Seeking Alpha α

# The Fed Appears To Be Losing Control Of Inflation Expectations

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## Summary

The Fed risks losing control of the inflation narrative as consumer and market-based inflation expectations rise sharply.

February saw significant jumps in consumer inflation expectations, with the University of Michigan's 1-year expectation rising to 4.3% and the Conference Board's to 6%.

Rising inflation expectations are causing monetary policy to ease further.

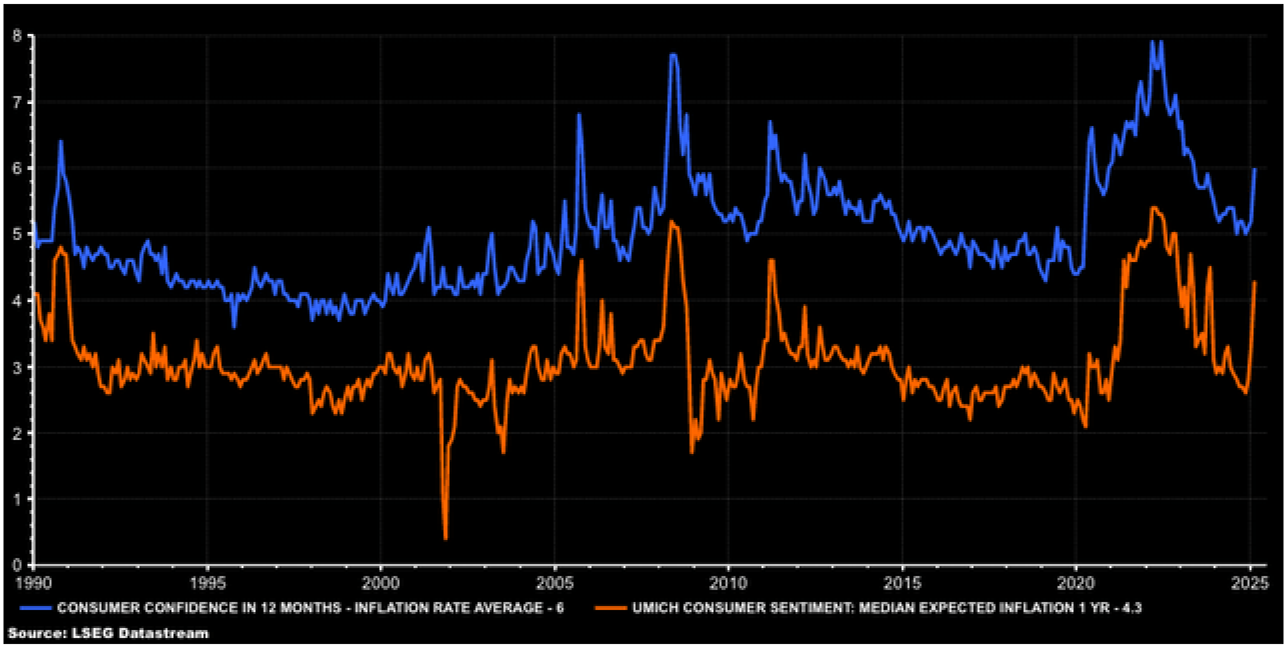
While one month of data isn't a trend, the recent surge in inflation expectations is concerning and warrants close attention.

**Alex Wong/Getty Images News**

Between the rise in market-based and consumer-based inflation expectations, the Fed appears to be losing control of the inflation narrative and is now at risk of inflation expectations becoming unanchored after all of this time.

The latest University of Michigan and Conference Board data showed that consumer inflation expectations rose dramatically in February. The University of Michigan saw the 1-year inflation expectation increase to 4.3% from 3.3%. Meanwhile, the conference board's consumer confidence 1-year inflation expectation rose to 6% from 5.2%.

Since 1990, there have only been a handful of times when the inflation measures jumped this much in one month and, more importantly, to levels that are this high.

