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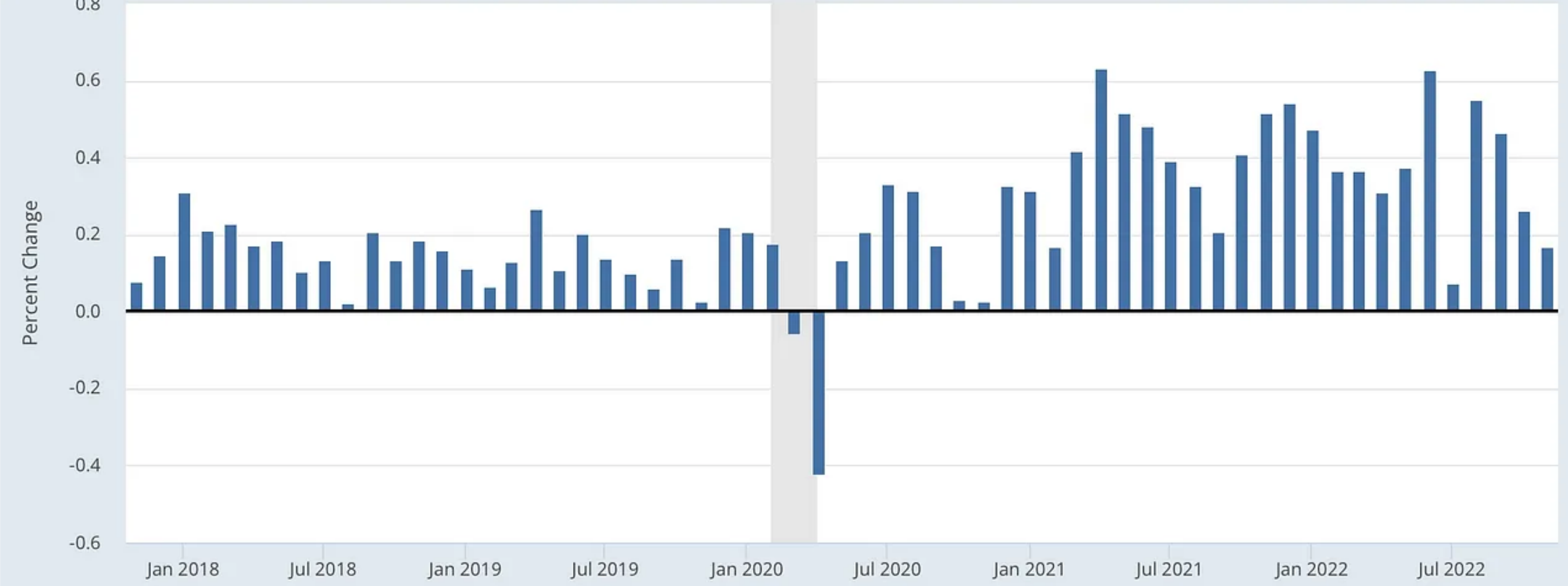
As of the start of February 2022, the five-year five-year forward CPI inflation breakeven rate in the bond market was hanging at 2% per yearâ€”a number corresponding to a PC each chain inflation forecast from 5 to 10 years hence of some 1.6% per year, materially below the Federal Reserveâ€™s 2% target. Thus as of the start of February, I was feeling very good about being on Team Transitory as far as inflation was concernedâ€”or at least on Team The-Fed-Has-Got-This, and Team The-Inflation-Expectations-Anchor-Is-Solid.

Then, on February 24, the grand prince of Muscovy sent his army to invade and try to conquer Ukraine in a lightning strike. Things did not go as he planned. Energy and grain prices went through the roof, as we contemplated the possibility of a world in which much of Western Europe froze and much of Nigeria and Egypt starved in the winter we are now going through. And the five-year five-year forward CPI inflation breakeven rate rocketed up: from 2% per year to its peak of 2.67% per year on April 21, 2022.

Expectations of annual PCE-chain inflation from five to ten years hence of 2.27% were not a major breaking of bond-trader confidence in the Federal Reserveâ€™s commitment to its target. But if you think the target-zone width is 0.6%-points annualized and thus that the bond market thinks that Fed is or will get on target whenever the five-year five-year forward CPI inflation breakeven rate is between 2% and 2.6% per year, there was reason to worry. As I asked my more hair-on-fire friends back then: Are we now only one more big supply shock away from losing the inflation-expectations anchor?

Perhaps we were.



But we did not get that additional large adverse supply shock. And the monthly PCE-chain inflation number for November released on December 23 was 0.16%, which when multiplied by 12 is less than 2% per year.

One swallow does not make a summer. One data point does not make a trend. Even the rundown from 0.62%â€"7% per yearâ€"in June is not necessarily bankable: after all, we saw rundowns from December 2021 to April 2022 and berfore that from Auguty 2021 to December 2021.

As I have said, this plague-ridden business cycle is one of the rare times that I do not envy the members of the FOMC. What they decide to do over the next six months will start to affect the real economy of demand, employment, and production starting one year from now, and start to affect the inflation news starting a year and a half from now. Many things good and bad will happen in the next eighteen months. And whatever the Federal Reserve decides to do, it is sure to regret it afterwards.

Will it overdo interest rate increasesâ€"has it already overdone interest rate increasesâ€"and will two years from now see the economy mired once again in secular stagnation, with interest rates at their zero lower bound, and no visible path for a rapid return to full employment? Will the economy attain the soft landing of immaculate disinflation? Will additional supply shocks or political pressures wind us in stagflation, or even in enough of a fear of stagflation that recession comes and is painful and prolonged?

If I were on the FOMC right now, I would hold very tight to two considerations:

1. The Federal Reserve does not have to move slowly. The past six months have demonstrated that there are very few downsides to the swift movement in monetary policy that 75 basis-points increases in interest rates every month and a half deliver. And a 75 basis-point increase at an FOMC meeting is not a speed limit. This suggests: Take advantage of optionality. When the situation is unclear, pauseâ€"and then move fast when the situation becomes clear.

2. In retrospect, Alan Greenspan's decision to set the Federal Reserveâ€™s target inflation rate at 2% per year was very ill-advised. There is an argument that there are substantial benefits from maintaining and strengthening credibility by getting the economy back to the 2% per year target, even if that target is going to be raised in the medium term. But is that really the kind of credibility the Federal Reserve wants to have? It is not clear to me that the Federal Reserve is better off with it. Is it good for markets to think that you will persist in policies when it is clear that circumstances have revealed that they are stupid, and do so just because?

Once again: I do not envy the members of the FOMC this winter.

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