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Reading the Markets After Fed Chair Warsh's Debut

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LIZ ANN: And this is *On Investing*, an original podcast from Charles Schwab. Every week we analyze what's happening in the markets and discuss how it might affect your investments.

COLLIN: Well, hi, Liz Ann, we're back again for another episode. There's lots to talk about, for me, not necessarily all that's going on with the Fed. You know, I'm based in New York. We're recording this Thursday, and we have the Knicks parade going on. And I realized I haven't mentioned the Knicks at all. So I had to throw that in there a little bit as a long-suffering Knicks fan to finally get that championship. And I have to say, the city is buzzing right now.

LIZ ANN: Yeah, I did some media on Monday and had on a bright orange jacket with, you know, a Knicks blue scarf, and one of our colleagues said, "Oh you're looking very Florida. What's the occasion?" I said, "Come on, man! Look at the colors!"

COLLIN: Yeah, come on, Knicks. Orange, orange and blue. All right, so enough fun about the Knicks. We do have a lot going on because we had an FOMC, Federal Open Market Committee, meeting this week and it was the first with Kevin Warsh in as the Fed chair, and it was interesting, to say the least. A lot of changes. I think we went in kind of expecting changes, but we really didn't know what to look for. So you know, what was your take on, I guess everything, whether it's the statement, the press conference, key takeaways, you know, what were your high-level thoughts?

LIZ ANN: So Collin, do you think we're up to the "task" of analyzing this Fed meeting?

COLLIN: You know, at first, it was the "unanimous and unambiguous" of the high word count, but that was taken over by the task force.

LIZ ANN: Yeah, so we've got task force. One of the interesting things at the outset was when the statement was released. So no one was anticipating a rate cut. But I don't think anybody was also anticipating there'd be so many words cut from the statement. It wasn't just the forward guidance, but it really went to a very basic statement. I think it went from 400 and some odd words to 130 words. And we're going to assume that that will continue to be how the statement reads and its brevity under the domain of Kevin Warsh. And he did talk about a pretty ambitious reform agenda and mentioned that there would be five task forces. And in many of the responses to questions during the press conference was some version of "We have a task force for that."

In addition to the shorter statement, everybody is assuming that there'll be changes to the communication policy. There's the well-watched dot plot that the FOMC puts out. And not unexpected was the fact that Kevin Warsh did not submit his own dot, which that's an array of expectations by Fed members of where the fed funds rate is going to be at the end of this year and the following year, the year after, long term. It's also the case that based on those dots and commentary, the committee is evenly split between those that think rate hikes are appropriate this year and those that think probably staying on some form of hold is the right move to make.

What I found most interesting, and then I'll turn it back to you, Collin, was how forceful he was in talking about the inflation side of the Fed's mandate. Every time it was brought back to the dual mandate, his emphasis was on the inflation side, not really much at all on the labor-market side of the mandate. So what were your takeaways?

COLLIN: Yeah, I'm in agreement there. Well, if we look at the big picture, there were a lot of hawkish nuggets in there. And you know, what stood out to me was, in addition to the short statement—I'm going to use air quotes here—that seemed like a "statement" from Kevin Warsh in terms of ... he thinks the Fed, you know, says too much, speaks too much. So by significantly trimming down the number of words, there really wasn't much in there, but the final line was "The committee will deliver price stability."

It kind of reminded me, I don't think it's the best comparison, but it kind of reminded me of Mario Draghi of the European Central Bank years ago when he said, you know, "Believe me, it will be enough," in terms of what the European Central Bank would do. That seemed a little bit hawkish there. And he made it very clear that fighting inflation was their number one goal. You mentioned all the task forces and the inflation mandate. One of the forces was viewing that inflation mandate, and he was asked about changing the goal or something like that. And he said, "Well we need to get to 2% first before we can talk about potentially changing that."

The dots, I think, were very interesting. And Liz Ann, I was pretty surprised by the number of dots projecting hikes. Were you a bit surprised by that?

