

Part 4

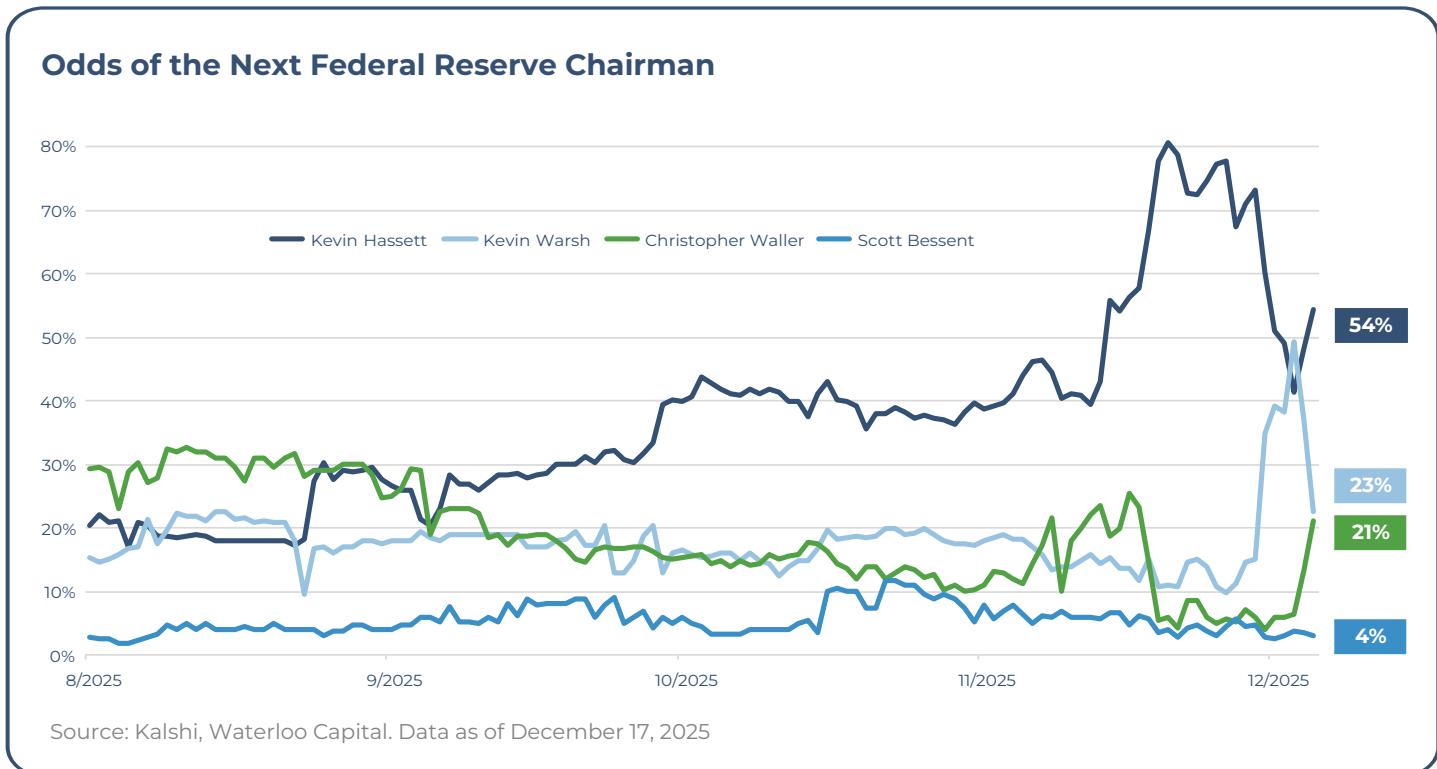
The Policy of Tolerance



THE POLICY OF TOLERANCE

The same Federal Reserve Chair appointed by President Trump during his first term, and later scolded during his second, is now entering the final miles of his tenure, set to step down in May 2026. Few Fed leaders have governed across as many extremes as Jerome Powell, spanning crisis-era policy during Covid, the fastest rate hiking cycle in decades, and now, a rare pivot toward rate cuts during a non-recessionary expansion.

As the baton handoff to a new Chair approaches, scrutiny of the Federal Reserve's independence has grown louder. With another political appointee waiting in the wings and policy already leaning towards accommodation, investors are questioning whether the Fed is nearing a point where monetary dovishness risks undermining credibility in 2026.



