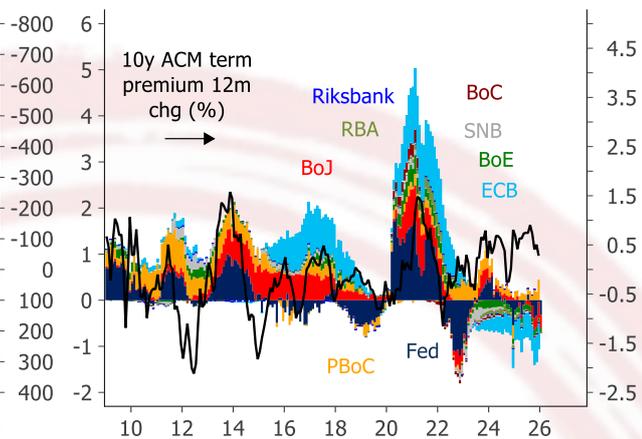
CB reserves chg (\$tn) vs \$ HY spreads, rolling 12m



Source: national central banks, Macrobond, Satori Insights.

TP link less obvious / counterintuitive

Global QE/QT (12m reserves chg, \$tn) vs UST term prem



Source: national central banks, Federal Reserve, Macrobond, Satori Insights.

We have written at length elsewhere about why QE's impact on risk assets is so much clearer than its effect on rates.⁶ But as with Bernanke's famous quip about it working in practice but not in theory, it seems straightforward provided you don't think about it too much. QE and balance sheet expansion created more money and simultaneously crowded investors away from risk-free assets and into risk. It may not have created CPI inflation as Warsh once feared, but it did create asset price inflation. QT was always likely to do the opposite.

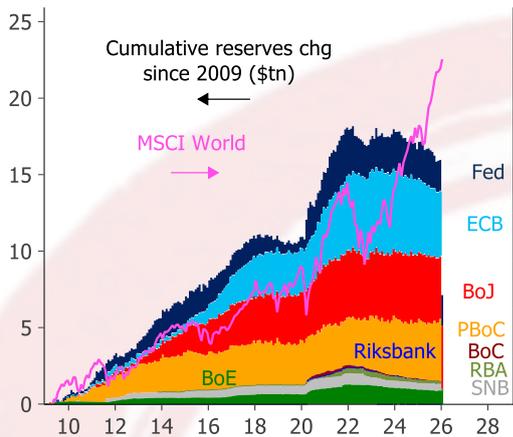
Whether you make much or little of this distinction between CPI and asset price inflation in our experience correlates closely with the extent to which you have studied economics – and marks the dividing line between those who struggle to come to terms with Warsh's seemingly unstable opinions (like *The Economist* and Martin Wolf⁷) and those (like us) who find them consistent and sympathize with them. Economists consider CPI inflation pernicious, but asset price inflation harmless or even positive. Others counter that in the real world it may prove little consolation that you can afford to buy bread if you can't afford either a house or a pension.

⁶ *Global QT: what central banks haven't learned*, Mar24.

⁷ "Reading the runes on a Warsh Fed", M. Wolf, *FT*, 4 Feb.

\$17tn added, only \$1tn drained

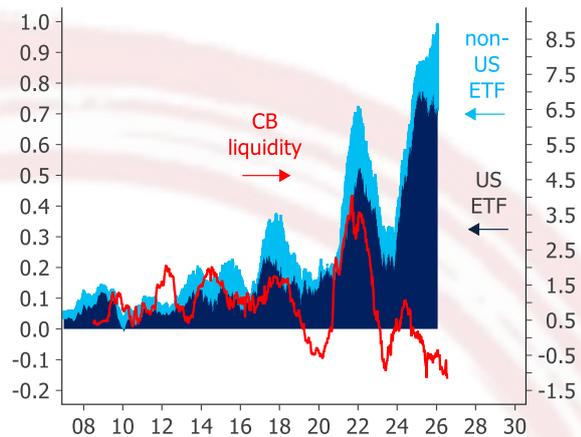
Central bank reserves chg vs equities



Source: national central banks, Macrobond, Satori Insights.

