

Norms! Say "Cheers" to Fed Independence (as we know it)

Powell positions himself to go out with a pause, Aerospace and Defense enters a new phase, a tale of two markets, ... and the implications of declining Fed autonomy

Dylan Smith

Monologue

There is a lot to look forward to for macro followers in this last full week before the holidays. The quirky post-shutdown data release schedule means we'll see the latest official labor market indicators (November nonfarm payrolls and the unemployment rate) and CPI inflation the week *after* the Fed's decision to cut rates by 25 basis points. Spare a thought for the FOMC; we'll be parsing their decision with the full benefit of hindsight. Meanwhile, central bank action will continue on the global stage, with the ECB, the Bank of England, and the Bank of Japan all meeting this week.

Speaking of the Fed, we've dedicated a lot of space in this week's Macro Monitor to pointing out how unusually uncertain the outlook for US interest rates has become. The FOMC is going into the new year as divided as it's ever been in living memory.

Zooming out even more, the topic of "Fed independence" will remain a theme in 2026, perhaps getting even more attention than in 2025. I believe that we've already seen a meaningful erosion of *de facto* independence this year.

Specifically, that President Trump's pressure campaign for lower rates ahead of a looming new Chair appointment has been worth 25-50 basis points of cuts already. There's really no other way to understand the Fed's actions in the second half of the year. Going into 2026, there is at least a risk that this trend continues, which, in our view, is worth more than a few tenths of a percentage point of long-term risk premium.

Let's start by laying out what "Federal Reserve independence" actually means.

The broad definition encompasses the ability of the institution to set interest rates at the level required to achieve its mandate (maximum employment and price stability) without political interference. The idea is that politicians on a 2-4-year election cycle always have an incentive to juice the economy with low rates, but less incentive to worry about medium-term inflation. Isolating monetary policy in the hands of experts who don't face these temptations helps entrench long-term economic stability and prosperity.

We can separate the concept into *de jure* independence – the legal structures that protect policymakers – and *de facto* independence, which covers the interpretation of laws, the exercise of power, and the norms of behavior that define the extent of influence politicians exert over the Fed in practice.

There are obvious parallels between central bank independence and the benefits of having an apex court that is as apolitical as possible. Since the US Constitution has been unable to sustain such an institution in the case of the Supreme Court (which is so politicized that its composition is a significant election factor—something alien to most developed democracies), it's natural to ask whether the Federal Reserve might be at risk of a similar loss of credibility.

The Fed's *de jure* independence is generally seen as very weak by institutional standards, the main reason that it is generally ranked well outside the top 50 central banks on this dimension in [academic studies](#). The Federal Reserve Act defines the purpose and legal structure of the Fed. It hands the power to select the seven Governors (including the Chair) to the President, with simple majority ratification by the Senate. The President has the authority to remove Governors "for cause." This term has been left undefined by law until now. The ongoing litigation over President Trump's attempts to fire Governor Cook will force the courts to define this power. There is a lower (but no less fuzzy) bar to stripping the Chair of their position.

In a legal sense, the executive branch of government has meaningful control over the composition of the Fed, should it wish to use it, much like appointments to the Supreme Court. The extent to which this influences interest rates is somewhat watered down by the appointment process for regional Fed Presidents, who are appointed by their own independent boards consisting of regional private member banks (6 members) and representatives from the Board of Governors (3 members). Five regional Presidents vote in each meeting, so they are outnumbered by the seven-member board of Governors. There is nothing to limit underhanded politics from indirectly affecting regional appointments, and we'd be naive to assume it can't happen.

Weak *de jure* protections have meant that Fed independence has always been derived from norms and conventions of governance. By the 1990s, the inflation trauma of the 70s and 80s had created strong buy-in to the idea of isolating interest rates from politics. From Reagan to Biden, Presidents have stayed away from exerting direct power over the institution, bowing to expert and market views on

appropriate appointments (though they have always asked for lower rates – they're only human).

Those norms have been significantly eroded in a short space of time by President Trump. It's now normal for TV coverage of the Fed's decision to switch to President Trump's response immediately after the press conference. The President has made it clear that a hawkish stance will make a Governor's life difficult. Nobody on his shortlist for Chair has expressed much concern about inflation in public speeches of late. The leading candidate, Kevin Hassett, has spent most of his public commentary this year supporting controversial (non-economic) aspects of the Trump agenda and said little about interest rates. Governor Miran, whom Trump appointed in September to serve out the rest of Governor Kugler's term after she resigned months early in anticipation of an adverse ethics investigation, has dissented in favor of more and deeper cuts in all of his meetings to date. The White House has tried to remove Governor Cook on shaky legal grounds (which would open up another appointment). It also tried to undermine Chair Powell for an overspend on renovations to the Federal Reserve building in Washington (relative to a pre-COVID costing), trimmed his budget, and asked him to cut staff.

When summarized in one paragraph, the extent of the public pressure on the Fed is remarkable. In my personal view, the rate-setting committee has bent under that pressure, over-emphasizing the labor market and playing down inflation risk to front-load easing and keep the pressure from building up further.

The Fed may not have broken, but it has bent. And having bent once, the risk is that it bends again.

