The Rising Risk of Stagflation

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Adapting portfolios to a new economic landscape

As you may know from my previous writing, I view markets first and foremost through an economic lens. With all the noise and complexity that gets embedded in financial instruments, I find it useful to trace assets back to their core drivers that you might remember from econ class: growth and inflation.

These long-term economic forces provide a logical starting point when thinking about markets and what fundamentally supports their returns. Applying the concept directly, we built our framework for analysis at Wavelength using growth and inflation as the principal components that set the foundation for the investment decisions we make. This approach is designed to be timeless, but the economy is constantly evolving and regularly offers new datapoints to update our understanding of market relationships.

In recent months, a crosscurrent of economic information has made this particularly true. The boom in spending coming out of the pandemic drove increased demand directly into supply constraints that were exacerbated by lockdowns in China and geopolitical tensions from Russia's invasion of Ukraine. These imbalances put sustained upward pressure on prices, creating uncertainty around the trajectory of economies across the globe. The double-edged drop for stocks and bonds reflects a paradigm shift in markets where a long-dormant but critical dynamic has emerged: the risk of stagflation.

What is Stagflation?

Unlike a recession, stagflation has no official definition – it's a painful portmanteau of economic stagnation and high inflation. The degree of stagnation can be measured by falling output or employment levels, and when combined with persistent price pressures, the resulting environment creates major challenges for central banks trying to meet policy goals.

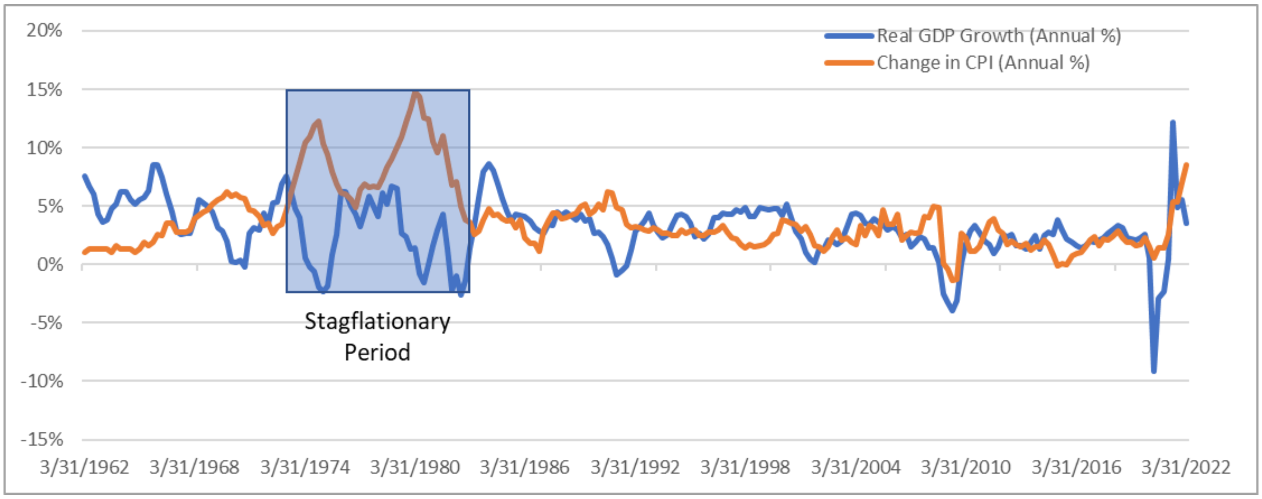
In practice, policymakers set interest rates in a balanced pursuit of their objectives, and the Federal Reserve's dual mandate includes stable prices and maximum sustainable employment. At their core, higher rates reduce the amount of money or credit in the economy to slow the pace of price increases, and lower rates do the opposite by encouraging borrowing to stimulate demand and business activity.

The Federal Reserve's goals are generally complementary, but stagflation puts stable prices and maximum employment at odds which makes striking a balance between them much more difficult. Raising rates sufficiently to cool high inflation when growth is already slowing can weaken employment conditions and drive the economy into a recession. This situation can leave central banks to choose between bad options on either side of their mandates – an economic predicament that has played out painfully in the past.

Historical Context: Have We Seen This Show Before?

While stagflation is an irregular economic condition, it is not without precedent. Nearly forty years have passed without a meaningful combination of high inflation and stagnating economic activity but looking at the mid-1970s to early 1980s provides a useful window into these dynamics.

Figure 1: Changes in US Real GDP & CPI from Q1 1962 to Q1 2022



For Illustrative Purposes Only. Source: Bloomberg L.P.

From Q1 of 1974 through Q4 of 1982, inflation was persistently above the Federal Reserve's target, reaching nearly 15% in 1980 before falling to a still elevated 3.8% as the period came to a close. Real GDP Growth over the same timeframe was also subdued, as it started with the economy in a recession, then rebounded into the double-dip recession of the early 1980s.

No two experiences are identical in markets and most notably, there was no global pandemic in the 1970s that lends itself to a clear comparison. Rough parallels to today, however, can be seen geopolitically, specifically in 1973's oil embargo which drove supply tensions and the price of crude to nearly [$11 per barrel from less than $3] in a matter of months. This came in response to the US providing aid to Israel in the Yom Kippur War and added meaningful inflation pressure to what were already unstable conditions following President Nixon's [New Economic Policy].

