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Is the Fed fighting the last inflation war?

Inflation looks to be on the march. The US April 'core' CPI came in well ahead of expectations at 3.0 per cent, the highest rate of increase in 25 years.

But the signs were there.

The prices paid component of the April Chicago PMI skyrocketed to a 41-year high. To put that in some context, this level was last reached in 1980 when inflation in the US hit 13 per cent, after a massive spike in oil prices in the wake of the 1979 Iranian Revolution.

Nationally, purchasing managers reported suppliers struggling to meet demand. Order backlogs are at their highest in 40 years.

Commodity prices are surging.

Warren Buffet in his annual address to Berkshire Hathaway investors stated that he was surprised by America's "red hot" rebound and that he was seeing "very substantial inflation".

Financial markets too were beginning to display signs of anxiety about the Fed's stance. Prior to last night's release, market-based 5-year inflation expectations in the US were approaching 2.8 per cent - their highest since 2008.

But central bankers appeared unmoved. The US Federal Reserve Chair, Jerome Powell, continues to assert that any inflation will be "transitory" and borders on dismissive of concerns regarding clear financial market imbalances. His comments have for the most part been supported by several other Fed speakers.

The April jobs report in the US was disappointing but that may have as much to do with supply-side issues as with any deficiency of demand. That notion is lent support by a much greater than expected increase in average earnings, indicating that wage inflation may be taking root in the US.

The emergent inflation anxiety has coincided with a shift by the world's major central banks to an 'outcomes-based' focus for monetary policy. In essence, that means that rather than be satisfied with a forecast that inflation will rise above a target (around 2 per cent in the Fed's case), the central bank will await an outcome that they believe indicates persistent inflation above that target. That locks the Fed into a process whereby it acts only if inflation persistently surprises on the upside.

The move to an 'outcomes-based' framework, however, looks to have occurred at a time when both cyclical and structural factors are suggesting that the downside risks to inflation are abating.

Certainly, cyclical momentum has been given a boost not only by historically high levels of monetary accommodation but by an unprecedented fiscal boost.

Structurally, pandemic induced supply shocks are coinciding with the reversal of structural trends that account for the deflationary tendency of the past three decades: viz; globalisation of labour supply (as well as that for goods and services) and baby boomer workforce participation.

Add into that mix the secular rise in female workforce participation, and the result was a massive global labour supply shock and a decline in wage growth and a structural deflationary trend. That is ending.

The move to an 'outcomes-based' framework for monetary policy at a time of intensifying inflation pressures and growing financial market imbalances increases the probability of a policy mistake, with the Fed getting behind the curve on the withdrawal of the current stimulus. Such a mistake may mean that later in the piece the Fed has to jam down hard on the monetary brakes, leading to sharp upward movements in bond yields and a significant correction in equity markets. Such a scenario looms as a major challenge for investors in the future, including how multi-asset investors react to a potential reversal of long-held assumptions regarding asset return correlation.

In this sense the move to an 'outcomes-based' focus may be akin to 'fighting the last war'.

Accordingly, with higher inflation now a reality, it will become an increasing preoccupation among investors. What markets are now contemplating is what that might mean for future Fed messaging, and whether an overhaul of the monetary arsenal might be required to fight the new 'inflation war'. Stephen Miller is an investment strategist with GSFM

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