Believe in Inflation Expectations

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The US inflation data for March painted a picture of moderating price pressures, with the year-on-year increases in consumer prices, producer prices, and import prices all easing. But the messaging around inflation remains discordant. In recent days, financial luminaries including JP Morgan boss Jamie Dimon, Larry Fink at Blackrock and Bank for International Settlements chief Agustín Carstens have all warned that inflation could prove sticky and that interest rates will have to stay higher for longer to bring it under control. On the other hand, US inflation expectations continue to trend lower, indicating a degree of confidence that the Federal Reserve will succeed in anchoring inflation at, or around, its 2% target rate.

So who is right? Will inflation prove stubbornly sticky? Or will it continue to fall in the near term, converging towards inflation expectations?

Your answer will likely depend on your view of the relevance and usefulness of inflation expectations. For decades, this was a question that seldom arose. For the most part, US inflation expectations moved in line with realized inflation, and so got little attention from market participants. The last two years, however, have seen the most pronounced divergence since 1980, with backward CPI inflation spiking to a high of almost 9% YoY in mid-2022, even as expectations remained relatively subdued, with short-term inflation expectations climbing no higher than 4.3%.

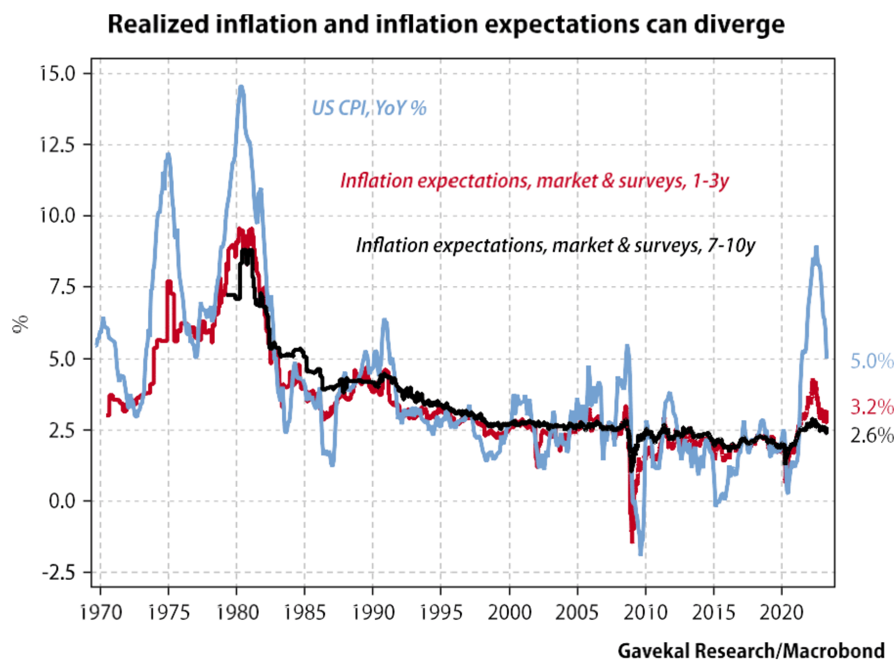
Some observers—notably Louis and Anatole—cite this as evidence that inflation expectations carry little useful information about the trajectory of actual realized inflation.

I would push back against this view, arguing that even though expectations and trailing inflation may diverge—and perhaps especially when they diverge—inflation expectations are important because they can, and do, affect realized inflation rates through their impact on consumer and investor behavior. Currently, this is happening in two important ways.

- **Consumers are deferring big-ticket purchases** such as new homes and automobiles. Housing and auto sales have both been sluggish over the last year or so. If US consumers thought inflation was likely to remain elevated, they would be rushing to buy before costs increase further. Instead, they have been buying fewer houses and cars, which suggests a degree of confidence that inflation—and financing costs—will fall in the near term. In turn, this willingness to wait before making big-ticket purchases depresses demand and helps to lower inflation.
- **Investors are allocating more assets to money market funds.** US money marketmutual fund net assets have been rising as a share of total mutual fund net assets sinceearly 2022. This is partly because savers are pulling money out of bank deposits in favorof higher-yielding money market funds. But it is also because investors' modest inflation expectations coupled with the inverted yield curve mean money market funds look relatively attractive compared with mutual funds investing in riskier assets. Currently, three-month T-bills, deflated by short-term inflation expectations, deliver a real yield of almost 2%. In contrast, 10-year treasuries, deflated by long-term inflation expectations, deliver 1%.

These considerations have real-economy consequences. The flow from deposits to money market funds means less bank credit in the economy. And investors' belief in disinflation, which means they are happy to hold money market funds instead of reaching for yield in riskier assets, equates to higher capital costs for risk-taking enterprises. Both point to reduced demand, and lower inflation.

In short, there is a feedback loop from inflation expectations to the real economy, in which lower inflation expectations lead to reduced demand for consumer goods, capital goods, and services. The risk is that this reduced demand leads to a recession—a recession which is now the base case of Federal Reserve staff according to the latest FOMC minutes.



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