TAKEAWAY:

In the short run, there is a material risk that the balance of voting members of the FOMC hold interest rates artificially low in 2026, adding to upside inflation pressures that will emerge over the next 12-18 months. Much depends on the willingness of the hawks on the committee to openly outvote a Trump-appointed governor. This would be positive in some respects, but it would also create substantial uncertainty and financial market volatility.

To be clear, I don't think the Fed will be "broken" – the dual mandate and 2% inflation target will stay in place. But it is "bending", and may continue to bend, undermining confidence in its competence to fulfill its mandate.

In my view, this justifies the elevated risk premium on the long end of the yield curve.

In the longer run, there is a tail risk to worry about. Imagine that Trump is able to make a number of openly political appointments to 14-year Governor terms. Would these presumably dovish Governors turn suddenly hawkish under a Democratic administration? It's not as far-fetched a scenario as it sounds. How would that hypothetical Democratic administration react? It might feel the need to appoint a set of Governors with the opposite political persuasion to balance things out. And hey presto! Just like that, the Central Bank is a political bargaining chip, just like the Supreme Court.

To reiterate, that's a tail risk. We don't think it will go that far, mostly because at some point, someone is left holding an inflation hot potato and will view a hawkish Fed as the lesser of evils. But it's a genuine tail risk and should be priced into long-term rates.

Reads of the Week

- **Every Outlook**: The FT's Alphaville blog has collected every 2026 sell-side Outlook that it can get its hands on in one giant Google Drive folder. *Caveat emptor*.
 - **Retail funds crowd traditional LPs out of co-investments**: Retail funds are starting to reshape the private assets industry: "as the industry's largest asset managers build out multibillion-dollar private wealth products, many are finding the opportunity to syndicate co-investments with fee-generating capital more enticing than taking a 'free' equity check from the traditional investor base."
 - **How the "Donroe Doctrine" is changing Puerto Rico**: Who needs economic aid when you can host the military?
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Market Monitor

It was a tale of two markets this week. It was the best of times for rate-sensitive sectors. It was the worst of times for AI hyperscalers.

The Fed's rate cut and retention of its easing bias (the dots still point to one more 25 basis point cut; see Macro Monitor below) helped the Dow Jones Industrial Average to a +1.0% gain on the week, and the Russell 2000 small-cap index picked up by 1.2%.

On the same day that the Fed cut rates, Oracle announced that it would be raising its capital spending to \$12 billion next quarter, up from \$8.5 billion currently, and raised its 2026 projection by \$16 billion. This sent tech stocks into a tailspin amid rising skepticism on the pace of AI infrastructure investment. On Friday, Broadcom's announcement of a \$21 billion order from Anthropic triggered another round of selling. The Nasdaq finished the week down -1.6%.

The Fed's actions also steepened the US yield curve. The 10y-2y slope rose by a hair shy of +0.1 percentage points, as traders priced in a near-term dovish bias in rates offset by longer-term higher inflation risk. Lower rates also helped the gold price to new highs, with the yellow metal breaking through the \$4,300 barrier for the first time.

The Week in Markets

	Latest*	Change since last week (units)	Change since last week (%)	3-month change (units)	3-month change (%)	Year-to-date change (units)	Year-to-date change (%)
Equity							
S&P 500	6827	-43	-0.6	240	3.6	946	16.1
Information Technology			-2.3		4.9		22.5
Financials			2.3		1.6		13.3
Consumer Discretionary			0.3		1.8		5.8
Communication Services			-3.2		5.4		30.6
Health Care			0.4		10.3		11.6
Industrials			1.4		2.7		18.6
Consumer Staples			1.1		-1.3		3.0
Energy			-0.6		2.3		5.7
Utilities			-1.1		0.7		12.3
Real Estate			-0.8		-3.8		0.1
Materials			2.4		-3.4		7.2
Nasdaq Composite	23195	-383	-1.6	1152	5.2	3884	20.1
Dow Jones Industrial Average	48458	503	1.0	2350	5.1	5914	13.9
Russell 2000	6341	74.5	1.2	323	5.4	799	14.4
Sovereign Fixed Income							
US: 2-year Treasury Note	3.52	-0.04		0		-0.73	
US: 5-year Treasury Note	3.75	0.03		0.16		-0.63	
US: 10-year Treasury Note	4.19	0.05		0.18		-0.39	
FRA: 10-year OAT benchmark	3.58	0.05		0.2		0.4	
GER: 10-year Bund benchmark	2.85	0.07		0.19		0.46	
CHN: 10-year CGB benchmark	1.84	-0.01		-0.0347		0.164	
CAN: 10-year GoC benchmark	3.42	0.16		0.25		0.19	
Corporate Bond Spreads							
US: A-rated	71.4	0.1		-4.2		-2.7	
US: BBB-rated	106	0.1		0.9		4.5	
Leveraged Loan Spreads							
US: B-rated	395	-3.6		3.24		-14.6	
US: BB rated	257	-1.56		1.82		119	
US: CCC-rated	1529	-29.7		156		258	
Foreign Exchange Rates							
DX US Dollar Index	98.4		-0.6		0.9		-9.3
EUR/USD	1.17		0.4		0.1		12.7
USD/CAD	1.38		-1.3		-0.6		-4.1
USD/CNY	7.06		-0.1		-0.9		-3.3
USD/JPY	156		0.4		5.7		-0.5
GBP/USD	1.34		0.2		-1.1		6.7
USD/CHF	0.797		-0.4		-0.2		-11.2
Commodities							
WTI Crude	57.3	-2.6	-4.3	-4.6	-7.4	-14.2	-19.9
Gold	4347	104	2.4	717	19.8	1738	66.6
S&P GSCI Commodities			-3.4		-0.1		-0.8
S&P GSCI Industrial Metals			-1.0		9.3		16.8
S&P GSCI Agriculture			-0.7		-1.4		-10.0

* Weekly closing value. Color indicates positive (green) or negative (red) change since prior week.