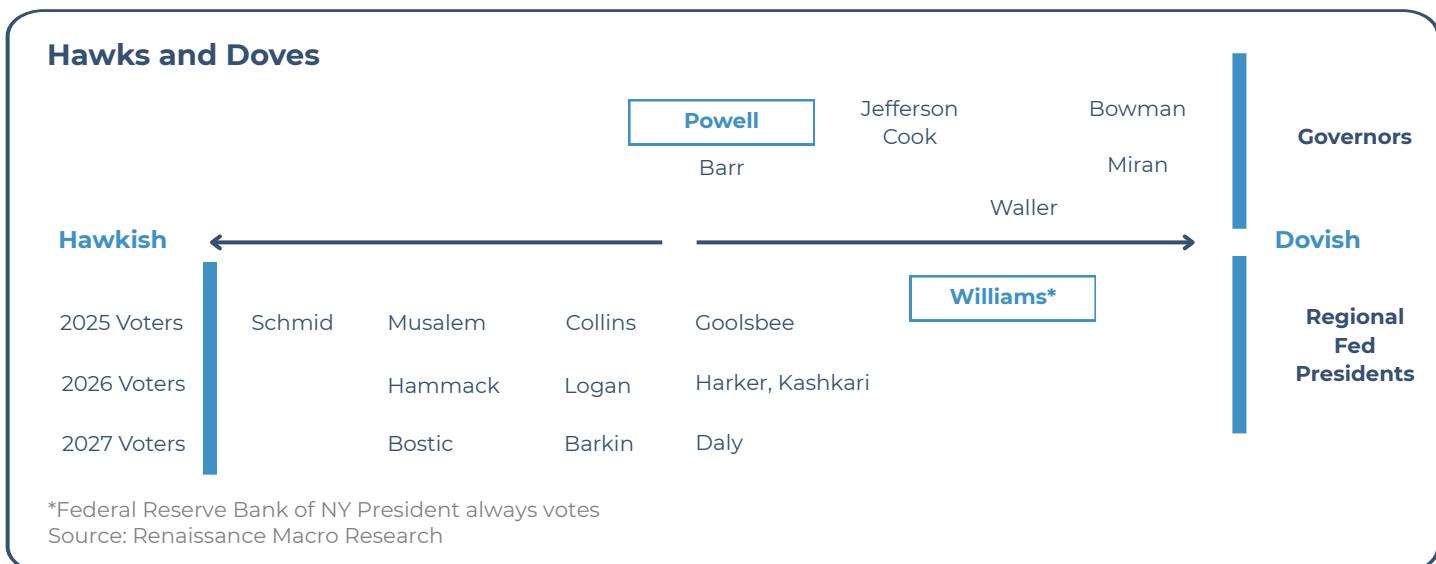
In our view, that framing misjudges the timing.

The dovish turn is not something that lies ahead, it is already behind us. That exit was missed miles ago. A central bank that has delivered 6 rate cuts, including one outsized move, into an economy growing near 4% last quarter with inflation well above target has already made clear how it plans to drive the rest of the trip.

A potential handoff to a more politically charged, or rhetorically dovish, Chair does not suddenly transform the Fed's stance, nor does it imply an imminent loss of independence. Political pressure exists at the margins, but it has not replaced the committee driven process. Monetary policy remains set by a collective, not an individual, and recent meetings have shown dissent on both sides of the debate. That matters. It suggests the institution is not operating in lockstep, even as its overall bias has tilted more dovish.

The December dot plot reinforces this with the 2025 projections offering the clearest window into the current voting members. A majority of policymakers signaled that policy is already near an appropriate level. 12 participants indicated rates are in a good spot, only 1 projected lower rates, while 6 saw the need for modestly higher rates. Taken together, this distribution suggests that much of the dovish adjustment has already been delivered. With easing front loaded, the bar for additional cuts in early 2026 is higher, not lower, and further action will likely require clearer evidence of economic deterioration rather than precaution alone.

