
# MARKET MATTERS

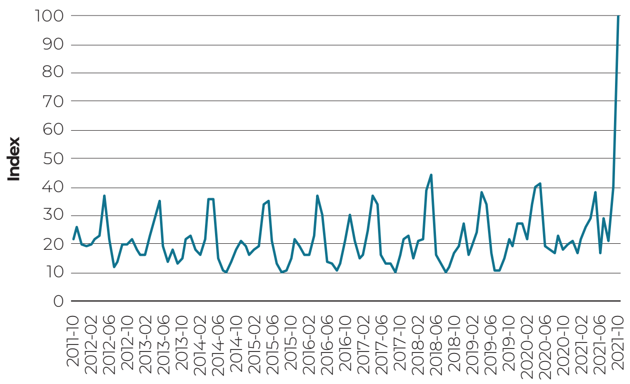
## THE SPECTRE OF STAGFLATION

11 OCTOBER - 15 OCTOBER 2021

Worldwide Google searches for the term stagflation are at the highest level in a decade. Bloomberg reported that its news service has published a record number of articles on the topic. There is clearly a worry that current elevated inflation will persist and coincide with global economic stagnation.

It certainly doesn't help that the UK recently saw long fuel lines and empty shelves for the first time since the 1970s, with the images recalling the 1979 "Winter of Discontent", or that the US government has warned that household heating bills will be 30% higher in the coming cold months. Even in the southern hemisphere, the recent surge in energy prices has exacerbated the fear of stagflation. High energy costs can cause inflation and slow output under the right (or should we say, wrong) conditions.

**CHART 1: GOOGLE SEARCHES FOR STAGFLATION**




Source: Google

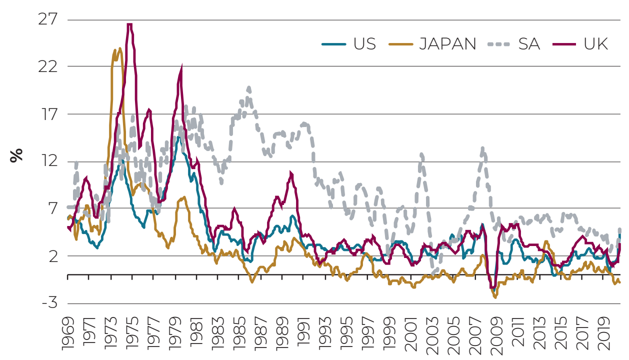
## THAT 70s SHOW

It is therefore important for investors to establish what those conditions might be. But first, it is useful to look at why stagflation is such a particular source of worry. In flexible market economies, high inflation and economic stagnation are generally not supposed to coincide for long periods. This is because stagnation and especially recessions tend to pull prices down as excess capacity or slack in the economy increases. A retailer, for instance, can't raise selling prices by much since competition is fierce when demand is weak. Workers similarly can't demand higher wages when unemployment is high.

Stagflation is a particular worry for central banks, because they basically have only one blunt policy tool, namely interest rates, and therefore cannot address high inflation and high unemployment simultaneously. They have to focus on one or the other.

That is why the stagflation of the 1970s stands out as such a dark period across the world. Policymakers seemed impotent in the face of high and rising inflation coinciding with economic malaise. The exact causes of this episode are still debated to this day, but it is generally agreed that it only came to an end when then-Fed Chair Paul Volcker hiked interest rates aggressively, triggering what was at the time the deepest post-war recession. The surge in unemployment and collapse in demand finally tamed the beast of inflation. In the subsequent years, the beast was further tamed by central banks adopting explicit inflation targeting (as opposed to trading off inflation and unemployment, or targeting money supply), globalisation, and rapid technological change.

**CHART 2: INFLATION IN THE 1970s AND NOW**




Source: Refinitiv Datastream

In fact, inflation was so tame in the post-2008 crisis years that several major central banks tried to raise it, instead of lowering it. They were mostly unsuccessful, since fine-tuning inflation with the blunt tools central banks have at their disposal is near impossible.

Today we are in an awkward phase where inflation is well above target in most countries, but driven by factors that seem temporary, notably supply chain disruptions. It is not clear where inflation will settle in a year or two. For the time being the official consensus is that disinflationary forces will reassert themselves once the Covid-related distortions pass.

