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Stagflation talk is back in the press, but is it really something to worry about? (UBS)

What is stagflation and should investors be worried?

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Recent talk of stagflation is still overstated, according the UBS Chief Investment Office.

Few scenarios alarm economists and investors as much as stagflation—a toxic combination of economic stagnation and inflation. This unfortunate mix is usually associated with the 1970s, when two separate oil shocks—an OPEC embargo in 1973 and a drop in production following the Iranian Revolution in 1979—led to a sharp rise in prices and undermined consumption.

Recently, the term stagflation has made an unwelcome comeback in the financial press. Inflation in most of the world has climbed above central bank targets while economic growth has started to moderate. The war in Ukraine has intensified concerns over elevated inflation and the risk of recession.

So, should investors be concerned about a return of stagflation? Why is stagflation such a troubling situation for investors, central bankers, and citizens alike? And is there any way investors can hedge themselves against this particular risk?

What is wrong with stagflation?

It is revealing that it was in the 1970s that economists took to referring to the “misery index”—the sum of inflation and unemployment. Either high unemployment or elevated inflation can reduce the living standards of many citizens, but the two together are especially pernicious.

Inflation erodes the spending power of wages and savings, undermining consumer spending and confidence. Meanwhile, high unemployment also chips away at demand in the economy. This is why stagflation is feared more than a standard recession. Stagflation also represents a painful dilemma for central bankers: If policy is tightened to combat inflation, unemployment is likely to be exacerbated. This leaves policymakers with no easy options.

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Finally, a stagflationary environment is problematic for investors, harming both equities and fixed income. First, higher inflation can erode profit margins—especially for companies that are unable to pass on higher costs to customers. For fixed income investors, inflation reduces the real spending power of coupon payments on high quality government bonds. Even the value of cash is eroded swiftly, leaving few places for investors to hide.

Is stagflation a significant risk at present?
We see some parallels with the 1970s at present. But talk of stagflation is still overstated, in our view.

First the parallels: On the price front, as in the 1970s, energy prices have risen swiftly. The Russian invasion of Ukraine has disrupted supplies of both oil and natural gas. Fears of a sudden drop in Russian output briefly pushed the price of Brent crude as high as USD 139 a barrel on 7 March, for an increase of close to 75% since the start of 2022.

Even after the subsequent decline, the price is still around a third higher year-to-date, as of 1 April. Also, the important role of both Russia and Ukraine as exporters of grains and fertilizer has pushed food prices higher. Even before the full impact of the war, the FAO Food Price Index hit a record high in February 2022, up around 20% on the prior year.

Meanwhile, worries over economic growth have intensified. The yield on the 2-year US Treasury climbed above the 10-year yield in late March, a popular gauge of recession fears among investors. A sustained rise in energy prices would also sap the spending power of consumers worldwide. Meanwhile, investors have become concerned that central banks—especially the Federal Reserve—will be forced to raise rates aggressively to curb inflation.

While investors are right to take such risks seriously, our base case is that a recession can be avoided and that inflation will subside into 2023. Current economic conditions look more benign than during the years of stagflation in the 1970s. For comparison, in 1975 the US economy contracted 0.2%, core inflation averaged 9%, and unemployment stood at 8.5%. At the time of writing, the US economy is on track to grow by around 3.5% in 2022, with unemployment below 4%. We see inflation falling from 5.8% in 2022 to 1.5% in 2023. Economies still have considerable momentum from a normalization of economic activity as pandemic restrictions are lifted.

The global economy is less vulnerable to higher energy prices than in the past, with the energy intensity of global GDP declining by more than 50% since the early 1970s. Finally, central bankers now stand ready to combat inflation. Fed chair Jerome Powell recently reiterated that policymakers "will take the necessary steps to ensure a return to price stability."

What does this mean for investors and should you seek protection?
The first conclusion for investors is not to panic. The financial press or pundits often indulge in predictions of impending doom that aren't realized—such as forecasts of hyperinflation following the 2008 financial crisis. In our view, talk of stagflation falls into this category. At present, consumer balance sheets are strong, following savings accumulated during pandemic lockdowns. Business profits are rising fast and have already surpassed pre-crisis levels.

Central bankers are eager to keep the economic recovery on track, while being willing to clamp down on inflation if needed. This is not to say that investors should ignore the threat of sustained higher inflation combined with slowing economic growth. What might be called "slowflation"—while not our central expectation—remains a possibility.

Given high levels of uncertainty, we do recommend investors add to hedges, including defensive sectors such as global healthcare. We also believe energy and commodities represent an effective hedge against the threat of a more sustained war in Ukraine or a sudden drop in Russian energy supplies.

But since we don't see a period of stagnant growth, we see the recent volatility as offering a more attractive entry point for industries such as 5G, automation and robotics, smart mobility, and consumer experience. For investors strategically underexposed to Chinese equities, we see now as a good time to diversify into a market that is cheap, oversold, and likely to gather momentum over the rest of the year.

See the full report: CIO tutorial: What is stagflation and should investors be worried?, published on 4 April 2022.

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