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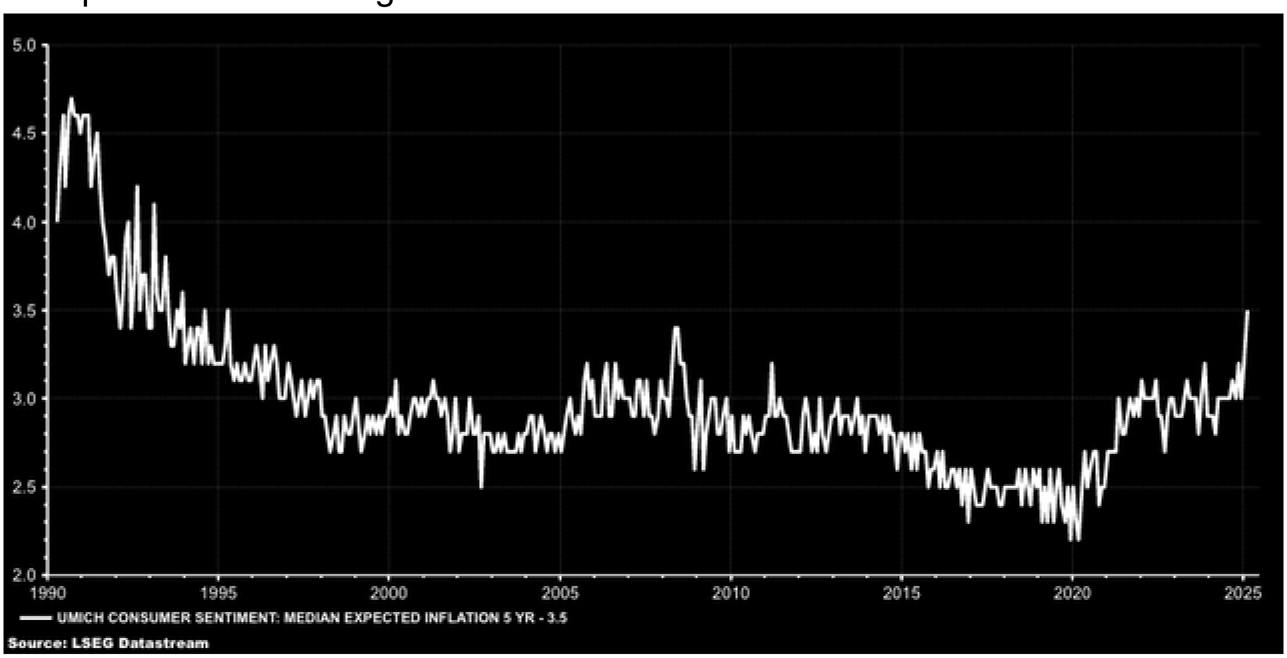
The University of Michigan's long-term inflation outlook was the most damaging. It jumped to 3.5% in February, its highest reading since April 1995 and, more importantly, a new cycle high. It is higher now than in June and July 2022 when inflation was much higher. At this point, consumers not only expected inflation to remain elevated over the short term but also beginning to expect it to remain high for some time to come.