## A CHANGED WORLD

Clearly the world has changed a lot since the 1970s. Economies were much more insular and highly regulated, even the freewheeling US economy. Goods did not flow freely across borders, nor did information about prices. Unions played a much bigger role in setting wages, and wages were often directly linked to inflation, leading to wage-price spirals. Many sectors received protection in the form of tariffs or licences, which limited the price-busting impact of competition.

Finally, it is hard to underestimate the impact of three oil shocks, both in terms of boosting inflation and in terms of slowing economic growth. The oil price, hitherto low and stable, jumped 51% in 1971 as the OPEC cartel started flexing its muscles for the first time. The oil embargo following the Yom Kippur War saw prices rise 200%, setting off a severe global recession, equity bear market and inflation surge. The 1979 Iranian Revolution caused another increase of almost 200%. While economic weakness caused some decline in oil demand, as might be expected, this was completely overwhelmed by the politically driven supply cut-backs.

Crucially, this all happened at a time when the global economy was a lot more dependent on oil than today. Each unit of economic output required much more energy than today, and oil was a bigger portion of the overall energy mix. To use one example, the US Environmental Protection Agency estimates that average fuel economy for light vehicles was 13 miles per gallon in 1975 compared to 25 today. You can now drive twice as far with the same amount of petrol (or gasoline, as the Americans call it). And this excludes electric vehicles.

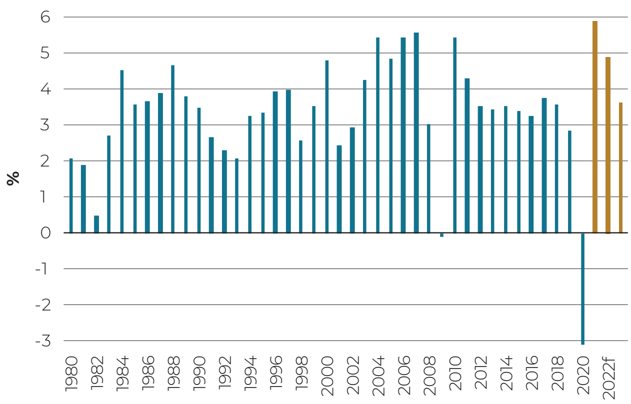
In other words, the recent increase in the oil price from a depressed level is a really small change compared to the 1970s. Inflation is clearly elevated, but it would require a massive shift in behaviour to persist at the current pace for several years. Moreover, the structure of economies has changed dramatically since the 1970s, becoming more open and flexible.

## NOT STAGNANT

The current environment also cannot be called stagflation since there is no sign of stagnation. The International Monetary Fund (IMF) has updated its global economic growth forecasts ahead of its annual meetings. While forecasts should be taken with several pinches of salt, this does represent a view of the future based on what we know today.

Global real economic growth this year is expected to be 5.9%, and 4.9% next year. The IMF did warn that the strong headline growth number hides divergences between countries and sectors, and that its outlook is subject to a number of risks, including further energy price spikes. But if realised, these growth rates would be a very good outcome given the severity of the 2020 recession, and provide ample room for listed companies to grow profits.

**CHART 3: IMF GLOBAL GROWTH ESTIMATE AND FORECASTS, %**




Source: International Monetary Fund

So far, the above relates mainly to the world's advanced economies. Stagflation is unfortunately very common in developing countries. For instance, Argentina's economy is the same size today as it was five years ago in real terms, but the price level has increased fivefold with inflation averaging 40% a year.

The institutional set-up in these countries is often more conducive to inflation. Memories of high or hyperinflation loom large, and this influences behaviour. Trust in authorities, including the central bank, is low. Exchange rate depreciations are usually the trigger, as was the case in Argentina. If the local currency declines during a period of economic weakness, imported prices push up inflation rates. The central bank is then forced to choose between hiking rates to tame inflation and prevent currency freefall or cutting rates to support the domestic economy. The less credible the central bank, the more it usually needs to overcompensate if it decides to push up rates.

On this basis, South Africa is at greater risk of stagflation than, say, the UK, but nowhere near as bad as Argentina or even Brazil. Firstly, because the pass-through from exchange rate weakness to higher inflation has diminished over time and is quite low today (around 10%).

