MarketDesk
Strategy Snapshot

Monthly Report

March 27, 2020

Is the Market Overlooking Stagflation Risk?

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SUMMARY

The coronavirus outbreak continues to impact the global economy. Containment efforts are simultaneously hurting supply and demand. Unemployment is expected to rise in the coming weeks. Economic growth is forecasted to decline sharply. Policymakers are trying to contain the outbreak as it develops. Central banks are cutting interest rates and launching asset purchase programs, while governments are passing fiscal stimulus measures. The biggest question is how long the outbreak will last.

The general consensus is that the U.S. is headed for a recession. From that point, the scenarios diverge drastically and questions arise. Will coronavirus containment efforts create systemic issues? How severe could a recession become? What happens to supply and demand?

Stagflation could arise if aggregate supply drops due to coronavirus containment efforts and aggregate demand falls less due to proactive stimulus measures. Stagflation is an economic phenomenon whereby economic growth slows, inflation increases, and unemployment remains high. The result is slow growth with rapidly rising prices, which can be a devastating economic environment. The combination of these economic forces is rare, because weak economic growth and high unemployment often lead to low inflation. In a stagflation environment, central banks and the government are unable to combat weak economic growth and high unemployment because their stimulus actions create more inflation.

MAIN POINTS

● **Monetary and fiscal stimulus can help support aggregate demand.** Global central banks were already engaged in an easing cycle before the coronavirus fallout, governments are passing fiscal stimulus measures, and the U.S. consumer was strong. After coronavirus containment efforts are relaxed, a case can be made that consumers will resume eating out, traveling, and spending.

● **Aggregate supply faced pressures before the coronavirus outbreak.** U.S. productivity growth remains muted. U.S. fixed investment spending contracted in 2019, which is likely attributed to the ongoing U.S.-China trade war. The current containment efforts are adding more stress to already fragile global supply chains, which could lead to a supply shock.

● Forecasts show GDP is expected to rebound in 3Q20 and return to a normal growth level in 2021 and 2022. Inflation expectations remain low. **The risk is that economic growth remains weak, and inflation surprises to the upside.**

● Markets are assuming consumer demand and supply chains will both either bounce back or decline together. Investors appear to overlook the risk that demand could rebound while supply chains remain pressured. If demand shows up first, what will prevent all of the stimulus bidding for the same products and services to create demand-pull inflation? The result could be a combination of low economic growth, inflation, and high unemployment. **A stagflation scare, even if a low probability event, could be economically disastrous.**

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Winners from Stagflation

B2B Companies at Front of Supply Chain
Raw Material Providers
Consumer Staples
Health Care
Energy

Losers from Stagflation

B2C Companies at End of Supply Chain
Fixed Income (esp. Long Duration)
Consumer Discretionary
Financials
Illiquid Securities

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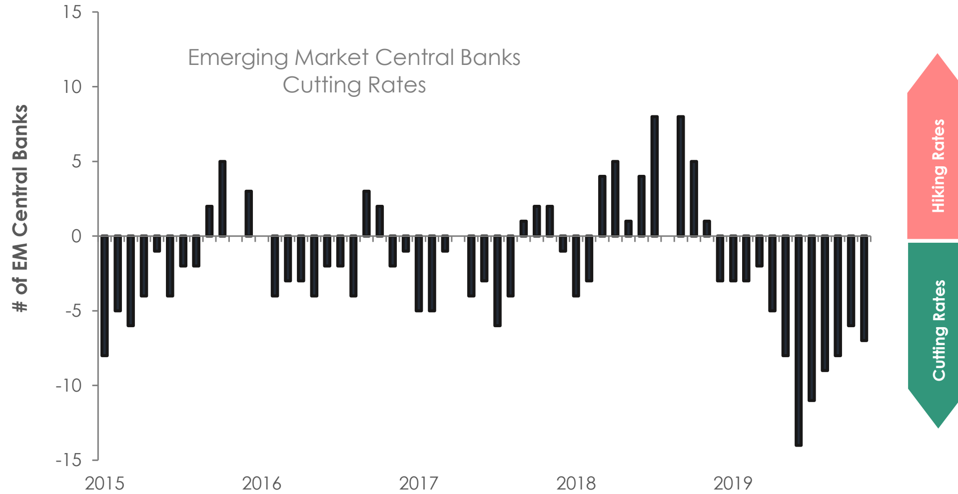
Demand Likely to Remain Supported by Monetary and Fiscal Stimulus Measures

