Key Questions

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Are We Staring at a Stagflationary Crisis?

George Mateyo, Chief Investment Officer, KeyBank Investment Center

The Key Wealth Institute is a team of highly experienced professionals from across wealth management, dedicated to delivering commentary and financial advice. From strategies to manage your wealth to the latest political and industry news, the Key Wealth Institute provides proactive insights to help grow your wealth.

Inflation… yes. Stagflation… no.

Patrick Higgins is an economist at the Federal Reserve Bank of Atlanta who, like many others, feels that the broadest indicator used to measure our economy is flawed. His rationale: GDP (more specifically, the growth rate of inflation-adjusted Gross Domestic Product) takes too long to compile to be relevant.

As evidence, while the Bureau of Economic Analysis (BEA) will release an "advance estimate" of third-quarter GDP this week, roughly thirty days after the quarter ended, it will release a "second estimate" in late November and a "third estimate" just before Christmas. Note that the BEA still uses the term "estimate" three months after the measurement period ends. In other words, economists are estimating the state of the economy for a long time.

To address this, Higgins developed a methodology to measure economic activity more quickly and, in so doing, he created a "GDPNowcast[1]." Not to be confused with an official forecast, the "nowcast" is a mathematical model composed of a series of faster-moving economic statistics and various assumptions designed to provide an estimate of GDP for the current quarter. Measured against a longer period such as a calendar year, the GDPNowcast is akin to forecasting (or nowcasting) the weather over a few hours.

Last week, Higgins' model showed that third-quarter GDP in 2021 grew a measly 0.5%, a significant slowdown from the official "third estimate" of the second quarter, which declared that the economy expanded by 6.7%, approximately three times its long-term average. At the same time, other reports, along with everyone's personal experiences, has revealed that prices on nearly everything from computer chips to potato chips are rising faster than expected.

This combination -– slower growth and higher inflation -– have spurred cries of "stagflation," a pernicious environment in which sluggish economic growth is overpowered by inflation, resulting in little economic progress. The decade of the 1970s was the last extended period of stagflation, and the history is worth summarizing.

Following the 1973 oil crisis, oil prices surged over 200% in early 1974. GDP contracted, inflation spiked, and both stock and bond prices fell. Inflationary pressures eased in 1975-76 but then rose again and remained elevated until 1982. At that time, the Federal Reserve aggressively raised interest rates, which further depressed bond prices and limited equity market gains.

Around this time, another economist wanted to synthesize this situation and make it relatable to the average person. To accomplish this, assuming that higher unemployment and worsening inflation creates financial hardship for most individuals, Arthur Okun, former chairman of the Council of

Economic Advisers, combined the unemployment rate and the annual inflation rate to form the "Misery Index," a measure still used widely today.

May 1980 marked the high-water mark of the Misery Index at 21.9% (inflation: 14.4% + unemployment: 7.5%), and it would take several years before it fell below its long-term average of around 10%. Three decades later, in the aftermath of the Global Financial Crisis in 2011, the Misery Index spiked to 12.8% (inflation: 3.8% + unemployment: 9.0%) but fell to 10% a relatively short time later.

Earlier this summer, the Misery Index again crested above 10% as inflation jumped above 5% and unemployment hovered above 5% (but down considerably from March 2020 levels).

This understandably raises some concerns: Misery may love company, but it's not a prescription for long-term economic prosperity. It's an indication that stagflationary pressures may be building.

In our view, while such concerns are valid, we believe inflationary pressures will eventually ease. Although they may persist for longer than desired, perhaps well into next year, much of the inflationary situation is a result of the lingering effects of the pandemic. To recall, demand fell sharply in the first half of 2020. Businesses responded accordingly, and supply was reduced. Later, once demand returned, inventories needed to be restocked. Moreover, inventory shortages were exacerbated by challenges in the global supply chain and several exogenous factors, namely adverse weather conditions experienced throughout the world.

Adverse weather and a harsher than expected winter, in particular, could further compound these challenges, providing further support for those who fear stagflation. But this, too, should prove temporary. Also, as the labor market continues its recovery, the unemployment rate should fall further as well.

As a result, we continue to recommend a modest overweight to risk assets and prefer high-quality, cyclically oriented assets (those that benefit from economic growth) versus defensive sectors (those that tend to outperform during economic contractions). In conclusion, while certain economists may enjoy assessing misery, investors are typically awarded for maintaining their long-term optimism. And while transitory inflation is proving to be more pervasive and longer-lasting than once forecasted, this too will inevitably pass.

For more information, please contact your advisor.

About the Author

As Chief Investment Officer, George Mateyo is responsible for establishing sound investment strategies for private and institutional clients, expanding internal and external research capabilities, and managing the delivery of solid risk-adjusted investment performance.

In previous roles, George spent more than 15 years in investment management and investment consulting, where he acquired firsthand knowledge and insights into the capital markets and the stewardship of investment portfolios for institutional and high net-worth investors.

George received his MBA from the Weatherhead School of Management at Case Western Reserve University and completed additional studies at the London School of Economics.

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Source: 1 - For more information regarding the GDPNow model, please refer to: https://www.atlantafed.org/cqer/research/gdpnow

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