Source: S&P Global, Russell Investment Group, Nasdaq, U.S. Department of Treasury, Macrobond Financial AB, Central Bank of Germany (Deutsche Bundesbank), Bank of Canada, Intercontinental Exchange (ICE), International Monetary Fund (IMF), LBMA (London Bullion Market Association), Robert Shiller, Chicago Board Options Exchange (CBOE), U.S. Department of Labor, Pitchbook | LCD, arcMacro



Macro Monitor

Fed "Well Positioned to Wait"

The US Federal Reserve cut its policy rate by -25 basis points on Wednesday to a range of 3.5-3.75 percent. The decision brings cumulative reductions to -75 basis points since September 2025 and -175 basis points over the full easing cycle that started in September 2024. Language tweaks in the statement and Chair Powell's responses in the press conference indicated that the Committee is now in a "pause." A January cut is unlikely.

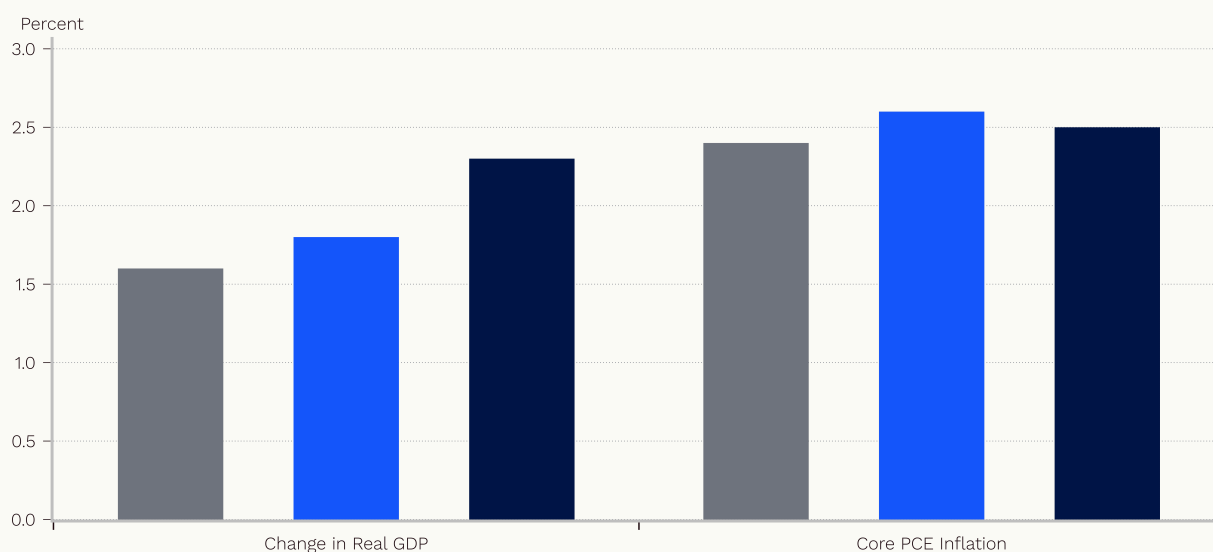
The Fed will also increase purchases of shorter-term Treasuries. This is a measure to ensure adequate liquidity in money markets, and is not QE or true macro-policy, so we needn't say more here (the Fed is still running down its long-dated bonds, so its balance sheet will not expand).

By most measures, this was a strange time to cut. Core inflation is stubbornly above the 2% target (PCE inflation at 2.8%, CPI at 2.9%). The labor market is easing very gradually from historically tight levels. And, because of the interruption to data collection caused by the government shutdown, the FOMC made the decision to reduce rates on the basis of very little new information since Chair Powell said shortly after the October meeting that a December cut was "not a forgone conclusion."

What's more, Chair Powell pointed out that the Committee believes that economic activity will accelerate materially in 2026 due to a combination of fiscal stimulus, higher productivity, and resilient consumption. Meanwhile, the committee members' inflation projections remain above target and risks are to the upside (although he did not commit to a view on whether tariffs are entirely transitory or might carry second-round effects – arcMacro's house view is that they will).

