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STREETWISE

Even Short-Term Inflation Will Test the Fed

The Fed should hold steady on interest rates even if inflation temporarily jumps above 5%

There is no sign that investors expect the Federal Reserve to be anything but super-dovish.

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By

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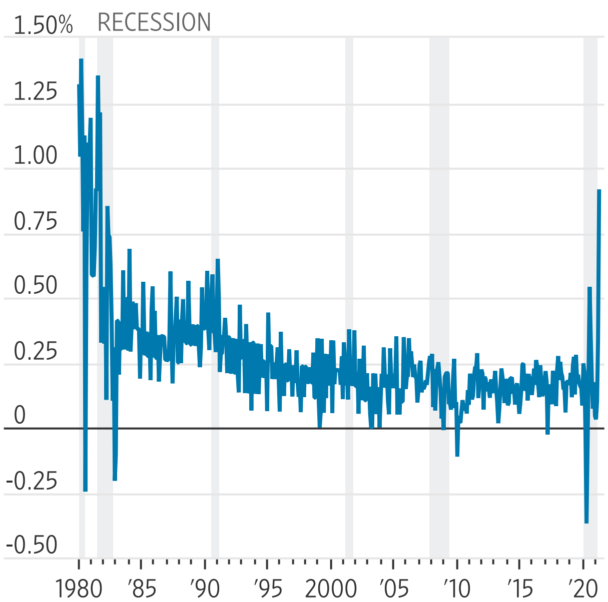
Just how much inflation would it take for the Federal Reserve to abandon its commitment to super-easy money and begin to talk about tightening? Markets think the answer is that the Fed will accept far more than consumers would like, and the market is probably right: Inflation could easily be at 5% early next year without prompting any change of strategy. So long as the Fed expects inflation to come back down and investors and workers have faith, it is under no pressure to move. The danger is that high inflation shakes that faith.

Investors were shocked by the jump in inflation reported last week. The core inflation that economists tend to focus on, which strips out volatile food and energy prices, rose 0.9%

month-on-month in April, an annualized rate above 11%. (Year-over-year, core inflation was 3%.)

Inflation Scare

Monthly change in core consumer prices*



*CPI less food and energy; seasonally adjusted
Source: Labor Department via St. Louis Fed

Bond yields duly jumped, but the 10-year Treasury yield is still below where it stood in March. There is no sign that investors expect the Fed to be anything but super-dovish.

“The bar’s going to be really high for the Fed to deviate from the path they’ve laid out,” said Andrew Balls, chief investment officer of global fixed income at Pimco.

To see why, consider one fairly rosy scenario for inflation. Over the next six months we have a smooth reduction in monthly core inflation, as supply constraints—shipping, lumber, microchips, cars, worker shortages, everything—ease and consumers have less leftover stimulus to spend. By November, assume prices are rising at a modest 0.17% a month, where they need to be to reach 2% a year. In this scenario the year-over-year rate, the one we usually look at, would peak at 5.2% next February, and still be above 3% next July.

What would the Fed do? Probably nothing. But the risk for the Fed, and for investors, is that Americans aren't used to inflation like this. Core inflation hasn't been above 5% over a 12-month period since 1991. The Fed's credibility might suffer a serious blow.

STREETWISE ON INFLATION

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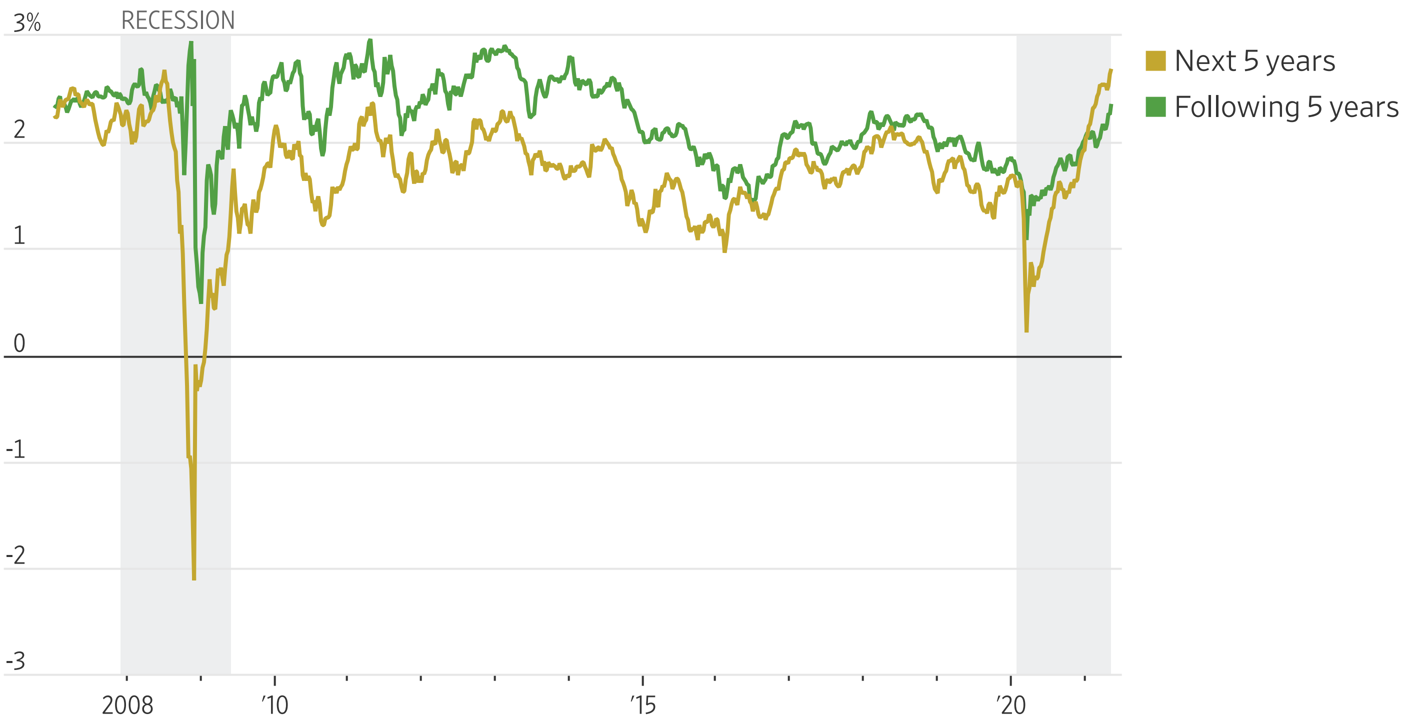
The Fed will explain at great length that it is one-off inflation, will be able to point to a monthly rate coming back under control even as the year-over-year changes look bad, and will emphasize that it stands ready to intervene if inflation ever looks likely to rise uncontrollably. Perhaps no one would worry that the Fed was allowing inflation at double or close to triple its target while rate rises remained far in the future. Perhaps everyone would accept that lower month-on-month inflation was what mattered, not higher year-on-year inflation. Perhaps. But given how loudly those concerned about inflation are already shouting, I suspect the Fed would be besieged by calls for action.