What if we ran this properly in reverse?

Equity ETF inflows vs G4 CB liquidity, rolling 12m, \$tn



Source: ICI, S&P Global, Macrobond, Satori Insights.

But if the major impact of QE was to drive up asset prices, it begs the question of why there has not been a more obvious reversal in risk assets – and rise in volatility – given QT to date. Economists’ rather convoluted answer is that the effects are asymmetric, with QT providing adverse effects only once liquidity becomes scarce – not when reserves remain in excess above some (slightly mysterious moving) threshold. A more intuitive alternative might revolve around some combination of the limited scale of QT to date, the offsetting impact of ongoing fiscal deficits, and a tremendous rotation into risk.⁸ If Warsh gets his way on the balance sheet, policymaking might just be sufficiently radical as to call the latter into question.

From Wall Street to Main Street

But surely no one could sensibly want to reverse the past fifteen years’ rally in risk? Economists tend either to dismiss Warsh’s balance sheet proposals as impractical⁹ or to ignore them entirely.¹⁰ Asset price inflation might be innocuous; policies designed almost to cause asset price deflation are unthinkable – especially on Wall Street.¹¹

But as the Heritage Foundation’s Project 2025 shows, unthinkable ideas are like the proverbial London buses, coming either not at all or else all at once. The prominence accorded to Fed balance sheet contraction by both Warsh and Bessent – who has repeatedly called the Fed’s large holdings a ‘distortionary’ experiment causing

⁸ [Replay: The limits of easy money](#), Oct25.

⁹ [“Warsh Promised More Than He Can or Should Deliver”](#), Bill Dudley, *Bloomberg*, 2 Feb.

¹⁰ [“Warsh Looks Like a Smart Choice for the Fed. For Now: Editorial”](#), *Bloomberg*, 2 Feb.

¹¹ [“Saying You Want to Shrink the Fed Is One Thing. Doing It Is Another.”](#) *WSJ*, 2 Feb.

‘unintended consequences’ like asset inflation and affordability pressures – makes it seem like this may even have been a deciding factor in his nomination.

So how might a Warshian balance sheet retrenchment work? Clearly its impact might in part be offset through aggressive rate cuts. It might also create conflict with Trump.¹² But as his November 2025 WSJ op ed makes clear, a desire to “tighten financial conditions for asset markets” would be a feature, not a bug.¹³

You’d need to be careful how you did it, of course: a K-shaped economy, with consumer spending driven by the ultra-wealthy, might prove vulnerable to abrupt equity market falls. But corporate and household debt levels are low, and the momentum behind hyperscaler capex currently feels robust. The fallout for the real economy might just as conceivably prove limited. Wider credit spreads would be offset by lower interest rates. Lower rates would also make the fiscal interest burden more bearable, especially with over 20% in T-bills – potentially creating a de facto accord without the need for any formal credibility-undermining coordination between Treasury and Fed.

There’s still the distinct likelihood that many on the FOMC might vote against such a radical shift from current policy. But despite concerns,¹⁴ repo or money market liquidity shortages could be dealt with using exactly the sorts of temporary, targeted mechanisms outlined by the Fed’s balance sheet specialist Annette Vissing-Jorgensen last year¹⁵ and currently being employed – without obvious disastrous effects – by the Bank of England. The pace of balance sheet tightening – and associated offsetting rate easing – could easily be tweaked as necessary, should markets be falling too fast. Runaway CPI inflation hardly feels likely with equities and conceivably house prices falling. The hurdle lies less in the implementation than in adopting the mindset.

Abandon asymmetry - think like a radical

As with the outlook in general, it feels hard to think about the potential for such a regime shift probabilistically – but it also seems clear that it is not priced in.¹⁶

Were you to shrink the Fed balance sheet back to pre-2008 norms “as quickly as is prudent”, as outlined (like so many other previously-unthinkable-but-now-implemented Trumpian policies) in *Project 2025*, the associated c.\$3tn drop in reserves could easily see

¹² [“Warsh’s White House Honeymoon Will Be Brief”](#), C. Crook, *Bloomberg*, 4 Feb.

