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State of Play

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Our Investment Specialist, Simon Durling, shares his thoughts in our latest update. The impacts of the global pandemic reach far and wide and, financially, the enormous cost and disruption to economies may have some unintended consequences. Why is this so important to savers and investors? And, a revisit to a scenario last spoken about decades ago – Stagflation.

Stagflation – A real threat or sensationalist headline?

The phrase 'Stagflation' was first coined by Iain McLeod, a Conservative MP speaking in the House of Commons in 1965, when his party was in opposition. The phrase is built from two words: stagnation, where the economy exhibits little or no growth; and inflation, the rise in the price of the goods and services we consume. Normally when these two factors combine the knock-on consequences can be severe, long lasting, and difficult to cure.

Until more recently, the expression has rarely been referred to outside of an educational setting since the dark economic period in the 1970's and 1980's when governments both in the UK and elsewhere struggled to resolve a damaging continuous economic cycle. We should also note that unemployment tends to be high during periods of stagflation, further exacerbating the economic impacts and making the escape back to growth even more difficult. I explore the root causes of investor concerns and whether markets are right to be nervous about the potential threat.

Economic growth

So, logically the first place to start is a review of the current economic growth and the short-term outlook. The pandemic brought national lockdowns around the world with economies grinding to a halt resulting in a massive global recession and, in the UK, the most severe economic downturn in over 300 years. It is hard to grasp in sufficient context the extent of the downturn and subsequent speed and size of the economic response that followed which, thus far, has cost trillions of dollars worldwide and may take many generations to repay.

The economic recovery has been rapidly causing enormous ripple effects: 'demand-pull', as too much money chases too few goods, and 'supply-shock' or 'cost-push', as supply chains are unable to respond quickly enough to make and distribute goods to meet the increased demand. This pushes up both the price-to-manufacture and price-to-distribute goods which filters through to consumers.

If the speed and strength of the economic recovery has been so strong, why on earth would markets be concerned about future economic growth? The answer is multi-faceted and, in many respects, is influenced by the driving forces behind the economic engine, like inflation, fiscal and monetary policy, and employment trends. Recent economic data points to a potential slowdown in the global recovery, where jobs data in the US in August was significantly below forecasts and in China, where for the first time since economic reforms were implemented in 1978, growth has slowed to below the 'magic' 6% target.

Whilst most economic forecasters are predicting varying degrees of growth over the next couple of years, the global economy slowing to a crawl cannot be completely ruled out due to several concerns that have been troubling financial markets in the recent weeks. Growth is flagging. Bank of England Governor, Andrew Bailey, said the economy would take a few months longer to return to pre-pandemic levels than expected. Deutsche Bank slashed its UK gross domestic product growth forecast for 2022 from 5% to 3.6% and from 2% to 1.5% for 2023.

Inflation – temporary or more persistent?

The investment story of 2021 has been dominated by the debate and relationship between global central banks and market participants. On the one hand central banks have sung to a harmonious tune called 'transitory', whilst the financial markets are more drawn to a song called 'suspicion'. The rise in the cost of goods and services, as measured by various baskets around the world, has never been so important. As I have commented in my last couple of updates, when too much money chases too few goods prices rise. If you combine this with other factors the combination can create shortages, sharp price rises and consumer panic.

One of these had already began well before the pandemic emerged. Globalisation has evolved over the last 30 years or so, creating a 'just-in-time' world where cheaper labour in the Far East, China and India helps to manufacture goods that can be distributed in market economies, and delivering components or finished goods at precisely when consumers choose to purchase. These arrangements have helped keep the price of making and distributing goods well under the long-term average.

De-globalisation, a reverse of the above, had already started in some regions - triggered in part by the growing wealth and influence of China, but also other complex factors which trigger many companies to re-think where their goods were made alongside how they can improve their distribution processes. With so many countries in lockdown this 'just-in-time' supply set-up was unable to function effectively. Even after vaccinations were successfully launched, bottle necks, raw material shortages and limited labour capacity often working under restricted environments, caused by isolation or COVID-19 protection measures, have caused abrupt restrictions in aggregate supply.

The essentials to our lives like petrol, food, energy and even bank notes are all commonly available which is a miracle of modern-day capitalism. Just enough of all these different types of essentials are produced in just the right amount and places, to be delivered to the correct freight trucks, to get where they are needed at exactly the right time. The just-in-time principle avoids the need for too much stock and warehousing, minimising the prices paid by consumers without affecting their range of choices. This system has been incredibly successful but only works if consumer behaviour remains consistent. Upset one element of the supply, or if shortages appear, and word spreads, consumers panic exacerbating the situation potentially crashing the balance. The petrol crisis over the last two weeks is a prime example of this: even though there was plenty of fuel, a shortage of delivery drivers initiated concerns, which once revealed in the media, created a consumer panic and the pumps went dry.

In the last week the energy price cap in the UK has been increased by 12%, with many energy suppliers going into administration, as the price of gas has risen 250% since the beginning of this year. The increased demand and supply issues have not only seen energy prices rise but also impacted the production of CO_2, which is used for food packaging and has in turn seen supermarket shelves either empty or devoid of choice (an industry also struggling with a shortage of delivery drivers). Oil prices are now higher than before the pandemic with limits set by the oil producers combining with increased global demand with the prospect of the price continuing to rise at least in the short-term.

