Thackray Report

Stagflation
Is it here already?

October 18, 2021 Written by Brooke Thackray

Stagflation is a term that is increasingly being used to describe the current economic environment. It is here and what does it mean for the stock market?

According to Investopedia: Stagflation is characterized by slow economic growth and relatively high unemployment—or economic stagnation—which is at the same time accompanied by rising prices (i.e. inflation). Stagflation can be alternatively defined as a period of inflation combined with a decline in the gross domestic product (GDP).

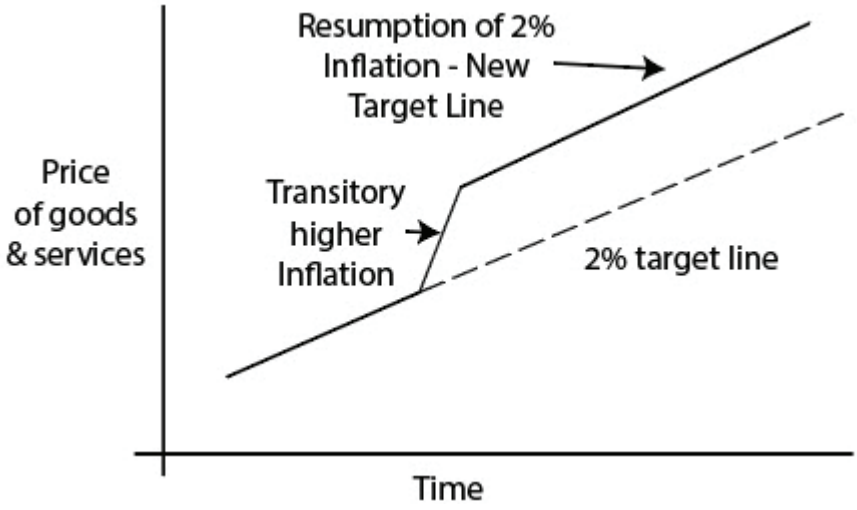
A number of other sources describe stagflation in a similar fashion. Some include high unemployment and others, slow economic growth. The constant in the definitions is high inflation.

BTW...Stagflation is an excellent example of a portmanteau: a blend of words to create an new word. In this case, stagnation and inflation blended together for stagflation.

Recently, Largarde, chairperson of the European Central Bank, stated that "I do not see stagflation on the horizon." Central bankers have a terrible track record of looking over the horizon. Given the track record of central bank's prognostications, investors have a legitimate fear that stagflation is here or just around the corner.

For many years, the Federal Reserve complained that there was not enough inflation in the economy. Back in the 1990's central banks arbitrarily established a target of 2% inflation. The rationale was that the 2% rate would be stimulative for the economy and allow for negative interest rates in emergency situations. I disagree. The ultimate inflation rate is 0%, but that is another story for another time.

The Federal Reserve has been using the word transitory for some time. To set the record straight, transitory means a permanent transitory bump in the price of goods and services. Permanent transitory is a cool oxymoron. The graph below illustrates the Federal Reserve expected case for "transitory inflation." The end result is that transitory higher inflation results in permanent higher prices, even when inflation recedes back to "normal levels."



The Federal Reserve has gone through several stages of reporting on inflation:

Before COVID-19

♦ *there is not enough inflation*

COVID-19 pandemic

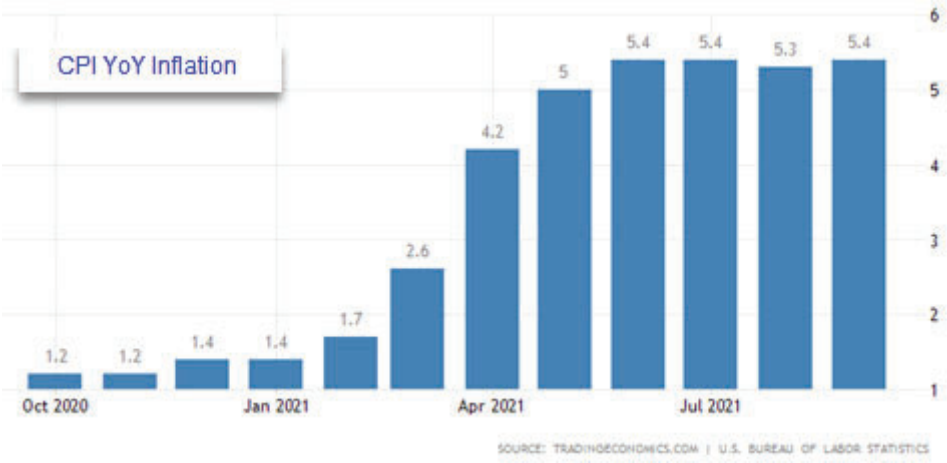
♦ *more inflation is needed*

♦ *inflation is not a problem when you take out things that people purchase such as cars*

♦ *inflation is transitory (after inflation ran above target)*

♦ *inflation is lingering longer than expected (Fed starting to realize that they may have a problem)*

The September Consumer Price Index (CPI) showed 5.4% growth on a year over year basis. Although this is a very high figure, the Federal Reserve keeps assuring the public that it is only transitory. It is not the first high reading, and investors are starting to not believe the Federal Reserve.