LIZ ANN: Um, I certainly expected there would be a number of them, but fully half, nine out the 18, that was a little sharper than I would have thought, yes.

COLLIN: Yeah. So I assumed we'd see some. You know, whatever some means, you know, three, four, maybe five, something like that. So I'm trying to figure out how to read into the hawkish dots projecting not just a hike, but there were some projecting two hikes and one projecting three hikes. When I look at those, well, one, we're not sure what the future of the dot plot looks like. So this might be some sort of stale projection, which kind of flows into Warsh's idea that we anchor these. I never want to anchor to them. I understand that they can change in real time.

But also if we think about what Fed officials have been saying—they give their regular speeches, we hear from them—I didn't get the idea from a lot of officials that that they were necessarily penciling in hikes. You know, even the more hawkish members were kind of in the wait-and-see mode. And if these trends continue, then maybe we need to consider, you know, tightening policy, and then we see nine dots projecting a hike. So I'm trying to figure out, you know, what's really going on there.

And then something that stood out to me, another, you know, hawkish tilt, Warsh was asked about the level of restriction. And he acknowledged that, aside from the housing market, which I think is important to point out, housing's expensive right now, mortgage rates are up lately and elevated relative to where we've seen over the past, you know, decade plus. But he acknowledged aside from housing, policy might not be restrictive. That was an interesting acknowledgement, suggesting that if you really do want to bring inflation down, the current rate might not get the job done. So lots of moving parts there. And I think I'm really curious to see what happens over the next, I guess, few meetings to see what these task forces deliver. Do you think ... he mentioned that they might all not, you know, come up with solutions or changes at the same time. Do you think that some might come sooner than others?

LIZ ANN: Well, I would think maybe the communication one, given he was most vocal about that, wouldn't surprise me if we get more details on that in the near term. But we walked away from that Fed meeting yesterday, and there was not a lot, but there was some skepticism. There were critiques.

And to me, what will be interesting is, in light of less communication, how much will they communicate about the task forces on an ongoing basis versus whatever you define the end of the task force, the conclusions coming out? So it'll be interesting to

see whether we're just in quiet mode while these task forces work on their tasks. So that's something that'll be interesting.

COLLIN: I do worry that the lack of communication or the decline in communication could result in more volatility. Because if, you know, going back to the some of the first comments you made here about how Warsh responded to questions in the press conference, he didn't give much at all. He actually was very explicit. If someone asked him a question that might result in him giving forward guidance, he kind of acknowledged, "I'm not going to do that right now" and then referred to the task force.

Which was very different from the way former Fed Chair, now just governor, Powell, you know, went along with his press conferences, where he would answer in how he was viewing the economy and the potential evolution of the economy, where he would, you know, strip out potential things that were changing where, "Well, I look at tariffs this way. I look at the potential oil shock from the Middle East this way," and he would give us an idea of what he might expect. Warsh gave us none of that.

And I think that just kind of puts us in the dark a little bit about, you know, what to expect going forward. And I think maybe we'll see, you know, larger movements given a data ... a specific data release. You know, if inflation comes out, you know, let's say higher or lower than expected, and we don't know how each policymaker is viewing that, you can see a lot of changes.

I will add here that, you know, we expect changes to come from the communications front. And a lot of these things and policies that Warsh is not a fan of, it's not like these are long-held traditions by the Fed. So that's why I think he'll have some success in making those changes, whether it's the number or frequency of press conferences—they only began about fifteen years ago or so. The dot plot only came out in 2012. So it's not like these are long-held traditions by the Fed that he's trying to totally upend. So that's why I think he'll actually have some success there.

In terms of market reaction, you know, we saw Treasury yields, at least short-end Treasury yields, rise, I'd say expectedly, given the more hawkish tilt and potential for the Fed to hike rates. We saw long-term Treasury yields kind of bounce all over the place. They rose, then they fell, I think on the idea that, well, if this shows that the committee is committed to fighting inflation, maybe that puts a lid on long-term Treasury yields, and then today they're actually down a little bit. But we saw equity indexes generally fall. What was the key driver there?