FIGURE 1: Net Number of Global Central Banks Hiking (Cutting) Interest Rates



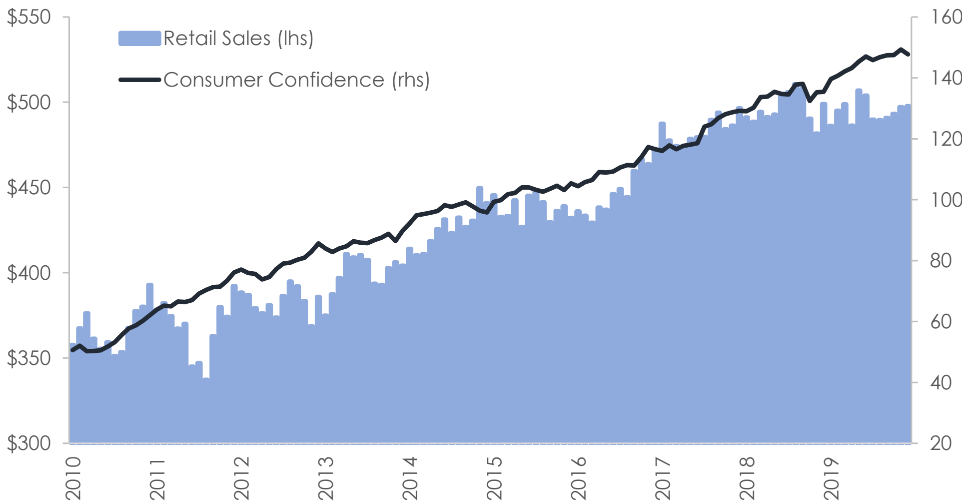
Source: MarketDesk Research, Reuters

FIGURE 2: Announced Coronavirus Monetary and Fiscal Stimulus Measures

Country	Type	Estimated Dollar Amount
U.S. Government	Fiscal Stimulus	$2 Trillion
Federal Reserve	Credit Support	Unlimited
Germany	Emergency Budget	$160 Billion
Bank of England	Asset Purchases	$233 Billion
European Central Bank	Asset Purchases	$820 Billion
Bank of Japan	Asset Purchases	$113 Billion

Source: MarketDesk Research

FIGURE 3: Consumer Confidence and Retail Sales



Source: MarketDesk Research, U.S. Conference Board, U.S. Census Bureau

Figure 1: Global Central Banks Enter Easing Cycle...

- Global central banks entered an easing cycle in 2019 as shown by the net number of emerging market central banks cutting interest rates vs hiking interest rates.
- Trade disruptions were a significant concern for monetary policymakers as the U.S. and China engaged in a tariff battle.

Figure 2: Governments Continue to Announced Fiscal Stimulus Measures...

- Governments continue to announce fiscal stimulus measures, in addition to monetary stimulus measures already announced by global central banks, to support their economies and blunt the coronavirus's economic impact.
- The goal of these fiscal measures is to get cash in citizens' pockets and support aggregate demand while the economy is temporarily slowed due to containment efforts.

Figure 3: Economic Growth Forecast to Rebound in 2H20...

- The general consensus is that the U.S. is headed toward a recession. 1H20 economic growth is expected to contract sharply, while 2H20 is expected to rebound.
- However, 2H20 economic growth expectations are highly sensitive to time. The longer containment efforts are in effect, the lower the GDP rebound.

