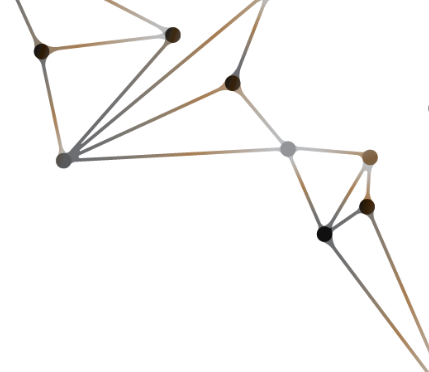

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Stagflation: For Real?

25 April 2022

Over the course of economic history, there have been many episodes of deflation, some periods of inflation but few of stagflation. Stagflation is a buzzword today but other than pointing to the 1970s, few can claim to truly appreciate what it is, what conditions lead to stagflation and whether these conditions exists today. We explored this phenomenon at our recent Havenport Micro Symposium held on 13th April 2022, and this paper summarises the key thoughts arising from that discussion.

Since the Global Financial Crisis in 2008, developed economies have been humming along a low-growth, low-inflation path enabled by accommodative monetary policy and a steady macro backdrop. The fear of stagflation has arisen as the calm waters of the recent past have given way to ripples of uncertainty in the near future. Inflation has surged due to the pandemic induced supply shock. Much of the developed world is already adequately vaccinated and the reopening and normalisation was to be upon us, alleviating the supply induced inflation pressure. This narrative has however aged poorly in light of the Ukraine war. While economic growth is robust in the US, it is looking fragile in Europe. China is hitting multiple speed bumps- a troubled real estate sector and now, the ill effects of a sustained zero covid policy. The world today is challenged by desynchronised (but mostly weak) growth at a time of seemingly runaway inflation.

A historic precedent of excruciating interest rate spikes?

Stagflation is often associated with the 1970s when the US economy witnessed high inflation, high unemployment, and most memorably, 2 oil shocks. Stagflation is a headwind to markets, as negative economic growth and rising prices is a poisoned chalice for both bonds and equities alike. This episode is best remembered for the pain of excruciatingly sharp rate rises to redress the situation.

Fast forward to today: the US Consumer Price Index in March rose to a multi-decade high of 8.5% y/y. Vocal members of the Fed are calling for aggressive rate hikes to combat the rising inflation. Is the fear of stagflation real? How does today compare with the 1970s and are we craning our necks looking upwards at a similar, excruciating rate trajectory that markets have yet to discount?

Same Same, but Different

1. Resilience of US economy

The war in Europe and China's persistent macro issues have left the US' robust economy as the lone standout. Stagflation in the 1970s was triggered by the 1973 and 1979 oil crisis, but the US today is less vulnerable to a shock to energy prices, which is key given Russia's dominance in the energy markets(see Chart 1). By 2020, the amount of energy required for each unit of GDP (also known as energy intensity) was 37% its level in 1970. It should also be noted that the world had already experienced $100 oil in the prior decade with little impact on growth or inflation. High oil price is a necessary but insufficient condition to predict an onset of stagflation.

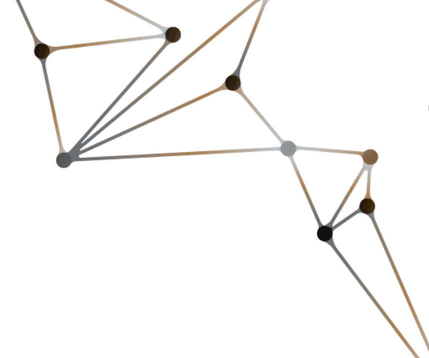
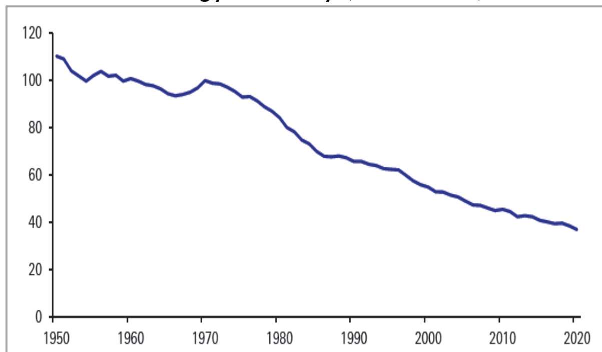
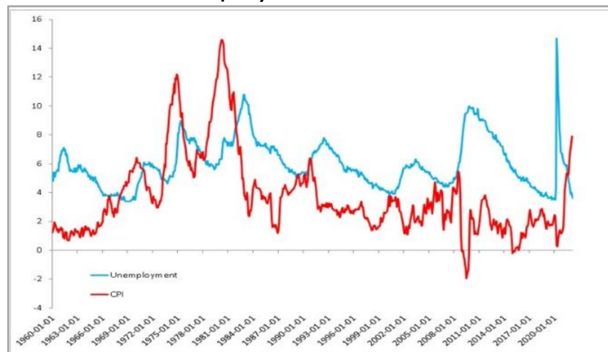


Chart 1: US Energy Intensity (1970 = 100)



Source: US EIA, Haver Analytics, Deutsche Bank
Note: Energy intensity calculated from the ratio of total primary energy consumption to real GDP

Chart 2: US Unemployment & Consumer Price Index



Source: DeSaque Macro Research, Bureau of Labour Statistics

Furthermore, headline unemployment today is low relative to the 1970s, notwithstanding the recent inflationary spike (see Chart 2). "The Great Resignation" today is not the unemployment of the 1970s. Voluntary unemployment today is associated with the burgeoning opportunities the gig economy offers and not with the dole line. For some, choosing not to work is choosing to live well. This is why consumption remains healthy unlike in the 1970s.

