THE KWAMMENTARY

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Stagflation – Santa's least favourite reindeer

♪ *You know Dasher, and Dancer, and Prancer, and Vixen*
Comet, and Cupid, and Donner and Blitzen
But do you recall, the least favourite reindeer of all? ♪

If you were around during the 1970s, you likely met this one. Its name is Stagflation, and in recent months, concerns around it swinging by for the holidays (and beyond) have increased. While the prospect of this happening would be ho-ho-horrible, there is a case to be made that the concerns are not yet fully justified.

What is stagflation?

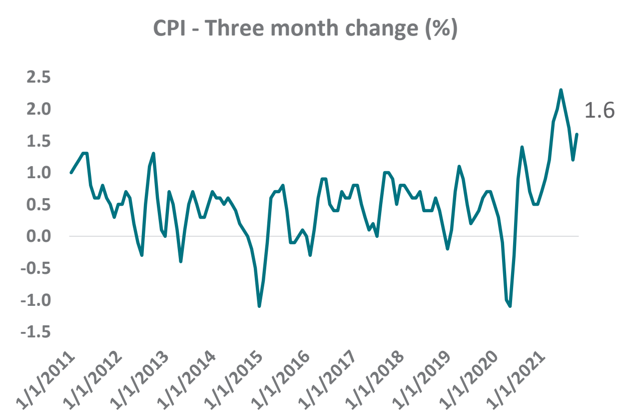
There are four types of price change environments that we can observe:

- **Inflation –** prices change in an upwards direction, either consistently accelerating or consistently decelerating. Typically indicative of a well- to hyper-functioning economy, easy monetary policy, or both.
- **Deflation –** prices change in a downwards direction, either consistently accelerating or consistently decelerating. This can be indicative of an underperforming economy, and/or tight monetary policy.
- **Disinflation –** prices change in an upwards direction, but at a slower pace. Think of an economy transitioning away from a highly expansionary phase toward a more mature growth profile.
- **Stagflation –** an environment where prices are increasing while economic activity is stagnant/decreasing.

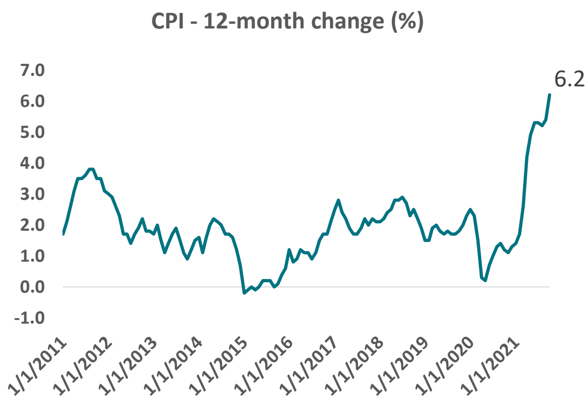
Each type of environment, on its own, is less than ideal when taken to the extreme, although I would argue that stagflation is the most difficult and painful to address. There are a range of tools that governments can use to combat inflation, both monetarily (e.g., money printing or increasing interest rates) or fiscally (e.g., higher taxes or decreasing direct payments), that can cool down demand. Doing any of those things while economic activity is stagnant, however, is a recipe for disaster.

The case for stagflation

Recently, there have been a few data points indicating a stagnant/inflationary environment that has given some investors pause. In the inflation camp, we have gotten a better sense of where things might be heading. The takeaway: inflation is here and will likely be around for a while.



Source: U.S. Bureau of Labour Statistics



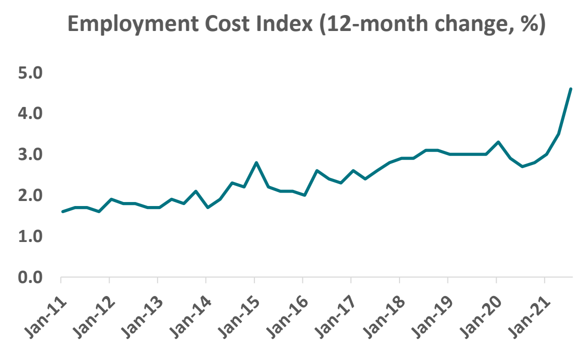
Source: U.S. Bureau of Labour Statistics

The Consumer Price Index (CPI) is a measurement commonly used by economists and investors to get a sense of how prices across multiple items are moving in aggregate. The graphs above and on the previous page are based on activity in the U.S., but the trend can be extrapolated to Canada and the rest of the developed world. When you look at anything from eggs and bread to natural gas and petrol, everything has gotten more expensive. I've spoken about inflation in previous notes, but it is worth providing some updated thoughts, especially given what we've recently seen happen. When I think about inflation, I tend to split it up into two components: the **scarcity component** and the **labour component.**

