WILSONS

Stagflation – Should Investors be Worried?

Our weekly view on asset allocation.

25 October 2021

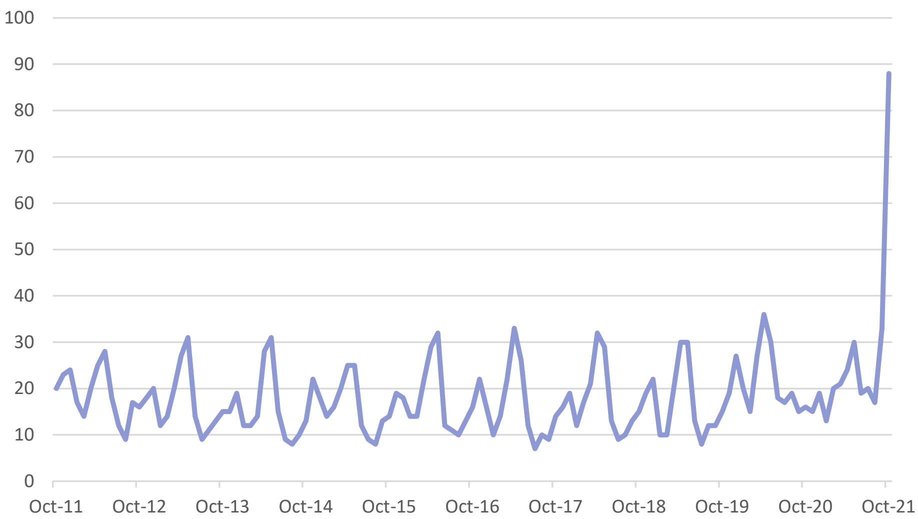
High Inflation Drives Talk of Stagflation

High inflation readings across many economies in recent months has led to talk of "stagflation". Stagflation is a term first coined in the early 1970s. It commonly refers to a period of stagnant (or indeed recessionary) economic growth accompanied by stubbornly high inflation.

The term is synonymous with the global economic regime that characterised much of 1970s and early 1980s as inflation surged to double-digit rates and remained stubbornly high – even in the face of three global recessions in the space of less than 10 years. This was also a fairly dire period for investors (apart from gold bulls), so talk of stagflation - if anywhere near the mark - is a potential concern for investors.

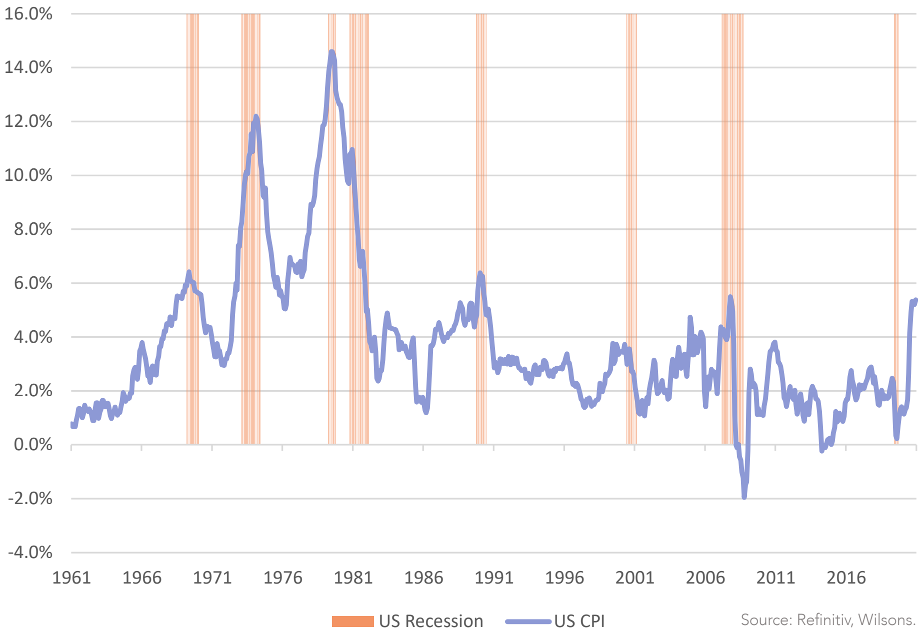
At the outset, we would emphasise that we think that the characterisation of the current (or near-term) economic environment as "stagflationary" is a fair way wide of the mark.

