

# REGIME CHANGE

As summer shifts to fall, change is in the air. And, now, it concerns an institution of great importance to investors and the economy: the Federal Reserve.

President Trump this week ratcheted up his challenge to Fed independence, a cornerstone of economic and financial policy for decades. After the sudden departure of one Biden-appointed Fed Governor in early August, with one week's notice, on August 25, President Trump said he was firing a second Governor, alleging "cause". Governor Lisa Cook, also appointed by President Biden and approved by the Senate to a position that only expires in 2038, has refused to step down, and is suing to block her firing. The President pointed out that if his nominees are in a majority on the Fed Board by the end of this year, they will effectively control not only the path of interest rates but also the broader composition of the central bank.

Most of the attention has been on the Fed's role in setting interest rates. The central bank has broader authority over monetary policy, including the management of the balance sheet, e.g., through Quantitative Easing (QE) and, more recently, QT (quantitative tightening) and is an important player in financial supervision.

The threat to independence is real. But does it truly matter?

Most experts would say yes, absolutely. Bringing the central bank effectively under political control of the White House could lead to higher inflation and ultimately higher interest rates and constrain

US growth. History, including in the US, shows that politically influenced central banks are poor at ensuring price and financial stability. Given the global importance of the dollar and US financial markets, the risks of financial instability in the US is a worldwide risk.

But financial markets this week appeared not to be concerned. With tailwinds from both tech hopes, still high after Nvidia's earnings, and expectations of an early interest rate cut helped to push US equities to new heights on August 28th, before sliding slightly on the last trading day of August. This brings the rise for August to 2.0%. For the year so far, overseas markets are still ahead of the US. But that largely reflects the dollar's decline in the first half of 2025.

## SQUARING THE CIRCLE?

With the Fed's cherished independence under threat, economists and many policymakers warn of great risk to the economy. Former Fed Chair and Treasury Secretary Janet Yellen characterized President Trump's battle this week against Fed Governor Lisa Cook as "profoundly dangerous."

Cook has been accused of mortgage fraud, allegedly listing two homes as "principal" residences. The Governor has not been charged with any offense and has refused to resign and promised to sue. If she were to leave, the President would have a second seat to fill on the Washington-based Board of Governors, bringing his appointees to four or a majority of the seven-member Board.

The regional Fed Presidents, who rotate on the policymaking committee of the Fed, are selected locally. But every five years, including in 2026, their reappointment must be approved by the Board.

The White House could thus be in a position to exert enormous influence over the formation of monetary and regulatory policy by the time Chair Powell's term ends next May, effectively substituting executive control for legislative oversight.

Financial markets appeared unrattled by this. Similarly, the President's recent moves to involve the government in private companies have been shrugged off, including steps to take a 10% stake in Intel, criticized as a move to "state capitalism" by some traditionally conservative commentators, such as AEI Economic Director Michael Strain.

As with the worries from economists about potential long-run damage to the US economy from high and shifting tariff barriers to trade, investors seem to be more focused on today's underlying strength and flexibility of the American economy and the promise for future innovation and growth from technology, notably AI. Moreover, the expectation of lower interest rates boosts stock prices of growing companies. Rate cuts increase the present-day value of expected future earnings from AI, in which US big tech firms are investing at scale. Market optimism about AI is still high, although there is discussion on how quickly and substantially AI investment will pay off, e.g., the recent MIT report on AI.

To reconcile the different views, it is worth remembering that the dangers from a shift towards less open markets, or a politicization of monetary policy, are both uncertain and likely to be felt gradually and over time. Much as it took years for the negative impact on the UK of Brexit to become evident, it could take time for any impact on productivity or inflation from today's changes to show up in the US economy. And the big successful tech companies that are driving up US equity

markets may still flourish in such a future.

Finally, it is difficult for markets to price uncertain risks. For example, markets have not been deterred by recent geopolitical turmoil. Wars raging in Europe and the Middle East appear unlikely to have an economic or financial impact in countries, like the US, that are not directly involved.

## WHERE WILL RATES GO: NEVERMIND NEXT MONTH – WHAT ABOUT NEXT YEAR?

There are opposing economic forces in the US right now.

As Fed Chair Jerome Powell noted in his speech to the Jackson Hole annual symposium of central bankers and academics, there are risks to both inflation and employment, the two sides of the Fed's dual mandate.

Employment first. Growth has slowed this year. Notwithstanding a pickup in Q2 GDP that was revised further upwards this week, growth for the first half of 2025 was running at a slower rate than expected at the beginning of the year. In the first half of 2025, output grew by 1.4% at an annual rate. Last December, the Fed expected growth this year to be almost twice that. The labor market appears to be weakening, with fewer jobs being created and fewer workers risking quitting existing jobs, although weekly unemployment data still show employers reluctant to lay off workers.

A weaker economy should dampen inflation. But so far in 2025, price increases have been higher than expected at the outset of the year. Although the impact from tariffs has been lower so far than many feared – and predicted – the pass through to prices is keeping inflation above the 2% target, viewed as equivalent to price stability. Warnings from some consumer companies of likely increased pass-through of tariffs in coming months suggest that it will be some time before we see a return to a downward trend in inflation.

These opposing forces kept the Fed from cutting interest rates so far this year, even as Presidential pressure to do so built up.

