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MARKET INSIGHTS

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THE SIX MONTHS WHERE EVERYTHING CHANGED:

The Federal Reserve, central bank ideology, and the future of economic order

Prologue: A battle for economic sovereignty

The Great Depression of the 1930s was more than an economic collapse; it was an ideological crucible. As capitalism faltered, socialism surged, promising salvation through state control.

Today, that battle rages anew, with the U.S. Federal Reserve at its heart. Martin's metaphor of the Federal Reserve as a chaperone—removing the punch bowl to curb excess—once defined an era of restraint: intervene only to prevent instability, never to orchestrate outcomes. That era is dead. The Federal Reserve has abandoned its traditional neutrality, embracing Keynesian dogma and becoming a partisan weapon in the war between capitalism and socialism, a war that threatens American economic sovereignty.

“

The Federal Reserve... is in the position of the chaperone who has ordered the punch bowl removed just when the party was really warming up.

”

- William McChesney Martin Jr.,
U.S. Federal Reserve chair, *in a 1955 speech*

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In Adam Smith's *America: How a Scottish philosopher became an icon of American capitalism*, Glory M. Liu chronicles how University of Chicago economists Jacob Viner and Frank Knight revived Smith's classical liberalism during the 1930s to counter socialism's rise. They reframed Smith not as a laissez-faire absolutist but as a philosopher of balanced liberty: individual initiative tempered by moral responsibility. Their work, built upon by economists Milton Friedman, Robert Lucas Jr., and Gary Becker, became capitalism's intellectual shield—leading to Nobel Prizes and global influence.

Yet, nearly a century later, the Federal Reserve is discarding this legacy, retreating from the neutral ground Martin and the Chicago School secured. Driven by political expediency rather than economic fundamentals, its policies now distort markets and heighten instability. For investors, the stakes are clear — the Federal Reserve's bias imperils portfolios, and only a return to neutrality can restore balance. U.S. President Donald Trump's policies are forcing this reckoning, exposing the Federal Reserve's Keynesian tilt as inherently political. The central bank must confront its ideological drift and reclaim its role as an impartial referee before it's too late. Simply put, since the Federal Reserve is beholden only to the Keynesian School of thought, it is implicitly biased. This bias is becoming too obvious to ignore. The Federal Reserve needs to cut rates to 2.75 per cent and will most likely start this summer. For sophisticated investors we must be honest: we have just lived through six months where everything changed.

The Smithian roots: Liberty, markets, and the Federal Reserve's original mandate

To grasp the Federal Reserve's fall, we must revisit its intellectual foundations. Established in 1913 to quell financial panics, the Federal Reserve initially oscillated between innovation and error. Benjamin Strong Jr., head of the Federal Reserve Bank of New York in the 1920s, pioneered open market operations to stabilize the economy after the First World War. Strong responded innovatively to the sharp but brief post-war depression—often called the “Forgotten Depression”—by pioneering large-scale open market operations, dramatically increasing the availability of credit, and helping the economy recover

quickly by stabilizing prices and supporting bank liquidity. At the same time, while Strong recognized the economically punitive flaws of the Treaty of Versailles—advocating for its speedy ratification despite imperfections and warning that harsh economic terms on Germany would perpetuate instability—he instead promoted moderate reparations and robust American involvement in European reconstruction to foster lasting peace and economic recovery.

Strong's death in 1928 left the Federal Reserve adrift, and its subsequent missteps—tightening money supply during a downturn and failing to halt banking panics—helped trigger the Great Depression. The collapse shattered faith in capitalism, fueling collectivist ideologies across the West.

In this crisis, the University of Chicago became a bastion of classical liberalism. Viner and Knight resurrected Smith's *The Wealth of Nations* and *The Theory of Moral Sentiments*, arguing that markets, guided by liberty and moral constraints, were the antidote to statism. Their vision of the Federal Reserve was clear: a neutral arbiter ensuring stability without distorting price signals. This nuanced Smithian framework, balancing freedom with responsibility, shaped American economic thought for decades, culminating in Friedman's free-market advocacy and the Chicago School's global dominance.

Yet, this equilibrium was fragile. The Federal Reserve's role as a neutral chaperone, as Martin envisioned, required discipline. It was not to dictate outcomes but to preserve the market's ability to allocate resources efficiently. That principle, rooted in Smith's invisible hand, is now under siege.