Exhibit 1: Stagflation searches - Google trends (worldwide)



Source: Refinitiv, Wilsons.

Exhibit 2: Stagflation took hold in the 1970s



Source: Refinitiv, Wilsons.

While inflation is currently well above the experience of recent decades, economic growth is also running at an above-trend pace. So, while there is a strong inflation pulse currently running through the global economy, there is little evidence, or in our view, little near-term risk of economic stagnation.

It is true that the global economic rebound has passed its peak, but economic growth is currently very strong and is expected to remain well above trend over the coming year.

Inflation, while currently high, is expected to moderate fairly significantly over the coming year as a number of "transitory" pressures fade. Of course, history has shown that expectations can be wrong, sometimes by a wide margin.

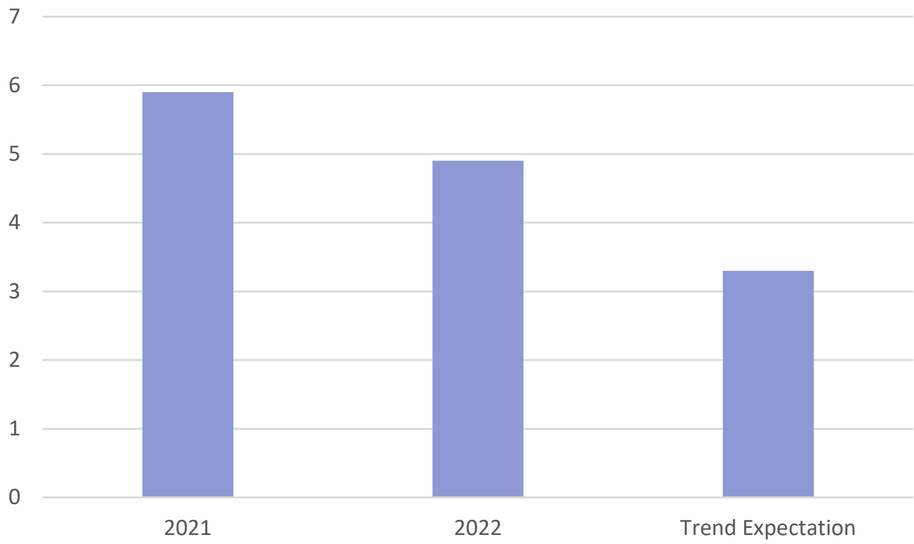
We think the "risk case", at least over the coming year or so, is not so much that the world ends up in a period of stagflation but that inflation surprises the current consensus to the upside. It is possible that growth may surprise moderately to the downside; however, stagnation - or even moderately below-average growth - appears highly unlikely.

In short, we believe the most probable range of potential outcomes are a long way from stagflation. However, given the current elevated pricing of both equities and bonds, markets could be vulnerable if we were to see a significant upside surprise on inflation accompanied by some downside surprise on growth.

