TD Global Investment Solutions

Investor Knowledge 5 Minutes

The Unwinding:

A New Chapter in U.S Monetary Policy

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At a Glance

This article outlines a major turning point in U.S. monetary policy as the Trump Administration aims to scale back the U.S Federal Reserve's (Fed) expanded post-2008 role. After years of unconventional tools, balance-sheet growth, and broad regulatory authority, the Fed is expected to return to a narrower mandate focused mainly on setting short-term rates, with many supervisory and crisis-management functions shifting to the executive branch. This shift carries significant investment implications—including greater political pressure for rate cuts, looser bank regulation, wider credit spreads, changes in private-market dynamics, and a renewed emphasis on reindustrialization and real-economy investment.

"**New Keynesianism**" (NK) came to dominate academic debates and central bank conferences after the stagflation crisis of the 1970s. The NK era was personified by Ben Bernanke, an expert on the Great Depression who chaired the U.S. Federal Reserve (Fed) from 2006-2014 and won the Nobel prize in economics in 2022. NK elevated the role of independent central banks in managing the macroeconomy and deemphasized government-led fiscal policy. That vision was severely tested by the Global Financial Crisis (GFC) of 2008/09, when interest rates fell to zero, but the Fed still couldn't seem to stimulate aggregate demand.

> **If economists could manage to get themselves thought of as humble, competent people, on a level with dentists, that would be splendid!**
>
> **John Maynard Keynes,**
> Economic Possibilities for Our Grandchildren (1930) in Essays in Persuasion (1932)

Unwanted Side Effects

During the NK era, the Fed underwent a profound transformation. It began as a relatively narrow, predictable institution, but its toolbox and responsibilities expanded dramatically. Its balance sheet increased nearly tenfold after 2007, its tools became increasingly experimental, and its influence on financial markets grew to an unprecedented scale. These changes produced a series of unwanted side effects: distorted asset prices, rising income inequality and a growing realization that the Fed had strayed from its traditional, politically neutral role.[1]

This NK era of expansive central banking is likely over, especially given the Trump administration's disdain of unelected, unaccountable, elite bureaucrats wielding so much power.[2] The White House has stressed that it wants the Fed's mandate to be narrowed, its balance sheet reduced, and its institutional role refocused around its core function: setting short-term interest rates to ensure low and stable inflation.

In many ways, the Trump presidency is transformational and will likely have a structural impact similar to Ronald Reagan or Franklin D. Roosevelt. Like those earlier shifts, Trump has reframed core pillars of economic governance, including trade and industrial policy, defense and NATO burden-sharing, immigration, and now monetary policy. They are being re-engineered through a worldview centered on reindustrialization to favour domestic labour and reduce strategic vulnerabilities.[3]

This shift carries significant implications for investors. We expect a much "smaller" or "simpler" Fed, with many of its current responsibilities transferred to the executive. This has critical implications for markets and is no longer a theoretical exercise. But before we get into the investment implications, let's take a quick look at how we got to this juncture.

Forecasting Failures: The Limits of Activist Monetary Policy

Since the GFC, the Fed has repeatedly overestimated the stimulative power of its unconventional tools. Further, during the 2021–2023 inflation surge it erred in the opposite direction, by underestimating the scale, persistence, and breadth of inflationary pressures. These forecasting errors undermined confidence in the broader belief that the Fed's newer tools gave it the ability to finely steer the real economy.

If anything, the post-GFC experience demonstrated the opposite. The channels through which unconventional tools operate, including wealth effects and term premium compression, proved difficult to model and even harder to calibrate. The theoretical and empirical foundations of hyperactive central banking are broadly acknowledged to be weak at best.[4]

Mission Creep: Institutional Overreach and Questions of Independence

As its policy reach expanded, so too did the Fed's regulatory footprint. Post-GFC reforms gave the central bank significant authority over large banks. Did it make sense to delegate such critical supervisory responsibilities to an independent agency? Recent high-profile supervisory lapses, such as the failures of Silicon Valley Bank and First Republic, have exposed the Fed to widespread criticism. Broader responsibilities and deep intervention in financial markets also opened the Fed up to charges that it is no longer politically neutral.

These criticisms have been made quite forcefully by U.S Treasury Secretary Scott Bessent and Fed Governor Stephen Miran.[5] Bessent emphasizes mission creep, institutional bloat and the Fed's lack of accountability. He concludes that, to be effective, the Fed needs a humble, narrow mandate.

Miran stresses that the Fed has moved beyond its traditional narrow, technocratic role. Instead, it has pursued a much more expansive agenda that is more consistent with an explicitly political institution. This includes bank supervision as well as credit allocation and the selection of economic winners and losers, particularly during crises. Similar to Bessent he concludes with the need to cordon off non-monetary-policy functions such as bank regulation and crisis response from the Federal Open Market Committee's (FOMC) rate setting responsibility.

Monetary Policy

Toward a Narrower Fed: What the Next Era Could Look Like

Given these criticisms, several features of a future "narrower" Fed seem plausible.

First, supervisory responsibilities might be redistributed, potentially shifting day-to-day oversight back to institutions such as the Treasury or the Federal Deposit Insurance Corporation (FDIC). This would restore the traditional separation between monetary policy and bank supervision.

Second, the balance sheet could be gradually reduced to a size closer to its pre-crisis proportion.