Keynesian ascendancy: From referee to central planner

The Smithian ideal of neutrality was eclipsed by Keynesian economics. The Great Depression and the Second World War mobilization fertilized John Maynard Keynes' theories of government intervention and demand management. By the 1950s, Martin's Federal Reserve, newly independent from the U.S. Treasury, embodied restraint—intervene only to curb excess, not to steer the economy. This “punch bowl” doctrine trusted markets to function, with the Federal Reserve as a steady hand.

Under Federal Reserve chair Alan Greenspan, this balance eroded. Widely referred to as “The Maestro,” he abandoned restraint, using low rates and liquidity to cushion every market dip. The “Greenspan put” fostered moral hazard, conditioning markets to expect perpetual support. Ben Bernanke’s response to the 2008 crisis—zero interest rate policy (ZIRP), quantitative easing (QE), and bailouts cemented this shift. The Federal Reserve morphed from referee to central planner, embracing Keynesian demand management and sidelining Smith’s core tenet: markets reveal truth through prices.

This technocratic hubris grew unchecked. The Federal Reserve began to believe it could fine-tune the business cycle, manage inflation, and stabilize asset prices. Its toolkit expanded as did its ambitions. Monetary policy became a driver of growth, employment, and even social outcomes: far beyond its dual mandate of price stability and maximum employment. The Federal Reserve’s role ballooned, and its self-perceived indispensability became dogma.

The 2013 “taper tantrum” marked a turning point in Federal Reserve ideology and market expectations. When the Federal Reserve hinted at reducing QE, markets panicked, yields spiked, and volatility surged, exposing heavy dependence on central bank support. This episode foreshadowed today’s “detox period,” where private sector leadership is again emphasized.

The illusion of neutrality: Ideology masquerading as policy

Today, the Federal Reserve’s claim to neutrality is a fiction. Its leadership operates in a Keynesian echo chamber where academic biases pose as rigor. This is not a central bank that trusts markets; it is an institution convinced of its role as the economy’s architect. Cognitive capture pervades its ranks. Central bank officials view markets as wayward pupils in need of technocratic guidance, dismissing Smith’s invisible hand as obsolete. The next Federal Reserve chair will have his or her work cut out for them. Decades of drift and mission creep will not be easily corrected.

This entrenched mission creep is rampant. The Federal Reserve now meddles in climate policy, inequality, and social engineering, diluting its focus on its core mandate.

It relies on outdated 1950s models, ignoring real-time digital signals that define today’s economy. This bias crystallized under Federal Reserve chair Jerome Powell. The Federal Reserve misdiagnosed 2021’s inflation surge as “transitory,” clinging to the Phillips Curve while ignoring supply-chain disruptions and shifting consumer behaviour. It scapegoated tariffs for inflation, despite services dominating U.S. gross domestic product (GDP) and imports being a minor factor. Most alarmingly, it has kept rates restrictive—around 5 per cent in mid-2025—despite data signaling a slowing economy and deflation risks, with the Consumer Price Index (CPI) excluding shelter falling to 1.5 per cent and commodity prices plunging.

These are not mere errors, they are philosophical betrayals. The Federal Reserve, once above politics, is now mired in it—its decisions swayed by Washington’s winds as much as market logic. For investors, the implications are stark: policy errors distort asset prices, starve liquidity, and erode confidence. The Federal Reserve’s credibility is unraveling, and markets are paying the price.

The unraveling: A fiscal and monetary reckoning

The evidence is undeniable; the Federal Reserve has traded economic theory for political convenience. My thesis, first articulated in 2022, warned of this drift. Today, relentless data, falling yields, the re-emergence of the liquidity trap in China, and deflationary signals have validated it. The fiscal crisis is equally dire. U.S. debt-to-GDP exceeds 120 per cent, a legacy of years of fiscal indiscipline. The Federal Reserve’s silence during this period was an act of complicity. The Federal Reserve needs to cut in July and get the federal funds rate (FFR) down to r^* , the neutral rate, without delay.

Yet the Federal Reserve doubles down. Despite clear signals of economic slowdown, unemployment rising to 4.2 per cent¹, and GDP growth projected at around 1.5 per cent for 2025, it refuses to cut rates to the neutral rate (r^*) of 2.75 per cent. Quantitative tightening (QT) continues, draining liquidity as credit markets tighten. Forward guidance is now dismissed as political theatre. Even Wall Street strategists, once Federal Reserve cheerleaders, struggle to defend its disconnect from reality. The Federal Reserve’s

¹ Source: <https://www.bls.gov/news.release/pdf/empisit.pdf>

reputation for technocratic excellence has given way to skepticism, even cynicism, among investors who once saw it as the ultimate backstop.

