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# THE BATTLE AGAINST STAGFLATION

## Key points

- Having been dormant for nearly 50 years, the term 'stagflation' has once again re-entered investors' lexicon and with it a concern of a lost decade like the one faced by investors in the US in the 1970s.
- While inflation risks have indeed risen driven by energy shortages and supply chain disruptions, what appears clear is that the balance between weak growth and low inflation that has prevailed in the post-Global Financial Crisis era has given way to a new growth-inflation equilibrium looking ahead.
- Though many fear a 1970s style 'stagflation' with low growth/ high inflation, a long-cycle investment boom driven by transformational global climate, energy, and supply chain policies still has the potential to create an era that looks more like the 1950s post-World War II boom – characterised by elevated inflation and strong growth.
- Policy error by global fiscal or monetary authorities appears to be the key catalyst that could trigger a 1970s error by fighting supply-driven inflation via tight, recession inducing policies or underinvesting in the transformation themes ahead.
- For equity investors, a 1950s style environment would portend a continued buy-and-hold approach for equities focused on sectors investing in transformation of the global economy, as seen almost 70 years ago.
- However, even for investors who fear a 1970s-style outcome, the 'Great Inflation' period saw no less than four episodes of multi-year rallies of 40–70% suggesting a more tactical, pro-cyclical investment approach paired with portfolio protection may offer a prudent way forward.

Global Investment Committee

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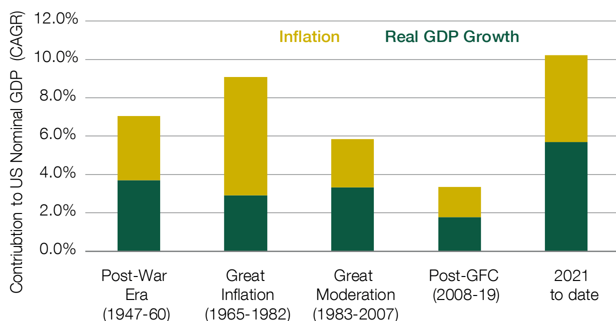
## Transitioning into a new era of growth and inflation

With the benefits of public sector largesse of 2020 and 2021 now fading, economies around the world are increasingly reliant on private sector demand and an increase in global trade to continue the pandemic-era expansion currently underway.

However, the partially self-inflicted energy shock that is making its way around the world in late-2021 has complicated the picture, potentially redistributing the balance between economic growth and inflation in many international economies.

**Chart 1. Growth & Inflation: Transitioning into a new era**




Sources: Federal Reserve Bank of St. Louis and UBP

As seen in China recently, reversal of policies with regards to imported coal and domestic coal production can ease some of this pressure just as an agreement between Russia and the European Union on the Nord Stream 2 pipeline could ease the upward climb in natural gas prices which is burdening European households entering the winter season.

Admittedly, should a colder than expected winter or renewed supply shocks prolong this rebalancing, risks exist that global demand could slow further while inflation remains stubbornly high, crystallising the stagflation fears that have been growing in recent months.

Just as importantly, however, the mix between growth and inflation in 2021 represents a clear departure from the post-Global Financial Crisis, decade-long stagnation (Chart 1). Indeed, looking further back in history, 2021's growth-inflation balance leaves policymakers at an important crossroads. They can repeat the mistakes of the Great Inflation that culminated in the 1970s or they can draw from the experiences of the post-World War II era that drove the 1950s boom in the US economy.

## Confronting a near-term policy dilemma…

In the near term, policymakers need to walk a fine line to navigate the road ahead. Behind the cyclical rebound, major economies around the world still need to combat a long-term trend of slowing productivity and falling potential growth.

On the other side of the ledger, the energy shock which is contributing to inflationary fears is only one of several factors driving the inflation dynamic. Clearly, reopening of economies around the world has spurred the strong demand for goods and services straining labour markets as well as production and transportation chains even with slow growth in its second largest economy, China.

However, the underinvestment and lack of diversity of supply chains is likewise a contributing factor to the not-so-transitory inflationary pressures currently.

While fears of a 1970-style stagflation are likely overstated given today's comparatively open economies around the world and the absence of wage/price indexation mechanisms – policymakers are increasingly faced with the dilemma of accepting higher rates of inflation than both the 1.6% p.a. seen in the post-Global Financial Crisis era or even the 2-2.5% of the pandemic era. As a result, central banks face the difficult choice between using monetary targets to preserve growth or tightening more sharply to contain risks of upside surprises to inflation. More importantly, central banks will be wary of any erosion in their hard-earned inflation fighting reputations built over recent decades.

