ODDO BHF

MARKET *view*

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Stagflation: consequences for the financial markets

KEY HIGHLIGHTS

- As the risk of a recession increases, we favour defensive equities.
- The economy will slow down which could lead to negative adjustments in earnings estimates in the coming quarters.
- Short-term interest rates will continue to rise and yield curves will likely continue to flatten.

"Brace yourselves for an economic hurricane," warns Jamie Dimon, CEO of JP Morgan. Whether it will be a storm or a full-blown hurricane with severe devastation is, of course, not a foregone conclusion. And indeed, the global economy is currently experiencing a supply shock that could lead to economic dislocation. A supply shock has six economic effects that can be described as follows:

1. Rising commodity prices as a result of the Ukraine conflict lead to a jump in inflation.
2. The rise in inflation acts like an "oil tax": those who spend more at the pump have less money available to buy other goods and services.
3. High inflation sooner or later leads to rising interest rates. In the US, interest rates will probably be raised five to seven times this year; in Europe, we will likely see the first rate in July and September 2022.
4. Rising interest rates lead to lower investment and a slowdown in growth.
5. As a result of a supply shock, uncertainty in the economy increases, following rising input costs, supply chain problems or rising credit defaults for example.
6. A possible further consequence is a wage-price spiral, if trade unions can enforce compensation for rising inflation in the form of higher wages.

In other words, the spectre of stagflation looms. The markets must prepare for a slowdown in growth with high inflation. There is now an 8 in front of the decimal point on both sides of the Atlantic: in the US, annual inflation stands at 8.3% at the end of April and for the Eurozone, Eurostat estimates annualised consumer price inflation at 8.1% at the end of May 2022. The probability that the US will experience a recession in the next 12 months has risen recently. However, it remains at just over 30%. In Europe, the economy is cooling more markedly than in the US. A recession would be unavoidable in Europe if an embargo on Russian gas were imposed or if Russia stopped supplying gas.

The current economic situation - for all the differences that historical comparisons always entail - is reminiscent of the situation in 1973/1974, when Arthur Burns was the head of the Federal Reserve. Monetary policy under Burns is now widely considered to have been too timid, partly because Burns gave in to pressure from the U.S.

President Richard Nixon, who was facing re-election and was calling for low interest rates. The Fed raised interest rates too late and too slowly after the first oil price shock, and could not prevent increased inflation expectations from leading to higher wages. The situation today appears similar: the war in Ukraine is leading to an energy price shock. Brent oil has risen from around USD70 a year ago to USD120 now. In addition, the high stimulus measures under Presidents Trump and Biden have spurred inflation. According to the "Taylor Rule", the Fed is still acting too late and too hesitantly today, as actual inflation is far above the targeted inflation and the US economy is running at high capacity. High inflation will almost certainly force the two major central banks - the Fed and the ECB - to raise interest rates above the neutral rate, which is around 2.5% in the US and around 1.5% in Europe. In addition, the Federal Reserve has announced that it will reduce its balance sheet through quantitative tightening, thus removing liquidity from the market. Investors would be well advised to prepare for an end to the era of cheap central bank money.

Inflation will probably fall more slowly than central banks on both sides of the Atlantic expected at the beginning of the year, given the high energy prices. In our view, a short duration on bonds is still advisable. Short-term interest rates will rise significantly and yield curves will become flatter. Flat or inverted yield curves often indicate a rising probability of a recession. As the probability of a recession increases, we remain cautious on high yield bonds. In the past, it has proven prudent to invest in high yield only after the recession has already set in and yields have risen sharply. We are not there yet. Defensive value stocks will probably continue to outperform expensive growth stocks in a rising interest rate environment. In the following quarters, supply chain problems and rising costs could lead to increased pressure on margins. We therefore focus on investments in companies with high pricing power. We remain fundamentally cautiously positioned and keep equity quotas below the neutral quotas agreed with our clients. China offers a first ray of hope: the latest news from the Middle Kingdom indicate that policy makers will take stimulus measures and relax the strict no-covid policy. As I said, it remains uncertain whether we can expect a mild storm or a severe hurricane.

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