The inflation killing fields - 04/14/2022

The Q1 2022 CPI prints are now in the books; and for the Fed, they leave an ugly mark on an otherwise stellar 40-year record of inflation slaying. The numbers for the last three months accelerated aggressively, coming in at 0.6%, 0.8%, and a whopping 1.2%, respectively. These monthly readings now take the year-over-year CPI from a very uncomfortable 7% at the end of 2021 to a downright shocking 8.5% today.

And while most professional forecasters are calling this the peak, largely because of tough Q2 comps, the reality is that no one has a clue when the supply disruptions that are at the root of this inflation surge will cease. After all, how many professional economic forecasters were penciling in 8 handles on inflation a year ago when we were sitting at a 2.6% CPI? Zero!! Why would one expect these folks to have any special insights on the Ukrainian war or the Chinese lockdown? They wouldn't!! And who is to say that these exogenous supply shocks, which are the current drivers of the inflation surge, are not going to stay with us, or even get worse, in the coming quarters. Nobody!!

Further, even if the inflation headline handles begin to fall back towards 6, 5, or even 4 in the coming quarters, the Fed is in no position to claim immediate victory. The inflation shock of the last year has certainly been large enough to compromise long-term expectations if left unchecked. The FOMC will need to act hawkish and stay hawkish, no matter how inflation evolves in the near term, in order to maintain the upper hand on long-run inflation expectations.

The good news for the Fed is that, thus far, the expectations anchor has remained firmly in the ground. The UMich and NYFED surveys have 5+ year inflation expectations at or below 3%, and 5y5y breakevens are hanging around 2.5%. One could also argue that the DXY above 100 is a further testament to the market's confidence in the Fed's long-term inflation-fighting credibility.

But even with credibility fully intact, this is no time for a cavalier attitude on the part of the FOMC. This 8.5% CPI scar will require immediate and lasting hawkish medicine. And by all accounts that is precisely where the committee is headed. The most recent FOMC member to move toward an excessively hawkish stance was Lael. In her speech last week, the first sentence contained a hat tip to Paul Volcker!! First, Jay puts Volcker up on a pedestal during his confirmation hearings a month ago, and then we get this high-profile Volcker reference from Lael. No wonder the market trusts the FOMC even as headline inflation has surged to 8.5%.

Looking ahead, the committee is readying itself for an epic battle with inflation. And to be honest, I suspect they would all happily trade off a moderate recession sometime in 2023 to get inflation back below 2% expeditiously. After all, wouldn't they rather have a recession in 2023, when there are no political considerations, instead of risking one during the 2024 election campaigns? Absolutely. Further, dillydallying around until 2024 to slay this inflation beast carries significant risks for the expectations anchor. At this point, it's better to shoot first and ask questions later!! Now, they may not have the guts to come out and forecast a recession in their SEP numbers, but deep down they all want to crush this 8.5% number, fast!! If some innocent bystanders perish in the battle via a mild recession, then so be it. That is standard collateral damage on the inflation-fighting battlefield.

And as they press forward aggressively with this inflation offensive, I doubt the committee members even want to engage in a debate about whether the source of this inflation emanated from overly stimulative demand-side policies, or whether it was just bad luck via adverse supply shocks. I'm sure they believe the latter, but the question is not worth fighting about. The sad reality is that these CPI prints are high enough to dislodge the long-term inflation anchor, no matter where they came from. And hence the inflation must be stopped dead in its tracks, quickly.

In fact, there is a great deal more at stake here than just the current inflation battle. If the Fed is not seen as being able to control this inflation outbreak, then their ability to use unconventional policies in the future to fight economic downturns will be compromised. Recall way back in 2009–2010 when the inflationistas were warning that Bernanke was going to turn us into Zimbabwe with QE. His response was always the same and ran something like this: We know how to solve a severe inflation problem if QE causes that, it's easy, we raise rates like Volcker did; however, at the zero bound, we have a great deal of difficulty solving a deflation problem. The FOMC is acutely aware of Bernanke's line of thinking. And they all understand how the birth of those highly controversial QE policies unfolded. The committee currently has the privilege of using these balance sheet policies to conduct wildly aggressive easing policies ONLY if they remain credible in the event of an inflation shock. Therefore, this spike needs to be crushed posthaste if the newfound freedoms that they have enjoyed in fighting the last two downturns are to remain intact. This is a critical feature of the battle, and it's why markets could get quite messy in the short-term. That said, once the Fed successfully beats down inflation, and shows that Bernanke was absolutely right about knowing how to fight it, they will come out even stronger. There will be less fear of QE the next time, as they prove that controlling any inflation spikes can be done quite easily.