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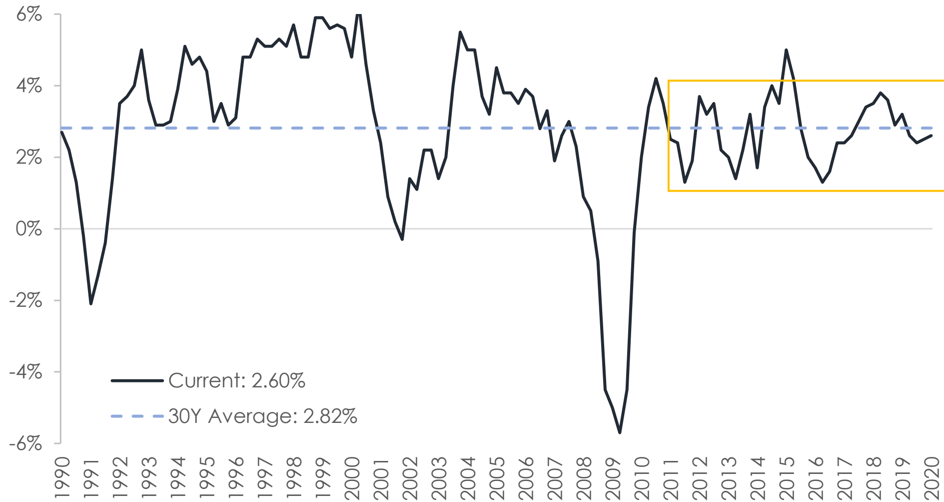
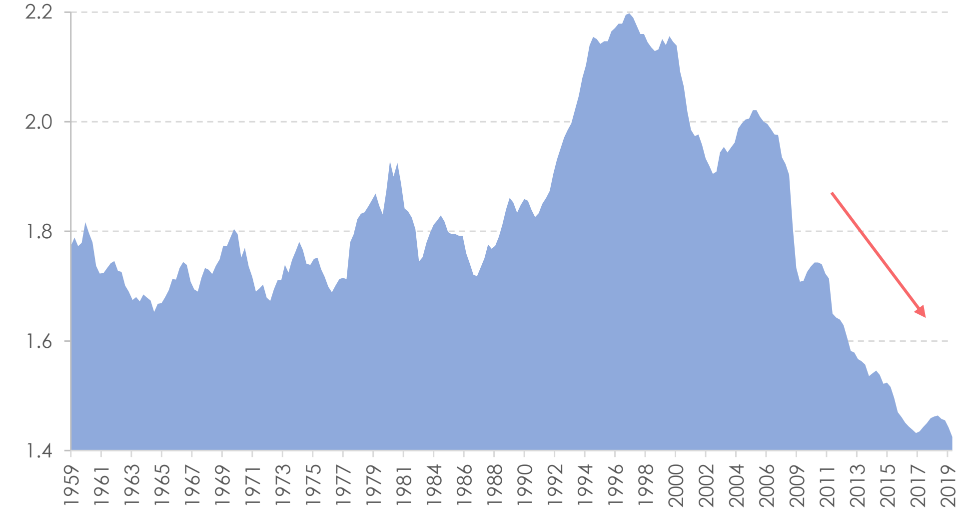
Aggregate Supply Constrained by Productivity Growth, Money Velocity, and Fixed Investment

FIGURE 4: U.S. Productivity Growth - Nonfarm Business, % Change YoY



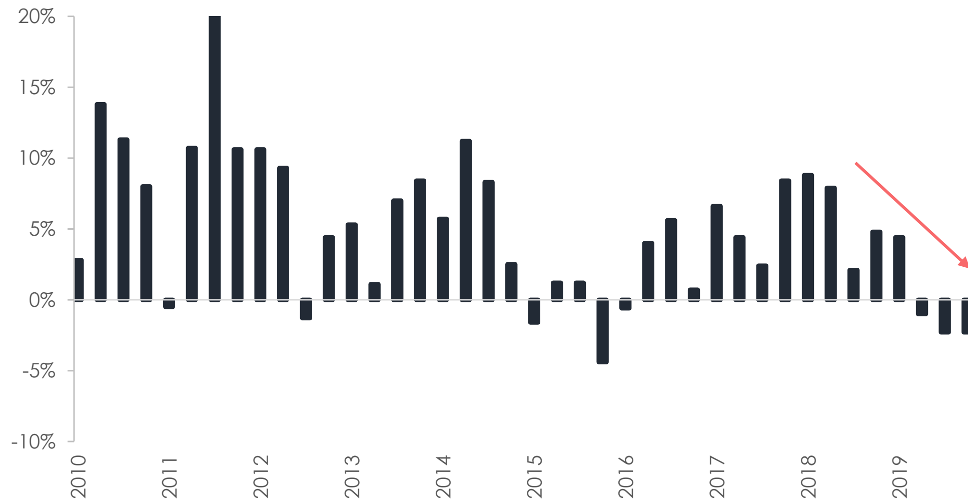
Source: MarketDesk Research, U.S. Bureau of Labor Statistics

FIGURE 5: Velocity of Money



Source: MarketDesk Research, St. Louis Federal Reserve Bank

FIGURE 6: U.S. Nonresidential Fixed Investment YoY Change



Source: MarketDesk Research, U.S. Bureau of Economic Analysis

Figure 4: U.S. Productivity Remains Weak...