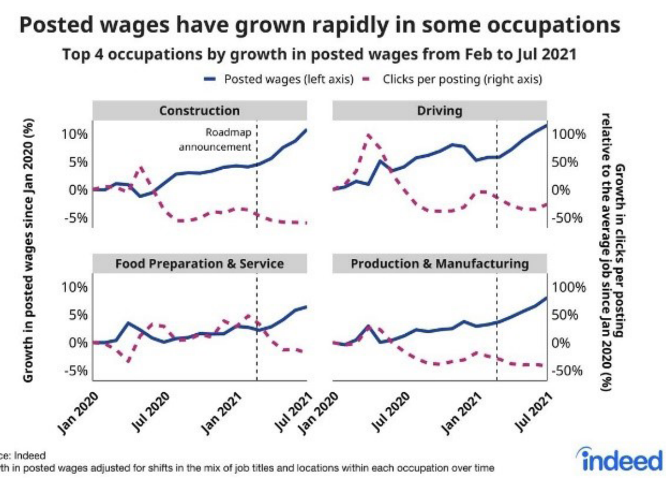
Scarcity: Supply and demand dynamics influence price, as we know, and the intensity of either side will have an outsized effect on how far the price of the good/service will move. In recent months, we have seen the supply side (across multiple products/goods) get squeezed for various reasons, while the demand side has marched upwards. This scarcity, while intense right now, can usually work itself out over time as the various kinks that lead to constrained supply get worked out. How long that will take is anyone's guess, but price changes due to this dynamic generally moderate.

Labour: The cost of human capital to produce goods/provide services is also a key dynamic in pricing. There is a reason why your fast-fashion clothes or the average button-down shirt (which are often highly labour intensive to make) don't cost $200 each. Taking advantage of lower-cost means of production has been a boon to developed economies for the better part of 20 years. However, this is increasingly not the case anymore, and the cost of goods adjusts accordingly.

More locally, the cost of labour for those in the agriculture space, front-line services and construction have increased as a consequence of labour shortages and a lack of interest at previously acceptable wage levels. Unlike the scarcity component described above, wage increases have a tendency to be sticky.

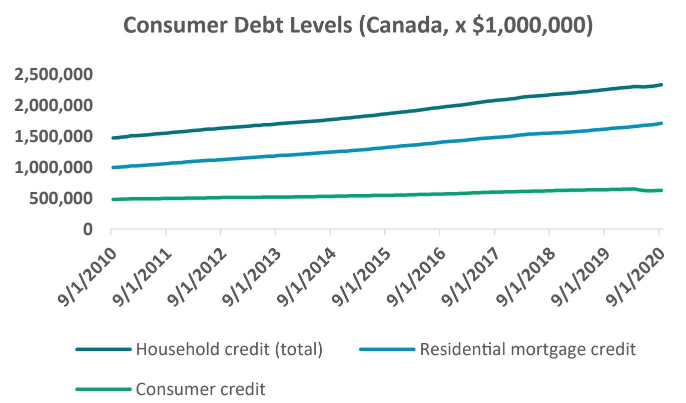


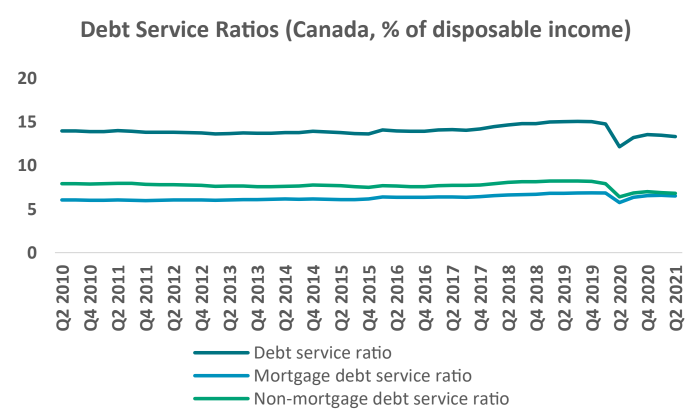
Source: U.S. Bureau of Labour Statistics



When you combine both of those dynamics, I think it's reasonable to expect inflation, in general, to increase persistently in the short to medium term. Longer term, as the scarcity component moderates, price increases should also settle, albeit, at a higher level than they have been historically due to the sticky labour cost component.

What about the prospects of a stagnant economy? So far, the numbers aren't showing it. Gross Domestic Product (GDP) growth in most developed countries has been robust coming out of the most restrictive periods of COVID-19, and that trend is likely to persist (with the occasional hiccup) as seasonality impacts COVID-19 case counts. What has made some nervous is the potential impact that an interest rate increase would have on economic activity. Let's consider the average Canadian and their debt loads.





Source: Statistics Canada

What you can see in the charts above is that debt levels have continued upwards (specifically the top chart), but in terms of the impact on disposable income (bottom chart), the effect has been minimal. This is exclusively a consequence of the ultra-low interest rate environment we have been in since the Great Financial Crisis in 2007/08. Should we enter a period where interest rates need to rise significantly (i.e., to combat inflation), this could prove to be a significant headwind to economic activity. I am picking on Canada at the consumer level, but we are seeing similar trends in multiple developed countries, both at the consumer and government levels.

The case against stagflation: to be continued

At this point, you might be thinking, "Well, Kwame, where's the holiday cheer?" I know the points above are a little gloomy, but I assure you there are more positives to the environment that we're currently in than meet the eye. In the next *Kwammentary*, I will elaborate on why I am not as concerned about stagflation as some may be, as well as what I will be looking for throughout 2022.

As always, very happy to chat.

Sincerely,

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