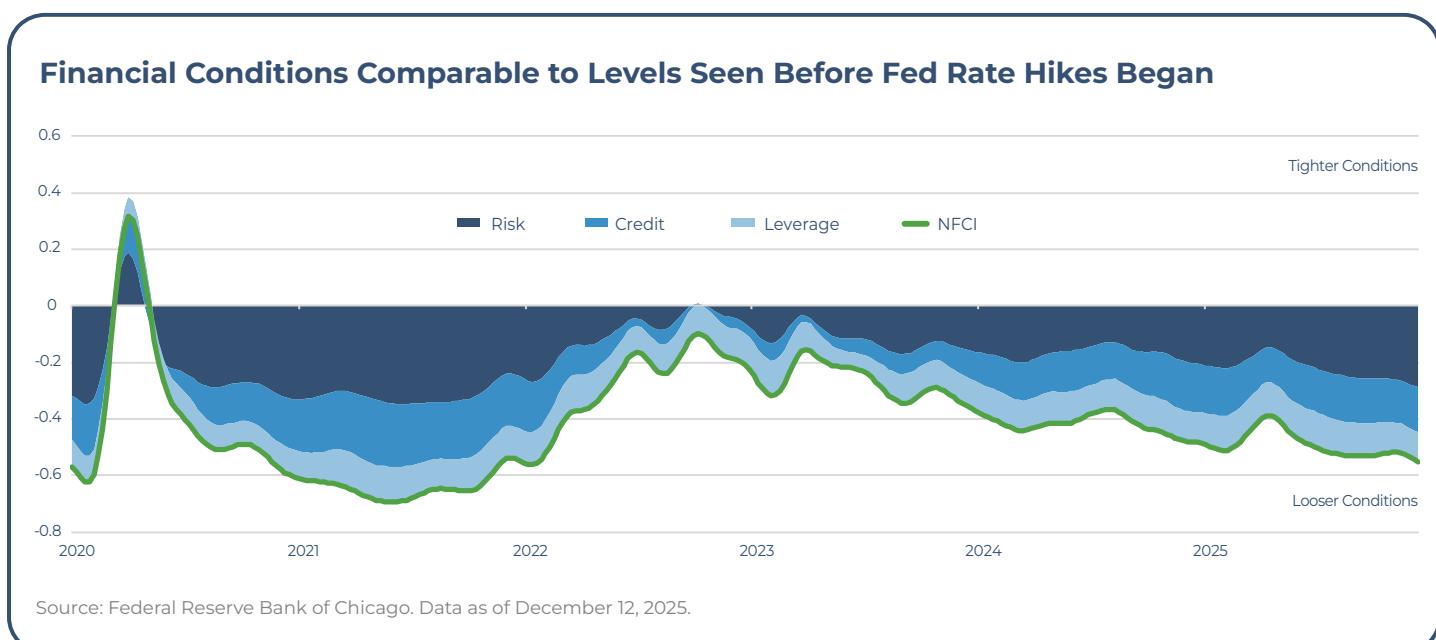
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The Federal Reserve operates under a dual mandate of price stability and maximum employment. In theory, that mandate is symmetric. In practice, it rarely is. Recently, policy justification has leaned more heavily on perceived labor market risks. We agree that earlier rate cuts were reasonable, particularly given how distorted the employment data has been by revisions, the government shutdown, and other sources of noise that made real time decision making unusually difficult. Chair Powell has even acknowledged that headline labor data may be understating underlying weakness. Within today's framework, the Fed's greater concern is not acting too soon, but waiting too long.

Looking ahead, however, a growing share of labor market softness appears driven by forces beyond the reach of rate policy, including immigration dynamics, slowing government hiring, tighter corporate cost discipline, and productivity gains from AI. Rate cuts may help at the margin, but they are not an immediate cure for structural labor supply and demand changes. That is what makes 2026 different as the Fed may be cutting into a labor slowdown it cannot fully influence, while simultaneously keeping inflation risks alive.

