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SUMMARY

- Concerns around a 1970s-style 'stagflation' have been rising, in our view.
- We believe these concerns are currently overstated.
- Today, inflation and unemployment are much lower, and growth more stable than in the 70s.

06.18.2024

Stagflation Scare? More Bark Than Bite

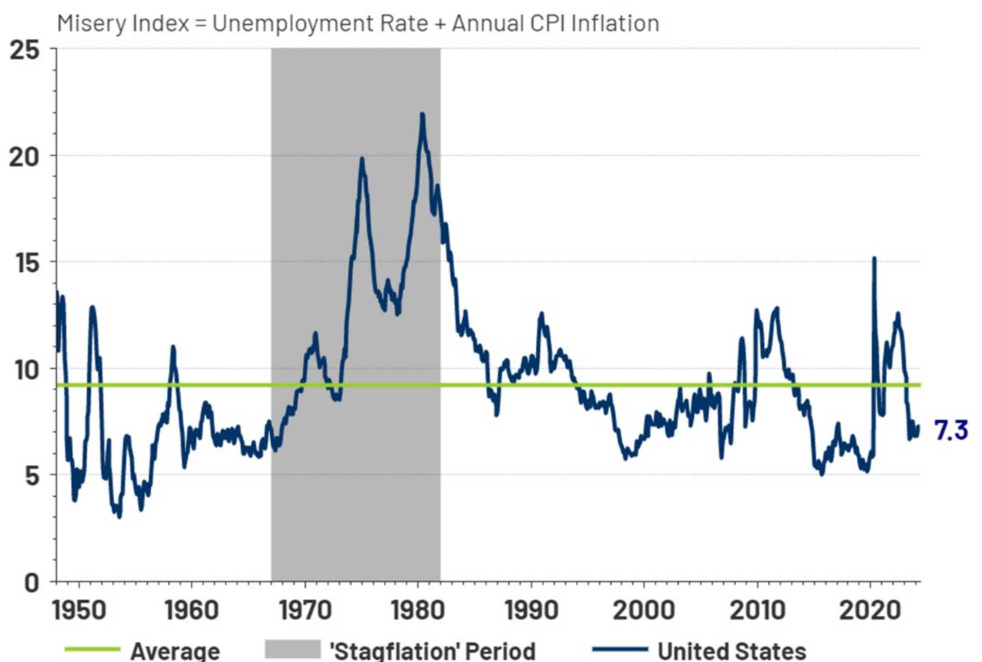
Economy Too Strong, Inflation Too Low for Concern Just Yet

The threat of 'stagflation,' much like leisure suits, roller skates and disco, is a 1970s phenomenon that is unfortunately back from the dead. Judging by a recent spike in media mentions of 'stagflation,' this issue is now back near the forefront of investors' concerns. **However, despite uneven trends in inflation in 2024, we continue to view stagflation as a low probability outcome.** In our *2024 Outlook* published back in December, we placed only a 25% probability of a 'Stagflationary Scare' over the next 12 months that would pressure both equity and bond markets...today we would place those odds at even lower levels.

True stagflation is a challenging economic environment where inflation and unemployment are elevated and persistent. This forces the Federal Reserve to keep rates high and restrict money supply even as the economy slows, and unemployment ultimately accelerates. This dynamic creates a vicious cycle of low economic growth combined with high unemployment and prices.

The 2020's are NOT the 1970's.... Inflation and Unemployment Lower Today

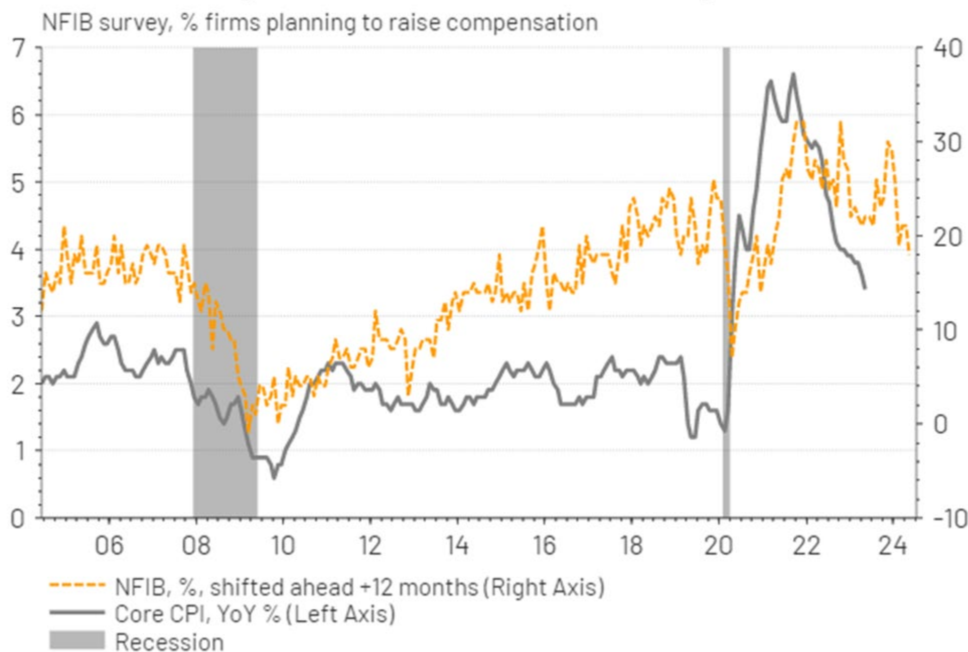
'Stagflation' was coined in the 1970's, when runaway inflation driven by an oil embargo ultimately caused the Federal Reserve to engage in not one but multiple rate hike cycles. This culminated in extremely high interest rates that finally brought lasting inflation relief by the early 1980s, but at a high economic cost. This painful period — defined by the St. Louis Fed as 1967-82 — was epitomized by abnormally high and sustained readings on the 'Misery Index', an economic measure that simply adds consumer inflation to the unemployment level (see shaded region, Chart 1, below).



