3Q2021 White Paper
Stagflation = Stagnation + Inflation

It is hard to ignore the inflation pressures that are prevalent in the economy due to the "Great Lockdown" recession of 2020. You can see it in the cost of grocery bills, at the gas pump, the price of a car and travel costs. Even the price of televisions, which have been in a deflationary spiral for decades, are up nearly 15% over the past year. Some of the inflation we have seen is transitory and has moderated a bit (e.g., airfare costs are down almost 10% in the past two months, lumber is down ~60% from its peak). However, as the global economy continues to struggle with supply chain disruptions and labor market constraints there is growing concern that economic growth will slow or even contract due to rising prices.

This phenomenon has an economic term, it is called stagflation. It means slowing and even contracting economic growth combined with high unemployment and rising inflation. The last time our economy saw true stagflation was during the 1970s. In this white paper we explain the dynamics behind how stagflation can develop and why it is being identified as a threat now, compare the current economic climate to the last period of stagflation we experienced in the 1970s, and discuss our recommendation on asset allocation given this risk.

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How does stagflation develop in an economy?

Economists have offered three primary drivers behind how stagflation can become an economic reality. Typically, not one of these circumstances alone leads to stagflation but a combination of these situations can lead to a prolonged period of economic stagflation.

Stagnation + Inflation =
Stagflation

1. **Supply-side shock –** A supply-side shock that can fuel stagflation is an unexpected decline in the supply of goods that results in higher prices for businesses and consumers (e.g., oil, food and/or commodities). Due to higher input costs and/or lack of supply, businesses are forced to slow or cease production of other goods which can hamper economic growth. Eventually it can also trickle to the consumer as they slow spending as prices rise and/or there are no products to purchase.

2. **Rapid expansion in the money supply –** We commonly see the government expand the money supply in times of economic slowdowns or recessions. However, stagflation becomes a risk when the government is rapidly expanding the availability of money while there are supply constraints (e.g., supply shocks). As a result, there is too much money chasing too few goods and inflation can emerge while economic growth slows.

3. **Policy error –** Monetary policy error can lead to many different economic scenarios. A central bank that is too aggressive in tightening monetary policy can push the economy into a recession. Being too loose in monetary policy can lead to inflation. Fiscal policy error has also been blamed for fueling stagflation. In the past, governments have irresponsibly used price and or/wage controls to fight inflation. However, the use of these policies was unsuccessful. They fueled inflation when controls were lifted and growth slowed, leading to stagflation.

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Why is stagflation a risk to monitor now?

Given the underlying drivers of stagflation that we outlined, it is not surprising that economists are ringing the alarm bells about the threat in the current economic climate. Economic growth has slowed after the record high growth rates coming out of the pandemic. The global supply chain is still suffering from the negative implications from COVID and creating supply shocks in many areas of the economy. Semiconductor chips that are a major input in a variety of goods (e.g., video game consoles, cars, lighting fixtures) are in astonishing shortage. In fact, the lead time (or wait time) for a chip has surged beyond 20 weeks (it is typically less than 10 weeks).[1] Household appliances are scarce and manufacturing inventories are sitting at a record low. **(Chart 1).** We are even seeing shortages across the world in necessities like energy products.

At the same time the U.S. government and Federal Reserve have implemented extraordinarily easy monetary policy and fiscal stimulus. The Federal Reserve's balance sheet has expanded to more than $8 trillion and the broad money supply (which accounts for money, checking, savings, time deposits) has skyrocketed to nearly 100% of nominal GDP **(Chart 2, next page).** The U.S. Government alone has handed out more than 170 million checks worth about ~$400 billion directly to Americans and that does not include the most recent advancement of the child tax credit which hits Americans' accounts the 15th of each month.[2] All of these actions are a recipe for inflation, and we have seen short term inflation expectations surge as a result **(Chart 3, next page).**

Chart 1

Supply Shocks Felt Across Many Areas of the Economy

Data is as of August 2021. Source: Bloomberg Finance LP, Verdence Capital Advisors.