FOMC cut interest rates while upgrading its growth outlook and expecting above-target inflation
United States, FOMC Economic Projections, median 2026 projection

■ June ■ September ■ December



Source: Federal Reserve, arcMacro

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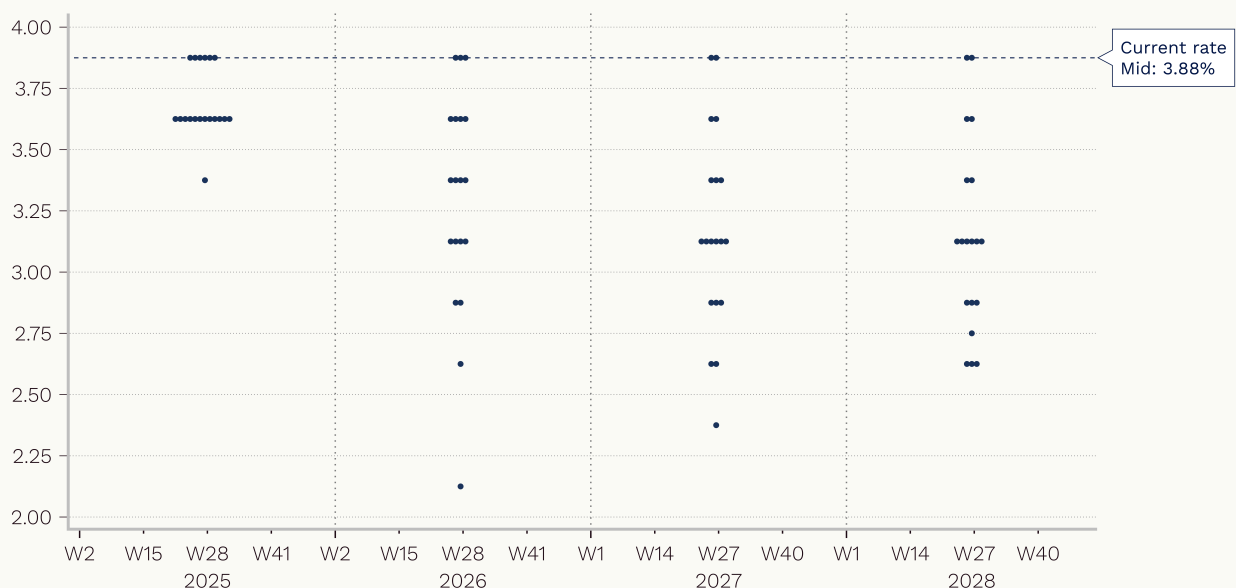
The combination of inflation risk and faster demand growth was enough to convince Chicago Fed President Austan Goolsbee to join Kansas City Fed President Jeffrey Schmid in dissenting in favor of no move (outweighing temporary Trump appointee Stephen Miran's predictable -50bp cut vote). Both defended their votes in public on Friday, warning that an excessively easy policy stance would be counter-productive because it would keep long-term risk premia elevated. Powell was able to convince several other colleagues who have made hawkish speeches of late to join him in voting for a cut.

His likely argument – and this week's cut does make more sense when expressed in these terms – concerns the long-run assessment. The FOMC's median estimate of equilibrium real rates is 1.0%. With inflation running just below 3% and the policy rate now comfortably below 4%, the Fed is mildly "accommodative" or "easy" relative to that stance. The median committee member's view of one more 25-basis point cut next year, combined with inflation falling to ~2.5% would keep the real interest rate steady.

The watchword going into 2026 is "uncertainty." With the message that the Fed can now watch and wait for a while, there is little clarity on the policy path. The range of views as to the appropriate target rate by the end of next year is extremely wide, with three members foreseeing a *hike* and four others no move from today's rate. And there will be turnover on the committee: four voting regional Fed Presidents will swap with new colleagues (all of whom have expressed hawkish views recently), a new Chair will be in place by the third meeting of the year, and there is legal/administrative uncertainty over Governors Miran and Cook's seats.

A committee divided

FOMC "dot plot": Summary of Economic Projections (December, 2025)



Source: Federal Reserve, arcMacro

arc MACRO

Bank of Canada: Back to Boring

"Governing Council sees the current policy rate at about the right level to keep inflation close to 2% while helping the economy through this period of structural adjustment."

With that statement, Bank of Canada governor Tiff Macklem signaled that the easing cycle is over. Since June 2024, he has lowered the policy rate by 275 basis points to 2.25%, creating a 150 basis point wedge to the US Federal Funds Rate (the highest since 1997). Low rates have supported the economy – which is proving more resilient than initially feared – both by supporting domestic demand and keeping the exchange rate weak (thereby lowering the cost of Canadian imports from a US perspective).