With that being said, it's important to note that the supply shocks of the 1970s came at a time when the US was more reliant on energy imports and the overall economy looked quite different. Technology, global trade, and financial markets have all expanded substantially over the past forty years, and the Federal Reserve has built on its credibility through policy since then. Perhaps the clearest contrast between then and now can be seen in the US employment rate which averaged 7.3% from 1974-82 versus [today's rate of 3.6%] that's just above historic lows. The present US employment situation is what most distinctly makes stagflation more of a risk at this stage versus the harsh reality of the past.

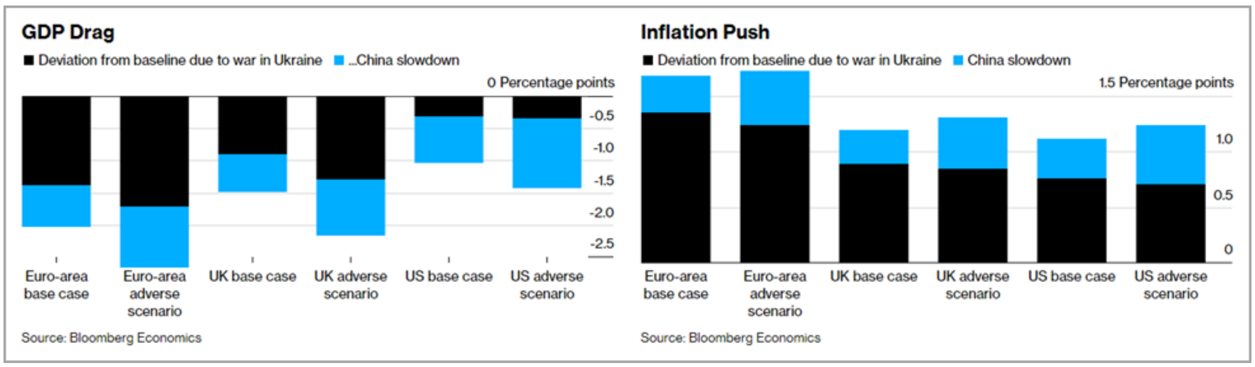
Current Environment: New Risks as Paradigm Shifts

As noted above, in its current state the US economy does not fall under the commonly accepted definition of stagflation. But with inflation reaching a new cyclical high above 8% in May's CPI reading and quarterly GDP figures turning negative for Q1, there is a clear and present risk this could change.

The Federal Reserve's hiking cycle is tightening financial conditions, and the 75 basis point increase announced at the last meeting marked the largest hike since 1994. The impact of this and future policy decisions will naturally take time to flow through the economy, and the lag raises the meaningful risk of policy errors in either the size or the speed of rate increases.

To complicate matters further, factors beyond the reach of central bank policies are simultaneously adding upward pressure on prices and downward pressure on growth. Russia's invasion of Ukraine and the most recent pandemic lockdowns in China have further disrupted supply chains that were already in a fragile state.

Figure 2: Projected Impact of War in Ukraine and Chinese Lockdowns



Source: Bloomberg Economics, as of May 25, 2022

The estimates from Bloomberg Economics shown above assume a base case of China's GDP slowing to 2% this year with the Russian and Ukrainian economies contracting 10% and 35%, respectively. In an integrated global economy, decreased Chinese production can have a critical impact on growth far beyond its borders. And on the inflation front, Russia and Ukraine are both significant commodity exporters where reduced supply can lead naturally to higher prices, or worse, a global food shortage.

Investing through the Risk of Stagflation

Policy errors by central banks, an escalation of the conflict in Ukraine, and Chinese supply chain disruptions are among the clearly identifiable risks in the current environment. For that reason, an unidentified event on the horizon will likely have the greatest impact overall. With that said, being aware of the factors at play and how they can affect growth and inflation is critically important at this juncture while the economy and markets adjust to a new policy regime.

The risk of stagflation highlighted above raises important questions for portfolios and could lead a typical mix of stocks and bonds to come under increasing pressure. A first line of defense can be established by monitoring factors behind stagflation and the market's response to changing conditions – this may help identify risks and whether they're increasing or decreasing. Based on these risks, investors can incorporate return streams in portfolios designed to fundamentally protect against inflation.

Inflation-linked bonds, commodities, and instruments with cash flows tied to real assets are among the areas that may offer an advantage over traditional investments that can be negatively impacted by price increases and higher costs of capital.

At the end of the day, predicting the future isn't easy and investing based on sweeping prognostications is rarely a good strategy. Thinking in probabilities to prepare for what can happen next, however, while maintaining one's core investment principles may help investors build more resilient portfolios in times of change. As markets have undergone meaningful repricings in recent months, the opportunity set they offer has in turn expanded. This is particularly true in fixed income, where increases to base interest rates set by central banks have disrupted many relationships and permeated across the asset class. In this environment, I believe that seeking to take advantage of these opportunities through a framework that remains focused on oncoming risks – like those posed by stagflation – can offer investors important advantages as we enter a new paradigm for markets and the economy.

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[1] SEC registration does not indicate a certain level of skill or training.