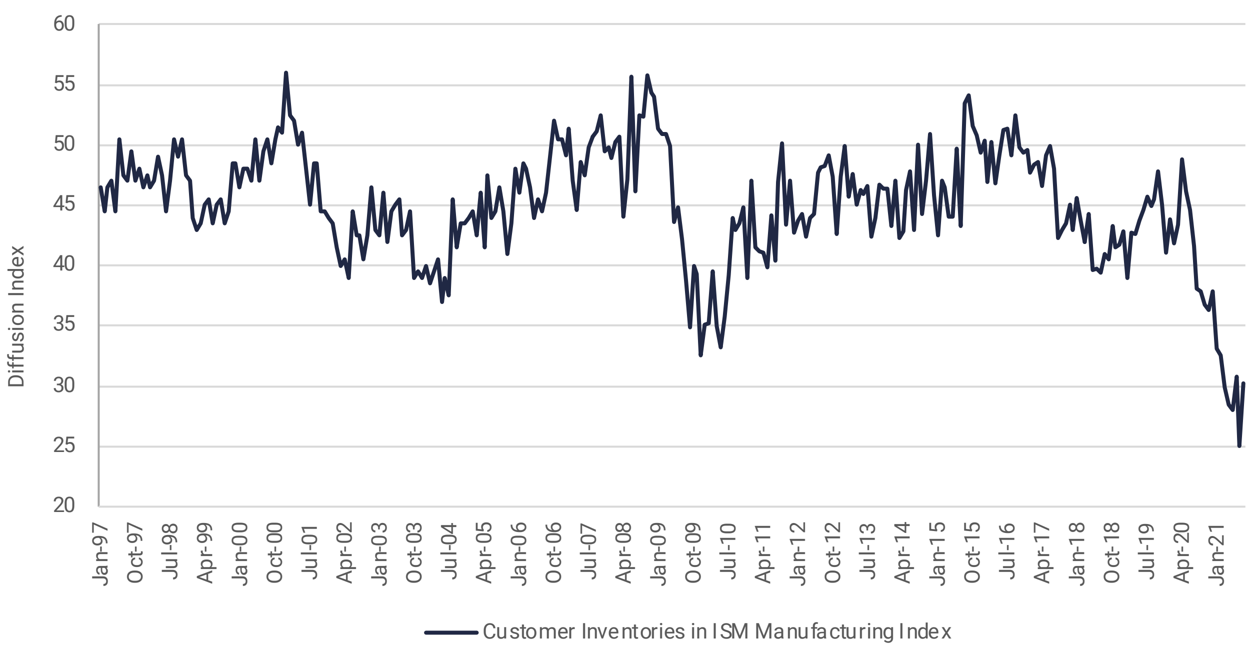

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Chart 2

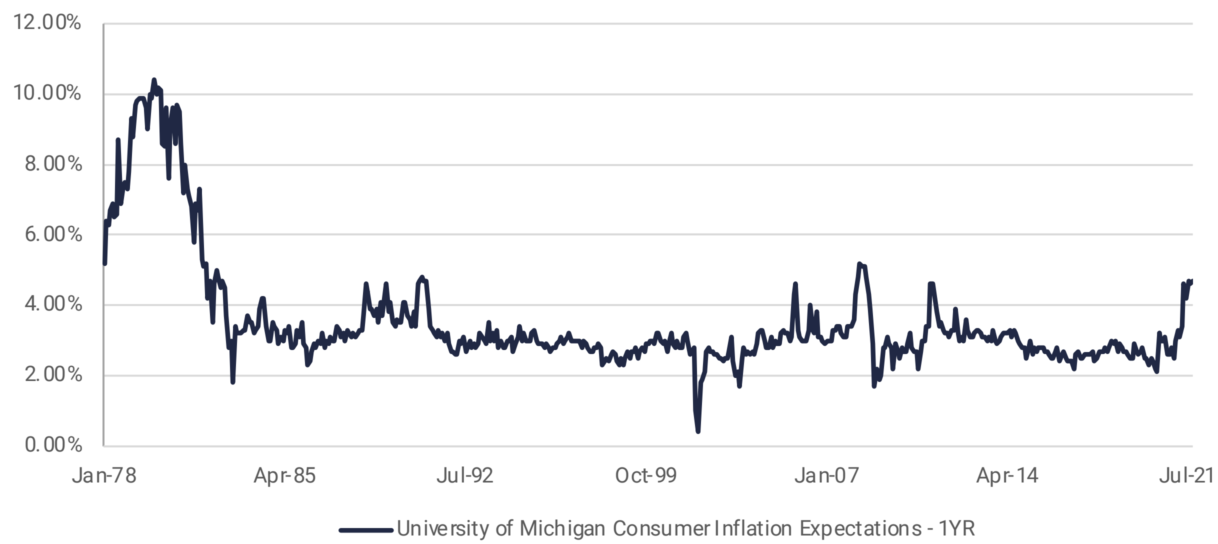
Money Supply Nearly as Much as Nominal GDP

Data is quarterly and as of 2Q21. Source: Bloomberg Finance LP, Verdence Capital Advisors.

Chart 3

Inflation Expectations are Surging Post Pandemic

Data is monthly and as of September 2021. Source: Bloomberg Finance LP, Verdence Capital Advisors.



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Comparing current economic climate to the 1970s stagflation period:

While slowing growth accompanied by rising prices is a valid risk to monitor, it is important to understand the complexities and difference between the 1970s stagflation period and our current economic climate. The stagflation period that plagued economic growth during the 1970's was spurred by a variety of policy errors, supply shocks, the collapse of the gold standard and entirely different monetary policy standards than we have today. All these events in aggregate contributed to three recessions (i.e., 1973-1975, 1980, 1981-1982), two of which were the longest since the Great Depression. The U.S. saw unemployment rise to a record high in the past WWII era, and inflation grow at a double-digit pace. Below we highlight some of the differences between the 1970s and today when looking at the three components of stagflation (e.g., high unemployment, slowing economic growth and rising inflation).

- **Labor market:** The labor market is vastly different today than it was during the 1970s stagflation period. In the 1970s employers were forced to lay off workers due to rising wage and input costs. As a result, the unemployment rate nearly doubled between 1973-1975. In contrast, today many U.S. companies are willingly raising wages and offering incentives to fulfill their need for