Secondly, the exchange rate itself is supported by elevated commodity prices. Thirdly, the Reserve Bank enjoys a high degree of credibility and most people seem to take it seriously when it says that it wants to keep inflation on target. Finally, as is the case globally, there is no stagnation on the cards even if the growth rate is decelerating from the initial post-lockdown bounce. The IMF has lagged local economists for some time, but has now raised its forecast for South Africa to 5%, despite the impact of the July unrest. It expects 2.2% growth in 2022.

## INVESTMENT IMPLICATIONS

The 1970s was a terrible time for bonds and equities, but great for gold. In fact, much of gold's reputation as a portfolio ballast comes from this period. A rerun of the 1970s is highly unlikely, as is a milder form of stagflation, but sustained higher inflation remains a risk for investors. Firstly, inflation is bad for investors simply because it depresses real returns. But inflation also interacts with asset classes in more direct ways.

Developed market bonds are particularly vulnerable, with yields insufficient to compensate for even modest inflation over the next few years. Yields would have to rise, inflicting capital losses. While many commentators assume that central bankers these days are completely soft on inflation and care only about pumping money into financial markets, this view is mistaken. The heads of the world's major central banks are all in their sixties or seventies. The stagflation in the 1970s would have been a formative experience early on in their careers, and they will not want to be caught off guard the way central bankers were in the age of ABBA and bell bottoms.

Equity returns could come under pressure from two sources, but it is likely to be company or sector specific. Firstly, where firms have pricing power, they can maintain margins and pass on rising input costs to consumers. These companies can actually benefit from inflation as it boosts top-line revenues. Firms that lack pricing power will face severe margin pressure. Since profit margins are already elevated – at record levels in the US particularly – one could argue that they are bound to drift lower anyway. However, if inflation leads to higher interest rates, companies will face pressure on earnings as their debt service costs rise, and customers will feel squeezed too. Higher interest rates act as a brake on economic growth, and therefore profit growth.

Secondly, equities are vulnerable if investors are prepared to pay less for each dollar's worth of profits generated. In other words, price: earnings ratios decline or derate, to use the jargon. The historical experience is that this is exactly what happens when inflation increases and interest rates jump. With global equity, particularly in the US, already at elevated PE ratios, there is plenty of room to derate. South African equities trade at much lower valuations, but are unlikely to escape a correction that emanates from the US.

So this is a delicate moment for investors, but it certainly isn't doom and gloom. Inflation is likely to return to acceptable levels, it is just taking longer to get there. Meanwhile, the global economic expansion is still underway, technological innovation continues apace (and will arguably accelerate as firms try to deal with the current supply chain bottlenecks) and there are investments that offer value, particularly in South Africa.

## EQUITIES - GLOBAL

| DESCRIPTION | INDEX | CURRENCY | INDEX VALUE | WEEK | MONTH-TO-DATE | YEAR-TO-DATE | 1 YEAR |
|---|---|---|---|---|---|---|---|
| Global | MSCI World | US$ | 3 109.0 | 2.14% | 3.39% | 65.02% | 27.63% |
| United States | S&P 500 | US$ | 4 471.0 | 1.82% | 3.78% | 78.34% | 28.37% |
| Europe | MSCI Europe | US$ | 2 055.0 | 2.90% | 3.42% | 38.29% | 28.44% |
| Britain | FTSE 100 | US$ | 9 945.0 | 2.93% | 4.15% | 15.84% | 32.14% |
| Germany | DAX | US$ | 1 703.0 | 2.71% | 1.31% | 1.33% | 20.78% |
| Japan | Nikkei 225 | US$ | 254.4 | 1.78% | -4.19% | -5.63% | 14.08% |
| Emerging Markets | MSCI Emerging Markets | US$ | 1 284.0 | 2.15% | 2.47% | 32.92% | 14.54% |
| Brazil | MSCI Brazil | US$ | 1 625.0 | 2.91% | 3.44% | -16.41% | 12.22% |
| China | MSCI China | US$ | 92.7 | 2.09% | 3.95% | 31.65% | -8.96% |
| India | MSCI India | US$ | 870.8 | 1.76% | 2.69% | 56.05% | 50.65% |
| South Africa | MSCI South Africa | US$ | 481.0 | 3.00% | 5.02% | 8.09% | 27.59% |