¹³ [“The Federal Reserve’s Broken Leadership”](#), K. Warsh, *WSJ*, 16 Nov.

¹⁴ [“The Treasury market is treading in dangerous waters”](#), M. Singh, *FT*, 4 Feb.

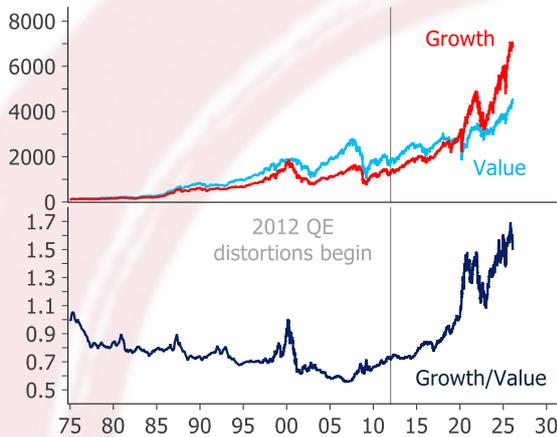
¹⁵ [“Fluctuations in the Treasury General Account and their effect on the Fed’s balance sheet”](#), FEDS Notes, Aug25.

¹⁶ [“Replay: Throwing bad money after good”](#), 27 Jan.

equities dropping 30%.¹⁷ That ought to facilitate cutting rates by at least 2%. Even if the curve steepened, yields across the curve (and world) would probably fall. So too would the dollar. Volatility would rise, but the volatility of volatility – and OTM skew – ought to fall.

Growth/Value used to mean revert

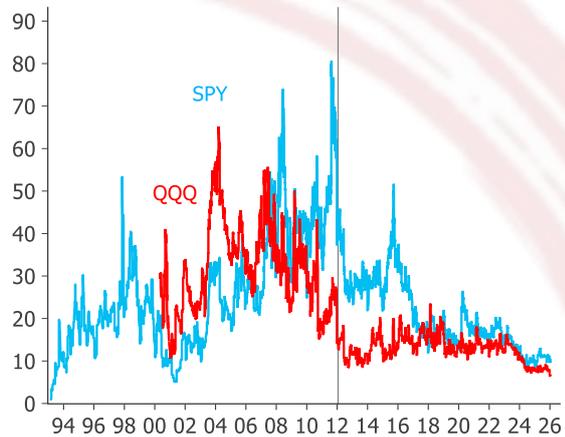
MSCI World sectors, indices



Source: MSCI, Satori Insights.

Investors used to dare to run shorts

Short interest, % outstanding

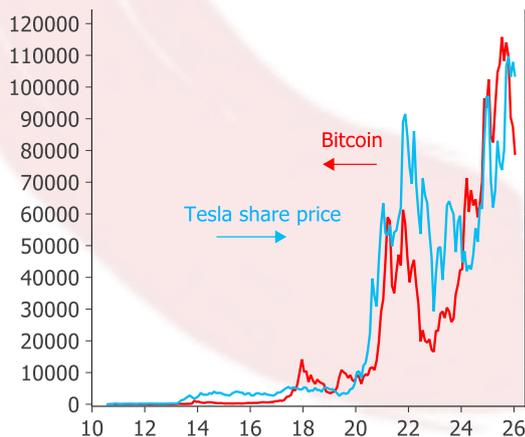


Source: Bloomberg, Satori Insights.

It seems ridiculous when stated like that. But think of it less as an overnight shift and more as a reduction in future upside, as a removal of the “invisible hand” we have complained has been pushing cyclical equities and other risk assets away from fundamentals since around 2012¹⁸, and forcing value investors out of business, and it becomes a bit more plausible.

Coincidence, or common factor?

