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Weekly perspective on current market sentiment October 20, 2021

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Last week's S&P 500 Index: +1.8%

Stagflation?

Key takeaways

- Investors are worried about an extended period of stagflation engulfing the U.S. economy.
- We do not believe that to be the case as a number of exogenous events have pushed inflation higher in the nearer term.

One of the questions we are getting most often from investors surrounds the topics of slowing economic growth and inflation that appears to be levitating at higher levels for longer than many expected. Granted, we have adjusted our growth forecasts down for this year in recent months while our inflation projections have moved higher. Many baby boomers (this strategist included) can remember the mid-to-late 1970s when inflation was rampant as growth stumbled.

Early in the '70s, fiscal and monetary policy was oriented to the belief that the U.S. should have been willing to put up with inflation as it reflected an economy that was growing and keeping unemployment low. In other words, an increase in the demand for goods pushes prices higher, which encourages firms to add workers and boost production capacity, which further results in additional demand throughout the economy. But in the 1970s, there was a period of what became known as stagflation; economic growth slowed and inflation jumped higher.

But what exactly is stagflation? We think of stagflation as persistently high inflation in combination with stagnant demand in the economy (low gross domestic product, or GDP, growth) and high unemployment. The key word here is "persistently." We would also add that the concept of self-perpetuation is important for stagflation to become reality. Are the conditions currently driving U.S. inflation higher persistent and self-perpetuating? In short, we do not believe they are for a number of reasons.

In our opinion, exogenous events are the chief culprit in this current bout of inflation. The COVID pandemic shut down many segments of the economy, which led to a very deep but short-lived recession. Then massive government stimulus helped the economy roar back as demand surged. Factories and supply chains couldn't keep up with the level of this new demand after being largely shut down for months. Supply-chain disruptions weigh heavily into our argument. In addition, a falling labor participation rate has helped fuel a shortage of workers. The ongoing truck-driver shortage, an issue in the years prior to the pandemic, has grown further and caused problems getting imported goods from ports to downstream distributors and is even causing some goods fully produced here in the U.S. to be in limited or short supply. We have been hearing warnings for many weeks about everything from Thanksgiving turkeys to some holiday toys and other gifts likely being in limited supply.

While these frictions could become self-perpetuating, especially wage inflation, we do not believe that will be the case in the longer term nor do we believe they are self-perpetuating. We look for the labor market to improve and some of those who left the labor market to re-enter as job opportunities and wages rise. Growth will likely stay above average, the unemployment rate should continue to fall, and inflation should decelerate next year as supply-chain stresses begin to ease. That does not meet the definition of stagflation.

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