labor. They simply cannot get people to work. In fact, there are so many job postings that there is at least one job posted for every unemployed American. In addition, the labor force participation rate is rising, and while the unemployment rate is elevated, it has been steadily falling.

- **Economic growth:** As can be seen in **Table 1 (next page),** economic growth is expected to slow after its stellar rebound this year. However, there is no forecast of a recession in sight. Household balance sheets are strong, and households make up more of GDP now than they did in the early 1970s **(Chart 4, next page)**. In addition, monetary policy is much more accommodative than it was in the early 1970s, which should support GDP. As seen in **Table 1 (next page),** the real Fed funds rate (taking into consideration inflation) is not expected to even turn positive until at least 2023.

- **Inflation environment:** Inflation has been elevated due to several factors including the expansion of the money supply, surge in pent up demand and most importantly the disruption in the global supply chain. One main difference between the inflation from the 1970s and today is monetary policy. Actions taken by the Federal Reserve in the early 1970s magnified inflation. The Oil Embargo of the 1970s caused oil prices to skyrocket, employees demanded higher wages and businesses had to make difficult choices that ultimately slowed growth. Instead of being held to a dual mandate like they are today (e.g., maximum employment and stable prices), the central bank was swayed by political officials to focus on unemployment. Ultimately, they were too accommodative with policy, and it exacerbated inflation. This differs from the central bank today that is in the end game of monetary easing and likely to start removing accommodative monetary policy before year end.