Just how plausible is the scenario? It is well within the boundaries of what's reasonable, because of the inexorable mathematics of last month's stonkingly-high inflation number. Try another scenario, even more favorable to the Fed: the core month-on-month rate halves this month and keeps rising at that rate until September, when federal unemployment benefits run out. Then it drops to 0.17% (as a reminder, that's the monthly price rise needed to reach 2% over a full year). April's price rise was so high that core year-on-year inflation would still be above 4% next February, even in this really good outcome.

Inflation Moderation, Eventually

Since the 2008 financial crisis investors have expected inflation to be higher in the long run than in the next five years. That's changed.

Breakeven inflation rate



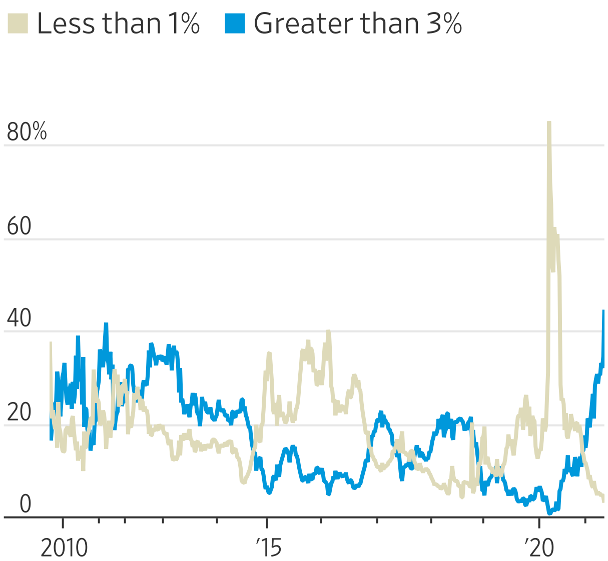
Source: Federal Reserve Bank of St. Louis

Again, I emphasize that the Fed in these scenarios shouldn't be tightening policy, because it should care about future inflation, which in these cases wouldn't be a problem. My concern is that the Fed loses credibility, which means higher and more volatile bond yields, hurting the price of pretty much everything else, and risking a self-fulfilling rise in inflation expectations.

For now the market is mostly buying the Fed's story of a temporary burst of inflation. Mostly. Treasurys are priced for annual inflation of 2.65% over the next five years, falling back to 2.37% over the following five years. That's compatible with the Fed's target of 2% because it uses a different measure of inflation that usually comes in a little lower.

The Great Inflation Switcheroo

Option-implied probability of inflation over the next five years being:



Note: Through May 5

Source: Federal Reserve Bank of Minneapolis

The trouble is that investors are much less confident now than before the pandemic about their predictions of inflation. Options pricing implies a 44% chance of inflation being above 3% over the next five years, according to the Minneapolis Fed, the highest in data back to 2009. And those market predictions now encompass a far wider range of possibilities; For the mathematically inclined, the standard deviation of the options-implied probability distribution has doubled.

Christian Mueller-Glissmann, multiasset strategist at Goldman Sachs, argues that the market is moving from preparing for an inflation overshoot to actually experiencing it, which is tough for investors to handle. "Neither the bond market nor the equity market like inflation surprises" in this phase, he said. Stocks shift from rising when Treasury yields rise, because a stronger economy pushes them both up, to falling when Treasury yields rise, because scary inflation hurts both equities and bonds—a pattern that was especially strong last week.

I still think it's likely this inflation proves to be a short-term spike that will mostly resolve itself as the economy returns to something like normal. But short-term inflation can become self-fulfilling if the Fed loses credibility, because then inflation expectations lose their anchor to its 2% target. If that happens, the short-term inflation problem might prove the start of the longer-run inflation that the shifting political economy, demographics and geopolitics make more likely.

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