After the Second World War and Alvin Hansen: A precedent setting road map

After the Second World War, the U.S. faced a 116 per cent debt-to-GDP ratio, similar to today's 120 per cent plus. Unlike modern fears of a permanent deficit, optimism prevailed after the war, with deficits seen as temporary wartime burdens. Economist Alvin Hansen, the father of the secular stagnation hypothesis, shaped this view, arguing that strong economic growth and moderate inflation would shrink the debt burden relative to GDP without austerity. He believed deficits were manageable as long as growth outpaced interest costs, a stance that calmed fears. Hansen advocated for cyclical balance, using deficits in crises but expecting surpluses in booms, rejecting the idea of perpetual deficits. By 1948, robust GDP growth of 4-5 per cent and a sharp reduction in military spending—from US\$83 billion in 1945 to US\$14 billion (both in nominal dollars)—led to a budget surplus, validating his optimism. Today's anxiety over structural deficits, fueled by entitlements and 1.5 per cent growth projections, contrasts sharply with Hansen's era of dynamism. Yet, if deficits become manageable in 2025, the Federal Reserve can catalyze recovery by cutting the FFR to the neutral rate (r^*) of 2.75 per cent, fostering real negative rates. This, paired with sustained economic growth, could make interest payments sustainable, echoing Hansen's faith in growth over austerity. The trick lies in balancing real negative rates, robust growth, and fiscal discipline to grow our way out: restoring confidence in a manageable fiscal future.

The Trump mandate: A return to markets

The 2024 U.S. election marked a turning point. Trump's mandate —re-privatization, deregulation, and supply-side economics—rejects progressive Keynesianism. His agenda echoes the Chicago School's Smithian roots, prioritizing private initiative over state control. The Federal Reserve's response, however, reveals its bias. Powell's reluctance to align with this shift stems from a Keynesian worldview that is

implicitly political. The Federal Reserve is no longer a neutral chaperone but a partisan guest, tilting the punch bowl based on who holds power.

To align with this new era, the Federal Reserve must act decisively, cut rates to 2.75 per cent, halt QT, and retire QE as a tool of social engineering. U.S. interest payments now consume nearly a third of the \$316 billion monthly deficit. The Federal Reserve's political bias does come at a cost, interest payments on debt. Most critically, it must restore Martin's doctrine: intervene only to prevent excess, not to control outcomes. Failure to do so risks irrelevance in a market-driven economy.

Six months that changed everything

The first half of 2025 was a seismic shift for the world, and markets, to the surprise of consensus, are quickly adapting. After a 20 per cent S&P 500 correction in April, driven by tariff fears and global uncertainty, the index rebounded 23 per cent to approach 6,000—with a year-end target of 7,000. This recovery was no accident. Structural reforms, bold policy, and a U.S.-China trade deal stabilized supply chains and quelled inflation fears. Despite Middle East conflicts and domestic unrest, markets signaled "risk-on" resilience, underpinned by economic strength.

Prime Minister Mark Carney's Athens-Rome analogy in his first address to Parliament—invoking Canada as "Athens" to America's "Rome"—frames this transformation. Drawing on former British prime minister Harold Macmillan's metaphor, which highlighted America's rise as a world power, Carney positions Canada not as a junior partner but as a source of democratic values, innovation, and resources. This vision of North American integration leverages Canada's resource wealth, digital leadership, and civic stability to complement U.S. scale. Trump's tariff strategy secured concessions from China, stabilizing trade, while Carney's "all of the above" energy policy positions Canada as a resource superpower. A U.S.-Canada deal, enhancing economic integration, is imminent.

Outlook: Policy and market drivers

With U.S. inflation excluding shelter at 1.5 per cent, markets are ignoring Federal Reserve chatter and anticipate rate cuts this summer. I still believe the

July meeting is live. Yes, they are late, extremely late. The Bank of Canada faces similar disinflationary pressures, with shelter costs driving residual price pressures amid weak demand and 7 per cent unemployment. Globally, deflation risks loom, China grapples with a liquidity trap, and the Swiss National Bank has cut rates to zero. Central bankers, ignoring lessons from the 1930s, risk repeating history's errors.