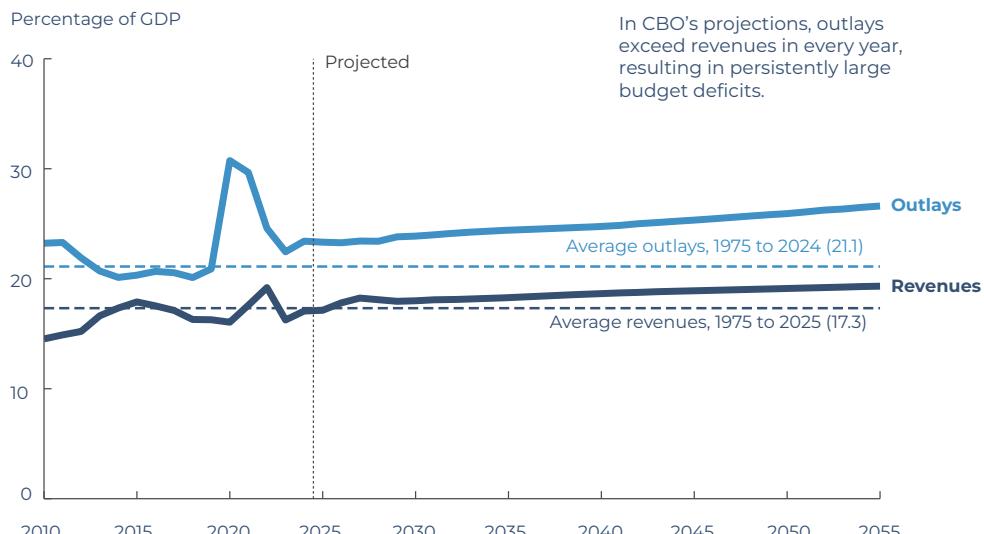
With much of the easing already delivered, in our view, the logical next step would be patience. Inflation remains elevated, growth remains resilient, and financial conditions are already loose by historical standards. A true wait-and-see approach would allow policymakers to assess the cumulative impact of prior cuts before risking further imbalance. With easing frontloaded, the burden of proof for future cuts should rise.



“That said, what we think is prudent policy and what the Fed is likely to pursue are not necessarily the same.”

Even as the Fed continues to assert 2% inflation is the goal, its actions and communication suggest a growing tolerance with the number closer to 3%, particularly if the alternative is a recessionary outcome triggered by a policy mistake. The decision to wind down Quantitative Tightening while growth and financial conditions remain expansionary reinforces that mindset. This is a Fed inclined to insure against downside risk rather than wait for perfect data.

Total Outlays and Revenues



Source: Congressional Budget Office. See www.cbo.gov/publication/61187#data.

A big driver of that tolerance is structural. US debt and deficits are historically large, narrowing the range of realistic policy choices. Interest costs are projected to approach \$1 trillion this year, nearly triple 2020 levels. Policymakers can try to grow their way through that problem or inflate their way out of it. In reality, the outcome is usually some combination of both.

A more tolerant Fed makes that possible. Allowing the economy to run somewhat hotter supports growth and sustains revenue, while permitting inflation to settle modestly above target can gradually erode the real burden of the outstanding debt. Neither approach is a cure, and neither solves the problem outright. But together, they provide marginal relief. When interest rates lag nominal growth, the math simply works better.