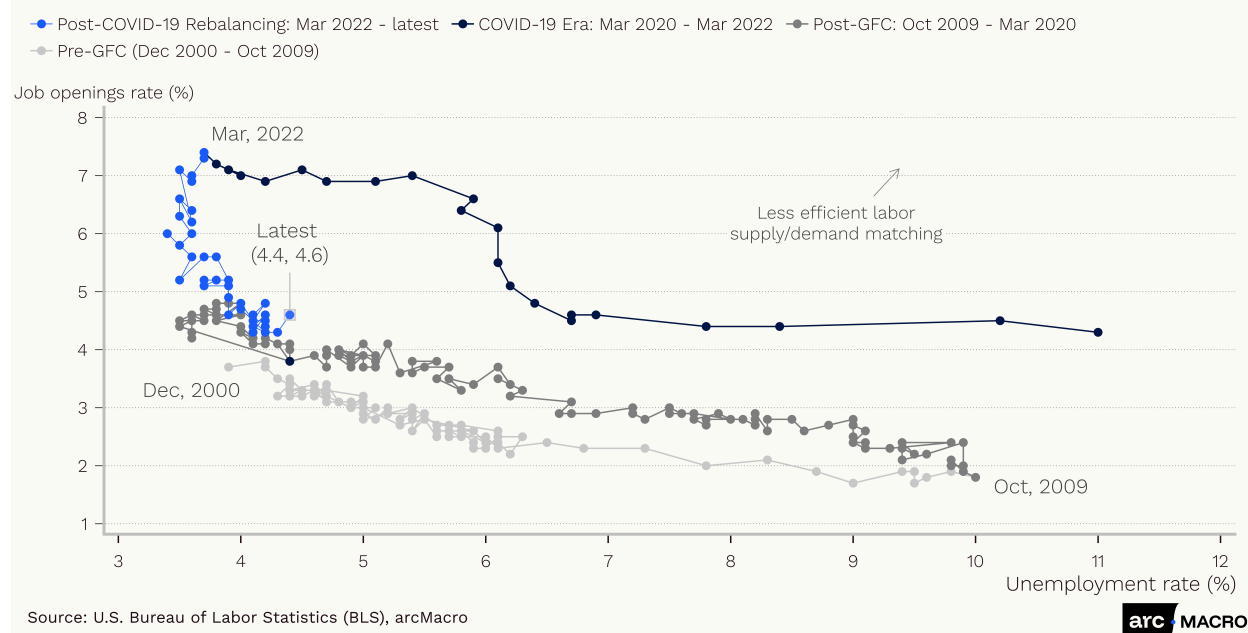
Looking forward, we see the bar to raising rates as high, at least for the next six months or so. Tariff risks remain front and center, with USMCA (CUSMA in Canada) up for "review" mid-year. What's more, the weak loonie has been an important tool to insulate Canada from the tariff shock, and with the Fed still projecting and easing bias and commodity prices putting some appreciation pressure on the Canadian currency, the BoC will not want to encourage appreciation by narrowing the interest rate differential with the US.

No Shock from JOLTS

Delayed data on the hiring and firing activity of US firms from October continued to show the US labor market gradually thawing and loosening. The number of job openings picked up by 10k to a five-month high of 7.67 million (mostly driven by retail and wholesale trade), but this was accompanied by a decline in actual hiring and a rise in layoffs to 1.85 million, the highest since 2023 (still low by historical standards). As the chart below shows, the labor market may be cooling, but it remains fairly strong by historical standards.

The Beveridge Curve says the labor market is gradually cooling

United States, unemployment rate vs. job openings rate



See the appendix for the top macroeconomic indicators tracking chart

What we'll be watching next week

- *Nonfarm payrolls (US)*: We'll get November and October data in one release on Tuesday. Consensus is for a tepid +35k pace of headline payrolls growth and unemployment holding steady at 4.4%.
- *CPI inflation (US)*: Consensus anticipates both core and headline rising above 3%, and an upside surprise could end speculation of a January cut.
- *Central banks (Global)*: The Bank of Japan headlines on Thursday evening (ET)

and has already telegraphed an increase in the policy rate, so attention will be on what the Governor communicated about the outlook. With inflation rising and the real rate falling, Japan has space for steady rate normalization. We'll also get decisions from the European Central Bank and Bank of England on Thursday.

Memo

Pick your Fighter: The Aerospace and Defense Rally Enters a New Phase

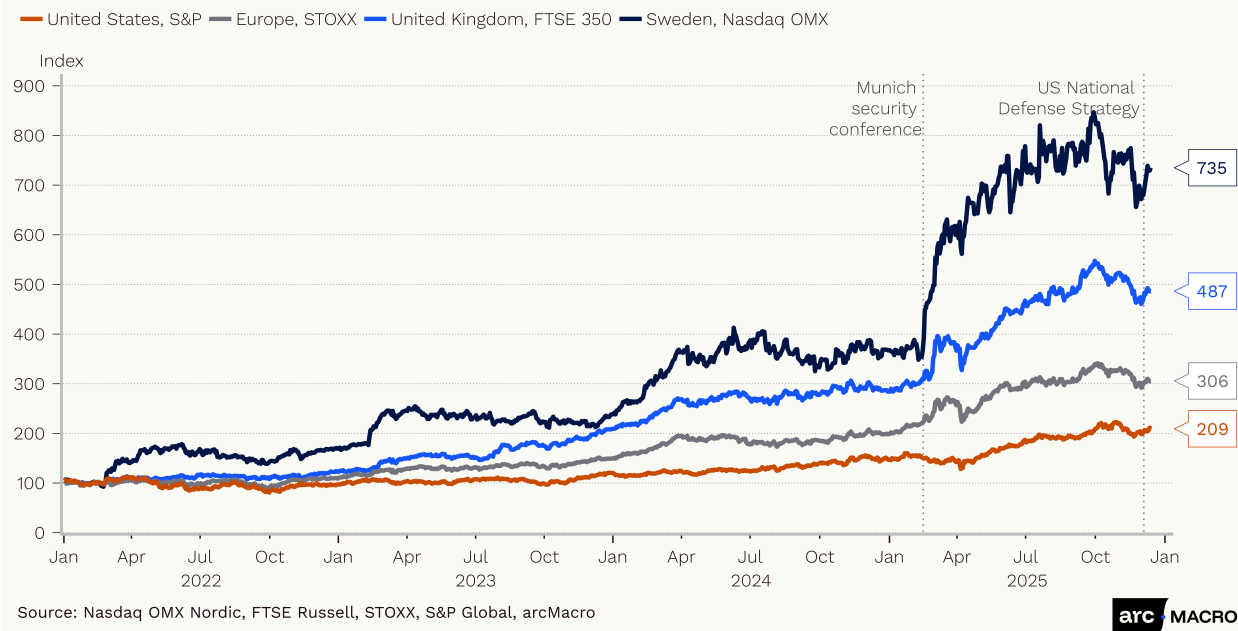
Bottom line: The secular bull market in Aerospace and Defense is entering a post-rally era in which alpha will come from identifying winners and finding value outside of star listed stocks. The mega-themes that have driven are not fading (even if the war in Ukraine ends), but with valuations now second only to AI stocks, this is a stock-picker's market and a private equity dealmaker's playground. The "macro" dimension of the theme has run its course.

