Do We Now Need to Worry About Stagflation?

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CIO Weekly Perspectives

Joseph V. Amato, President and Chief Investment Officer—Equities
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We believe high nominal growth, peak rates and broadening earnings performance continue to underpin equity market performance.

Jerome Powell, Chair of the U.S. Federal Reserve, offered a memorable antidote to the gloomy sentiment at his last press conference on May 1: "I don't see the 'stag' or the 'flation'."

It capped a performance that was less hawkish than investors had expected, acknowledging the stickiness of inflation while dismissing fears of another rate hike. By highlighting the incongruity of investors cheering a soft landing in one month and fretting about stagflation the next, it also helped to lift some of the market gloom.

As Powell observed, 1970s stagflation was a toxic mix of double-digit unemployment, almost double-digit inflation and virtually nonexistent growth. By contrast, as we've been suggesting since our *Solving for 2024* outlook back in November, current conditions appear to be more constructive for equity investors.

Haves and Have-Nots

The U.S. 10-year Treasury yield climbed by 50 basis points in the first three weeks of April. The S&P 500 Index slipped by 5.5%, and investors rotated out of cyclical stocks back into quality and the mega-cap technology stocks.

What drove this change? U.S. inflation came in higher than expected for the third month in a row. GDP growth appears to have dropped to 1.6% in the first quarter, after the Atlanta Fed's GDPNow model suggested it would come in at 2.7%. Consumer confidence has taken a knock.

Last week's quarterly Senior Loan Officer Survey from the Fed revealed tighter credit conditions and lower demand for borrowing among U.S. corporations, for example—further signs that higher rates and bond yields could yet slow down economic activity. Lower-income consumers are feeling the pinch more than those in the middle and upper brackets. As rates stay higher for longer, the gap between the consumer and corporate haves and have-nots widens.

The Destination, Not the Journey

Even so, while slower growth and higher inflation can be seen as having some stagflation characteristics, we remain convinced that inflation and rates are trending lower.

The message we take from the past month is that, while rates may stay high as we cover the last mile of excess inflation, we believe it would take a considerable and persistent upside surprise in consumer prices to trigger another hike.

Even at their most pessimistic moment in April, markets still priced at least one rate cut this year. Following some softer growth and jobs data, they are again toying with the idea of two. And as Brad Tank and Ashok Bhatia wrote at the start of this year, the destination is more important for determining risk appetite than the journey.

A return to trend in real GDP growth paired with sticky inflation leaves us with relatively high nominal growth; add modestly declining rates into that mix and in our view it is not difficult to justify positive equity market sentiment.

Stagflation concerns may have persuaded some investors to sell in April. But it is more likely, in our view, that markets were simply due a bit of a breather after bond yields dropped 120 basis points in two months at the end of last year, and U.S. equities rallied almost 30% from the end of October. As such, we think these breathers represent opportunities to add equity market exposure.

Broadening Bottom-Line Performance

Beyond macroeconomic fundamentals, another concern for investors—valuations—is really a concern about expensive mega-cap growth, tech and tech-related stocks.

Outside these parts of the market, valuations are more reasonable. Setting aside pullbacks like the one we saw in April, this year investors have responded to these diverging valuations by seeking more exposure to cyclical, value and small- and mid-cap stocks, in both the U.S. and beyond.

Fundamentals are also improving. As the latest earnings season got underway, we noted early signs of broadening bottom-line performance, and with more than 80% of the S&P 500 Index results now in, those signs have become clearer to us.

According to FactSet, both the number of companies reporting earnings above estimates and the amount by which estimates have been exceeded are ahead of the 10-year average, and eight of the 11 sectors have grown earnings, year-over-year.

To some extent, these upside surprises reflect the caution in management guidance; however, we can add that to the reasons why we think current prices in the broader equity market may not fully reflect earning potential in a high nominal-growth environment.

Life Outside the Large-Cap 'Fortress Balance Sheets'

While this broadening of fundamental performance is reassuring, we are still talking about the S&P 500 Index: among the world's biggest companies, generally characterized by fortress balance sheets, modest leverage and easy access to capital—and therefore less likely to be dependent on the path of interest rates.

That brings us back to the question of the haves and the have-nots.

We view their differing exposure to rates and the cost of capital as a major reason why the Russell 2000 Index has lagged the Russell 1000 Index by eight percentage points over the past 12 months, and why the National Federation of Independent Business's Small Business Optimism Index has hit an 11-year low at the same time the S&P 500 Index is close to an all-time high.

If we were entering a period of genuine stagflation, those smaller businesses would be canaries in the coal mine, warning of trouble about to spread into mid- and large-cap equities. We think it is more likely that declining inflation and rates will ultimately bring some relief to many of these smaller businesses, helping to broaden fundamental strength still further, and bringing macroeconomic data in line with large-cap equity market performance.

A Cautious Eye

We therefore are maintaining a cautious eye on the consumer and corporate have-nots while rates remain at current levels. We would not want to see U.S. real GDP growth weaken much further than it appears to have done in the first quarter. And, like everyone else, we await Wednesday's inflation data with interest.

But we don't see the "stag" and we don't see the "flation," and for that reason, we remain constructive on equities.

In Case You Missed It

- **Eurozone Producer Price Index:** -7.8% year-over-year in March
- **University of Michigan Consumer Sentiment:** -9.8 to 67.4; one-year inflation expectations +0.3% to 3.5% in May

What to Watch For

- **Tuesday, May 14:**
  - U.S. Producer Price Index
- **Wednesday, May 15:**
  - Eurozone Q1 GDP (Second Preliminary)
  - U.S. Consumer Price Index
  - U.S Retail Sales
  - NAHB Housing Market Index
  - Japan Q1 GDP (Preliminary)
- **Thursday, May 16:**
  - U.S. Housing Starts
  - U.S. Building Permits

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