## EQUITIES - SOUTH AFRICA (TOTAL RETURN UNLESS INDICATED OTHERWISE)

| DESCRIPTION | INDEX | CURRENCY | INDEX VALUE | WEEK | MONTH-TO-DATE | YEAR-TO-DATE | 1 YEAR |
|---|---|---|---|---|---|---|---|
| All Share (Capital Only) | All Share (Capital Index) | Rand | 67 029.0 | 2.74% | 4.27% | 27.10% | 22.22% |
| All Share | All Share (Total Return) | Rand | 10 857.0 | 2.84% | 4.37% | 40.45% | 27.19% |
| JSE Capped SWIX | Capped SWIX (Total Return) | Rand | 27 846.8 | 1.82% | 2.72% | 28.95% | 32.36% |
| TOP 40/Large Caps | Top 40 | Rand | 9 759.0 | 2.92% | 4.65% | 42.91% | 24.70% |
| Mid Caps | Mid Cap | Rand | 18 961.0 | 1.76% | 0.72% | 23.73% | 40.21% |
| Small Companies | Small Cap | Rand | 25 791.0 | 2.48% | 2.68% | 43.64% | 75.20% |
| Resources | Resource 20 | Rand | 4 903.8 | 4.67% | 10.78% | 82.14% | 27.85% |
| Industrials | Industrial 25 | Rand | 17 353.0 | 2.73% | 3.47% | 39.77% | 15.67% |
| Financials | Financial 15 | Rand | 9 034.0 | -0.03% | -4.00% | -2.95% | 47.40% |
| Listed Property | SA Listed Property | Rand | 1 524.1 | -0.62% | -1.93% | -17.22% | 57.93% |

## FIXED INTEREST - GLOBAL

| DESCRIPTION | INDEX | CURRENCY | INDEX VALUE | WEEK | MONTH-TO-DATE | YEAR-TO-DATE | 1 YEAR |
|---|---|---|---|---|---|---|---|
| US Aggregate Bond Index | Bloomberg Barclays | US$ | 535.3 | 0.23% | -0.13% | 11.78% | -1.39% |

## FIXED INTEREST - SOUTH AFRICA

| DESCRIPTION | INDEX | CURRENCY | INDEX VALUE | WEEK | MONTH-TO-DATE | YEAR-TO-DATE | 1 YEAR |
|---|---|---|---|---|---|---|---|
| All Bond | BESA ALBI | Rand | 799.6 | 0.92% | -0.03% | 26.28% | 12.24% |
| Government Bonds | BESA GOVI | Rand | 789.3 | 0.91% | -0.06% | 25.96% | 12.17% |
| Inflation Linked Bonds | BESA CILI | Rand | 300.5 | 0.19% | 0.93% | 18.55% | 15.73% |
| Cash | STEFI Composite | Rand | 478.4 | 0.07% | 0.16% | 16.43% | 3.79% |

## COMMODITIES

| DESCRIPTION | INDEX | CURRENCY | INDEX VALUE | WEEK | MONTH-TO-DATE | YEAR-TO-DATE | 1 YEAR |
|---|---|---|---|---|---|---|---|
| Brent Crude Oil | Brent Crude ICE | US$ | 84.9 | 3.00% | 8.79% | 57.15% | 97.35% |
| Gold | Gold Spot | US$ | 1 768.0 | 0.68% | 2.37% | 38.02% | -7.00% |
| Platinum | Platinum Spot | US$ | 1 059.0 | 7.62% | 11.01% | 33.54% | 23.28% |

## CURRENCIES

| DESCRIPTION | INDEX | CURRENCY | INDEX VALUE | WEEK | MONTH-TO-DATE | YEAR-TO-DATE | 1 YEAR |
|---|---|---|---|---|---|---|---|
| ZAR/Dollar | ZAR/USD | Rand | 14.55 | 2.60% | 3.58% | -1.39% | 14.28% |
| ZAR/Pound | ZAR/GBP | Rand | 20.08 | 1.25% | 1.15% | -8.76% | 6.92% |
| ZAR/Euro | ZAR/EUR | Rand | 16.94 | 1.95% | 3.02% | -2.77% | 15.00% |
| Dollar/Euro | USD/EUR | US$ | 1.16 | 0.00% | -0.17% | -1.12% | 0.86% |
| Dollar/Pound | USD/GBP | US$ | 1.37 | -0.95% | -1.80% | -6.89% | -6.16% |
| Dollar/Yen | USD/JPY | US$ | 0.01 | 1.82% | 2.70% | 4.26% | 8.40% |

Source: I-Net, figures as at 15 October 2021



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