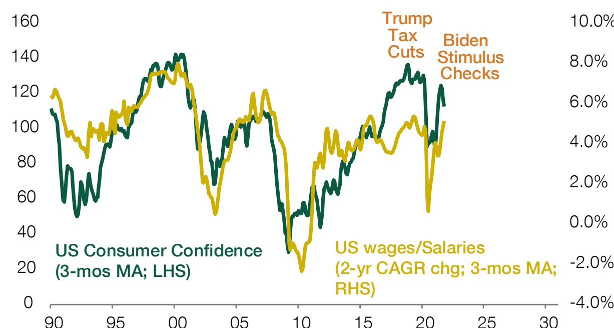
To date, the approaches taken have been varied. In China, for example, policymakers have accepted a slowdown in exchange for progress on other policy goals. However, as this slowdown has deepened, we are seeing the first signs of pivots and deployment of other policy options to strike a balance between growth and inflation.

In Europe, in the face of rising energy costs, fiscal policy has been deployed in an attempt to sustain demand momentum, effectively accepting the elevated inflation dynamic in the near term.

In contrast, in the US, fiscal support for waning growth is still taking shape while the Federal Reserve has announced a tapering of its pandemic-era bond purchase programme to at least signal to markets that the groundwork is being laid should inflation become more durable looking ahead.

Fortunately, while 'non-core' food and energy pressures are clear, removing the effects of the pandemic on wages in 2020, a 1970s-style wage-price spiral is less in evidence as the recovery in wages to date is consistent with cyclical peaks in the post-Global Financial Crisis era (Chart 2) spurred by the 1st half reopening of the economy and supported by the surge in consumer confidence created by President Biden's stimulus cheques at the start of his term.

**Chart 2. Wages: still only a cyclical recovery to date…**




Sources: Bureau of Economic Analysis, Bloomberg Finance L.P. and UBP

Perhaps more troubling for US policymakers is the sharp rise in home prices across the country. Indeed, even adjusting for the low pandemic-related base effects of 2020, US home prices have risen 12-14% CAGR over the past two years. Since the early-1980s, the US has witnessed only three episodes of

home price rises near this pace (Chart 3), in the late-1980s, as a prelude to the US Savings & Loan Crisis, in the mid-2000s, in the run-up to the Sub-Prime and subsequent Global Financial Crisis, and most recently in 2013, when the Fed's tapering policy engineering a comparative soft landing in US home price growth.

These rises are already having their lagged impact on consumer price inflation via rising implied rental rates which should continue into mid-2022. However, more concerning for policymakers will likely be the potential for such rises to trigger instability in the financial system as seen in the late-1980s or mid-2000s.

With the 2013 Fed playbook in hand, investors should expect a similar policy trajectory in the months ahead to avoid such risks leaving the Fed susceptible to unanticipated shocks to the global economy potentially disrupting the growth-inflation balance being pursued.

### …as well as a long-term policy opportunity…

While this near-term policy tug of war is important, it likely represents a modest skirmish in a wider war against the risks of stagflation. Indeed, in this war, central banks will require greater cooperation and leadership from fiscal authorities, similar to that seen at the height of the 2020 global pandemic.

The US Congress is finalising the social components to complement its hard infrastructure spending in its post-pandemic fiscal agenda set to be implemented in the new year. Similarly, Chinese policy momentum looks set to re-accelerate only as we move closer to its National People's Congress in March, 2022. Admittedly, the European Union has begun approving plans under its Recovery Plan and NextGeneration EU programmes though rollout begins in earnest in 2022.

The outcome of these three, ostensibly independent developments will be important in the battle against stagflation as productivity boosting investments will be key to counteracting the secular slowdown seen in recent years.

Indeed, if deployed well, while inflation may remain elevated during a transitional phase, the benefits of these investments could lead inflation to ease going forward as productivity gains take hold (Chart 4).

