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What is stagflation?

A guide to a feared economic phenomenon

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Ask most people what they know about stagflation, and they'll say it happens when the economy isn't growing, but prices are, and unemployment figures are creeping up.

To be prepared for stagflation and to minimize its potential harm to your finances, including your retirement, you may want to become familiar with its concepts and implications.

Stagflation is a "perfect storm" of economic behaviors. Yes, growing inflation, rising unemployment and slow growth do put pressure on the economy. But during stagflation, inflation and unemployment are going in the same direction—something they usually don't do. (Typically, if one goes up, the other goes down.)

And stagflation needs two more factors: a period of lax fiscal and monetary policy, plus the appearance of an external supply shock that disrupts the economy.

Stagflation—a word combining "stagnation" and "inflation"— defines an economic condition that hasn't been seen in the US in 50 years. While the last occurrence has been studied extensively, few of today's financial and fiscal decision-makers were proactively making decisions back then. In addition, this potential round of stagflation isn't identical to the earlier one. Several similarities exist, but so do some essential differences.

The last time we saw stagflation

You have to go back to the 1970s to see our economy struggling with stagflation. The economic boom after World War II was fading, manufacturing jobs were being lost and the US was paying for the costly Vietnam War. As a result, unemployment rates grew, as did inflation.

The US and world economies relied heavily on Middle Eastern oil, and an OPEC embargo started in 1973 caused oil prices worldwide to skyrocket. The resulting higher manufacturing costs were passed on to consumers, demand fell, production dropped and more jobs disappeared.

Excess growth in the money supply can be a significant contributor to stagflation. And in the early 1970s, then-Federal Reserve Chairman Arthur Burns was pressured to ease monetary policy to help boost the economy before an election.[1]

Destructive inflationary pressures set in for the decade. It took the audacity of Fed Chairman Paul Volker to reverse the momentum of ever-higher inflation. Interest rates were raised dramatically, starting in 1979, which triggered a severe recession in 1981 and 1982. It took another 10 years—into the 1990s—to convince investors that inflation would not reemerge. The damage to the economy was vast.

How things are different today

Several conditions from the 1970s exist again today. First, inflation has been triggered by the Fed's massive money-printing, artificially low interest rates—and in this case, pandemic-related product shortages. Then, Russia's attack on Ukraine has caused supply shocks in several industries, including wheat exports, but primarily oil. Although the US is less dependent on foreign oil today and doesn't import Ukrainian or Russian wheat, rising global prices have also affected US prices.

But what differs is that the US economy has been far more robust than it was in the 1970s as it recuperated after the COVID-19 shutdowns. For now, unemployment levels are low, with companies struggling to find workers to fill open jobs.

However, the impact of supply chain constraints is unknown, and they go well beyond the energy-driven ones of the 1970s. In our interrelated global economy, we don't just have problems with domestic production,

warehousing and shipping. In addition, rolling shutdowns in factories abroad, plus port shutdowns, have kept our post-pandemic economy from returning to normal. Add the increase in demand caused by the government borrowing and printing money to distribute to its citizens, and the supply chain problem is aggravated.

Once again, the Fed cannot correct supply-chain problems. Its primary action would have to replicate Volker's 1980s solution: raise interest rates until consumer demand breaks—and suffer the consequences throughout the economy.

Is the US at risk of experiencing stagflation?
Experts are at odds about whether the US economy will evolve into stagflation. For now, inflation is proving more persistent than the "transitory" increase described by the Federal Reserve. Economists are monitoring trends in case growth cools from the COVID-19 recovery. US consumers have been able to absorb the higher prices so far, supported by a strong job market. However, consumer expectations are being dampened by volatile high gas prices and fears of the Ukraine war escalating.[2]

Most of all, experts are watching supply disruptions and how the Fed deals with interest rates and the money supply. (You may want to watch them as well.) If the Fed raises rates too much, it could increase unemployment, choke off growth and trigger stagflation.

How does stagflation affect the economy?
For the economy, stagflation can lead to investment distortions caused by inflation levels that are high and uncertain. Shifts in investment can affect flagging economic sectors even further.

For investors, stagflation can cut across most asset classes, leaving few safe shelters. For example, increasing interest rates in fixed-income markets can push bond prices down and depress equity valuations, thus wiping out the traditional safe harbors preferred by retirees.

For households, during stagflation, Americans will be paying more for food, housing, medical and consumer goods while suffering the effects of a bad economy, including job loss. With time, spending will slow, corporations will see their revenues fall and the economy will continue to struggle.

What do retirees fear about stagflation?
Inflation is a factor that can derail retirement plans if it is underestimated during calculations. Resources will not have the expected buying power when called upon to finance a projected lifestyle. The impact can be worse if the inflation rate is higher than the portfolio's growth rate.

Stagflation magnifies the inflation concern even further, as it disrupts the very economy underpinning the portfolio's performance.

Traditionally, those already retired or retiring count on income from relatively safe resources, such as government and corporate debt. However, as the Fed raises interest rates, such debt will lose principal value, and the value of portfolios will decline. For instance, US Treasury bonds have already lost value in recent months.

Not only are the financial aspects of retirement plans affected. Some practical ones could be as well. For example, housing prices are already impacted by high construction costs and a record-low inventory of homes for sale. As a result, record-high prices and higher mortgage interest rates could wipe out any chance to relocate or downsize.

But the main fear comes from the fact that the tools usually used by the Fed and Washington policymakers are ineffective. (They can spark demand, but stagflation is usually a supply-side issue.) Many of the necessary remedies have unpopular consequences that most politicians are unwilling to face.

So how do you prepare for stagflation?
There is no guarantee that the US economy is headed into stagflation, but several required elements are either in place or possibly on the horizon.

US inflation is at 40-year highs, and the Fed sounds hawkish about a string of rate increases. And the supply chain—which the Fed cannot fix—remains broken. In addition, the Ukraine–Russia geopolitical event increases the unknowns, including how the conflict might expand further and influence markets.

Correcting an economy for stagflation is a slow, complicated process. In the 1970s, it led to what many called a "lost decade." If you are already in retirement or 10 to 15 years from it, revisiting your retirement plan is vital. Steps can be taken to mitigate the impact of high inflation—even if stagflation itself never develops.

Alternatives to the traditional combinations of stocks and bonds are available to help protect your retirement. Qualified financial advisors have been exploring such solutions since long before the word "stagflation" entered the recent financial narrative. Most importantly, being prepared is key, so seeking professional guidance may be a wise choice at this time.

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[1] *https://fraser.stlouisfed.org/files/docs/meltzer/jep_2006_abrams_how_richard_nixon.pdf.*
[2] *https://www.conference-board.org/topics/consumer-confidence.*

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