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In the Markets Now

Flation with no stag

We believe in the old saying: a picture is worth a thousand words. Here, we aim to recap recent market action and provide some perspective to investors.

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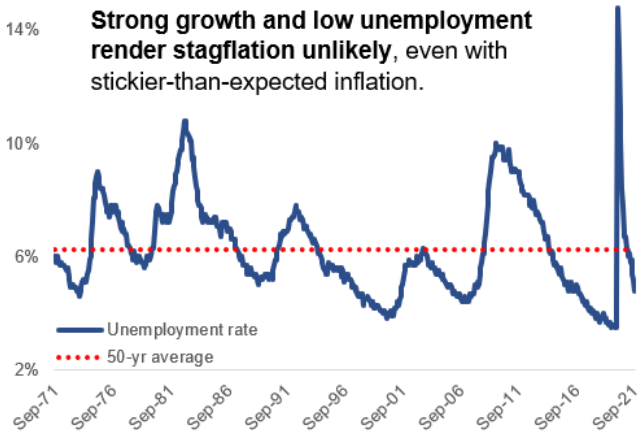
A FEW THOUGHTS ON STAGFLATION RISK

As we've noted before, scary headlines sell ads and get reactions. So after digesting China risk in July, the Delta variant in August, and debt ceiling drama in September, what's the latest boogeyman for investors to worry about? It would seem that "stagflation" (the devastating combination of low growth, high unemployment, and high inflation) is our answer. After all, as our friends at Strategas note, the percentage of articles mentioning "stagflation" has nearly doubled the previous record this month.

But stagflation requires two things to be true: stag- (stagnant economic growth) and -flation (inflation). We certainly have the latter: Inflation has been higher-than-forecast and more persistent-than-expected. And while supply chain issues are likely to abate with time, it is hard to deny that we are experiencing inflationary pressure unlike any in recent memory. So then the critical next question: do we have the stag-? Luckily, by most metrics, it's a firm no – and we'll get into some right now:

- **Output.** Real (inflation-adjusted) GDP has already fully recovered from it's historic pandemic dip, hitting a record high in 2Q21.
- **Retail sales.** Well-above pre-pandemic highs and clobbering forecasts. The US consumer is as healthy as they've been in some time – wages are up, debt is down… and they are spending voraciously.
- **Labor picture.** Stagflation is often defined by high unemployment. At 4.8% today, the unemployment rate is below its five-, ten-, fifteen-, twenty-, twenty five-year averages (and so on; you get the picture). While the economy is still a few million jobs shy of pre-Covid, the number of job openings is at records and quit rates are soaring.



- **Wage growth.** Average hourly earnings (particularly for lower income work) have been growing nicely. While this could be contributing to inflationary pressure, growing incomes are critical for a consumption-based economy to thrive.
- **Manufacturing.** The ISM Manufacturing PMI – an indicator of manufacturing activity based on surveys of purchasing managers – has been in expansion territory since June 2020 and touched a 35-yr high in March. The New Orders index, a proxy for demand, has been holding near multi-decade highs for essentially the entirety of 2021.
- **Productivity.** Output per hour worked (aka how efficient are people) is high and rising. It's possible that some efficiency gains made during the pandemic (WFH, service automation, etc.) could lead to a productivity mini-boom.

In addition, JPMorgan's David Kelly notes that stagflationary forces are naturally opposed: High unemployment reduces demand, allowing supply to catch up quickly and prices to fall, while fast-rising prices encourage businesses to hire more people so they can sell while the selling is good. This doesn't happen overnight, but it makes stagflation difficult to sustain.

In the end the economy may not be what we'd hoped when Pfizer's vaccine data shocked the world in November – a grand reopening unlike anything we'd ever seen – but it's still doing pretty good, especially as Covid-19 continues to wane. **Scary headlines will undoubtedly persist, but at this juncture, stagflation is not in the cards.**

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