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MARKET INSIGHTS

James Thorne, *Chief Market Strategist*



WELLINGTON-ALTUS



WARSH FAILS THE TEST:

From being part of the solution to being part of the problem

Alexander Hamilton understood that debt is not necessarily a burden if it is matched by the means of extinguishment. The same principle should guide the American economy today. Debt can be managed when it finances productivity, expands the tax base and accelerates growth. It becomes dangerous when governments borrow merely to preserve stagnation.

That is the wager behind the economic strategy of U.S. President Donald Trump's administration—run the economy hot enough to grow out of the debt. The objective is not simply short-term stimulus. It is to expand energy production, rebuild manufacturing, accelerate artificial-intelligence (AI) investment and bring industrial capacity back to the U.S.

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“ *A national debt, if it is not excessive, will be to us a national blessing.*

– Alexander Hamilton

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This is a Hamiltonian strategy. It assumes that productive investment can enlarge the economy faster than liabilities accumulate. It treats energy, infrastructure, semiconductors, data centres, logistics and advanced manufacturing not as inflationary excesses but as the foundations of future supply.

Kevin Warsh, current Chair of the U.S. Federal Reserve (the 'Fed'), appears to fail that test.

Warsh's policy instincts remain anchored in the Fed's old reaction function: watch headline inflation, monitor financial conditions, interpret market pricing as a signal of future inflation and tighten whenever economic activity appears too strong. That framework may have been defensible in a service economy dominated by incremental investment and relatively stable supply chains. It is badly suited to an economy undergoing a once-in-a-generation expansion of productive capacity.

The central danger is that Warsh would treat the AI investment boom as a conventional demand shock. Data centres require electricity, land, chips, networking equipment and construction. The spending is enormous. But the economic question is not whether the investment creates demand today—it does. The question is what that investment does to supply tomorrow.

AI capex can increase productivity, lower costs, expand output and create entirely new industries. It can reduce the labour required to produce goods and services. It can improve logistics, energy management, medical research, engineering and manufacturing. To treat every dollar spent on this infrastructure as evidence of overheating is to confuse the construction of productive capacity with the consumption of existing capacity.

That is a category error.

The Fed's traditional models are not designed to distinguish sufficiently between speculative excess and foundational investment. They see spending, employment and credit growth. They are less capable of identifying whether that spending is building tomorrow's economy or merely bidding up today's limited resources.

The distinction matters. If the Fed tightens aggressively into a productive investment cycle, it may suppress the very supply response needed to bring inflation down. Higher interest rates make it more expensive to build power plants, transmission lines, semiconductor facilities, factories and data centres. The central bank could end up restricting supply in the name of controlling prices.

That is not monetary discipline. It is policy confusion.

A similar problem would arise if the Fed responded to an oil-supply shock with rate hikes. An energy shock raises prices by reducing supply and transferring purchasing power from consumers to producers. It does not, by itself, prove that the domestic economy is overheating.

Former Federal Reserve Chair Alan Greenspan made this point in describing an oil shock as something akin to a tax. It reduces real incomes and redistributes purchasing power; it does not automatically create the kind of demand-driven inflation that monetary tightening is designed to suppress. The Fed must watch carefully for second-round effects in wages, expectations and broader pricing behaviour. But it should not confuse the initial increase in energy prices with proof of excessive domestic demand.

The historical evidence is not reassuring. Research by Ben Bernanke, former Federal Reserve Chair, and American economists Mark Gertler and Mark Watson found that monetary policy helped amplify the effect of oil shocks in earlier episodes. When central banks tightened in response to energy prices, they transformed a temporary supply disruption into a broader economic slowdown.

The lesson is straightforward—a central bank can turn a shock into a crisis by reacting to the first-round price effect rather than the underlying economic mechanism.

Warsh's apparent instinct is to preserve precisely this mechanical response. He would risk tightening into energy disruptions, restricting investment and treating the market's inflation expectations as a substitute for independent analysis.

That would be particularly dangerous in an economy where the supply side is changing rapidly. The U.S. is entering a period of massive investment in AI, electricity generation, advanced manufacturing and strategic infrastructure. The Fed should ask whether the investment is likely to expand productive capacity. Instead, it appears increasingly tempted to ask only whether the investment is pushing up near-term prices.

