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Market Update

Inflation

As regular readers of our articles will know, inflation has been a favoured topic over recent months. With covid seemingly contained by the vaccination effort, markets are now focusing on the factors which will drive a change in direction from global policymakers, i.e. away from stimulus and towards calming measures. Such topics remain of key concern, and especially so with the recent announcement that US inflation has once again beaten expectations, yet one area within this topic which we have not yet discussed and which has the potential to hurt markets is the possibility of stagflation.

The Good and the Bad

Inflation occurs as the result of too much demand chasing too few resources. When this mismatch results from buoyant growth, inflation can be a healthy side-effect of a well-functioning economy. Yet, when inflation emerges from problems delivering supply in the face of only tepid demand, then prices can rise despite a stagnant economy. This latter scenario is stagflation.

Ineffective Policy

While in and of itself stagflation is a sign of a sub-par economy, it can also become a cause of further deterioration. A traditional response of central banks facing inflation is to raise interest rates. This raises the cost of borrowing so that individuals and corporations are more inclined to put money in the bank and less likely to borrow to consume or invest, which then weakens demand and so reduces price pressure, thus reducing inflation. Yet, in a stagflationary environment where demand is already weak, cooling the economy further through higher interest rates is more likely to lead towards recession and so can be an ominous sign for investors.

Stags on the Horizon

In the current environment, there are a number of signs suggesting that stagflation may emerge, but at this stage it appears to be a possibility rather than a probability. Supply is facing a number of concerning constraints, with blocked shipping ports, HGV driver shortages and escalating energy prices all leading to higher costs in getting products on shelves. Yet demand is currently strong thanks to the huge volumes of stimulus in the system, and so a high cost, high demand balance is in play. However, with central banks now taking tentative steps towards tightening and with government policy also becoming less accommodative, a fall in demand over the next six months would not be a shock and so with it we could soon face stagflationary pressures.

Growth to Emerge

This is therefore likely to lead to times when markets take a pessimistic view of the future, and there have been days over recent weeks where this mood has taken hold. Yet, in our opinion it is what happens beyond this short term horizon which is likely to be most important in determining the path of the global economy. While the removal of crisis era stimulus is expected to create difficulties, supply-side bottlenecks are unlikely to persist over the longer term and so a new equilibrium is likely to be found as 2022 progresses. At this point the economy is likely to be benefitting from the latent effects of the pandemic support (low unemployment and a healthy banking system) and also from

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government policy seeking to engender productivity. In this scenario, inflation may well remain above target levels, but with growth also present a healthy economic scenario would be achieved.

Eyes Peeled

Of course this projection may turn out to be overly optimistic and in which case markets would likely experience a challenging time. As such, closely following the driving forces in inflation figures will be important. Yet, with central bankers highly attuned to this risk and with strong economic fundamentals currently in place, we do believe we are on course for inflation, but that of the growth variety and not of the stag.

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