Stagflation or Recession – What's Next?

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Featuring:

Alicia Levine, *Head of Equities, Capital Markets Advisory, BNY Mellon Wealth Management*
John Flahive, *Head of Fixed Income, BNY Mellon Wealth Management*

VO [00:00:01] Is your wealth strategy supporting your long-term goals? Welcome to *Your Active Wealth* with BNY Mellon Wealth Management, where we offer insights that can help you move closer to your goals. We'll tackle timely topics through the lens of the five pillars that comprise our Active Wealth framework, Invest, Spend, Manage, Borrow and Protect, and provide guidance on navigating the unpredictable, to help you build and sustain wealth.

Alicia [00:00:30] Hi, everyone, and welcome back to *Your Active Wealth*, where we discuss topics to help you build and sustain wealth. I'm your host, Alicia Levine, and today we're going to discuss why investors are increasingly fearful that the U.S. will be plagued by the return of stagflation, the unholy union of persistent rising inflation and a weakening economy. In March, a sell-side bank on Wall Street polled institutional investors, and they found that 60% of institutional investors were forecasting stagflation, which is just up from 40% the month before. And investors also voted that recession was the second largest tail risk to markets behind the continuation of the Russia Ukraine conflict. So stagflation, recession, terrible words to hear for an investor. What will it be? Our very own John Flahive, head of fixed income, thinks that neither are likely in the near term. And while recessions are part of normal economic cycles, stagflation like we saw in the 1970s is probably off the table. So I've invited him here today to help me break it all down and to explain what we think is happening. John, welcome to the podcast.

John [00:01:48] Hi, Alicia, thanks for having me on.

Alicia [00:01:50] I think this is great because this is really on the minds of all of our investors. You and I both have very strong opinions about the potential for stagflation and recession in the U.S. for 2022. But before we get to that, let's set the stage and define a very ill-defined term, stagflation.

John [00:02:10] When you think of stagflation, it's really the melding of two words: stagnation and inflation. Think of it the same as motor and hotel, creating motel. And as you mentioned earlier, it's really quite rare, Alicia. It's where unemployment is going up, inflation is also going up, but the economy is going down and that usually doesn't happen. It's very rare to get all those ingredients going the same way, they usually don't do that. And the last time we saw this is in the late 70s, early 80s when we had that commodity shock, when we had those two huge spikes in the 1970s in oil, one from the Middle East oil embargo conflict in 1973 and then later in the 70s from the Iran Iraq conflict. And so that was really the catalyst in the late 70s to produce it. So that's how I would define it.

Alicia [00:03:12] Very unusual. And I'll say this, John. I don't think many investors remember the 70s as a great period for returns for asset classes. So I mean, do you remember anything about that? I just remember sitting in gas lines with my parents, and I think there were like even and odd days, depending on your license plate when you can fill up your tank of gas. It felt like a time when everybody was sort of depressed.

John [00:03:33] Yeah, we were both quite young. I remember that as well. I remember really gas more than oil. And I remember gas being below twenty-five cents a gallon and in the late 70s, it jumping to more than a dollar a gallon, and everybody was shocked. It's a dollar a gallon and that really put pressure on families. Like I always remember, would we be able to take that car trip because it would cost so much? Also remember, we all had big, huge gas guzzlers and cars. It was even more expensive because the fuel mileage was so bad. So I remember, mostly Alicia, on the gas price side.

Alicia [00:04:13] That's right. I remember that conversation a lot. You know, one of the things that the conversation is about now is what do embedded inflation expectations do for already high inflation? Could you explain kind of what this death spiral is all about?

John [00:04:29] Sure, the death spiral concept is really a dynamic that gets into this consumer psychology that you better buy something today because tomorrow it's just going to cost you more money and that feeds upon itself. So the more you go out and buy, the more demand there is, and the more producers are able to increase prices again and supply goes down, demand continues to go up. And it's a death spiral of higher and higher inflation.

Alicia [00:04:55] Before we get too upset here, the good news is that you don't think stagflation in this kind of 1970s style is actually likely. And can you just like, tell us why you think the situation is different today?

