WARSH ENTRUSTS THE FED
AI *BOND VIGILANTES*

Kevin Warsh, the new chairman of the Federal Reserve (Fed), did not feel like acting. He raised the white flag and decided to rely on the market, on *bond vigilantes*. The concise statement released at the end of the Federal Open Market Committee (FOMC) meeting on July 29 already makes it clear in the first line that the decision was not unanimous: with a vote of 9 to 3, it was chosen to leave interest rates unchanged in the range between 3.50% and 3.75%. Yet, the same statement points out that economic activity "continues to expand at a sustained pace despite high uncertainty, due in part to the conflict in the Middle East". While highlighting the strength of the economy and the risks of inflation, the message also recalls the factors that could help contain it: capital investment remains robust, productivity growth, the labour market close to full employment and employment growth in line with the expansion of the workforce. The conclusion is implicit: make your assessments, bearing in mind that the 2% inflation target remains imperative and that the Federal Reserve is determined to pursue it.

The bond market then asked itself a question: Is it possible to reiterate the 2% target so forcefully without concretely indicating how to achieve it? The answer came immediately from yields. The two-year Treasury fell, as expected, because it partly incorporated the assumption of a rate hike. The reaction of the long end of the curve was very different: the yield on the ten-year Treasury rose to 4.72%, while that of the 30-year, particularly sensitive to inflation expectations, exceeded the 5.20% threshold for the first time since 2007. Essentially, the market decided to test the Federal Reserve's credibility.

The technical reasons for the failure to tighten monetary policy had been anticipated by Fed Vice Chairman Philip N. Jefferson in his speech on July 16 at Stanford University. Jefferson had explained that the central bank must distinguish between temporary and persistent shocks, avoiding hasty reactions[1]. He acknowledged that both higher energy prices and investments in artificial intelligence could fuel inflation but stressed that the effects are still uncertain and need to be assessed in light of the data. He also recalled that the labour market remains close to full employment and that monetary policy is already sufficiently restrictive. These could be the official reasons that prompted the Fed to leave rates unchanged on July 29th, reserving the right to intervene only if inflation were to interrupt the path back towards 2%.

Alongside the technical aspects, however, there are also political considerations. Raising rates while the United States is going through an extremely delicate phase of the conflict with Iran and on the eve of Netanyahu's visit to the White House would have placed the new Fed chairman in a very politically uncomfortable position, exposing him to criticism from Donald Trump and the lobbies close to him. Better, therefore, to let the market do part of the work.

On Wall Street, it is widely believed that ten-year Treasury yields steadily above 5% would mark a turning point for both the stock market and the financial sustainability of US debt. Trump, as a real estate entrepreneur, knows well the weight of the cost of money, as well as the *lobbies* that support him. It is no coincidence that the tone of his speeches tends to soften every time yields approach that threshold. For Warsh, who is determined to bring inflation back to 2%, it therefore seems more prudent to let the *bond vigilantes* work, knowing that, should yields become excessively high, not even Trump could oppose a decisive intervention by the Federal Reserve.

After all, markets spent much of the month fearing a 25-basis point hike on July 29. The Nasdaq had corrected nearly 10% from its highs before the July 30 rebound, ending the month with a loss of more than 3%. The correction of the Nasdaq 100,

[1] Philip N. Jefferson, *Navigating Economic Shocks: A Monetary Policymaker's Perspective,* July 16, 2026, https://www.federalreserve.gov/newsevents/speech/jefferson20260716a.htm

more focused on the big artificial intelligence stocks, was even more marked, which had touched -12% (from the highs) before limiting the monthly decline to -6.6%.

The correction was driven by both the awareness of extremely high valuations and the uncertainty about the timing with which the huge investments in artificial intelligence will be monetized, investments that today absorb increasing amounts of liquidity. Emblematic is the case of Alphabet which, for the first time since listing on the Stock Exchange, recorded a negative *free cash flow*.

High valuations and inflation fears were the two dominant themes for the month. The end of the truce between the United States and Iran has pushed the price of Brent from around $70 per barrel on July 6 to $102 reached on July 23. Higher oil prices have reignited inflationary fears and fuelled expectations of tighter monetary policy, particularly hurting stocks with higher valuations.

The case of the Korean Kospi is also significant, supported by two large companies related to artificial intelligence (Samsung Electronics and SK Hynix) which together account for about 58% of the index, also amplified by the spread of leveraged products. Over the month, the index lost more than 5%, partially recovering from -16% on July 29, and still maintaining a gain of more than 48% since the beginning of the year.

Warsh's silence therefore represented a precise message. The markets have corrected above all the most overvalued component of artificial intelligence, as if to cool an enthusiasm that was taking on self-referential characteristics. The more diversified S&P 500, on the other hand, ended July largely unchanged, while the fair-weighted version even advanced close to 1%.

Quarterly reports were very solid in both the United States and Europe. Investors have mainly rewarded companies that are able to expand margins rather than revenues, demonstrating that, in an environment characterized by still high inflation, the real protective factor is the ability of companies to preserve and increase profitability.

European stock exchanges, which are still cheaper than those in the United States, have also benefited. The STOXX Europe

600 ended July at parity, bringing its year-to-date gain to 10%, supported by energy stocks, banks, consumer staples, industrials and some technology companies, including Germany's SAP. At the same time, the euro also strengthened, from 1.13 to 1.15 dollars per euro, while the Swiss franc appreciated further against the dollar, with the exchange rate falling from 0.81 to 0.80 francs per dollar.

Despite Warsh's silence, the last days of the month were supported by Microsoft's excellent quarterly reports. From a technical point of view, the Nasdaq reacted exactly at the 50% retracement of the bullish movement that began on March 31st, while simultaneously finding support near the 200-day moving average. The area of 24,425 points therefore seems to represent a technical level of particular importance.

Will we have positive markets in August as well? The response will continue to come mainly from the bond market. July closes with the yield on the 30-year Treasury still close to its highest since 2007. Soon, quarterly reports alone may no longer be enough to support stock indices. Concrete signs of lower inflation expectations will be needed, therefore favorable news on the international conflict front.