The Athens-Rome blueprint is taking shape. Canada's resource development and artificial intelligence (AI) leadership attract global capital, while U.S. deregulation and energy independence create a self-reliant continent. The "permanent inflation" narrative has collapsed, supply chains are healed, wage growth is subdued, and tariffs have minimal impact in a weak demand environment. I expect at least 75 basis points of easing by year-end, signaling confidence in a soft landing in the U.S. In Canada, I still expect the Bank of Canada overnight rates to be close to 2 per cent by the end of the year.

The peace dividend in a complex world: Opportunities amidst challenges

As British Prime Minister Winston Churchill is said to have observed, "The further backward you look, the farther forward you are likely to see." This wisdom underscores the importance of perspective when assessing global stability and investment opportunities.

While the recent U.S.-China agreement marks a notable development, the realization of a genuine "peace dividend" remains elusive amid persistent global conflicts. Currently, defence spending is at historic levels, often overshadowing critical investments in healthcare and infrastructure. For NATO allies, a new phase of increased defence expenditure has begun, whereas the U.S. may be approaching a period of strategic recalibration. History indicates that periods of heightened tension often precede opportunities for renewal and stability.

Looking ahead over the next five quarters, astute investors who anticipate a decline in geopolitical risks are likely to be well-positioned for future gains. Meanwhile, secular growth drivers—including

advancements in AI, power infrastructure, semiconductors, housing, and financial sectors—continue to demonstrate resilience and robust potential. Deregulatory initiatives in banking and insurance, together with legislative support for digital assets embodied in the Guiding and Establishing National Innovation for U.S. Stablecoins (GENIUS) Act, are poised to stimulate credit creation and foster innovation across sectors.

Over the past six months, Trump has pursued a strategic approach rooted in the philosophy of "peace through strength," combining assertive diplomacy with military preparedness. Notable achievements include the May 2025 ceasefire between India and Pakistan, effectively preventing a nuclear escalation, and the June 21, 2025, peace treaty between Rwanda and Congo. Pakistan publicly recognized Trump's "decisive diplomatic intervention" in the India-Pakistan crisis, even nominating him for the 2026 Nobel Peace Prize.

On June 22, 2025, Trump authorized targeted U.S. strikes against Iran's nuclear facilities at Fordow, Natanz, and Isfahan. This decisive response underscores a strategic belief that credible military strength is essential for deterrence and stability. While I had anticipated that Trump's leadership might catalyze a broader peace dividend, these developments serve as a reminder that periods of uncertainty often give way to opportunities. They highlight the importance of strategic foresight in navigating the complex geopolitical landscape.

Looking ahead: Volatility and opportunity

The second half of 2025 will test markets. Lagged effects of high rates and government efficiency programs kicking in will slow U.S. GDP to 1.5 per cent. Expect a strong second-quarter GDP print based on payback from the excessively weak first quarter. Fiscal imbalances persist, U.S. interest payments strain budgets, requiring real negative rates and time to resolve. Volatility looms in the fourth quarter, but lower-quality stocks may rally as underinvested funds chase returns. A Republican Congress, pushing deregulation and defence spending, could drive a 2026 rally into the U.S. midterms. Major corrections are unlikely to repeat.

The Federal Reserve has enough data to have the FFR sitting at the natural rate (r^*) of 2.75 per cent. An early summer rate cut would not surprise or be profound. It's the glide path to 2.75 per cent investors need to focus on. Slowing growth and increasing liquidity has been the investment playbook page to monitor. We climb the Wall of Worry on the way to the S&P 500 reaching 7,000. As for Canada, expect the TSX to underperform the S&P 500. Exposure to risk assets is the name of the game until late 2026.

Conclusion: Courage and clarity

The Federal Reserve stands at an inflection point. Will it cling to Keynesian control or rediscover Smith's wisdom that markets, guided by moral limits, drive prosperity? The data is clear, cut rates to 2.75 per cent, halt QT, and retire QE. The Federal Reserve must restore Martin's restraint. Its choices will shape not just the business cycle but the soul of American capitalism. A peace dividend is in the making— and while it may still feel uncertain, it's often darkest just before the dawn.

The first half of 2025 proves the power of fundamentals and policy clarity. North America, guided by Trump's market-driven vision, is being built on the foundation of a peace dividend. The Federal Reserve must step back, ease its constrictions on the private sector, and let markets and the private sector breathe. The Federal Reserve's fear of second-order effects creating an uncontrollable inflation spiral is misplaced—this is not the 1970s. For investors, the lesson is clear: look beyond headlines, embrace the long view, and seize the dawn of a new bull market.

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