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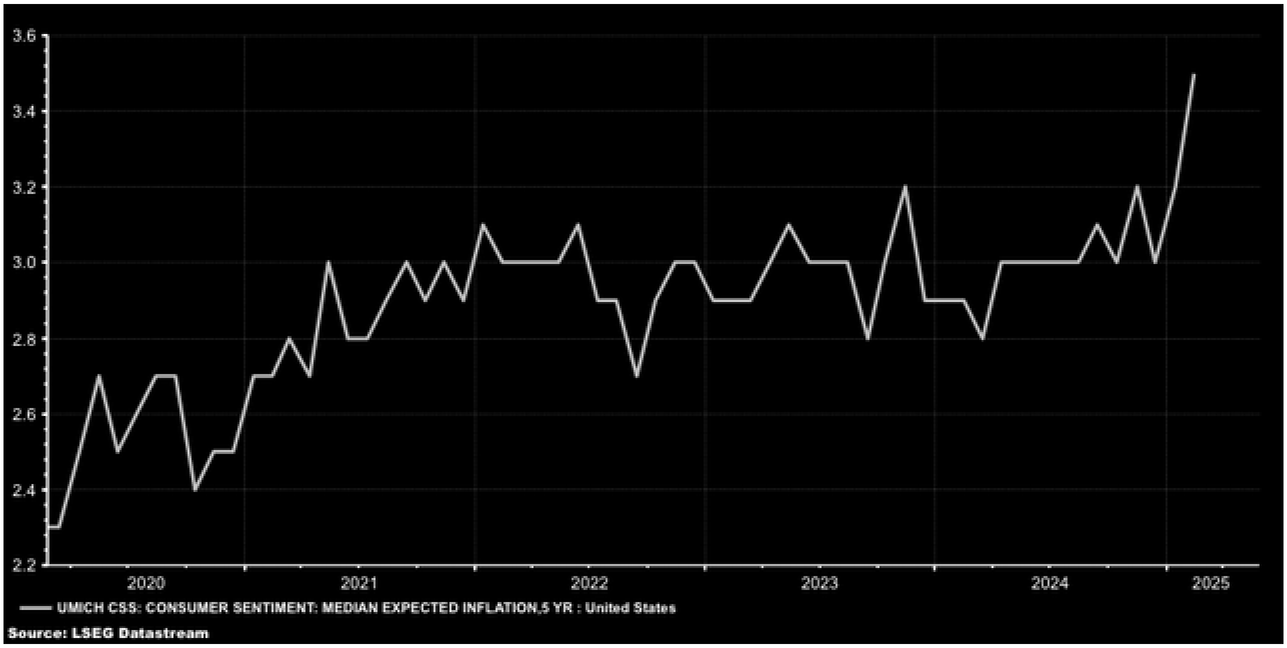
In some ways, the recent surge is not all that surprising, considering that this longer-run measure of inflation expectations has been flirting with moving higher since August when it started to make a series of higher highs.

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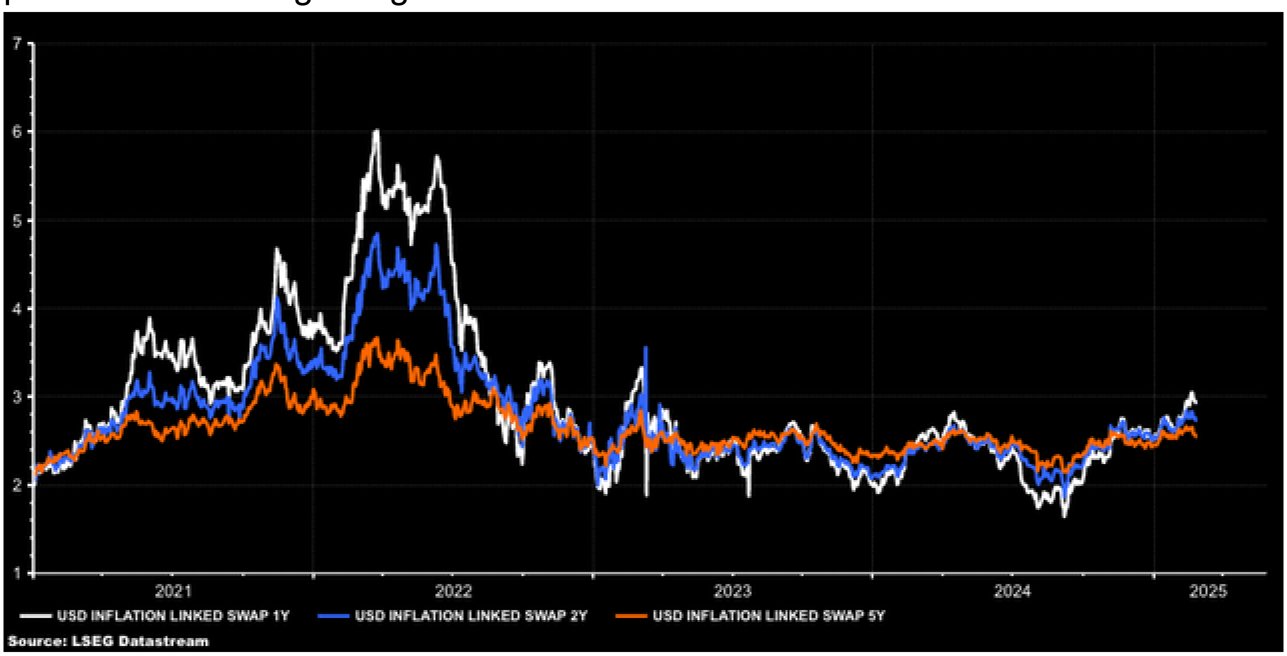
The recent surge in consumer-based inflation expectations follows what we have seen from market-based inflation swaps, which have been trading higher since bottoming in early September. They have all risen back to the upper end of their trading ranges, which have been in place since the beginning of 2023.