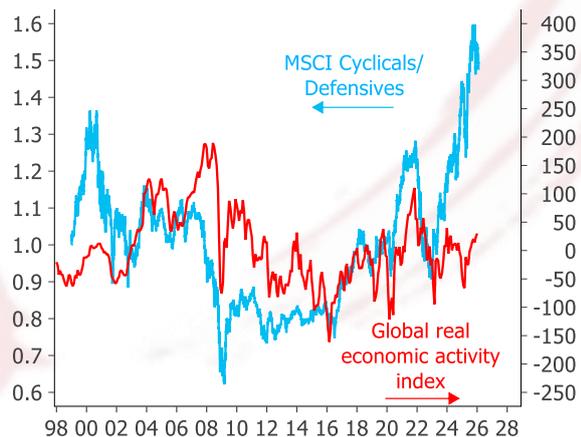
Tesla vs bitcoin, \$



Source: Macrobond, Satori Insights.

Upswing or market froth?

MSCI World equities vs FRB Dallas activity, indices



Source: MSCI, Bloomberg, FRB Dallas, Satori Insights.

¹⁷ Relying – rather dubiously, given the magnitude of the moves – on our long-standing empirically derived rule of thumb of \$100bn change in reserves corresponding with 1% gain or loss in equities.

¹⁸ *Why are financial conditions so benign?*, May24.

The barrier to persuading others on the FOMC would doubtless be high. With Senate hearings likely in mid March and instatement probably only in time for the June FOMC, many would argue sweeping changes to balance sheet policy are unlikely prior to 2027.

But bear in mind that it might be easier to change minds on a technical topic like the balance sheet than on, say, the outlook for inflation. Warsh’s market experience is widely respected: if he could win over Roberto Perli and Lorie Logan, it seems plausible others would follow. And with a large shift in balance sheet policy could also come a large shift in rates. Like the zen enlightenment which provides the name *satori*, regime changes are a long time in the making but then tend to occur suddenly.

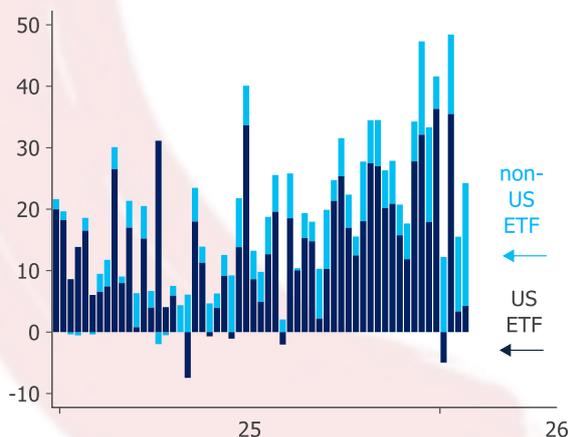
Storm in a silver chalice

If this all seems a little speculative, where it gets interesting is the interaction with recent price action.

We have argued previously that no one in the current Fed is sufficiently concerned about financial stability as to cast doubt on current signs of exuberance in markets – meaning that if outsized fund inflows are to stop, they would have to do so of their own accord. But there are already signs investors may be re-evaluating the risks they are running – and speeches or testimony from Warsh could easily encourage this.

What happened to the wall of inflows?

Equity ETF inflows, weekly, \$bn



Source: ICI, S&P Global, Macrobond, Satori Insights.

PE's soft(ware) underbelly

Total return indices, Jul14=100



Source: Morningstar, Bloomberg, Cliffwater, Macrobond, Satori Insights.

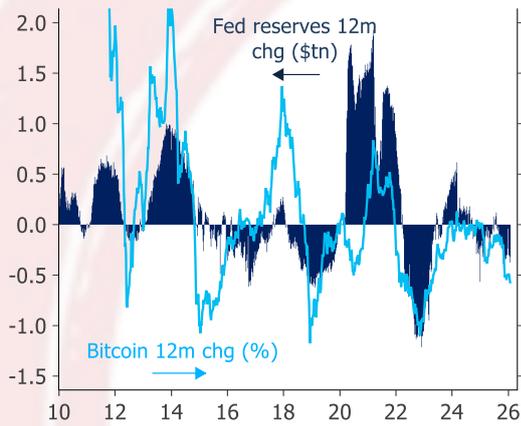
So far this has primarily taken the form of an acceleration in the rotation away from US equities and away from US tech software and BDCs – but without a real reduction in risk or decisive shift towards broader fund outflows. But it is striking that it is occurring at all, given outsized US economic surprises and generally decent corporate earnings.