Third, unconventional monetary tools could be reserved for rare, clearly defined crises. And such responses would be led by the Treasury. This would include the usage of USD swap lines, which the Fed extended to fourteen global central banks during the GFC and COVID.

The default stance of monetary policy would once again revolve around the overnight interest rate. However, given Trump's belief in an all-of-government approach to problems, he would like the structure of the FOMC to evolve. That is, becoming more aligned with broader governmental objectives, like almost all other federal institutions, while still preserving independence in day-to-day operations. Under this scenario, it is reasonable to expect the Fed to become increasingly subject to political pressures. This implies a return of the political business cycle, for example, with the Fed pressured to cut interest rates ahead of November elections.

Investment Implications: Is the Fed's Job to Take the Punch Bowl Away or to Keep on Pouring?

We expect the Fed will have a narrower mandate, with several of its responsibilities transferred to the Treasury or other parts of the government. Overall, this is likely to result in even more meddling and intervention in markets, and to feature greater alignment with the government's priorities. As a result, the investment environment is likely to shift in several important ways:

- **Greater pressure to reduce the Fed's policy rate.** The U.S President has, on numerous occasions, demanded much lower interest rates from the Fed. This view has been reiterated by senior members of the administration, including Bessent and Miran. Futures markets are pricing in three cuts during 2026, but we believe the risks are skewed to more aggressive Fed action.

- **Less stringent bank supervision and lower reserve requirements will reinvigorate traditional lending.** As regulatory intensity declines, especially for regional and mid-sized institutions, banks regain balance-sheet flexibility. Loan growth should improve, net interest margins widen, and the regulatory playing field tilt back toward money-center and regional banks. This is broadly bullish for U.S. financials and for credit-intensive parts of the real economy.

Fed balance-sheet reduction will require substantial private sector financing, with the possibility of wider credit spreads. If mortgage-backed securities migrate from the Fed's balance sheet back to Fannie Mae and Freddie Mac, supported temporarily by Treasury financing, private markets will need to absorb materially more duration and credit risk. Term premia should rise, agency spreads may widen, and investment-grade and high-yield credit are likely to reprice accordingly.[6] Active credit selection becomes more important in this environment.

When the next crisis occurs, market intervention could be even more aggressive, but it will be designed by the White House and just implemented by the Fed. With the aim of benefitting Main St more than Wall St and the Fed viewed as an underlying rather than as an equal partner. This also implies the QE-era policies that fueled private-market expansion are over and that trades in private equity and private credit must be right-sized. Funds that relied on artificially low financing costs will face pressure, and the sector may need a robust initial public offering (IPO) cycle to attract fresh equity capital. Public markets may reclaim share from private alternatives.

Nominal GDP growth should rise moderately as financialization recedes. With fewer incentives for financial engineering and more capital flowing toward domestic capacity, supply-chain reshoring, and industrial activity, nominal growth may run structurally higher. This supports sectors tied to physical investment, labour demand, and productivity improvements. Crucially, this is consistent with Trump's key economic objective, which is reindustrializing America and eliminating critical vulnerabilities.

A Narrower Fed Mandate: Economic Policy Becomes More Aligned with the Government

The extraordinary interventions of recent decades were responses to extraordinary circumstances. But they created the NK regime in which the Fed became not just a referee of the financial system but one of its most dominant players. Further, the Fed's competency is increasingly challenged, as is its political neutrality. For these reasons the Trump administration is determined to ensure a narrower, simpler mandate for the Fed.

For long-term investors, as always, disciplined analysis, global diversification, and active management are the tools that can help navigate a complex world. Especially one that is being transformed in many ways, including with a new monetary policy framework. ■

Economic Policy

Investing

[1] As with almost all institutions in America, the Fed is now perceived as being highly partisan. In 2024, 92% of political donations by Federal Reserve staff went to Democrats. By contrast, in 2000, such donations were roughly evenly divided. Moreover, the Fed chair before Powell, Janet Yellen, later served as Biden's Treasury Secretary, and the next Fed chair is likely to be Trump loyalist Kevin Hassett (82% probability according to prediction markets). https://www.semafor.com/article/11/12/2024/federal-reserve-employees-overwhemingly-donate-to-democratic-causes https://www.axios.com/2024/11/18/fed-partisan-trump-allies

[2] The Fed is now arguably the 5th most powerful political office in the world – trailing only the leaders of the U.S., China, Russia and India (but ahead of the leaders of Japan, Germany, France, the UK and Brazil). See: https://bharatramamurti.substack.com/p/what-are-the-most-powerful-political

[3] Please see our forthcoming paper, "The U.S.-China Trade War: What to Expect in 2026."

[4] While still Fed Chair in 2012, Bernanke quipped, "Well, the problem with QE is it works in practice, but it doesn't work in theory." https://www.philadelphiafed.org/-/media/FRBP/Assets/Economy/Articles/economic-insights/2016/q1/eiq116_did-quantitative_easing_work.pdf

[5] "The Fed's New "Gain-of-Function" Monetary Policy" and https://manhattan.institute/article/reform-the-federal-reserves-governance-to-deliver-better-monetary-outcomes

[6] Housing affordability has become a hot-button issue ahead of the November 2026 midterms and Trump is unlikely to approve of policies that drive mortgage rates higher. This suggests balance-sheet reduction could occur at a much slower pace than Treasury Secretary Bessent would like.

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