1970s Stagflation: policy errors, supply shocks, collapse of the gold standard, and tight monetary policy

Table 1

Differences Between Now and 1970s Stagflation

Estimates for 2021 and 2022 economic indicators are as of September 27, 2021. Source: Bloomberg Finance LP, Verdence Capital Advisors.

	1971	1972	1973	1974	1975	1976	1977	1978	1979	2020	2021	2022	2023
Real GDP (Annual %)	3.3%	5.3%	5.6%	**-0.5%**	**-0.2%**	5.4%	4.6%	5.5%	3.2%	**-3.4%**	5.9%	4.2%	2.4%
Inflation (AVG CPI YoY %)	4.3%	3.3%	6.2%	11.0%	9.2%	5.8%	6.5%	7.6%	11.2%	1.2%	4.3%	3.0%	2.3%
Unemployment Rate (AVG Monthly)	6.0%	5.6%	4.9%	5.6%	8.5%	7.7%	7.1%	6.1%	5.9%	8.1%	5.5%	4.3%	3.8%
Fed Funds Rate (AVG Annual)	5.0%	5.2%	8.2%	9.9%	5.9%	5.1%	6.0%	7.9%	11.3%	0.3%	0.3%	0.4%	0.9%
Real Fed Funds Rate (AVG Annual)	0.7%	1.9%	2.0%	**-1.1%**	**-3.3%**	**-0.7%**	**-0.5%**	0.3%	0.1%	**-1.0%**	**-4.1%**	**-2.7%**	**-1.5%**

Chart 4

Consumer More Important to GDP than in the 1970s

Data is as of 2Q21. Source: Bloomberg Finance LP, Verdence Capital Advisors.

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Past performance is not indicitative of future returns

How to position portfolios in the current environment?

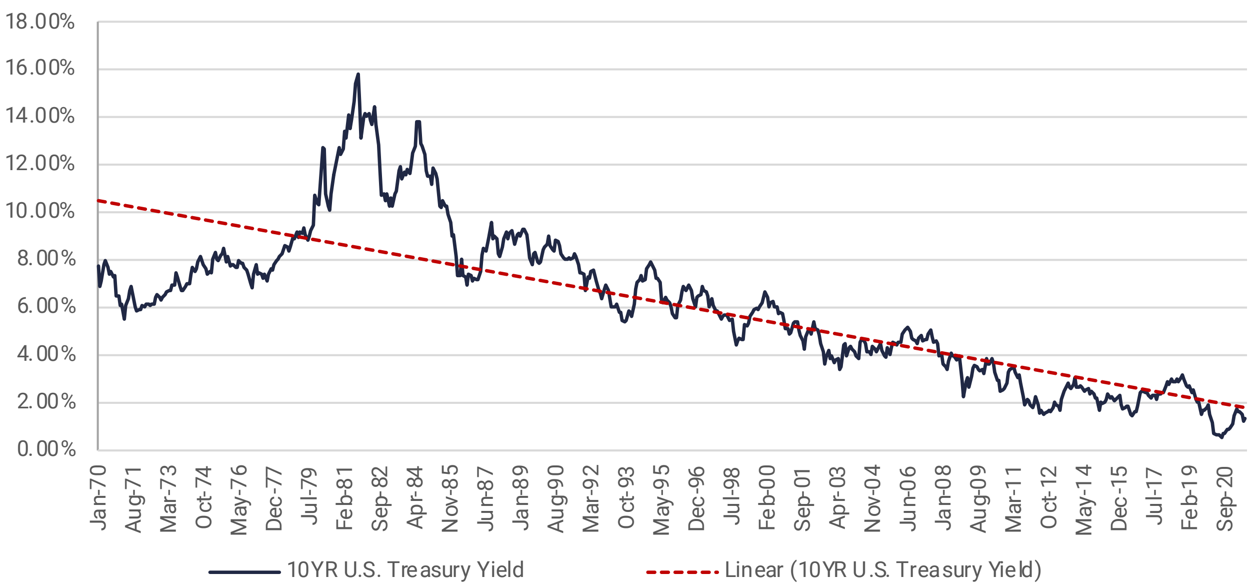
There are many differences (some of which we have described) between the 1970s stagflation period and today's market environment that should calm fears about a prolonged period of economic stagflation. It would also be unrealistic to use the 1970s as a historical example of how to be positioned for a stagflation risk. For example, if we used the 1970s and 1980s as a historical example, we would point to bonds for an attractive risk adjusted return. However, we are in a wildly different interest rate environment today than in the 1970s and 1980s. Instead of the start of a 30+ year bull market in bonds witnessed in the 1970s, we are at the bottom of a long-term downtrend in yields **(Chart 5).**