2. Financial markets doing the Fed's job

The Fed has a dual mandate of maximum employment and stabilising prices. Given the sharp rise in inflation, the Fed is under pressure to hike rates, having being accused by many to be "behind the curve".

The sharp surge in bond yields this year have taken the 2-year treasury from 0.7% at the end of 2021 to 2.7%. As the worst bond rout in decades, the markets have gone a long way to do the work of the Fed. At the margin, this is already having some impact on discretionary consumption. Importantly and unlike the 70s, this is taking place in the context of redressing the deeply negative real rates sustained for an extended period of time (see Chart 3).

3. Household wealth effect- Far larger than in the 1970s

The 1970s saw the advent of the mutual fund industry, making it easier for more households to begin in the financial markets. Today, the mutual fund industry is a whopping USD 24 trillion industry, outmatched only by the advent of ETFs in the past decade. Household wealth in financial markets is reported by the Fed to be topping USD150 trillion in 2021, almost 600% of GDP. Technology, low cost and increased access to markets have only accelerated their participation. Unlike the 1970s, this outsized market participation means a more reflexive response to market corrections in terms of adjustments in discretionary spending. The bond bear market in particular will not have gone unnoticed in terms of the negative wealth effect.

This is again accentuating how financial markets have done the work for the Fed in moderating discretionary spending.

4. Productivity- an unimpeded secular tailwind

The internet has been for this century what the steam engine and railroad was for the previous. The pandemic has further accentuated the indispensability our "always on", "anywhere, everywhere" internet connected world. We have proven to ourselves that our productivity has more to do with a connected world than it has to do with our gathering in a particular place of work or under a particular set of conditions. This monumental shift in culture and work practices have taken productivity to a new and higher level. Productivity is an unimpeded tailwind today as a result, standing in sharp contrast to the poor productivity of the 1970s.

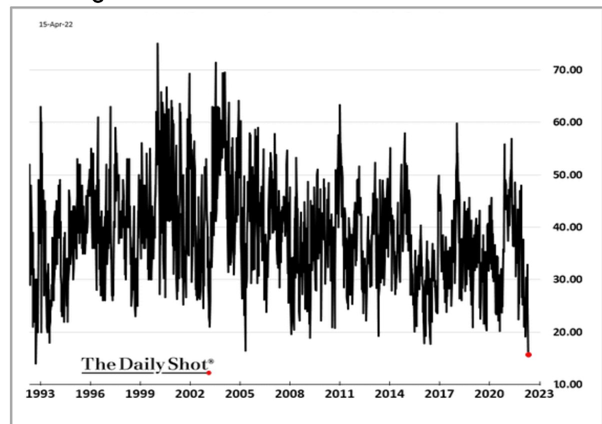
How do we view the market now?

Russia's invasion of Ukraine, and the stubborn inflationary pressures have pushed market sentiment to its most bearish level in decades (see Chart 5&6). The market is well positioned for bad news.

Chart 5: Global Growth Optimism at all-time lows FMS net % expecting stronger economy

Source: BofA Global Fund Manager Survey

Chart 6: AAII US Investor Sentiment Survey: Bullish Readings



Source: The Daily Shot

It is clear we are also in a globally desynchronised growth cycle as mentioned earlier. This has asset allocation implications. We favour the US equity markets over other developed markets, and we favour developed market equities over emerging markets. Bond markets are deep in bear territory and has some ways more to go. Even so, there are pockets of opportunities in oversold areas of the market such as global high yield credit. On a 12 to 18 month view, we favour equities over bonds, especially given companies likely have some pricing power to pass on the inflationary pressures. While the carnage in the equity markets may not be so evident in the stock indices, the negative breadth of stock markets is the very reason for the gloom and doom evident in charts 5&6.

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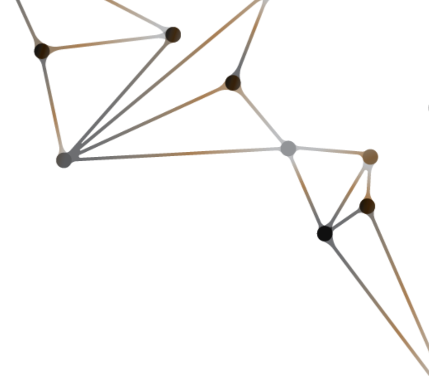

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