Source: Bloomberg, RiverFront. Data monthly as of June 3, 2024. Past performance is no guarantee of future results. Chart, right, shown for illustrative purposes. Not indicative of RiverFront portfolio performance.

In 2020, a COVID-driven spike in the Misery Index put stagflation watchers back on notice. However, the current employment and inflation data does not point to stagflation, in our opinion. Today the Misery Index reading is way below stagflation-era peaks…a function not only of lower levels of inflation but also much lower unemployment. Currently, unemployment is hovering close to multi-year lows at around 4%, with year-over-year CPI inflation currently at 3.3%. This is in stark contrast to 1967-82, where in addition to four recessions, unemployment averaged 6%, and average annual inflation was 6.5%, according to research from the St. Louis Federal Reserve[1]. The economy stayed in the 6% range for another five years even after the stagflation period was over. Another contrast to the 1970s is that the US is now a net exporter of oil and gas and largely energy self-sufficient.

Importantly, Wednesday's Consumer Price Index (CPI) inflation and Thursday's Producer Price Index (PPI) readings for May both surprised to the downside relative to economist consensus estimates. We would also look to the National Federation of Independent Business (NFIB) surveys for the month of May. This survey includes a useful forward inflation indicator concerning employers' propensity to raise wages. The indicator has moderated meaningfully over the past seven months, and — at a current 18% reading — are now back closer to pre-pandemic levels (see orange dotted line, Chart 2, right).



Source: LSEG Datastream/Fathom Consulting; Data monthly as of May 15, 2024. Past performance is no guarantee of future results. Chart shown for illustrative purposes. Not indicative of RiverFront portfolio performance.

Real Economic Growth More Stable and Sustainable Now

It's comforting to see just how much better the economic backdrop is today compared to the 1970s, but what about the potential for stagflation to settle in over the next couple of years? Admittedly, RiverFront expects a 'reflationary' environment through the next business cycle, wherein inflation may have a challenging time moderating all the way back down to the Fed's 2% target in the near-term. This is partially a function of the inflationary impacts of heightened geopolitics, encouraging 'friendshoring' and other supply chain realignments in light of wars (both cold and hot) in Asia and Europe.

However, the positive side to our 'reflation' view is the solid 'real' (inflation-adjusted) economic growth that accompanies it. This, in our view, is underpinned by the US's superior productivity relative to other large economic blocs, a highly positive disinflationary impulse which we have discussed at length (see *Weekly View* on American Economic Exceptionalism). We view the rapid adoption of artificial intelligence as another potential significant productivity enhancer through the next business cycle, with much of the economic benefit accruing to US companies. This US 'economic exceptionalism' is in full display, in our view. The Atlanta Fed GDPNow Tracker, a real time forecast of economic growth, is currently annualizing at around +3% year-over-year GDP growth for Q2, a solid reading, in our opinion.

CONCLUSION

In conclusion, while the risk of stagflation has not gone away, the likelihood of it happening has diminished since the beginning of the year, in our view. This is one of the reasons we remain constructive on US equity markets and why our balanced portfolios continue to slightly favor stocks over bonds.

[1] *https://www.stlouisfed.org/open-vault/2022/nov/three-ways-high-inflation-ends*

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Definitions:

Stagflation is an economic cycle characterized by slow growth and a high unemployment rate accompanied by inflation. Economic policymakers find this combination particularly difficult to handle, as attempting to correct one of the factors can exacerbate another.

Inflation is a gradual loss of purchasing power, reflected in a broad rise in prices for goods and services over time.

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Deflation is a general decline in prices for goods and services, typically associated with a contraction in the supply of money and credit in the economy. During deflation, the purchasing power of currency rises over time.

Reflation is a fiscal or monetary policy designed to expand output, stimulate spending, and curb the effects of deflation, which usually occurs after a period of economic uncertainty or a recession. The term may also be used to describe the first phase of economic recovery after a period of contraction.

The misery index is a measure of economic distress felt by everyday people, due to the risk of (or actual) joblessness combined with an increasing cost of living. The misery index is calculated by adding the seasonally adjusted unemployment rate to the inflation rate.

The Consumer Price Index (CPI) measures the monthly change in prices paid by U.S. consumers. The Bureau of Labor Statistics (BLS) calculates the CPI as a weighted average of prices for a basket of goods and services representative of aggregate U.S. consumer spending.

The Purchasing Managers' Index (PMI) is an indicator of the prevailing direction of economic trends in the manufacturing and service sectors. The indicator is compiled and released monthly by the Institute for Supply Management (ISM), a nonprofit supply management organization.

Gross domestic product (GDP) is the total monetary or market value of all the finished goods and services produced within a country's borders in a specific time period. As a broad measure of overall domestic production, it functions as a comprehensive scorecard of a given country's economic health.

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