A fair bit of the current inflation pulse appears transitory

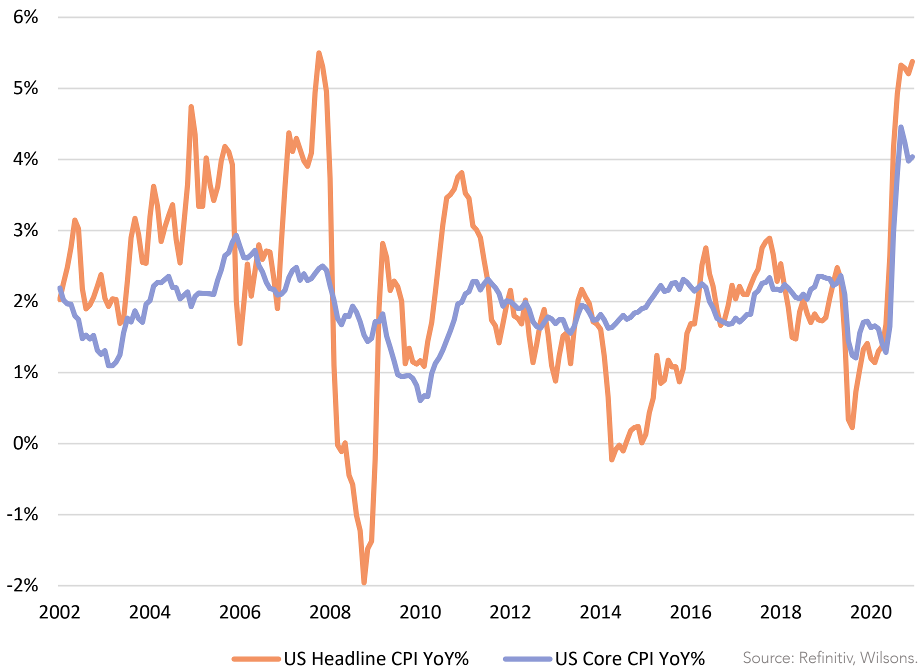
To be clear, our 12-month base case is that inflation does prove to be largely transitory, so inflation should come down significantly. We do see the 12-month risk for inflation as at least moderately skewed to the upside versus current expectations, but we view a big upside surprise on inflation as unlikely. On the growth side, we remain relatively positive and see risks around current (above-trend growth) as reasonably symmetric. Based on our expectations for growth and inflation, we remain reasonably constructive on risk assets but significantly underweight bonds.

Exhibit 3: The IMF expects global GDP growth to remain well above trend in 2022 (% Real GDP Growth)



Source: Refinitiv, Wilsons.

Exhibit 4: Inflation has spiked this year at both the "headline" and "core" level



Source: Refinitiv, Wilsons.

When our outlook flexes to shorter or longer time frames, our views become a little more nuanced. On a short-term view (3-6 months), our concern around sticky inflation goes up a notch. There is some risk that some of the much-discussed "transitory inflation" pressures prove a bit stickier than the consensus expects. Once again, we think a good deal of this transitory inflation pressure will wash out of the system on a 6-12 month view.

Our medium-term view (2-3 years) also encapsulates a higher risk of some moderate upside surprise on inflation. This is still a long way from anything approaching a 1970s style stagflation regime. Still, we do think inflation is arguably the key risk for investors to monitor on a medium-term perspective.

Why it is not Back to the 70s

The 1970s and early 80s saw inflation climb from an average of 2.3% in the 1950s and 1960s to an average of 8.7% in the 10 years from 1972-1982, with several periods of double-digit inflation (see exhibit 2).

Inflation began trending higher in the late 1960s before sharp restrictions imposed on the supply of oil (the oil price shock of 1973) saw inflation spike to double-digit levels.

Crucially a significant wage-price spiral took hold, causing high inflation to become ingrained in the global economy for more than a decade even in the face of three severe economic downturns in the space of 10 years.

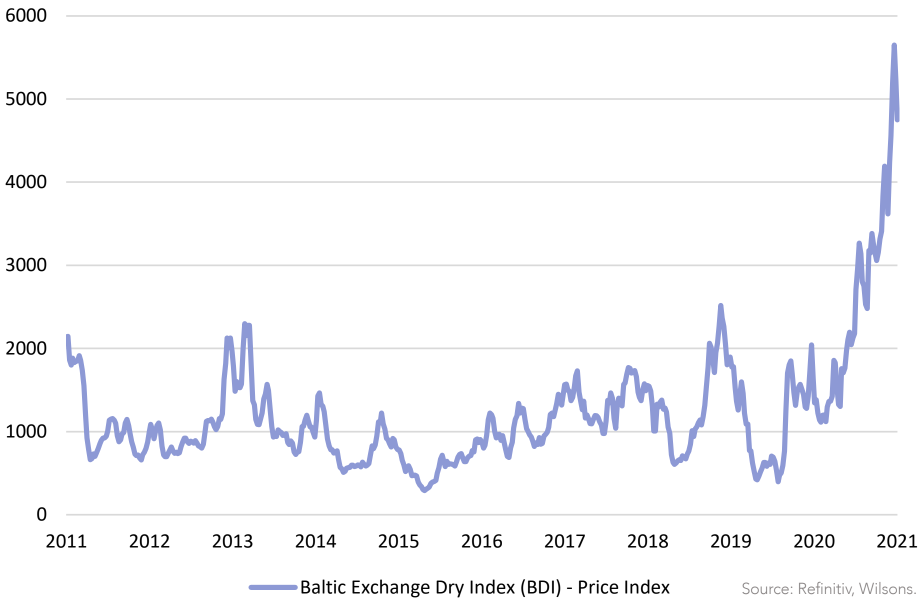
The inflation the world is currently experiencing does have a "supply shock" dimension that is at least superficially similar to the oil supply shocks of the 1970s, albeit the origin of the current supply dislocation is quite different in many respects.