- U.S. productivity growth has slowed over the past five years, with the exception of 2018 as tax cuts were enacted and businesses invested in productivity increase.
- Below average productivity growth means less output, which can limit wage growth, dent corporate profits, and constrain aggregate supply.

Figure 5: Velocity of Money Signals Companies & Consumers Could be Hoarding Cash...

- Velocity of money measures the number of times one dollar is spent to buy goods and services. A higher velocity indicates more transactions.
- The velocity of money today is down from the late 1990s peak and sitting at record lows. Current levels indicate businesses and consumers are less willing to part with cash.

Figure 6: U.S. Business Investment Remains Muted...

- U.S. business investment weakened materially during 2019, with YoY growth turning negative. Trade tensions, weak productivity growth, and low money velocity are likely combining to limit business investment.
- The trend is unlikely to change in 2020 as the coronavirus outbreak pressures supply chains.

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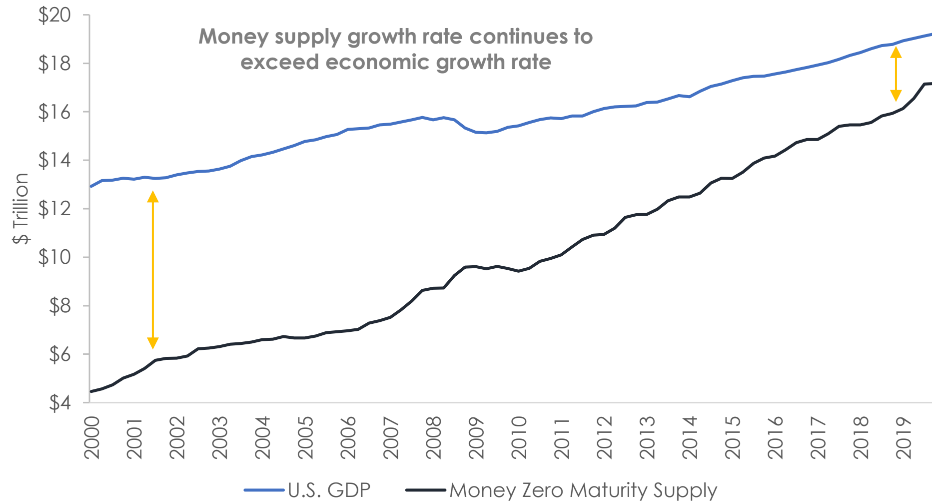
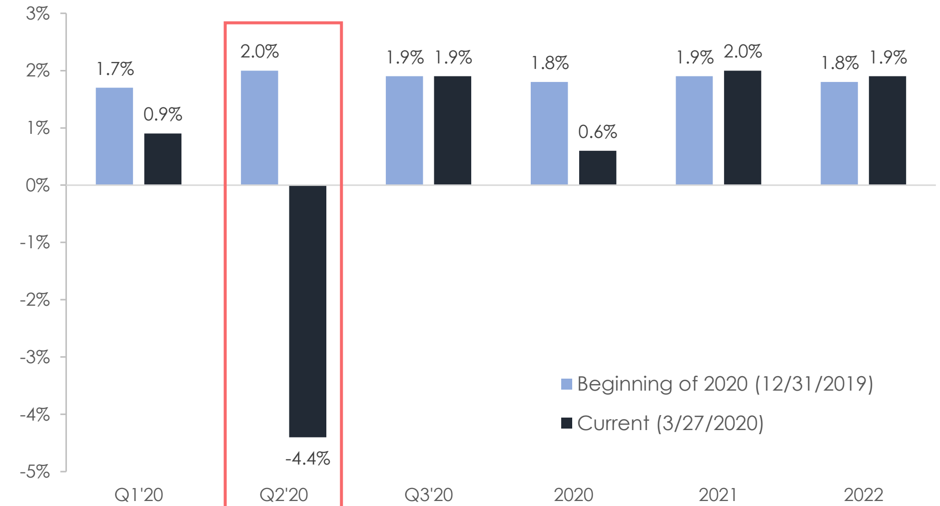
Examining Market Forecasts — Weak Growth and Low Inflation

FIGURE 7: Money Zero Maturity (MZM) Supply vs Total U.S. GDP



Source: MarketDesk Research, St. Louis Federal Reserve Bank

FIGURE 8: Forecasted U.S. Economic Growth



Source: MarketDesk Research, FactSet

FIGURE 9: 5-Year, 5-Year Forward Inflation Expectation Rate

Source: MarketDesk Research, St. Louis Federal Reserve Bank

Figure 7: Money Supply Growth Outpacing Economic Growth...

