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We don't anticipate 'stagflation' in 2022. Here's why.

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Now that our 2022 outlook is out, one of the questions I am getting is why we don't believe 2022 will be a "stagflationary" environment in the United States.

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Well, let's start with the definition of stagflation. Investopedia defines stagflation as an environment "characterized by slow economic growth and relatively high unemployment — or economic stagnation — which is at the same time accompanied by rising prices (i.e., inflation)."

Let's look at each component of that definition:

- **Inflation.** In terms of the inflation portion of the definition, we have certainly seen rising prices. In fact, November US Consumer Price Index data was released on Friday, showing that headline inflation rose 6.8% year over year — which is the highest level since 1991.[1] And yes, we do think inflation could remain high — and even rise further — in coming months. However, our base case for 2022 expects the rate of increase to peak by mid-year as supply chain issues resolve, vaccination levels increase, and more employees return to the workforce. So in the back half of 2022, we do not expect prices to continue to rise at a quickening pace. By that time, the rising prices portion of the stagflation definition is unlikely to apply, in our view.
- **Economic growth.** But where we really think the stagflation definition does not apply even today is when it comes to economic growth. Based on gross domestic product, economic growth is well above trend in the United States and, even though we anticipate it decelerating in 2022, we believe it will remain modestly above trend. What's more, unemployment is low and has been improving quickly. For example, this past week, initial jobless claims in the United States clocked in at 184,000 — the lowest level since 1969.[2] We believe the United States is likely to see continued improvement in employment and reach pre-pandemic levels of unemployment in 2022.

How might 2022 compare with 1970s stagflation?

It's also worth thinking about how the 2022 macro environment might compare to past periods of stagflation.

The main example of stagflation that people rightly worry about was during the 1970s — specifically 1973 and 1979, when inflation shot up following the Arab Oil Embargo and the Iranian Oil Embargo, respectively. These two major oil shocks weren't the only challenge back then, but they were certainly a big part of the problem because they drove inflation up sharply and they hit growth hard all over the world.

So what's different today? It's true that energy prices have surged sharply, but it is more demand-driven than supply-driven. While OPEC+ has instituted some production controls that have seriously limited the growth in output, the current rise in energy prices has been largely driven by demand as economies have re-opened. And more importantly, the global economy is far less energy intensive now than it was in the 1970s.

Now some have suggested that semiconductors are to this economy what energy was to the economy of the 1970s. There is certainly some truth to that — we have become far more dependent on semiconductors; they are part of a variety of products, from washing machines to automobiles to cell phones. And while there have been serious supply shortages for semiconductors, their production is not controlled by a cartel such as the Organization of the Petroleum Exporting Countries (OPEC) in the 1970s. Semiconductor manufacturers want to increase supply to meet demand; there is just a time lag given the need to build foundries to increase production. And it appears that the worst is behind us in terms of semiconductor shortages, which is welcome news as we head into 2022.

Other parts of the 1970s story were, in our view, much worse and much more "stagflationary" than today, especially crucial government actions. In 1973, the Nixon administration imposed price and wage controls and rationing. These included requiring Americans to buy gasoline on odd- or even-numbered calendar days, depending on their license plate numbers. These were effectively Soviet-type policies, which created shortages — first they repressed growth and consumption, and then they boosted inflation when the controls were lifted.

While there are shortages today, they're not due to price controls. In fact, inflation and rising wages should eventually cause more production and more people to come back into the labor market. The shortages reflect pandemic-related problems in the supply chains and deliveries, rather than embargoes or boycotts.

The Nixon administration also de-linked the dollar from gold, and the value of the dollar initially fell quite significantly. This boosted the price in dollar terms of all commodities, including energy, as well as goods. Today, in contrast, the dollar is strong and is tending to appreciate, not fall — which should reduce upward pressure on commodity and goods prices.

Moreover — and perhaps most importantly — the Federal Reserve made major mistakes in the 1960s and '70s. Most important of these was that the Fed repeatedly caved into presidential pressure for easy monetary policy. In 1965, then-US President Lyndon B. Johnson put enormous pressure on the Fed to maintain an easy money policy. It went so far that Johnson reportedly physically attacked Fed Chair William McChesney Martin, throwing him into a wall, when he refused to heed Johnson's request and instead raised rates.[3] After this attack, the Fed didn't raise rates again until after Johnson decided not to run for re-election in 1968, but instead tried to use regulation to slow credit growth (albeit with little success).

In 1973, the Fed cut rates under political pressure from then-President Richard Nixon, even though inflation was rising, which helped spur a further acceleration in consumer prices. Nixon infamously said that he respected the Fed's independence, but expected his Fed Chair, Arthur Burns, to independently draw the same conclusions as him.[4]

Inflation is again a political problem for the Biden administration. In fact, it may be the single biggest problem going into the mid-term elections, with President Joe Biden recently saying that bringing down inflation is his top priority. That gives the Fed another reason to focus more on inflation than on economic growth. An additional reason is that the Fed is starting from a position of extreme accommodation, and so it likely feels more comfortable — and perhaps believes there is a greater need — for normalization of some sort. And so Powell's Fed could be different than the Burns or Martin Feds, which allowed inflation to run without tightening policy, with the Burns Fed actually easing further. We expect the Fed will normalize monetary policy by not only tapering asset purchases but accelerating that tapering at its meeting this week. In other words, it is taking a far more proactive stance in tackling inflation. Now I continue to believe there is a much higher hurdle for raising rates, which is appropriate, but that doesn't mean we won't see a rate hike by mid-2022 depending on economic conditions.

Conclusion

In short, our view is that stagflation is an extremely unlikely scenario in 2022. But that doesn't mean that the Fed isn't concerned about inflation — in fact, moving closer to its "full employment" target means it can focus more on inflation. Navigating the current inflationary environment will not be easy for the Fed. It seems the most appropriate response for the Fed right now should be a relatively neutral policy, neither too loose (to avoid pumping up demand because supply is restricted), nor tight (because that could interfere with investment in raising supply to ease bottlenecks and shortages). And that's just where the Fed seems to be going now.

Happy holidays!

Please note that this edition of Weekly Market Compass will be my last one for 2021. I wish you and your families a very happy holiday season, and I look forward to this commentary returning in the new year on Jan. 3, 2022!

With contributions from Arnab Das, Ashley Oerth and Paul Jackson

Notes

[1]US Bureau of Labor Statistics

[2]US Department of Labor

[3]MarketWatch, "The history of presidential Fed-bashing suggests it has not been a fruitful strategy," Dec. 22, 2018

[4]BBC News, "The perils of a political Federal Reserve," Dec. 10, 2017

Tapering is the gradual winding down of central bank activities that aimed to reverse poor economic conditions.

Gross domestic product is a broad indicator of a region's economic activity, measuring the monetary value of all the finished goods and services produced in that region over a specified period of time.

The consumer price index (CPI) measures change in consumer prices as determined by the US Bureau of Labor Statistics.

OPEC is an intergovernmental organization of 13 oil-exporting, developing nations that coordinates and unifies the petroleum policies of its member countries. OPEC+ is an amalgamation of OPEC and 10 other oil-exporting nations.