Now some folks may think I'm being overdramatic in my assessment of the Fed's desires on inflation fighting here. But there is a huge difference between the current fight and any other inflation battle of the last 30 years. The last time we had anything similar to the current situation was during the 1989–1990 cycle when inflation spiked up to 6.3%. Back then, Greenspan jacked rates to 9.75%, squashed the inflation, and created a rather nasty little recession. The difference back then was a lack of Fed credibility, given the then-recent high inflation experiences of the 1970s and early 1980s. Greenspan had to go the extra mile with such a lack of trust in the market. Jay will not have to be so draconian after decades of credibility building, but he will have to act forcefully given the rise in ACTUAL inflation. That is the key point here. The last time ACTUAL inflation was sustainably pushing above the 6-handle region was back during this 1989–1990 period. Since that time, the Fed has only been fighting the "prospect" of high inflation. They have never seen meaningful ACTUAL inflation since that cycle over 32 years ago. And that is a huge problem!!

Let's take a quick trip down memory lane just to illustrate this point more forcefully, as it is extremely important when considering how the Fed will react to the current ACTUAL inflation surge in the coming quarters. If we step back to the 1994 rate-hike cycle, there was no material inflation rise prior to, during, or after the tightening process. The Fed was only fighting its own expectation of inflation pressures. Their trusty Phillips Curve-based models told them it was coming, but it never did. Then, in the 1999–2000 hiking cycle, the same thing happened. There was never any sign of inflation at any time. The Phillips Curves were all flashing red, but inflation never showed up before, during, or after the hikes. Next up was the 2004–2007 rate-hike cycle. Once again there was no material rise in inflation at any point. They were just fighting a phantom. And finally, in the 2015–2018 hiking cycle, inflation was consistently coming in below the 2% target the entire time. For nearly 30 years, through four hiking cycles, they were shooting at a ghost. Their faulty models kept telling them that inflation was lurking just behind the bushes. And they always started shooting. But in the end, the inflation was never there, and the only thing they ever killed were jobs!!!

I'm not sure the market fully appreciates this narrative. And I'm not sure the market understands how seriously the FOMC takes the arrival of ACTUAL high inflation. For everyone on the committee, this is the first time in their careers as a policy maker that they can see, feel, and taste meaningful inflation. It is right there in their crosshairs. This is not some phantom from the Keynesian cesspool of dead Phillips Curves. It's the real deal. And as such, they will come out guns blazing. Jay, in particular, is not about to go down in history as the central bank chair who blew 40 years of hard-earned inflation-fighting credibility. He wants to have a spot in central bank heaven next to Paul Volcker. He does not want to be flanked by Bill Martin and Arthur Burns in central bank hell.

So as the Fed heads off into the killing fields to put down both inflation and inflationistas in the coming quarters, the critical issue for the market will be how much it uses short-rate weaponry versus that in the balance-sheet arena. After all, they have two ways to kill in this battle. And after last week's minutes release, it is quite clear that the market may have underestimated how large a role the balance sheet is set to play in the process. The FOMC are allowing runoff to start earlier than anticipated. And they are setting the initial pace of balance sheet contraction at a level that is basically that of the previous cycle. More importantly though, they opened up the idea of MBS asset sales later in the tightening process. Here is the exact statement on sales from the minutes:

> Participants generally agreed that after balance sheet runoff was well underway, it will be appropriate to consider sales of agency MBS to enable suitable progress toward a longer-run SOMA portfolio composed primarily of Treasury

securities.

Now I caught a fair amount of flack earlier this year for suggesting that asset sales could play an important role in this tightening cycle. Many clients pushed back aggressively, saying the Fed could never sell. Well, guess what?? They are gonna do it!! And if the curve inverts sharply, they will increase the pace and broaden the scope of this selling for sure. I am convinced they do not want to go back to the bad old days when 5s30s was at -75 bps!!! Especially when they have plenty of duration to unload on the market if it can handle it.

Of course, the market has reacted to the balance-sheet news in the minutes by sharply steepening the curve. And that no doubt will make the Fed quite happy. A 2s10s inversion after one rate hike was not what they wanted to see. So they will no doubt have gained some confidence in the future use of the balance sheet during the tightening process after the minutes release. And I suspect they stand ready to bring out bigger balance sheet guns if any undesirable inversions begin to take hold again.

All this said, though, it's still too early for me to tell if enough tightening is priced into the front end. Using the balance sheet more aggressively takes some pressure off the short end for sure. And I would love to go back to risk parity trades, as those low 97 handles on blues look quite tasty by historical standards. But I never imagined inflation surging to 8.5%, and it may take higher short rates for a longer time AS WELL AS a more aggressive balance sheet contraction to solidify the kill. Further, even as the economy weakens in response to the tightening, the Fed will be slow to backstop any economic duress with a dovish short rate pivot. They need to drive inflation (and the inflationistas) into the ground and make sure they stay there. No immediate resurrections can be tolerated. That clearly makes risk parity less appealing in the near term. So, for now, I'm content to stick with my covered spoo call position from the beginning of the year and steer clear of the rate market until the inflation picture becomes less clouded by these highly unpleasant adverse supply shocks. Good luck trading.