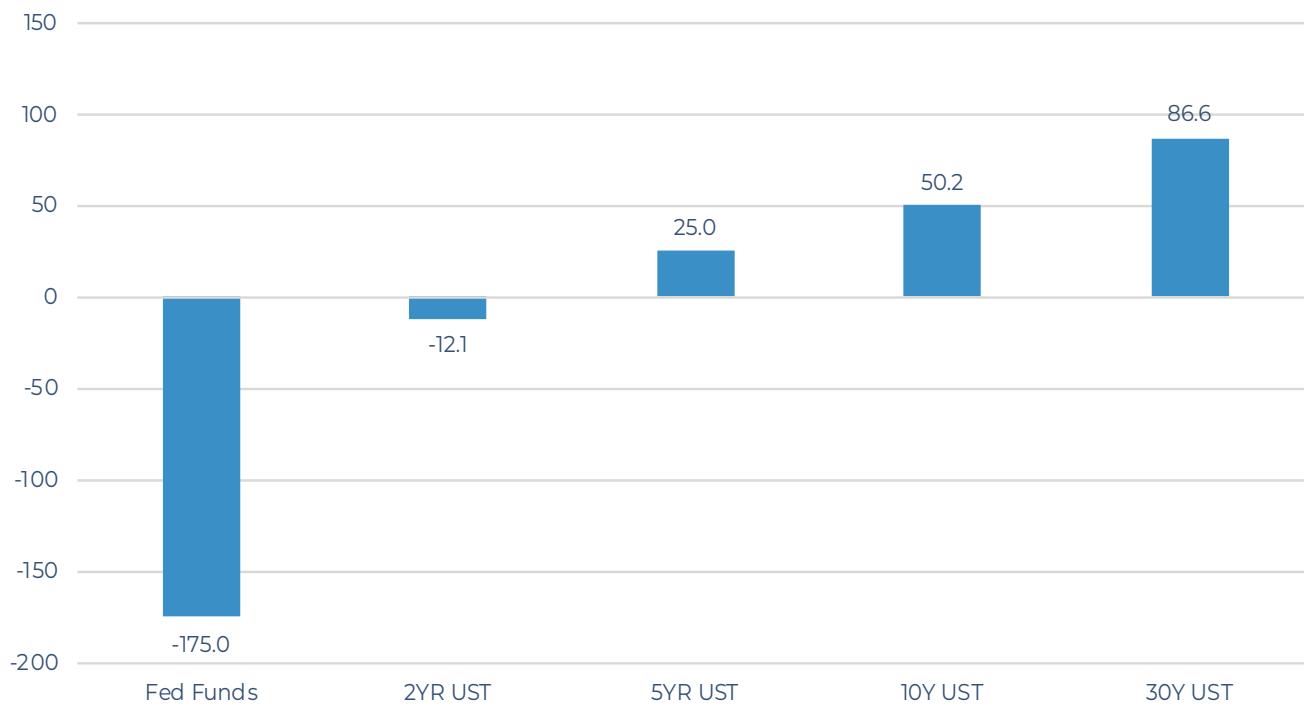
This does not require explicit coordination between monetary and fiscal authorities. It has emerged naturally given elevated debt levels and the high economic costs of forcing inflation back to target. Independence still matters, but it is not absolute. That is why tolerance has become such a durable feature of monetary policy. Even with solid growth and inflation above target, the Fed is likely to remain biased toward accommodation and quick to react if the labor market falters. Patience may make sense in theory. In practice, this Fed has shown a clear preference for moving early rather than risking a repeat of past mistakes.

For markets, this distinction is critical. A Fed that is more tolerant of an environment defined by higher inflation and solid growth has very different implications across asset classes. Inflation that settles into a middle ground can support nominal revenue growth and earnings, which is generally constructive for equities so long as policy remains supportive. That same backdrop becomes far more problematic when the Fed is tightening aggressively, as it did in 2022. In this cycle, the Fed's posture matters as much as the level of inflation itself. Hard assets and inflation-sensitive exposures, such as gold, are likely to continue benefiting in 2026 as liquidity improves and inflation risk persists. Fixed income, by contrast, faces a more uphill climb.

Fed rate cuts generally support fixed income, but they will not guarantee price appreciation. The Federal Reserve exerts its influence primarily at the front end of the yield curve while longer-term yields are driven by inflation forecasts, growth expectations, and term premium. Over the past year, all three have moved higher. Despite 6 rate cuts, longer term yields have risen rather than fallen, a clear signal that markets are pushing back against the idea that easier policy alone can anchor the curve.

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Despite 6 Fed Rate Cuts, Long Term Yields Are Higher



Source: Bespoke, Bloomberg, Waterloo Capital. Data as of December 19, 2025.

Investors are demanding greater compensation to hold long duration assets as inflation risks remain more skewed to the upside, growth has proven resilient, and uncertainty around policy and supply has increased. The rising term premium, especially, reflects that reality.

Debt and deficits set the backdrop for this adjustment. The volume of issuance required to fund persistent deficits raises supply at the long end, while marginal demand has become more price sensitive. As a result, yields adjust higher. This dynamic does not require a fiscal crisis to be relevant, it simply raises the floor for how low long-term yields can fall, even in a cutting cycle.

The result is a fixed income environment that looks materially different from prior easing cycles. Returns will be driven by income rather than duration. Bonds still play an important role, but the path to capital gains is far narrower when inflation is tolerated and the term premium is rising. In that context, we favor an underweight to duration. It is not a call for sharply higher rates, but an acknowledgment that the structural tailwinds for long bonds remain weak.

Whether or not one agrees with every decision, the pattern is clear. The Fed has chosen to err on the side of accommodation and speed, a bias we expect to continue in 2026. For investors, the challenge is no longer just predicting the next cut, but understanding what a more reactive Fed means for asset prices, particularly in a fixed income market that is no longer willing to follow policy rates lower without demanding compensation.

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