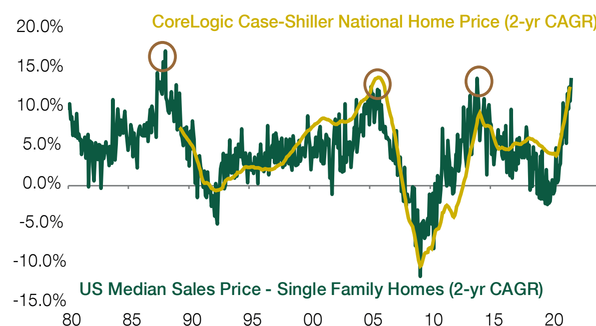
With US capital spending sitting just above levels consistent with previous recessions, the combination of supply chain constraints, a global energy shock and the climate transformation will likely spur corporate boards to increase capital spending to shield their businesses from these recurring tremors in the years ahead.

Monetary authorities will still play an important, though increasingly supporting role going forward. They will need to remain nimble in deploying policy tools – both traditional and on occasion non-traditional – to limit pressure on both nominal and real interest rates while at the same time containing pass-through impacts on wages and other core prices.

Indeed, we suspect the recent moves by the Federal Reserve seek to do just that as signs are growing that rising real estate prices are making their way through US rental markets joining the to date, cyclical rise in wages prompting consumer price inflation.

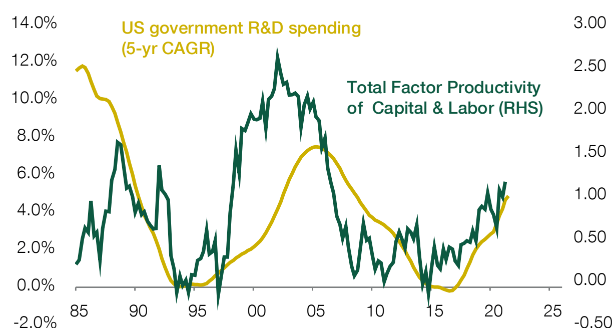
Encouragingly, the Fed faced a similar battle – albeit without the energy price shock – in 2013 in which it engineered a comparatively soft landing relative to the episode it faced in 2007.

**Chart 3. …US home prices are rising at a pace only seen on three previous occasions since the 1980s.**



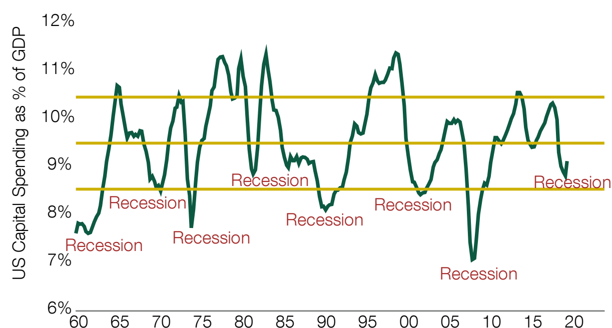

Sources: CoreLogic Case-Shiller, Bureau of Economic Analysis, Bloomberg Finance L.P. and UBP

**Chart 4. Increased capex/R&D spending could spur a productivity boom, keeping inflation in check…**




Sources: Clocktower Group, Federal Reserve Bank of San Francisco, Federal Reserve Bank of St. Louis and UBP

**Chart 5. …just as US capital spending sits near levels consistent with previous recessionary troughs**




Sources: Federal Reserve Bank of St. Louis and UBP

### …and threat of increased risk of policy errors

The challenge for policymakers – both fiscal and monetary – looking ahead will be to balance the near-term political pressures to provide inflation relief against longer-term productivity gains. So, while, undoubtedly, fiscal support will be needed to mitigate the effects on demand of high energy prices and other supply constraints, sharply higher interest rates to combat such supply-side shocks could represent an error on the part of policymakers.

Similarly, fiscal policymakers need to accept that budget deficits will need to remain high. They should also be mindful about not focusing primarily on efforts to mitigate the near-term effects of inflation on household demand and voter sentiment (as was the case in the 1970s) especially entering important elections in 2022 but instead concentrate on productivity enhancing investments.

A return to fiscal austerity, as seen too soon after the Global Financial Crisis, or a poorly struck balance between household assistance and investments would similarly represent a policy error looking ahead.

Fortunately, with the green transition underway globally, nations have plentiful investment opportunities to fill this need. Moreover, with global supply chains strained following the pandemic, companies around the world will be moving to diversify and redomicile supply chains while at the same time upgrading their factories, warehouses and transport infrastructure to not only ease the current situation, but more importantly to avoid a re-occurrence in the future.