This may well prove to be just another idiosyncratic shock, like First Brands, which does little to change the big picture. But our rule of thumb has always been that central bank

reserves expansion has a habit of fuelling the frothiest parts of the market, discouraging value trading and encouraging momentum and FOMO. It is quite easy to construct a scenario where one by one – starting with bitcoin – these segments are called into question. We have long argued that momentum-driven markets are subject to sawtooth-shaped retrenchments. A shift to a smaller balance sheet would be likely to accelerate such reversals. And just as rate increases did little to curtail the run-up, so rate reductions would prove of limited use in stemming a retrenchment.

Bitcoin bros love a big balance sheet

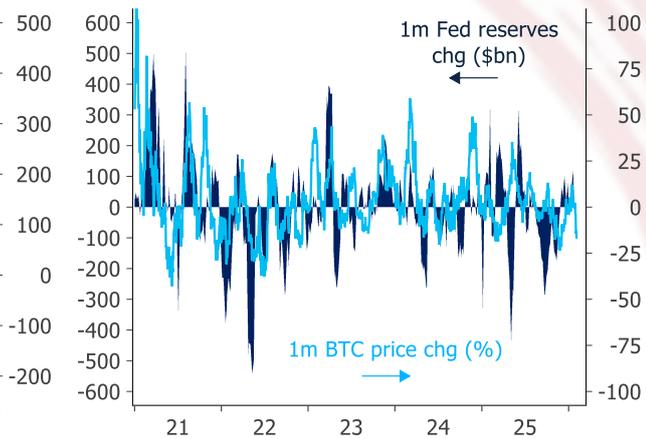
Reserves at Fed vs bitcoin, 12m changes



Source: Federal Reserve, Macrobond, Satori Insights. Percentage change may have minor inaccuracies due to compounding of weekly changes and bitcoin's extreme volatility.

Might Warsh make them lose faith?

Fed reserves chg vs BTC



Source: Fed, Macrobond, Satori Insights.

Finally, note that while gold and silver have also been surprisingly volatile, the drivers here, especially for gold, seem different. Unlike bitcoin, gold has never correlated well with either global or US reserves changes. To the extent to which its rally is being fuelled by speculation – as opposed to long-lasting disquiet at changes in the world order – the source of that speculation appears to be China. It was China selling which drove the recent sell-off, but positioning metrics there have already corrected considerably.¹⁹

¹⁹ See the gold page in our daily [UST-USD capital flight charts](#).

Gold follows a mostly different tune

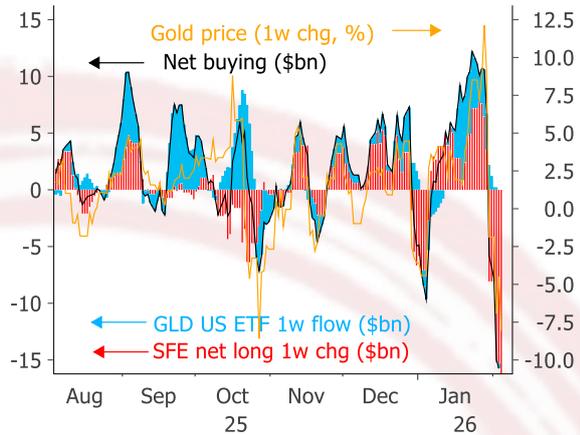
Gold and bitcoin prices (% chg since 2015)



Source: Macrobond, Satori Insights.

Who sold gold? Ask Shanghai

GLD ETF vs Shanghai futures gold rolling 1w flow, \$bn



Source: SFE, LBMA, Satori Insights.

With tax rebate cheques on the way, Trump under pressure to provide goodies to offset his trailing position in the polls, and corporate profits robust, it still feels premature to call for more than a mere risk rotation.²⁰ But just as it would have been a mistake to underestimate the radicalism of the Trumpian White House, so we think it would be a mistake to underestimate the radicalism of a Warshian Fed.

²⁰ [Replay: Throwing bad money after good](#), 27 Jan.