That approach would sacrifice long-term growth for the appearance of short-term control.

A Fed trapped in its own mirror

The central bank also appears trapped in a hall of mirrors, responding to market expectations that are in turn responding to the Fed. Prediction markets, bond markets and financial commentary increasingly shape the public interpretation of future policy. Policymakers then look to those same markets to confirm what they should do next.

This is not independence. It is circularity.

Markets can provide information, but they cannot replace judgment. Prediction markets are especially vulnerable to political narratives, positioning, liquidity constraints and herd behaviour. They may be useful indicators of sentiment, but they are not economic models.

A central bank that follows market pricing too closely risks outsourcing its reaction function. If prediction markets price rate hikes, the Fed may feel compelled to validate them. Once validated, those hikes become evidence that the prediction markets were correct.

The result is a self-reinforcing policy loop.

Prediction markets now point towards rate hikes in October, December and March. If that path materializes, it would suggest the beginning of another tightening cycle—even as the economy faces large investment requirements and potential supply shocks. Whether the mistake is political, analytical or institutional, investors should not ignore the consequences.

The danger is not merely that rates rise. It is that the Fed's response becomes pro-cyclical: tightening when investment is most needed, restricting capital formation when supply must expand and weakening demand after the central bank itself has helped constrain productive capacity.

Warsh should have exposed the Fed

Warsh's most important test may not be economic but institutional. One could also conclude that Warsh's behaviour, while surprising many—including me—could be a politically astute move.

It has been suggested that Warsh privately opposed a Federal Open Market Committee decision but voted with the majority because, in effect, the outcome was already determined, and his dissent would not matter. If accurately reported, that is not a minor detail. It goes to the heart of the Federal Reserve's credibility.

A central banker who believes a policy decision is wrong has an obligation to make that disagreement visible. Dissent is not an act of disloyalty. It is an institutional mechanism through which a central bank demonstrates independence and accountability.

If Warsh believed the Fed was making a serious mistake, he should have exposed the disagreement. He should have explained why the policy was wrong, what risks it created and what alternative approach he supported. Instead, the reported logic suggests resignation; that the vote was predetermined, so dissent would not change the outcome.

To be clear, tariffs do not cause inflation. An energy supply shock is a negative growth shock. Wages do not cause inflation. Growth that is generated by investments in the productive capital of the economy is not inflationary. Warsh is misdiagnosing the situation. Investors should expect the Fed to once again create a policy mistake that was completely avoidable. Warsh is unwilling to go against bias at the Fed, he is unwilling to use theory and facts to go against institutional inertia.

That is precisely how institutions become politicized. If officials suppress disagreement because they believe the political or institutional machinery has already chosen the result, the Fed ceases to function as an independent deliberative body. It becomes an institution performing consensus while privately accepting that the decision has been made elsewhere.

For investors, this is a major red flag. Markets can tolerate policy mistakes. They struggle to price institutions whose internal process is opaque, predetermined or politically constrained.

The Federal Reserve's legitimacy rests not only on its statutory independence but on the visible quality of its reasoning. It must show that decisions are debated, evidence-based and open to challenge. If dissent is suppressed because it is considered irrelevant, then the problem is deeper than one rate decision.

The Fed risks becoming an explicit political counterweight to an elected administration rather than an independent institution applying a consistent economic framework.

The price of mechanical thinking

Warsh's defenders may argue that the central bank has no choice but to remain focused on inflation. That is correct in principle but incomplete in practice.

The Fed's mandate does not require it to treat every price increase as evidence of excess demand. Nor does it require the central bank to undermine investment that expands future supply. Price stability is not achieved by suppressing every sign of economic dynamism. It is achieved by understanding the sources of inflation and responding proportionately.

A rate hike can reduce demand. It cannot produce more oil, build a transmission line, manufacture a semiconductor or accelerate the construction of a data centre. Indeed, by raising the cost of capital, it can delay them instead.

The Fed's challenge is therefore not simply to determine whether prices are rising. It must determine why they are rising and whether the economy's productive capacity is expanding or contracting.

That requires judgment. It requires distinguishing between temporary supply shocks and persistent demand inflation, between productive capital expenditure and speculative leverage, and between investment that raises future output and consumption that merely bids up scarce goods.

