The coronavirus pandemic has disrupted everyday life and caused a devastating impact on the global economy. At the peak of the outbreak, the U.S. unemployment rate reached 11.1% and real GDP growth fell by 9.0%, which marked the second worst economic crisis since the Great Depression. On the bright side, the COVID relief programs and expansionary economic policies projected an air of optimism; as of January 2021, the unemployment rate came down to 6.3% and real GDP growth has started to recover since cratering during the first half of 2020. However, these figures are still at concerning levels, and an emerging fear is that the magnitude of economic stimulus may create a surge in inflation, in spite of middling economic growth. This week’s chart examines the nature of stagflation and how the markets perform under this condition.

The term “stagflation” comes from “stagnation” and “inflation” and can be identified as a period of slow economic growth, high unemployment, and high inflation. An example of stagflation was in the 1970s as shown in the chart. The inflation and unemployment rates (blue and orange lines) stayed in a 10–15% range when the economic growth (purple line) was slow or negative. The typical cause of stagflation is an external shock that breaks the inverse relationship between the inflation and unemployment rate; the high inflation usually indicates that the demand for goods and services is high, the economy is expanding and unemployment is low. In this case, the supply shock of oil was the main contributing factor for driving prices higher, discouraging consumption, and resulting in a recession. Stagflation is not only detrimental to the economy but also difficult
to address. For example, contractionary policies such as increasing interest rates to reduce inflation may make unemployment even worse.

As shown at the bottom of the chart, the U.S. stock, international stock, bond, real estate, and commodity markets held up well during stagflation in the 1970s. The S&P GSCI commodity index returned 54.3% per year and the other markets returned 25% to 28% per year. The international stock market outperformed the U.S. stock market. The commodity market performed best but highly fluctuated with a 0.72 correlation with inflation.

The economic crisis from the pandemic coupled with the aid to boost the economy may seem like a recipe for stagflation. However, impending stagflation is unlikely. The current inflation of 1.3% is well below the central bank’s 2% target, oil prices are stable, the personal consumption expenditure is down but has recovered to 96% of its pre-pandemic level, vaccines are becoming more accessible and IMF projections are generally positive (dotted lines). As the economy further re-opens later this year, the threat of stagflation should dissipate as attention turns toward renewed economic growth.