LIZ ANN: Well, clearly it was less about oil prices in this case, and, I think, more about some of the surprise factors associated with the Fed meeting. I continue to

think that whether it's volatility in the bond market and volatility in a yield like the 10-year or any kind of meaningful move higher, I think that could be the detriment of the equity market. We're back in a pretty steep negative or inverse correlation between the 10-year yield and equities. So I think the bond market to some degree is in the driver's seat for the equity market, especially in an environment where we're not in the midst of earnings season or in spans of days where we don't have significant market moving economic data.

I think the moves in yields and oil prices of course will dictate what the market does. But there's less attention these days on something that has happened that I don't think a lot of investors realize because there's still so much of a focus on tech and AI and concerns ... I know at client events, I get nonstop expression of concerns about concentration and how do investors avoid that in their own portfolio, a narrowness in the market.

But the market actually has broadened out a bit. We're now at 42% of the S&P 500® index constituents have outperformed the index itself over the past month. That had gotten down into high-single-digit territory not all that long ago. The Russell 2000 index of small cap stocks is up 17.5% year to date versus 8.5% for the S&P 500. Equal-weight S&P is actually slightly outperforming the cap-weighted S&P on a year-to-date basis. And it's surprising to me that a lot of investors don't realize that they're still just in the mindset mantra of it's ... you know, the S&P is the only game in town, and within that it's just the AI space and the mega-cap tech stocks. But there's been this almost stealth and quiet broadening out.

Now there's still an overarching AI theme to what is working even as you go down the cap spectrum. But even that theme has broadened out because it's more than just the hyperscalers and the memory stocks. We're in that mode now as it relates to AI where there's a broader amount of thinking on data-center buildout and what is needed for that, the inputs and power generation and compute. And so that's bringing a lot of other companies and industries into the mix as investors are looking for opportunities.

But I'll turn it back to you because I said I think that the bond market to some degree is in the driver's seat for the equity market. So that means, Collin, the onus is on you to tell me what the 10-year is going to do and then in turn tell me what the equity market is going to do. And then if it doesn't do that, then I have somebody to blame. So that'd be great if you could step back into the conversation here.

COLLIN: Well, that's ... this is good because I was going to ask you a follow-up on that and that 10-year/S&P 500 relationship. So let me talk about the 10-year real quickly. I mentioned that it did rise ultimately yesterday after the Fed meeting,

following kind of that hawkish tilt, but it's back down today. So as we're recording this on Thursday morning, it's about 4.45% on the 10-year Treasury yield.

Our theme lately and our outlook lately is that the 10-year Treasury will probably hold in in the 4% to 4.5% range, although probably closer to the 4.5% range because it's been elevated lately, for a handful of reasons. And those reasons are mostly still in place. Although the key reason that we've talked about, inflation, may be that ... not that it's not a risk now, but if the Fed is truly committed to bringing it down, which I think they always have been, but Kevin Warsh made that very clear yesterday, I think that might help keep a lid on it to a degree.

There's still plenty of other factors out there that we think can keep long-term yields elevated, just, you know, fiscal concerns with our ongoing budget deficits, the general level of global bond yields, because if you're an investor domestically or abroad, and you start to see higher yields elsewhere and something that might look more attractive to you, that could take demand away from the U.S., which might keep our yields elevated or maybe pull them up a little bit. And when we look at across the global spectrum, you know, the Bank of Japan hiked rates again. And the European Central Bank hiked rates. So that might put somewhat of a floor under U.S. Treasury yields.