John [00:05:08] Well, today we're in a much stronger economy. The unemployment rate just came out, and it shows that unemployment's down there 3.6%. And economy is certainly growing more than trend growth. In fact, much higher than trend growth. So much different today. Also inflation, particularly commodities, were even more extreme in the late 70s than they are today. So we just have a different dynamic really having to do with the idea that the consumer now is in much better condition and consequently be able to handle these increases in prices as opposed to more of the shock level that happened in the late 70s. So the combination of a stronger economy and not as dramatic of a move in commodity prices differentiates today versus the late 70s.

Alicia [00:06:04] Well, that's comforting. Although I'll say this, we did at BNY Mellon Wealth Management, we just increased our outlook for inflation and reduced our forecast for GDP in 2022. In part because of the impact of the war in Ukraine and the effect on commodity and oil prices, as well as the potential for supply chain disruption. And there's some evidence that the inflation is more broad-based than it was six months ago, but we've only changed them modestly. Can you talk about that?

John [00:06:35] Yes, sure. We originally thought that inflation by the end of the year would go back down toward 3 to 3.5%. But we do recognize that some of this inflationary pressure will be more persistent, particularly wages and housing. So our new inflation targets are more along the lines of 3.75% to 4.25% by the end of the year as opposed to 3% to 3.5%. We're also of course decreasing our economic outlook from before we thought it could be as high as 4%, now we're more along the line of in the low threes. Remember, the Fed is in the high 2s by the end of 2022. That's still growth. That's not recession. And so we see a slowing economy and we see slightly more persistent inflation. But that doesn't define stagflation.

Alicia [00:07:34] That's right. And look, I just want to remind everybody that 2% growth is trend growth for the U.S. So anything two or above is actually pretty good growth for the year. So I count that in the good news column. But you know, I like to say, John, that the Fed is sort of dancing on the head of a pin here with managing the growth issue and the inflation issue. Can you explain for us what the essence of the Fed's job is here?

John [00:08:00] Yeah, and it's a tough one today. On the one hand, they're absolutely committed to keeping inflation under control, targeting toward 2% level and keeping employment at the full level. So it's a really difficult balancing act. They want to orchestrate what's called a soft landing, so they slow the economy down enough that inflation correspondingly goes with it and declines, but not so much that they throw us into a recession; allow unemployment to go slightly higher, but not significantly higher. So it's not going to be an easy situation for them to pull off, especially taking into consideration the Russian Ukraine conflict that just makes supply channels more difficult. It makes oil prices higher. So it's really, really going to be tough for the Federal Reserve to pull off when you have Europe, which appears to be even greater likelihood of going into recession because they're closer to the conflict. So it's not going to be easy. So how quickly do they increase short-term interest rates? Do they do it more modestly? Or do they have to be more aggressive to choke off inflationary pressures? And so not an easy situation of the Fed as they look out for the remainder of 2022 and into 2023.

Alicia [00:09:21] That's right. Just to remind everybody, the Fed already had a tough job before Russia invaded Ukraine at the end of February. We already had 40-year high inflation of close to 8%, naturally slowing growth in 2022 given the high rates of last year and the fiscal and monetary support from the pandemic. I think what's deepened the issue and what's deepened the problem is that we've had a continued oil price shock that doesn't seem to go away so quickly if there's a stalemate on the battlefield. And with that, other surging commodity prices, including food, which may threaten some of the developing markets that are dependent on Ukraine and Russian wheat. And on top of that, we have a sense that what may have started, as deglobalization as a result of the trade wars of 2018 and the pandemic may actually get worse as a result of the war in Ukraine. So it's just really played into some of the already existing difficult issues that the Fed has to deal with when thinking about growth and inflation. So I guess the question is the Fed has lately signaled that it's looking to 1994 as a way of achieving a soft landing. So a couple of hikes, which are more than 25 basis points, maybe 50, but then a soft landing. How confident are you, John, that the Fed can orchestrate a soft landing?