Therefore, though the journey ahead remains fraught –with a colder than expected winter joining monetary/fiscal policy errors as the key risks – policymakers do appear to be laying the groundwork to steer clear of the risks of stagflation ahead and potentially achieve an outcome that mirrors more closely the US in the 1950s – high real economic growth and elevated inflation – rather than necessarily, the 1970s, when high inflation and modest growth were the norm.

### Investing amidst the battle against stagflation

The difference between a 1950s-style outcome and a 1970s-style stagflation is a stark one for equity investors though bond investors should assume a more cautious stance irrespective of which of the outcomes emerge.

In each scenario from the past, bond investors faced coupons which largely were unable to cover the elevated/high inflation of the eras amidst a trend of higher secular yields evident in both 10-year US Treasuries as well as among Baa credit (Chart 6).

In equities, however, the prospective outlook varies greatly between scenarios. A 1950s-style outcome should allow investors to retain a long-term buy-and-hold approach in equities focused on key transformations in the global economy.

Much as the post-war period represented a transformational phase for the US and European economies alike driven by high levels of investment, the US and the rest of the global economy have the opportunity to drive multiple transformations simultaneously at a scale larger than seen in the post-war era.

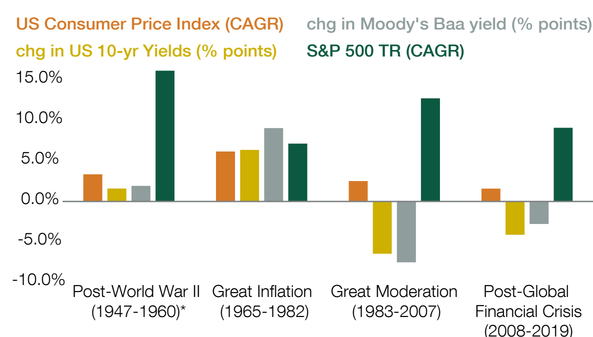
A 1970s-style episode, perhaps triggered by policy error on the part of either fiscal or monetary authorities around the world or even by a renewed exogenous shock, would pose a risk to the elevated valuations in markets today just as in the late-1960s and as well as potentially to the historically high profit corporate margins.

However, interestingly, though returns for the Great Inflation in aggregate were weak and largely driven by corporate dividends paid, of the 18 years between 1965-82, 12 of the calendar years delivered positive returns averaging 11.5% per annum with eight of the 12 years delivering returns in excess of 10%.

Moreover, the 1965-77 period saw three multi-year periods of between two to three years each where the S&P 500 delivered 40-70% gains or 17-26% annualised driven primarily by the policy easing cycle of the Federal Reserve. Admittedly, these were then followed by sharp drawdowns ranging from 19-46% suggesting that pairing a pro-cyclical approach with protection or portfolio asymmetry may offer a more attractive risk-reward profile.

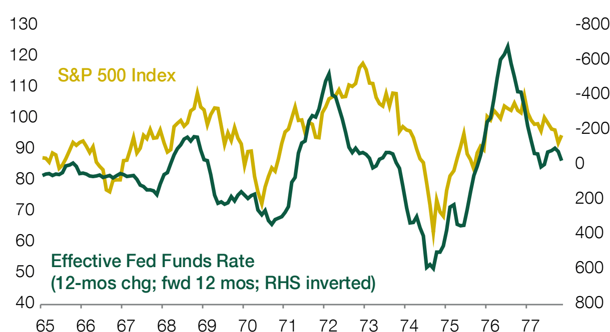
So, with this distinction between the attractive post-war era scenario and the challenging 'Great Inflation' era, the policy trajectory from the US Federal Reserve in particular in 2022 will likely be key in determining which of these two paths lie ahead for investors warranting a balanced, risk managed approach to engaging in markets until that clarity emerges.

**Chart 6. Caution for bond investors in either a 1950s or 1970s scenario**




Sources: Moody's Inc., Standard & Poor's, Prof. Robert Shiller/Yale University, Bloomberg Finance L.P. and UBP
* Note: US 10-year yields were fixed at 2.5% until 1952 by agreement between the US Treasury and the US Federal Reserve

**Chart 7. In a 1970s scenario, trading the policy cycle rather than long-cycle trends may be more prudent**




Sources: Standard & Poor's, Bloomberg Finance L.P. and UBP

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