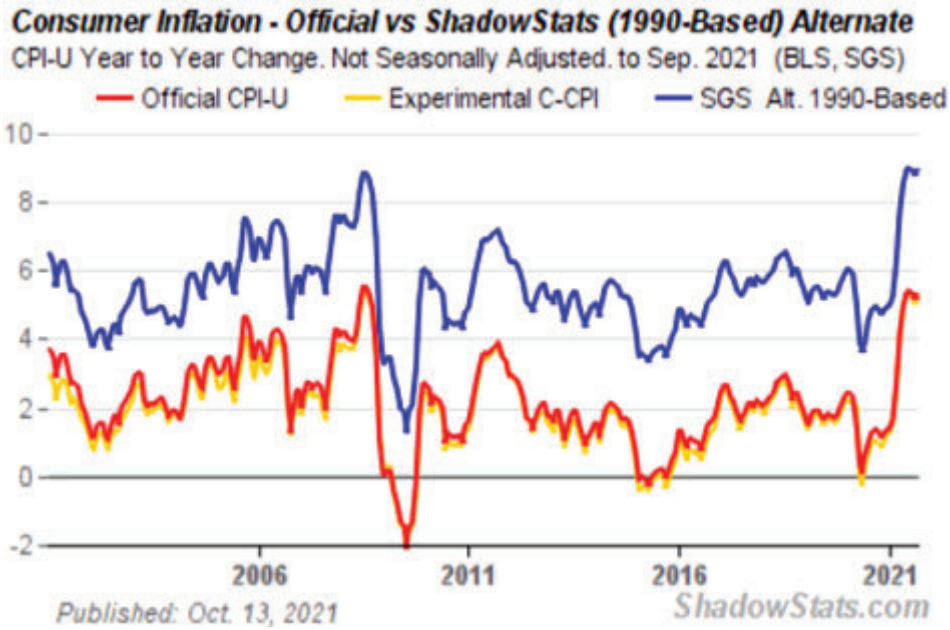


The 5.4% CPI growth rate is a ridiculously high number. It is the collateral damage from the actions of the Federal Reserve and government taken during the COVID-19 pandemic, particularly the Federal Reserve. I am not here to argue about whether the amount of stimulus that was added was necessary, but rather the effect of the stimulus.

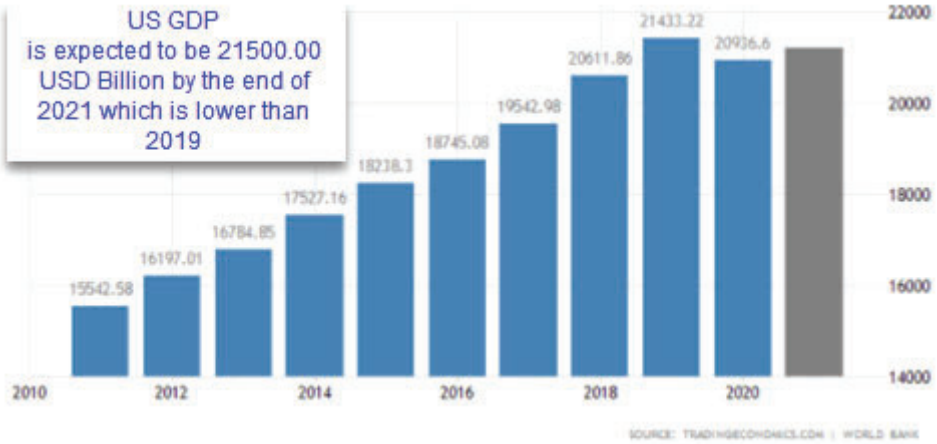
There is a strong argument to suggest that the 5.4% inflation rate understates the true inflation rate that consumer experience at the cash register. The way that CPI is measured has changed over time. The current CPI uses hedonistic adjustments, which incorporates improvement in quality and function. If you buy a car in year x and then buy the same model in year x+1, if the price has increased, but additional features of the car have been added, such as a better radio etc, it is possible that the CPI would show no inflation for the car, regardless of the higher price. The CPI also uses substitution. It assumes that if beef goes up in price, that consumer will consume less beef and more chicken, blunting the effects of inflation.

The CPI does not include the price of houses. It calculates what is called homeowners equivalent rent. In other words, it is rent based. Someone buying a house may have a different idea of what is right.