- The rate of money supply growth continues to exceed the rate of GDP growth. However, the money supply growth has not lead to inflationary pressures.
- If the trend continues, today's coronavirus related monetary and fiscal policies discussed may not lead to an inflation surprise.

Figure 8: U.S. Economic Growth Forecasted to Rebound in 2H20...

- U.S. GDP is forecasted to have declined drastically as the coronavirus outbreak continues to spread. Analysts now project a sharp contraction in 2Q20 as compared to an increase as of year-end 2019.
- Forecasts show GDP is expected to rebound in 3Q20 and return to a normal growth level in 2021 and 2022. However, these projections will change depending on the length of coronavirus containment efforts.

Figure 9: Market Inflation Expectations Remain Low...

- 5-Year, 5-Year forward inflation expectation measures the expected average inflation over the five-year period beginning five years from today.
- The measure plummeted earlier in March 2020 as coronavirus containment efforts dented expected aggregate demand. Investors do not expect inflation to materialize.

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POSITIONING

Investors should prioritize investments in two business models to combat stagflation: pricing power and basic necessities. Companies with pricing power, such as those that mine or manufacture raw materials, can raise prices to combat inflation and protect profit margins. These types of companies are often at the front of the supply chain and engaged in business-to-business sales rather than business-to-consumer sales. Direct exposure to the commodity can also provide a hedge against inflation. Companies that provide basic necessities, such as the consumer staples, health care, and energy sectors, are less likely to experience a drop in demand. It can also be claimed that technology and software are now basic corporate necessities. In contrast, consumer discretionary and financials could face decreased demand for their products and services.

Fixed income would be hurt by inflation, which eats away at interest returns and causes investors to demand higher interest rates. Investors searching for yield, especially those in long-duration fixed income, could experience significant principal drawdowns in a credit sell-off. Slower economic growth could mean credit losses become a higher probability and more severe. Shortening duration and investing across geographies would likely help diversify interest rate risk and issuer exposure, respectively.

Finally, illiquid securities, which have been in demand amid low interest rates, could sell-off significantly as investors rush to liquidate their assets. The impact of leverage unwinding could pressure illiquid securities even more.

LOOKING AHEAD

In our view, there are two significant questions that will determine the potential for stagflation. How quickly will consumer demand return? How quickly will supply chains rebound? A rebound in both demand and supply would mean a less severe economic downturn. However, a rebound in demand without a proportional rebound in supply, could mean high unemployment and a potential inflation surprise in the near-term.

The rebound in consumer demand will be impacted by how long containment efforts last. A shorter quarantine period means a higher probability that demand bounces back more robustly. Unlike the 2008 financial crisis's systemic issues (e.g. weak balance sheets, high nonperforming loan losses), today's lack of capital flow is due to a self-imposed physical shutdown. Because the lack of capital was created by a physical shutdown, it could be at least partially reversed when the shutdown is relaxed. While lack of capital flow can turn into a systemic issue, it does not definitively create a systemic issue. If current stimulus measures can bridge consumers and businesses through a temporary lack of capital flow, the economic impact will be less severe. There is a scenario where the coronavirus is contained in the next 2-3mo, and consumers start spending again by eating out, traveling, and shopping.

A quick supply chain rebound is less certain in our view. Supply chains entered 2020 under pressure from 2019's U.S.-China trade war, NAFTA 2.0 uncertainty, and U.S.-EU trade battle. The coronavirus outbreak further stressed those supply chains, first by shutting down China's supply chains and then by spreading globally. National and state lockdowns have resulted in furloughed employees, raw material shortages, and less consumer demand. A significant amount of damage has already been done to supply chains. This makes businesses more hesitant to scale back up quickly and reinvest in capacity. As a result, we're concerned it will take longer to restart supply chains and rehire former employees.

If demand shows up first, what will prevent all of the stimulus bidding for a lower supply of products and services to create demand-pull inflation? While demand-pull inflation typically results from demand soaring relative to supply, what stops it from emerging when demand stays constant but supply drops? The result could be a combination of low economic growth, inflation, and high unemployment. Though this scenario seems unlikely, stagflation could surface. While we would not expect a return to 1970s stagflation levels, a stagflation scare would be disastrous.

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