And then the same theme that that we've been talking about a lot, Liz Ann, is just kind of the regime we're in, more uncertainty, more inflation uncertainty, even though the Fed is very committed to bringing it down, the outlook is kind of very hazy and murky right now. So there could be a term premium. And then let me throw in one final one of why we think yields can stay elevated. Again, we're not expecting them to surge significantly higher. I don't even know if they'll get back to the recent cyclical peak of 5% percent, but there could be some upside from that 4.5% level that we've been talking about. And that's just the overall resilience of the economy. The economy continues to grow. The labor market has been showing strength lately, not just stability. And when you have a healthy economy, a positively sloped yield curve is normal, you know, the slope between, say, the fed funds rate and the 10-year Treasury yield, a positively sloped curve is a good thing.

So I think as long as that economic resilience continues, we're probably going to see that 10-year hold near this 4.5% range. We do see more upside than downside, or maybe a better way to frame it is more factors that could pull it higher than lower. Because we don't think the magnitude of the upside is very high. But I think to see a significant drop in the 10-year Treasury yield, we'd need to see that economic outlook change pretty markedly and start talking about recession. And that's not our base case right now. So my question to you, because you mentioned that relationship with the 10-year and the stock markets we've seen recently, how are

you looking at that in an environment where we've seen short-term yields rise a little bit because of those hawkish Fed expectations? But if those hawkish Fed expectations keep a lid on long-term yields, what does that mean for the stock market?

LIZ ANN: Well, I think some stability in long-term yields would probably be a pretty decent case scenario for the equity market. So it's not simply just a move in either direction causes the stock market to move in the opposite direction. We are in that inverse correlation mode right now. But what tends to trip up the equity market is magnitude and speed. And if we are somewhat range-bound, as you have suggested, and we don't get a quick move back up to those prior cyclical highs of 5%, I think the equity market is probably fine in that backdrop but, I think, still could see some volatility to the extent you get some of these shorter-term sharper moves, which we have seen in the bond market.

One other thing you mentioned that I wanted to touch on is the strength in the economy, which pretty much across the board, we are seeing that, and there was a report out this week that, as it always does, garnered some attention, which is retail sales, which was a bit stronger than expected, including what's called the control group, a component of that that feeds directly into the GDP numbers. One just reminder maybe to people or just a knowledge tidbit for those that might not know, retail sales is expressed in nominal terms, not in inflation-adjusted terms, or real terms.

So the biggest driver of the upside in retail sales was gasoline. And keep in mind, that's a function of the price. That means people are spending more at gas stations. Unfortunately, they're not getting more gas. Their tank still fits the same amount of gas in gallons terms. They're just paying more for it. Now, if you look in real terms, it wasn't a terrible reading either, but it is important because in the last several years, in an environment where nominal retail sales have been quite strong, real retail sales have been somewhat flat and range-bound in a flat pattern.

So I think it's important in an environment of, not just higher inflation with which we're dealing, but heightened inflation anxiety, that we understand that there are certain economic numbers that are expressed in nominal terms and others that are expressed in real terms, like GDP is expressed in real terms. The headline reading that you get is real. So I think that's just a little bit of a public service announcement for listeners that might not be aware of that.

COLLIN: Yeah, it's a price issue as much of a volumes issue, and it's important to pay attention to that. Let me ... I want to follow up on something you mentioned before talking about the stock markets. Also, I always love the opportunity to bring in

conversations I have with my dad to these discussions. So a lot of times I'll be talking with my dad, and he'll say something like, "The market's up" and I say, "What market are you talking about?" And then also, and he's going to laugh when he listens to this, he always references the Dow. And I say, "Dad, that's, you know, a handful of stocks, like at least look at the S&P 500. It's a much bigger, bigger index." But you just mentioned before that it's also not just the S&P 500, and there's a lot of moving parts in there. So ... and I'm asking because I'm not an equity guy, and these things confuse me as well. So given that there are those nuances, and you mentioned, you know, where are these AI companies, which indexes they're in, what should our listeners be thinking about? Or what are like conversations that they can have with their consultant, wealth advisor, specialist about, you know, just thinking about what their equity allocations look like, knowing that there's so many different things under the surface?