The Aerospace and Defense (A&D) sector has been one of the strongest-performing investment themes of the past two years. Since Russia's invasion of Ukraine, American Aerospace and Defense stocks have more than doubled in value. The real action has been in Europe, where Russia's aggression has spurred a race to catch up to NATO's 2% of GDP defense spending requirements, and President Trump's explicit withdrawal of America from its role as global hegemonic watchdog has exposed Europe's defense vulnerabilities.

The STOXX index of European A&D companies is up 206% since 2022 and the equivalent UK index up 380%. Sweden, home to Saab AB, has seen an astonishing 635% rise in A&D stocks, most of it coming in the wake of the Munich Security conference in February 2025.

Aerospace and Defense is in a secular bull market

Global, Aerospace and Defense Indices, Index 2021-12 = 100



Recently, two developments have led investors to start questioning the durability of the rally, which has stalled and slightly reversed since peaking in late September.

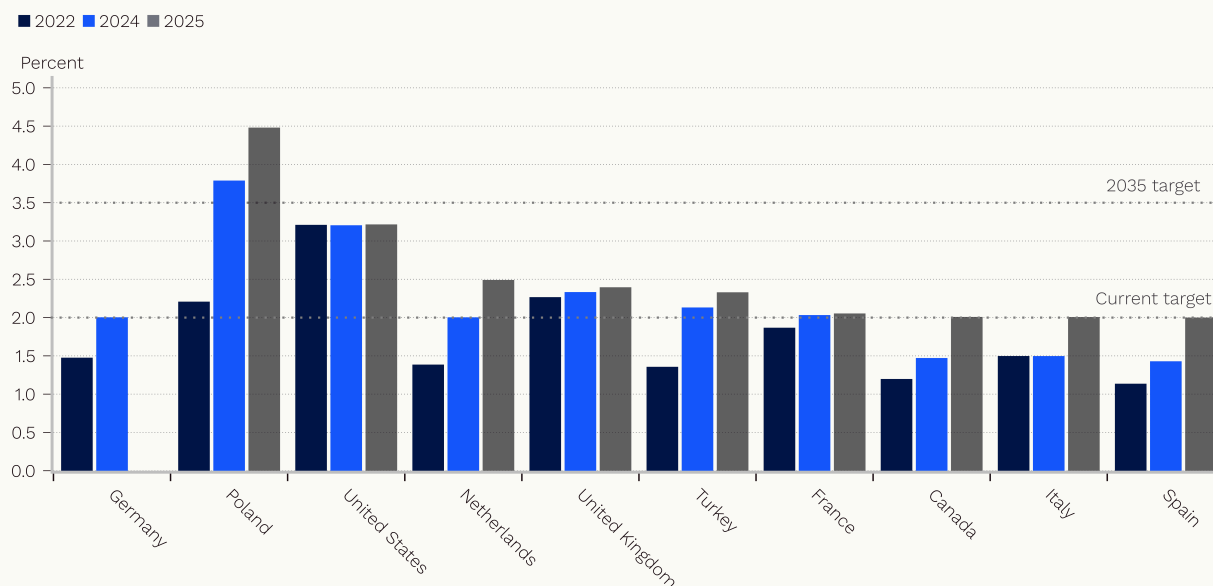
The first reason is the rising possibility of an end to the war in Ukraine and the consequent cancellation of U.S. and European defense contracts that have been keeping Ukraine in the war. This fear is evident in the large corrections in A&D stocks that have occurred with each American effort to get a deal done.

This concern can be easily dismissed, in our view. Unlike AI, where there are legitimate "known unknowns" regarding the ultimate reach of the new technology, there is no ambiguity regarding the rearmament of Europe, whether or not a peace deal is reached in Ukraine.

For one thing, all members have now met their NATO spending pledge and have committed to raising defense spending from 2% of GDP to 3.5% of GDP over the next decade. At a time of budget constraints and concern about debt overhangs, the willingness of NATO members from Canada to the UK and France to shift resources to defense is a testament to their commitment to bolstering their security.

NATO members have hit their defense spending targets in 2025

NATO, Defense spending, share of GDP



Source: North Atlantic Treaty Organization (NATO), arcMacro

arc MACRO

More importantly, the matter of European defense investment now goes beyond NATO and has become an existential issue for the continent. European leaders are convinced that Russia is a permanent threat to their eastern flank, especially in important EU border states in the Baltic and Poland.

As the war has progressed, the US has become an increasingly unreliable security guarantor. More recently, that's evident to Europe in the lack of cooperation between the US and its NATO allies in working toward a peace in Ukraine that is acceptable to Kyiv.