Labour restrictions limiting capacity, and severe shortages in raw materials causing a limited supply of components for cars have had a dramatic effect over the last 18 months. From the offset of 2020 new car sales slumped by record amounts as factories and showrooms closed during lockdowns. New data from Auto Trader shows the average price of a used car has now risen for 65 consecutive weeks, and by nearly 14% year-on-year - the highest the marketplace's tracker recorded in a decade.

Expectations of inflation are picking up with the UK market at an eight-year high and the public's short-term expectations at a 13-year high. The Bank of England predicts inflation to climb above 4% which will be the highest in a decade. Some market commentators believe it is not unreasonable to expect UK inflation to hit 6%, which if it does will be the highest since 1992. In Germany, inflation is at a 29-year high whilst in the US, a 13-year high. Some of the spike reflects a fall in prices during lockdowns last year as inflation measures are a rolling 12-month calculation experts call the 'base effect'. The Organisation for Economic Cooperation and Development expects the supply-shock caused by commodity prices, such as aluminium and gold, and logistical bottlenecks will 'linger through much of 2022'.

Employment

The third important element normally affected by stagflation is the jobs market. The economic theory prior to the 1970's was that you couldn't have high inflation combined with high unemployment. The idea being that prices wouldn't rise when demand is low due to less of the population in work and able to buy goods. However, this consensus was disproved as the impossible became a reality. For example, by the middle of the decade a toxic mix of 9% unemployment in the US and double-digit inflation became the norm as President Richard Nixon abandoned wage-price controls that were supposed to restrain inflation.

The common thread binding the 1970s and today, is the supply-shock. Oil prices rose sharply on two occasions: when Organization of the Petroleum Exporting Countries (OPEC) enforced an embargo on countries that supported Israel in the Yom Kippur war; and then again in 1979 after the Iranian revolution. Under severe cost pressures, companies struggled to maintain production, lowering economic capacity. As prices rose, workers demanded higher pay, which drove prices up. The US was caught in a stagflation trap, echoed in the UK where unions were also at their most powerful.

Today the employment market here in the UK and elsewhere looks very different to the 1970's. Furlough schemes have been very effective at limiting the effects for those who have lost their jobs and companies under stress. The most recent data released from the Office for National Statistics (ONS) showed a record of more than a million vacancies and severe shortages of applicants in certain sectors. Current unemployment rates in isolation are very low by comparison but the changing nature of the economy during the pandemic triggered lots of older workers to bring forward full retirement and increased younger people choosing higher education over work.

In addition, Brexit has cut access to cheap migrant labour and increased administrative border costs which has magnified the COVID-19 supply-shock in the UK. Changing consumer buying habits with the older generation adapting to using laptops, tablets and smart phones have increased online shopping and consequently the demand for more delivery drivers. Dario Perkins, an economist at TS Lombard, said 'The second inflationary impact from the pandemic is that it made most economies less efficient at allocating resources. We see this most clearly in labour markets, where a serious mismatch has emerged. The coexistence of large numbers of unfilled job vacancies and high levels of unemployment suggests the market is not working as effectively as it used to. What if these supply disruptions do not end quickly? What if we now need fewer waiters and more cloud-computing experts? That is not to say the world won't eventually adjust, but the adjustment could take longer than people realise. Combine booming world trade with various supply bottlenecks and shortages and you get a large spike in consumer price.'

The big question is what will happen now furlough has been withdrawn? Just over one million people were estimated to be on the scheme when it ended on 30 September, half of whom were working part time. Since the crisis, a further 820,000 have lost their job or left the jobs market. Will they fill the one million job vacancies, or are they in the wrong place with the wrong skills? The UK has struggled to raise productivity and with wage growth more than 4% it is inevitable this will continue to drive up prices. What made the 1970s different was that the shocks came in waves. First an oil shock, then a wage shock, then a food price shock followed by another oil shock. That was enough to upend economics. So far whilst the pandemic has cost more than any other crisis in our history, it has not thrown us back 50 years economically just yet.

Potential impact on investments

My sense is that the prospects of stagflation are very unlikely especially given the commitment of central banks and governments alike to support the recovery until such time as it is assured, but it cannot be completely dismissed. Clearly unemployment alone is not a huge threat, although matching skills, vacancies and sectors may prove to be a tough nut to crack in the short-term. Above target inflation may linger longer than central banks would want but if economic growth slows, supply issues settle down and the pent-up demand cools, then inflation should settle back closer to the targets set by central banks around the world.

The key to this may lie in the employment mismatch being solved, fitting in with the change in consumer demand and habits. On the positive side governments and central banks remain committed to supporting their respective economies for as long as it takes to escape the worst of the current shocks and the shadow of the pandemic. Very low interest rates support individuals and businesses, but not savers. It also helps risk assets like shares as investors seek better returns to protect against inflation. If inflation becomes more stubborn then bonds suffer as interest rates rise earlier, quicker, and higher than markets anticipate triggering a rise in yields and a fall in bond value.

Our world is a complex one with many interconnected moving parts. Although based on the current evidence, stagflation appears the most unexpected of outcomes, the memory of the 1970's and 80's lives on with investors glancing over their shoulder and hoping the nightmare does not return to haunt our future. Investment consensus suggests that investing in a diversified portfolio matching the right risk profile and time horizon should help to mitigate what lies ahead. Only time will tell whether the market fear in recent days is justified.

Find out more!

Listen **here** to our latest Market Views from Stefano Amato, Head of Multi Asset Solutions UK, as he shares his thoughts on the main themes dominating markets.

Note: Data as at 5 October 2021.

Important Information