John [00:10:52] Well, it's no easy task, that's for sure. And even Chairman Powell himself in a recent quote said no one expressed that bringing a soft landing will be straightforward in the current context. So they've been pretty humble about the challenge ahead. They've already increased interest rates 25 basis points in March and appears that they are most likely going to do another 50 basis points in May and maybe follow that up with another 50 in June because the economy's feeling really strong now. And as we mentioned, it appears that they're certainly ready to be more aggressive and the markets are already pricing this in. I think they have all the tools necessary to increase interest rates enough, but not necessarily slowing down or slamming the economy. So I think it's doable. But it's certainly going to be a challenge, and I don't want to belittle the challenge ahead for the Federal Reserve in 2022.

Alicia [00:11:52] No, so while we think there may not be stagflation, it's certainly clear that a faster and tighter hiking cycle in the near term does increase the risks of recession.

John [00:12:02] In fact, there's been a lot of conversation about the inversion of the yield curve. And what that means is that the yield on 2-year Treasury securities is actually higher than 10-year Treasury securities, and this has been a very good predictor of future economic activity. There's never been a recession without this yield curve inversion that is 2-year yields being higher than 10-year yields. But importantly, monetary policy in this signal are lagging indicators. It takes as much as 15 to 18 months for this to actually occur. So as we look out to 2022, we see very little probability of going into a recession.

Alicia [00:12:48] Let's just talk about some of the strengths of the U.S. economy right now, which you've mentioned the really strong and tight labor market. The household savings rate is high as well as household wealth has gone up dramatically in two years. And we do see some signs of supply chains and the bottlenecks easing. And the retail spending is very interesting because you're starting to see the movement from the goods spending into services, services like travel and doctor's appointments and concerts and going to Disney and amusement parks and things like that. Things that people were very reluctant to do in the middle of this pandemic. So there are signs that inflation on its own may be able to start coming down, particularly with some of the base effects. But I guess what I want to ask you is, if the Fed has a choice and had to choose one over the other, would the Fed fight inflation, or would it worry about hurting the economy? Which one do you think would be most important?

John [00:13:49] Well, that's an easy one. It's inflation. They will absolutely fight inflation. Everything coming out of comments, coming out of Chairman Powell and the rest of the Fed governors are pointing to the idea that the economy's in really good shape. And so mainly again, because of the consumer and the wealth effect. Housing has gone up, the equity markets have gone up. So there's a lot of buoyancy out there in the economy. So when they look at the two problems at hand, it's really the inflation problem that they really have to take on. So clearly, it's the main factor that the Federal Reserve is fighting. The other one is not as important. It's all about fighting inflation.

Alicia [00:14:28] That makes sense really having to get to inflation expectations, as we talked about earlier. But also, there's something here I think about the concern about credibility of the institution and attacking what its main function is, which is to fight inflation. And I think that's part of it as well. So it makes a lot of sense what you just said. But if we don't think there's a recession this year, what about next year? I personally think it could happen. I mean, the yield curve is telling us it might happen. Just wondering what you think about a probability of recession in 2023?

John [00:15:01] Yeah, I kind of agree with you, Alicia, that the probability of a recession in 2023 has leaped forward here, it's a recent dynamic. If you had asked that question a couple of months ago, I'd have said, probably not. But now we're hearing from the Federal Reserve that they're going to be even more aggressive with monetary policy early this year, in the second quarter of 2022. So the time frame for a recession, which we thought was more likely for 2024, has leaped forward into 2023.

Alicia [00:15:34] I want to pivot for a second over to markets. You know, you're head of fixed income, I'm head of equities. So far, the equity market has been surprisingly resilient, and particularly as Powell and a bevy of Fed speakers came out and all but endorsed 50 basis points in May and probably another 50 basis points in June. And the market went straight up, which is remarkable. Nevertheless, as an organization, we think a neutral exposure to equities is appropriate here because we still see this as a year of volatility as the market begins to digest the reality of a faster and tighter fed. We have made some changes under the surface, including we might recommend moving to higher quality, high dividend stocks and also stocks that do well in an inflationary environment. So some of those include the materials and energy. We do like utilities here. And actually, we think a defensive move here would put some tech into the portfolio because if you think there's a slowdown, tech can do well. We made sector moves and we have moved our recommendation to neutral. But in this kind of environment, can you talk about the challenges for bonds? What's your outlook for bonds and what's your advice for investors?