It's also abundantly clear in the Trump administration's 2025 National Security Strategy, which entails Europe "taking primary responsibility for its own defense." While European leaders have responded with alarm to the document's tone and perceived overreach on internal affairs, the message on defense has landed. French government officials, for instance, called the strategy a "brutal clarification" of America's posture and have emphasized the need for self-sufficiency in defense.

The second reason that the rally has stalled is harder to dismiss: having surged so powerfully over the past few years, stock prices of aerospace and defense companies (especially larger firms) now fully capture or perhaps even overestimate strong future earnings growth tied to the wave of public money heading their way.

With prices sitting at 30+ times forward earnings (depending on the index), it's difficult to make a case to buy into the macro theme of European defense spending.

But that doesn't mean the theme has fizzled out.

Instead, we're entering a new phase of the Aerospace and Defense super-theme. The "speculative" phase – a macro bet on a persistent long-term rise in defense spending and hence defense contractor earnings implemented through broad indices and large-caps – has paid off. Now the rubber is hitting the road, and industry expertise is required to come out ahead on this investment theme.

Companies are vying for contracts as governments assess how to enact spending commitments. This will create winners and losers (relative to current valuations), which are hard to predict amid shifting strategic concerns (E.g., Canada recently announced it may cancel orders for US-made F-35 jets in favor of a joint domestic/Swedish alternative).

What's more, along with raw output, rusty militaries and the wider A&D ecosystem are in dire need of modernizing. After years of underinvestment, there is an emerging focus on digital infrastructure, process modernization, AI integration, and asset regeneration. **That will require expert advice and investment that private equity professionals are well-positioned to support.**

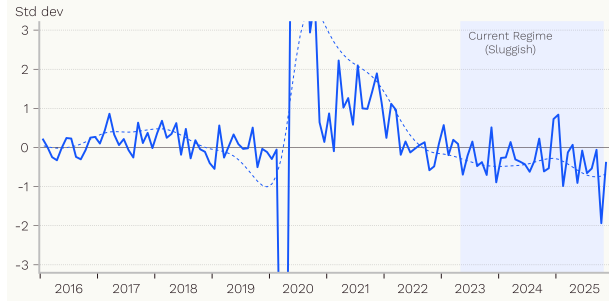
Appendix

Proprietary Factor and Regime Model and Key Macro Indicators

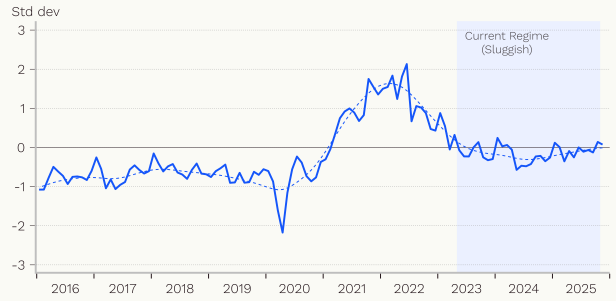
arcMacro Real Time Factors

United States, z-score

Real Factor



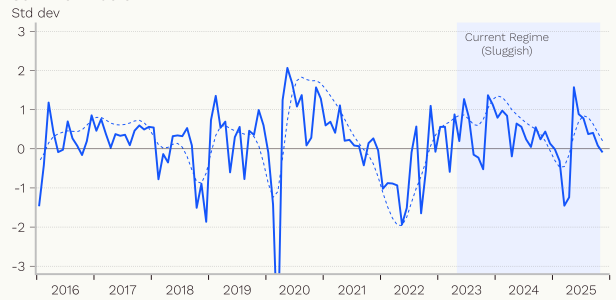
Price Factor



Financial Factor



Sentiment Factor

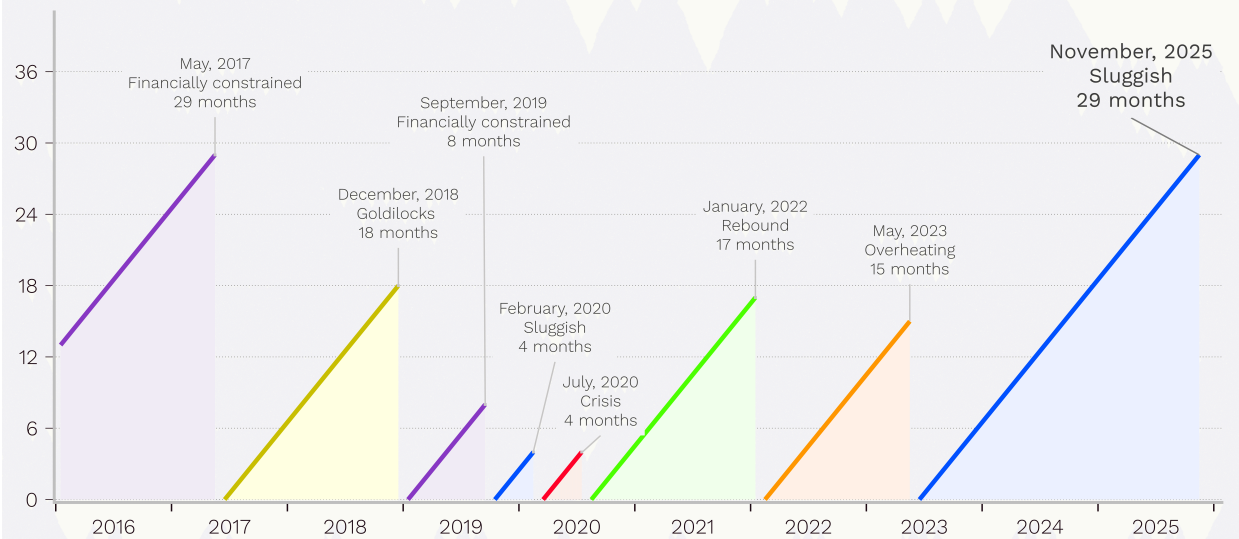


Source: arcMacro

arcMacro Regime Summary

United States

— Stagflation — Sluggish — Rebound — Overheating — Goldilocks — Financially constrained — Crisis