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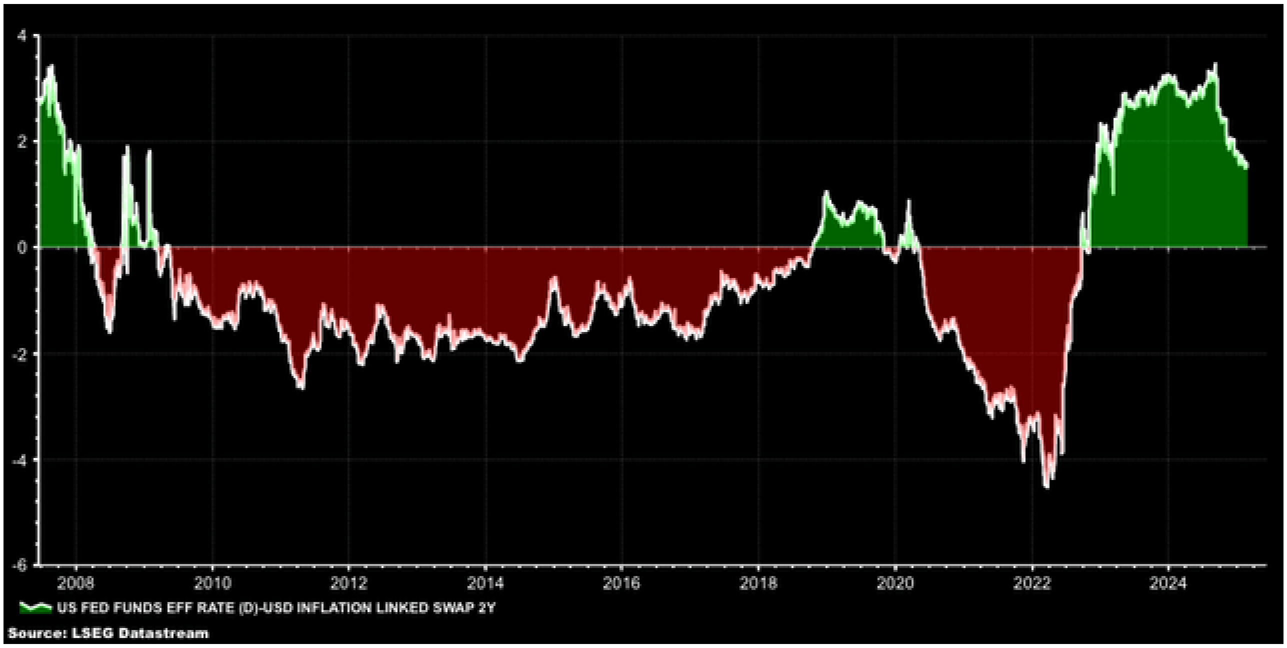
This is somewhat problematic for the Fed because, at this point, inflation expectations should not be rising, especially when it seems that monetary policy is still supposed to be restrictive. But in reality, rising inflation rates and rising inflation expectations coupled with Fed rate cuts have actually helped to make it less stringent.