Warsh's approach appears insufficiently sensitive to those distinctions.

The consequences could be severe. A Fed that tightens into the AI investment cycle could slow the construction of the very infrastructure required to make AI deflationary. A Fed that hikes into an oil shock could turn an energy-price increase into a recession. A Fed that follows prediction markets could transform market expectations into a self-fulfilling policy mistake.

None of this is inevitable. But investors should assign a meaningful probability.

The crypto regulatory escape hatch

The same conflict between political failure and economic transformation can be seen in crypto regulation.

Democrats killed the Clarity Act, preserving the regulatory purgatory that has constrained the American digital-asset industry for years. The failure to establish a comprehensive framework left businesses uncertain about which tokens could be traded, how digital securities would be regulated and whether American financial institutions could participate without inviting enforcement action.

But the Securities and Exchange Commission (SEC) has now offered a countermeasure: a five-year innovation exemption designed to give the market a defined period of clear rules.

The SEC's language is unusually direct: "Our Innovation Exemption is intentionally limited and set to expire after five years."

The translation is equally clear—for the next five years, the agency is creating room for the development and trading of tokenized stocks and other blockchain-based financial assets without forcing the industry to wait indefinitely for comprehensive legislation.

That five-year window could be decisive.

Stablecoins, tokenization and digital securities can now move from regulatory theory to commercial infrastructure. Banks, exchanges, asset managers and fintech companies have a timetable within which to build products, establish liquidity and bring traditional assets onto blockchains.

This does not eliminate regulatory risk. The exemption will expire, and the SEC will retain supervisory authority. But it may finally allow the crypto market to escape regulatory purgatory.

Even after Congress blocked the broader legislative framework, the agency's five-year exemption could provide enough clarity to develop a new layer of the financial system.

For investors, this is more than a speculative crypto theme. It is a potential infrastructure cycle involving regulated stablecoins, tokenized securities, blockchain settlement, digital custody and the software required to connect traditional finance to public networks.

While the political system failed to deliver a durable legislative framework, the SEC's temporary exemption may still give the market enough time to establish the foundations of one.

There's an old rule—don't fight the Fed!

Investors should be honest about the likely policy environment rather than the policy environment they wish to see.

If the Fed follows prediction markets towards rate hikes in October, December and March, another policy mistake becomes increasingly probable. Cyclical, banks, housing and businesses dependent on the strength of Main Street would be vulnerable to tighter financial conditions and weaker credit creation.

The more attractive areas are those supported by secular investment rather than short-term consumer demand.

That includes data-centre infrastructure, power generation, grid equipment, semiconductors, networking, industrial automation, logistics, energy infrastructure and companies tied to reshoring. These sectors may face volatility, but their underlying demand is connected to the construction of future capacity.

The same logic applies to parts of the digital-asset ecosystem. Regulated stablecoins, tokenization, digital custody and blockchain settlement could benefit from the SEC's five-year exemption, even if Congress remains unable or unwilling to provide a comprehensive framework.

This is not a call to ignore valuation or risk. A five-year exemption is not permanent legislation. Political opposition can return, regulatory interpretations can change and investment booms can become speculative. But investors should distinguish between temporary volatility and structural demand.

The central question is whether the U.S. will allow capital to build the next economy or whether monetary and political institutions will suppress that investment in the name of defending an outdated reaction function.

Hamilton understood that debt could become manageable when paired with growth and productive capacity. America could apply that principle through energy, manufacturing, AI and digital finance.

Warsh appears prepared to fail the test. His framework risks confusing investment with inflation, supply shocks with overheating and market expectations with independent analysis. His reported reluctance to expose internal disagreement raises an even more serious concern about the Fed's institutional health.

If the central bank tightens into the transformation, investors should not be surprised when growth slows, supply fails to expand and political pressure intensifies. Yes, we must respect the tail risk that Warsh is unable or unwilling to change the Fed's reaction function.

The mistake would not be merely economic. It would be strategic.

America is trying to build the future. The Fed should not stand in the way. Early indicators suggest that they are. Investors need to respect the red flags staring them in the face.

However, there is always the possibility that Warsh raised rates not to keep them high, but to create the room—and credibility—to cut them later. As Trump put it: "Sometimes by losing a battle you find a new way to win the war."

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