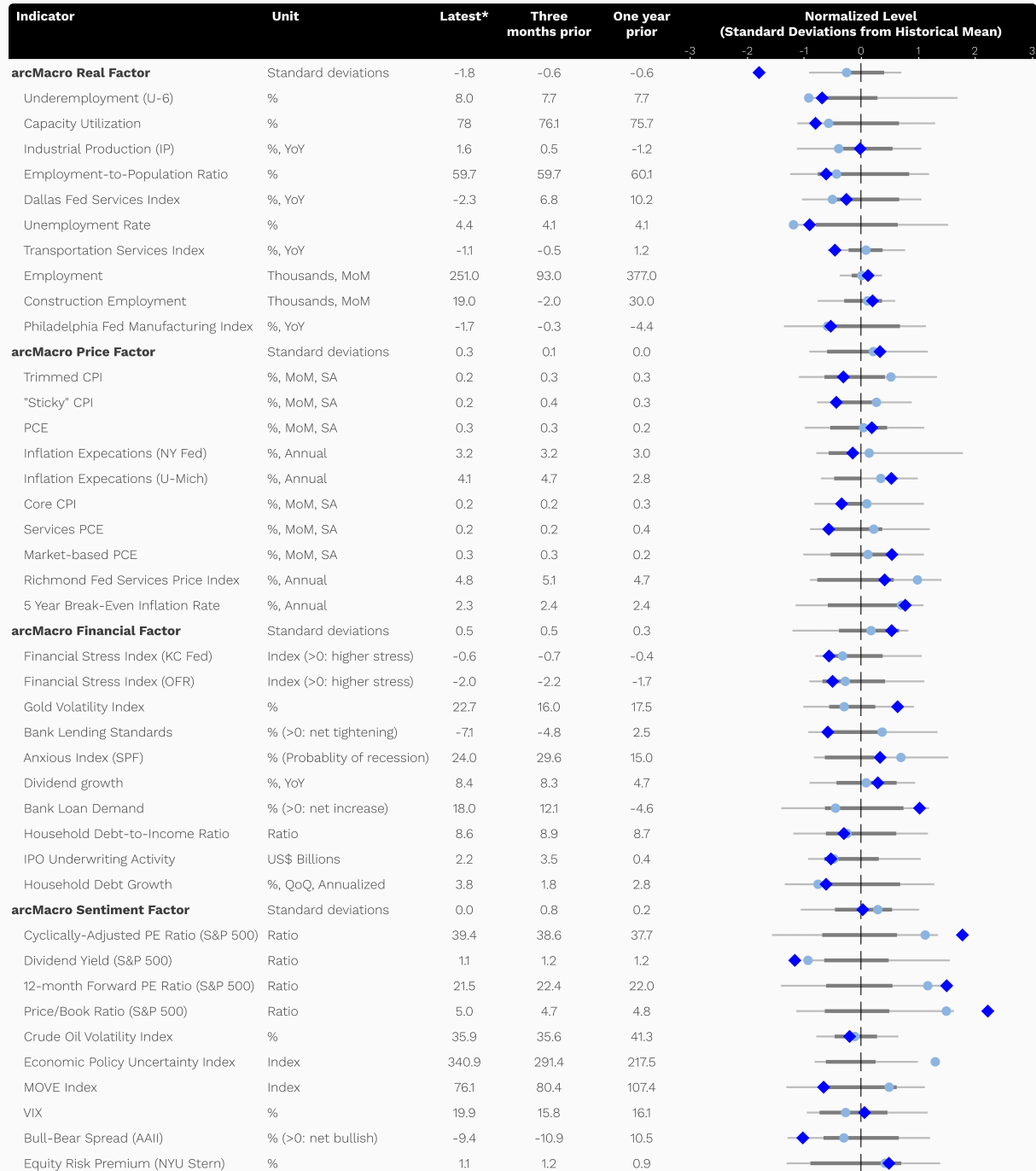


Source: arcMacro

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arcMacro Factor Input Monitor

Top 10 inputs by factor loading



■ 10th-90th Percentile ■ 25th to 75th Percentile ● Mean of past 5 years ◆ Latest Value

Source: arcMacro, BLS, Fed, Dallas Fed, DOT, Philadelphia Fed, Cleveland Fed, Atlanta Fed, BEA, New York Fed, University of Michigan, Richmond Fed, Macrobond, Kansas City Fed, The Office of Financial Research (OFR), CBOE, S&P Global, SIFMA, Robert Shiller, Economic Policy Uncertainty, ICE BofAML, LJKmfa, AAIL
*Most recent published data point. Time period and frequency do not necessarily align.