But after months of waiting, markets finally got an easing signal on August 22 Chair Powell noted that the balance of risks had likely shifted, with a weaker labor market of more concern. This week's release of the Fed's preferred measure of inflation, PCE, for July reaffirmed the easing message. Inflation in July remained elevated, but generally in line with expectations. Interest rate cuts are on the way, with a likely 25 basis point move at the Fed's September meeting. Markets were happy. Equity prices in the US jumped on the day of Chair Powell's Jackson Hole speech with the S&P 500 rising 1.5%. The equal-weighted version of that index did even better, as did small caps. But investors looking further ahead are wondering how far even a Fed full of new appointees will bring down interest rates if inflation stays high. More significantly, while the Fed can cut short-term rates, it does not control the longer-term rates that feed through to the real economy through mortgage costs, auto loans and credit cards. If monetary policy is eased too quickly, long rates may back up (see below) frustrating the President's aims.

## TARIFF NEWS

The US economy may be able to absorb the shock from higher tariffs with surprisingly little immediate pain. But for trading partners, the risk to export industries from a sudden increase in trade barriers to the US can be great. President Trump has doubled the tariff on Indian goods to 50%, effective August 27. This complicates plans to shift supply chains from China to India and will likely add considerably to the price of the \$80 billion or so of consumer goods imported into the US from India every year. For India, exports to the US amount to a little over 1% of annual GDP. The President said that the tariff doubling was in response to India's continued purchases of Russian oil. Another major

emerging market, Brazil, also faces 50% tariffs on goods imported into the US, in this case for a political reason, that former President Jair Bolsonaro is being prosecuted for an attempt to overturn his election defeat.

## EQUITIES

Investors were treated to an earnings release from the world's largest AI bellwether this week, with Nvidia reporting record sales. However, the market's reaction was one of mild disappointment given the lofty expectations heading in. After nearly four months of impressive price momentum, the AI ecosystem has been facing renewed skepticism. Once again, questions are being raised about whether AI can deliver on its electrifying promises—and whether hyperscalers' massive investments will translate into sustained earnings growth.

With AI bets increasingly crowded and valuations arguably stretched, many investors are looking elsewhere for opportunities. Smaller-cap stocks were clear beneficiaries when Jay Powell signaled an upcoming interest-rate cut, helping the Russell 2000 close the performance gap by nearly 400 bps versus the S&P 500 this month. Still, small- and mid-caps remain well behind their large-cap counterparts on a YTD basis.

While rate cuts should provide some support for broader market strength, stronger economic data will likely be needed for the rotation to have staying power. That remains in question. Retailers report that US consumers are becoming more cautious on big-ticket purchases and are gravitating toward discount chains to maximize value. Tariff effects are beginning to seep through the economy, and the labor market is showing early signs of weakness. The key question is whether rate cuts, deregulation, OBBBA provisions such as accelerated depreciation, and other pro-growth measures will arrive in time to stave off stagflation—even if outright recession is unlikely.

Outside the US, Europe has looked like an attractive diversification play within equity portfolios. The MSCI Europe Index is up about 25% YTD in US dollar terms, but can it continue to outpace US benchmarks? According to Goldman Sachs, corporate earnings in the region barely cleared a low bar, with estimates revised down 7% going into the season. Ex-financials—which surprised 7% to the upside—overall results were roughly in line with the downwardly revised expectations. Moreover, EPS guidance for 2025 and 2026 has been trimmed by 2% and 1%, respectively, since July. Europe may continue to outperform, but more likely via a weaker dollar or shifting price multiples than through robust earnings growth. We expect a choppy Fall ahead.

## RATES AND CURRENCIES

As mentioned above, interest rates in the US have been pulled in two directions in recent weeks, continuing tensions that have been persistent throughout 2025. The front end of the US interest curve, particularly around the two-year point, has rallied substantially in August with the two-year yield falling 30 basis points and bringing the year-to-date rally to more than 60 basis points. This reflects rising expectations that the Federal Reserve will cut interest rates approximately three times over the next two years.

On the opposite end of the curve, the 30-year yield has risen an additional basis point in August, bringing the YTD rise to 13 basis points. A back-up in longer dated rates is a logical response to fears of inflationary pressures further down the road driven by overly accommodative monetary policy, sustained pricing pressures due to tariffs, or both – not to mention fiscal concerns. Points in between, however, have rallied to varying degrees, meaning one must look at other indicators to get a better sense of what markets are pricing.

While much discussed during peak COVID era, breakeven inflation has more recently been

relegated to its traditional back seat status. It may, however, prove topical again soon. Inflation expectations, on this measure, have risen across time horizons from the two-year out to the ten-year point both in August and YTD. Notably, two-year breakeven inflation reached nearly 2.8% by the end of August. These data suggest markets are not expecting inflation to return to the 2% target over the near-term at least. Breaking 10-year breakeven inflation into its 5yr and 5yr forward components indicates that inflation is however likely to abate over the longer term. Finally, 30-year breakeven inflation has fallen over the same period as 30-year real yields have backed-up more than nominal rates – potentially signaling small but growing concerns over the country’s long term fiscal trajectory as investors demand a higher real rate of return to hold treasury debt.

Fiscal concerns are once again topical on the other side of the pond as well. Government stability concerns have caused French government bond spreads to widen by 12 basis points over their German equivalent. French debt now trades at wider spreads than Greece, Spain, and Portugal.

Government and fiscal dynamics have not weighed on the Euro, however. The currency continues to trade at approximately \$1.17, near its year-to-date high. This partly reflects views of the dollar, which was pushed back to its lows of 2025 in late August after a brief rebound at the start of this quarter. The Euro, which has risen 12.5% against the dollar this year, is one of the strongest performers along with other continental European currencies such as the Swiss Franc, Norwegian Krone and Swedish Krona. Perhaps the most notable relative performer has been gold. The precious metal is up 31.4% in dollar terms YTD and set an all time high to close the week. Looking ahead investors appear to be betting on further dollar weakness. Futures positioning in late August points to significant short bets against the Greenback.