John [00:16:55] Well, yeah, it's been very unsettling. The first quarter just ended, and it's been one of the worst quarters on record, with rates going higher dramatically. It's really, really been a difficult environment for investors to stomach. The result is a lot of throwing in the towel and saying it's just going to get even worse. But we eventually think interest rates will find some form of range. And so the magnitude of negative declines will not be as dramatic as what we've seen here in the first quarter. And I think a lot of the movement in yields have priced in what the Federal Reserve is going to do over the next several quarters. And we actually saw a little bit of recovery in corporate bonds in the latter part of the quarter, too, because fundamentally the economy's in good shape. Corporate profitability is in good shape, and even municipal bonds, from a credit perspective are in very good shape. Their balance sheets have been replenished. There's going to be far more upgrades continuing the theme that we saw in 2021. So as we look at the quarters ahead, we'd like to think that most of the damage is done here in the first quarter of 2022, and we'll have the ability to accrue higher yields. It's one of the dynamics that occurs. Yields have gone up and consequently our reinvestment into those securities, those yields are going to be higher, which increases the probability of having better returns as we look at the quarters ahead. So our mantra all along has been to underweight, but don't eliminate. We still believe that the equity market will outperform the bond market, but we don't anticipate seeing another quarter like we saw in the first quarter of 2022 any time soon. Again, more along the lines of pause and allow the markets to somewhat stabilize and earn more income to produce better total returns in the fixed income space in the quarters ahead.

Alicia [00:19:00] That makes sense because fixed income has been acting as a ballast to riskier parts of portfolios. And one of the things I know you've talked about a lot is the effect of overseas buyers for the U.S. bond market. I can only imagine with the yields at 2.5%, it must attract some buying from overseas, particularly in a world where major central banks are pretty much at zero or close to zero.

John [00:19:25] Yeah, we've been seeing that. Most of the Treasury auctions, there's been a good underlying tone of foreign buying on our securities. Even institutional buyers such as pension buyers, property and casualty life buyers. They find these levels more compelling than we've seen in quite a while. We've actually seen the corporate bond market have a very strong demand as well, even though corporate bond supply was even higher than last year. The market was able to digest it. So there's enough demand if you price the security right at these higher yields. Deals are multiple times oversubscribed, so demand seems to be coming back. It's really digesting the idea of what is the Federal Reserve going to do with short-term interest rates, which will dictate long-term interest rates. As I just mentioned, we think the short-term interest rates, particularly two years to five years, have already taken into consideration the Federal Reserve is going to move short-term interest rates above 2%. So with these higher yields, we're certainly seeing much more demand. And it isn't just foreign buyers, it's strong demand across the board at these new, attractive yield levels.

Alicia [00:20:36] Well, this has been really fascinating, John. What a great discussion. And it's really on the top of mind of all of our clients. So thanks so much for doing this today with me.

John [00:20:47] You're welcome, Alicia. Thanks for having me.

Alicia [00:20:49] So I'm just going to summarize. The bottom line is that we think that stagflation is unlikely. And even though we think risks of recession could rise if the Fed gets too aggressive with its rate hikes, there are enough positive economic factors in the U.S. economy, and we think there's enough resilience in the U.S. economy in the near term to keep the US growing near trends. But we do think that in all asset classes, we're going to see more volatility. It's very rare for the Fed to withdraw liquidity without there being volatility in markets, and we think that 2022 is going to continue being this kind of volatile year. Most important thing, as we talked about in previous podcasts, is not to let your emotions to get the best of you, have your plan, have a yearly investment plan, have a quarterly plan, referred to the plan with their wealth advisor and stick to it because the less likely we are to go with the vicissitudes of the market is more successful, we will be. Thank you everyone for listening today to the episode of *Your Active Wealth* and we look forward to talking to you again.

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