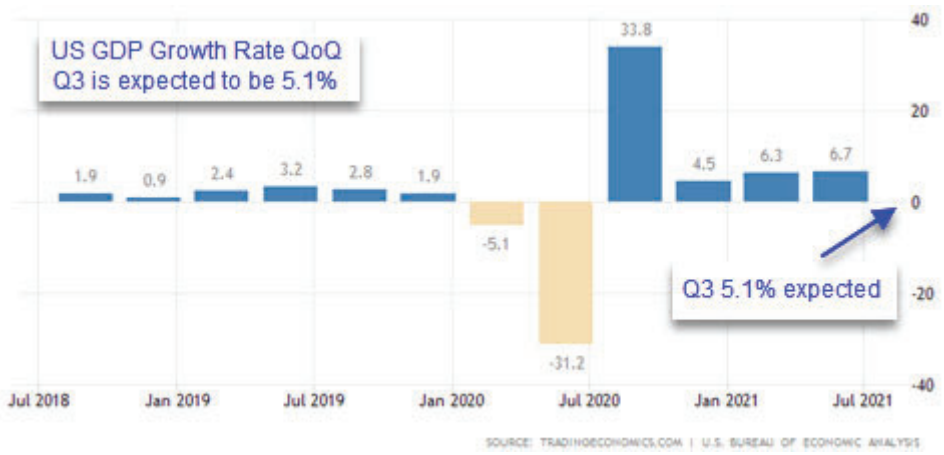
A company called shadowstats.com calculates inflation using the exact same methodology as it was calculated in 1990. According to their calculation, inflation is recently shown to be over 8% (blue line in graph below).



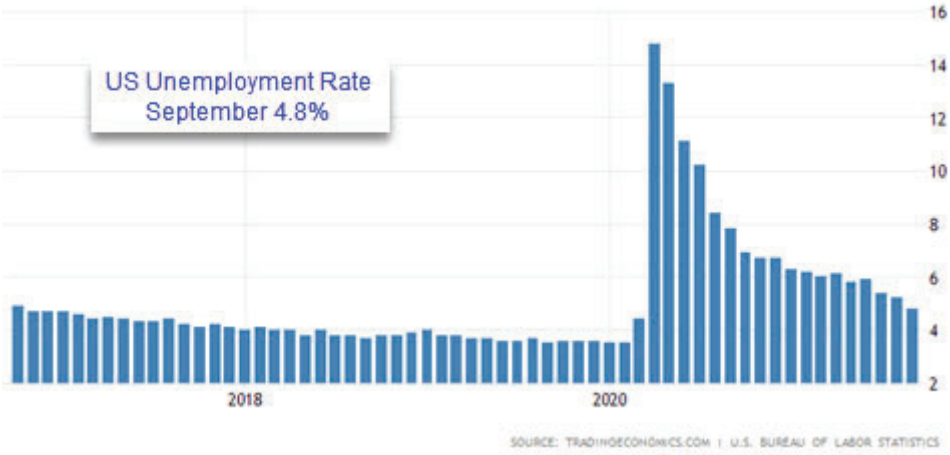
Sometimes investors get caught up in looking at the stock market as a measurement of the economy. The two are related, but the stock market can expand and contract with animal spirits along the axis of economic growth. The economy has expanded out of the COVID-19 pandemic, but most people do not realize that the expected GDP for 2021 is still forecasted to be less than the GDP for 2019.



The growth rate for the economy is slowing. Although the growth rate is expected to continue to slow, it is still not showing signs of very low growth.



U-3 unemployment is down to 4.8%. This is a fairly good number, but there is all sorts of problems with the typical U-3 number. There are other problems with unemployment such as a low participation rate and a lot of people quitting their jobs. Unemployment is a separate topic altogether. But overall, unemployment is at a reasonable level.



Where does that leave us with stagflation? Relatively high inflation exists, but we are currently not in a slow growth environment and unemployment is not unreasonable. At this point, it is difficult to say that we are in stagflation, but it is possible that it is on the horizon. If inflation keeps lingering (or increasing) and the economy continues to slow, then we could enter into stagflation. We are just not there yet.

Investing Implications

Currently, the narrative in the stock market is for higher than normal inflation, but decent economic growth (slowing, but still acceptable). This narrative supports the cyclical sectors of the stock market and the commodity sectors. Investors should be monitoring the relative performance of the cyclical and commodity sectors compared to the S&P 500. These sectors are currently showing relative strength.

Investors are riding the wave of expecting inflation to dissipate and continued economic growth. If economic growth slows faster than expected, the narrative supporting the stock market could shift quickly.

Likewise, if inflation rises more than expected, forcing investors to face the reality of an interest rate hike by the Fed, the narrative could negative for the stock market quickly.

The current situation is a "Goldilocks" scenario: high but stable inflation, slowing growth but not too slow and reasonable unemployment despite a large number of job openings. This scenario should help support the stock market. The scenario could break down if the many moving parts of the scenario start to get out of sync.

On a seasonal basis, the cyclical sectors of the stock market tend to start performing well in late October. This year, it appears that they have started their seasonal rally early, in September. Most of the cyclical sectors, such as the industrials and materials sectors, tend to finish their first seasonal leg of strength in late December, before starting their next seasonal leg of strength in late January. Investors should be watching for the cyclical sectors to start underperforming the S&P 500 before the end of their first seasonal leg. If the narrative switches to stronger inflation than expected, or an economy slowing faster than expected, this could provide the impetus the cyclicals to start heading lower and possibly could drag the overall stock market lower.