Instead, we expect yields to rise to reflect the higher inflation environment and better economic growth (yields rise=prices lower). While we would not abandon bonds as a portfolio diversifier, we would focus on short-term maturing bonds and floating rate notes that should mitigate losses in a rising rate environment. We favor equities over bonds but are cautious around the expensive sectors with elevated price to earnings multiples (e.g., growth and technology). These areas can be challenged by rising interest rates and higher inflation. Instead, investors might consider focusing on areas that can benefit from higher long-term yields (e.g., financials) and what we believe to be somewhat slower but still solid economic growth (e.g., cyclicals). Lastly, alternative investments, especially in the real asset space (e.g., real estate and infrastructure) are designed to help hedge against inflation and benefit from the ongoing economic expansion. In addition, volatility is removed from alternatives in this space and if the 1970s and 1980s taught us anything, it is to expect volatility as the central bank works to contain inflation.

Chart 5

It is Hard to say Yields can go Much Lower from Here

Data is monthly and as of August 2021. Source: Bloomberg Finance LP, Verdence Capital Advisors.



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The Verdence View

While the current economic environment carries some similarities to the textbook definition of stagflation, we also acknowledge the very different dynamics in today's economy that should help to calm the worst fears for investors. Yes, inflation is likely to remain higher than we are accustomed to. However, in contrast to the 1970s-style stagflation, major reasons for the higher inflation today are the disruption in the supply chain and labor market shortage. There is no other greater example than what we are witnessing off the coast of Los Angeles, which is responsible for more than a quarter of America's imports, where it is reported that more than 60 ships are idled waiting for workers to unload their cargo. In fact, the wait time to unload a ship has increased to upwards of three weeks.[3] The supply is there but the shortage of workers (e.g., at ports and truckers) is creating a bottleneck that is colliding with pent up holiday demand. With the recent wave of COVID cases rolling over, the end to extended unemployment benefits and ports increasing work schedules, we can start to tackle the supply disruptions. However, we realize it will take time and volatility will remain as we navigate through the backlogs and accompanying rise in prices. We continue to believe the economic expansion remains intact and equities (in the public and private space) offer a better opportunity than bonds given this outlook. We will continue to monitor market developments and make portfolio changes as we deem necessary.

If you have any questions or comments, please feel free to reach out to your financial advisor.

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Important Disclosures:

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1.According to Bloomberg as of August 11, 2021. Per article in tomshardware.com. https://www.tomshardware.com/news/semiconductor-delivery-times-get-worse#:~:text=The%20semiconductor%20shortages%20continue%20to,advanced%20semiconductors%2C%20and%2026.5%20weeks

2.According to CNBC as of June 9, 2021. https://www.cnbc.com/2021/06/09/more-than-2point3-million-new-stimulus-checks-have-been-sent.html

3.According to Wall Street Journal as of September 26, 2021. https://www.wsj.com/articles/cargo-delays-are-getting-worse-but-california-ports-still-rest-on-weekends-11632648602

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