The Fed Funds rate, minus the 2-year inflation swap rate, peaked at around 3.5% in September, but since then, the Fed has cut rates by 100 bps. However, the 2-year swap has also risen by almost 100 bps. As a result, the Fed Funds rate minus a 2-year inflation swap has fallen to 1.5% from around 3.5%, which translates to 200 bps of easing. The problem is that if inflation expectations continue to rise, policy will just continue to ease.

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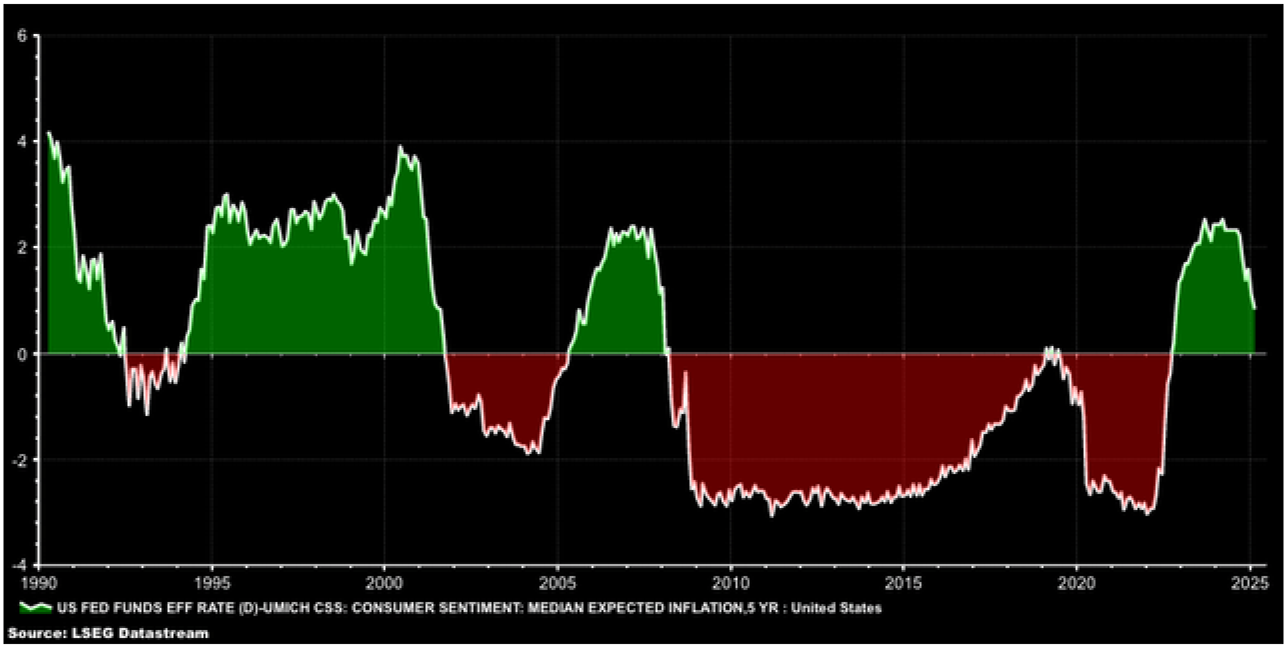
The policy is even easier when using consumer-based inflation expectations. Using the University of Michigan's 5-year inflation consumer outlook, current policy finds that it has fallen from around 2.5% to 0.85 bps. So, while the policy is still tight, it is not nearly as tight as it had been, and if inflation expectations continue to rise, it will continue to loosen.

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This is where the danger lurks because if expectations continue to increase, policy will continue to ease. The more policy eases, the more likely it is that interest rates will get stuck at these higher levels, or worse, the Fed will be forced to go back and start hiking again. Once consumers expect inflation to run at a higher rate, those expectations will allow businesses to pass on those higher prices more easily.

While one month of data does not make a trend, and the recent break-out in inflation expectations is concerning, it is not yet time to worry. But it is time to take notice because if this does become a trend, it will not be good for anyone.



This article was written by

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