The COVID-19 pandemic has disrupted many global supply chains, with lockdowns impacting manufacturing output and transport efficiency. As economies emerged from the depths of last year's shutdowns, demand - particularly for goods - has surged. This demand surge has left supply chains unable to cope in many cases.

Strengthening demand at a time of constrained supply has seen the price of many raw commodities and manufacturing component inputs e.g. semi-conductors surge.

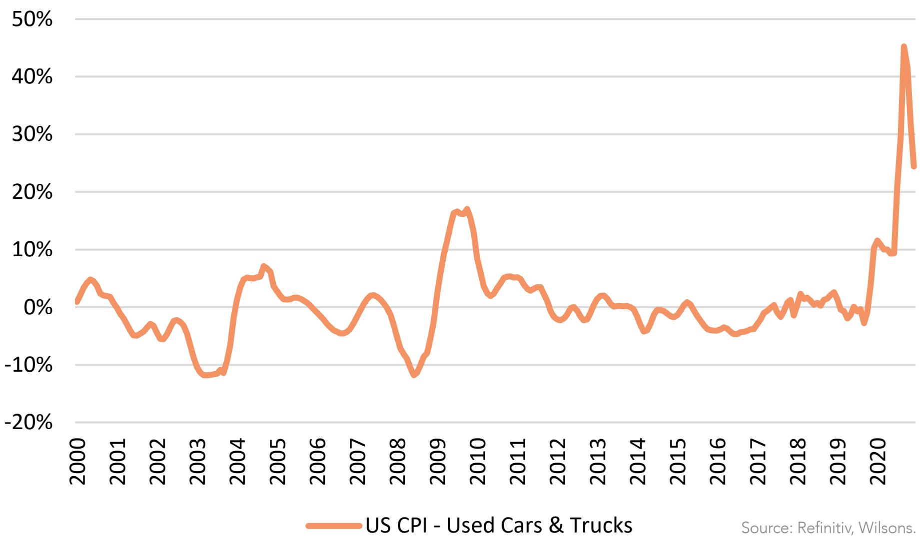
We see a large part of this supply/demand dislocation as inherently transitory. On the supply side, COVID disruptions should continue to progressively ease as lockdowns and other social restrictions become rarer. The demand surge in many goods markets should moderate as the consumption rebound slows while the consumption mix will rebalance back towards many underutilised services.

Exhibit 5: Global shipping costs have surged



Source: Refinitiv, Wilsons.

Exhibit 6: A few COVID impacted components within the US CPI have surged



Source: Refinitiv, Wilsons.

As we discussed, we see the risk of a broad-based wage breakout near-term as unlikely. While there are some pockets of wage pressure, particularly in lower-paid service jobs, labour supply should also become more plentiful as the pandemic-related constraints on labour participation fade.

Importantly, we do not see anything approaching a 1970s wage price spiral as a genuine risk as labour and most product markets are much more competitive and decentralised than in the 1970s.

Stagflation a Flimsy Debate

In summary, our core view is that inflation moderates fairly significantly over the next 12 months. On the growth side, growth should slow but still proceed at an above-trend pace due to both pent-up consumer demand and also via an overdue inventory rebuild from the business sector. Policy settings also remain very conducive to above-trend growth. We feel that the "stagnation" side of the stagflation argument appears relatively flimsy.