LIZ ANN: Well, I think probably the first conversation that any investor should have with their financial consultant or their advisor is, "OK, let's establish a plan." So you have a baseline. So you've got that strategic asset allocation. And one of the most important components of that is diversification. We also often talk about diversification across asset classes, but also within asset classes.

So I think that's where it comes into play because there's been so much of a focus on passive strategies or index-based strategies and people thinking that getting equity exposure is just about indexing to the S&P 500. But you need to be mindful that that doesn't quite provide the diversification within the equity asset class that it might have in years and decades in the past because the S&P has become so much more highly concentrated in the tech sphere.

The combination of technology and communication services is now approaching 50% of the index. So I think we need to have a broader conversation about diversification. I also will say, as a bit of a preview, even though I've talked about it a lot in the past, we're doing a lot more work on factor-based investing, which simply means investing based on characteristics of companies, as opposed to monolithic sector-type investing. And I think that the factor that is most relevant now that you want to look for if you're an individual stock picker, if you use screening tools, is that forward earnings guidance and strength, being on a positive earnings trajectory, having stability in profit margins, but then as a kind of an added kicker, making sure you're not paying a crazy valuation for it. So it's almost old school back to what I think was probably popularized in the 1990s, the GARP approach, which is "growth at a reasonable price." So that's the way I think about the innards of the equity portion of the portfolio.

COLLIN: All right, Liz Ann, let's look ahead to next week. But I want to state that the markets are closed this Friday for Juneteenth. But looking ahead, what's on your radar?

LIZ ANN: Yeah, so there's not a cacophony of incredibly important indicators coming out, with the exception maybe of one, the Personal Consumption Expenditures Price Index, which is the Fed's preferred measure of inflation. Now, we know Kevin Warsh's preferred measure is some form of trimmed mean, so maybe we should start de-emphasizing that a bit, but I don't think we're there yet.

We get the ADP version of jobs. So in the absence of a week with, you know, we don't have a jobs report, I think that's important. We get S&P Global's version of the PMIs, the Purchasing Managers' Indexes, both on the manufacturing side of the economy and the services side, and notwithstanding the fact that the ISM version of those gets more attention, the S&P Global's version is actually a bit broader. So I think we need to look at that in parallel with the ISM.

We'll get another update to first quarter GDP, see if there's any adjustments of note. And then we get the University of Michigan data out, which is everything from consumer sentiment to inflation expectations. So what about you, Collin?

COLLIN: I'm going to tie it back to the Fed. So every time there's an FOMC, Federal Open Market Committee, meeting, leading up to it, they have a communications blackout period, and then it goes a day after the meeting, and then Friday, that blackout period ends. And normally you get this, you know, onslaught of Fed speakers providing their views. Right now that calendar appears to be pretty light. Now, maybe it's an incomplete calendar I'm looking at, but it doesn't look like there's a lot of Fed District Bank presidents or governors providing speeches. There's a few that I see on the calendar. So that might be by design, given potential changes in communications.

But the few that are scheduled to speak next week, I'm really interested to see, you know, what their outlook is and how they approach their Fed outlook in this kind of evolving communications environment we're in. So that that's something I'll be keeping an eye on. And then just to piggyback on what you said, we have the Personal Consumption Expenditures, the PCE release. Knowing that the Fed has made it clear that they're focusing more on inflation than the labor market right now, I think inflation indicators are very important. And that's ... I think that's going to be very important as we figure out what that expected path of Fed policy is over the next few months.

LIZ ANN: So that's it for us this week. Thanks for listening, everybody. As a reminder, you can keep up with us in real time on social media. I'm @LizAnnSonders on X and LinkedIn. Still have lots of imposters, so please make sure you're following the real me.

COLLIN: And I'm @CollinMartinCS on X and LinkedIn. That's Collin with two L's, and the CS is for Charles Schwab. And you can find all of our written reports, which include lots of charts and graphs, at schwab.com/learn.

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