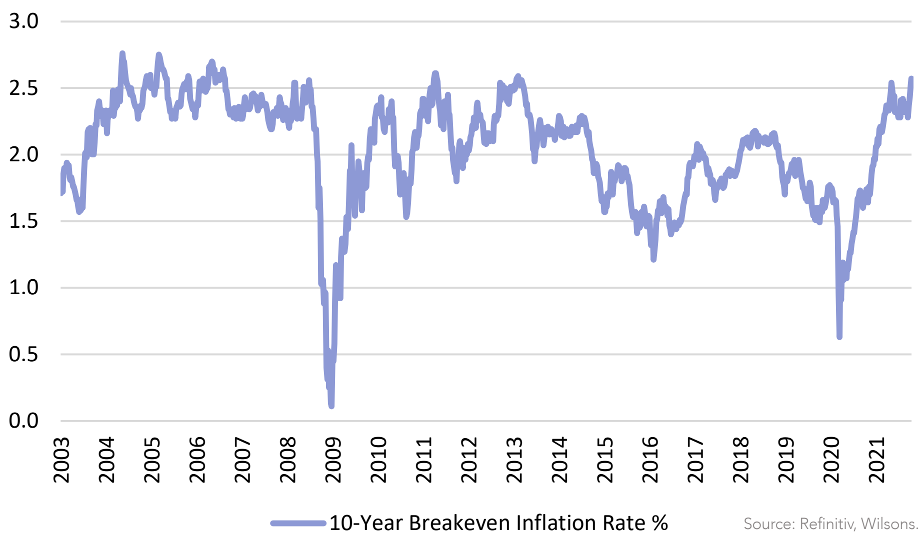
Assessing the Risk Case - Taper Tantrum or Inflation Impatience?

In the short-term, there is some risk that inflation proves stickier than the market expects. For example, high-frequency data suggests used car prices in the US are rising again. A sticky inflation scenario could cause markets to become impatient with inflation over the next few months. Perhaps the biggest near-term risk to markets may not so much be a "taper tantrum" but the risk of a bout of "inflation impatience". Even if the inflation impatience scenario transpires, this is likely to be a temporary problem not an inflation regime shift. We do not see current high inflation readings being sustained on a 12-month outlook, but it could be a source of volatility near term.

Some medium-term risk of old-style overheating?

Beyond the next 12 months, we attach some risk to the chance that we see some economic "overheating", particularly in respect of the US economy, which is already fairly advanced in its recovery. A classic overheating scenario is something we did not really see in the post-GFC decade as the global economy struggled to build up and hold decent growth momentum.

Exhibit 7: Market inflation expectations have risen but remain relatively moderate (Inflation Linked bonds)



Source: Refinitiv, Wilsons.

Policymakers now appear much more willing to accommodate some above-trend inflation in their quest for finding the limits of "full employment". We think the risk of a "stronger for longer" growth cycle accompanied by a medium-term cyclical inflation pickup is quite plausible.

The prospect of buoyant (supply constrained) energy prices over the medium term likely adds to the risk of a medium-term inflation pick -up.

This could cause a bigger medium-term adjustment in central bank and market interest rates than currently expected, so this is a risk we will be monitoring.

More Reflation than Stagflation - How to Position

We think talk of stagflation is likely to be well wide of the mark. Inflation is high and may stay a bit high for a bit longer but should moderate fairy significantly on 12-month view. Importantly, economic growth is likely to stay well above-trend. This reflationary backdrop should, on balance, be a decent environment for risk assets.

We do see some moderate short-term risk and probably, more importantly, some medium-term risk around inflation.

So, the inflation environment stands out to us as perhaps the key risk factor for investors to monitor.

On a 12-month view, we continue to like value (including energy) over growth and remain underweight conventional fixed interest. We are overweight alternatives (e.g. real assets, market-neutral hedge funds, floating rate private credit) and think some exposure to gold and/or gold stocks makes sense in case we see more inflation than under our central case.

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Wilsons contact

david.cassidy@wilsonsadvisory.com.au | +61 2 8247 3149

john.lockton@wilsonsadvisory.com.au | +61 2 8247 3118

rob.crookston@wilsonsadvisory.com.au | +61 2 8247 3101

www.wilsonsadvisory.com.au