Bracing for Stagflation

APRIL 2025

QUARTERLY LETTER FROM THE DIRECTOR OF RESEARCH

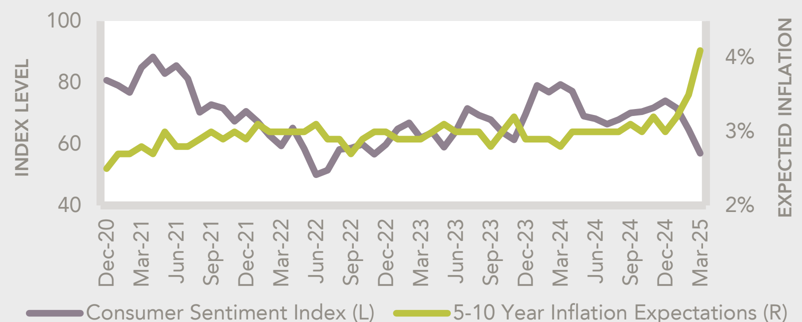
As markets swirl and stagflation fears mount, what should investors do?

Our newsletter last week outlined the broad context of President Trump's new tariff policy as well as the most notable market impacts. Granted, the news seems to change daily, as does the market's reaction; trying to pen a targeted newsletter is an almost worthless endeavor because by the time the ink has dried, markets have shifted due to another policy pivot. In the short term, the omnipresent cloud of uncertainty will continue to drive market volatility and investor sentiment. The best recipe for investors to weather this storm is patience and discipline, both of which can be difficult to come by in the current environment.

As we step back and take a longer-term view of the future, however, the threat of stagflation is becoming more realistic. Coined as a combination of the words "stagnation" and "inflation," it is an economic backdrop characterized by high inflation, slow economic growth, and in some cases, high unemployment. The underlying theory is that as tariffs take hold and drive input prices higher, those higher prices will be passed along to consumers (voila, inflation) and as a result, consumption will fall. U.S. economic growth is heavily reliant on the consumer, so if consumption falls, growth flatlines. With inflation rearing its ugly head, the Federal Reserve has its hands tied and is limited in its ability to cut rates to promote growth. Rates stay higher for longer, and a "doom spiral" of high inflation, higher rates, and low growth takes hold.

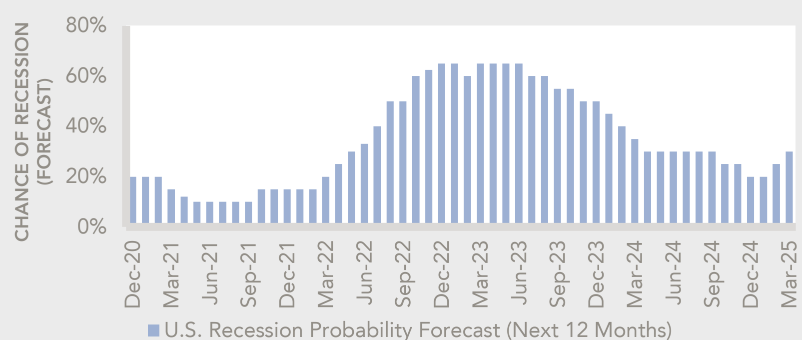
Granted, this is not (yet) the base case for consensus expectations. Nonetheless, it is important for investors to understand what this will mean for their portfolios, specifically which asset classes are most exposed to stagflation and which can offer shelter. Admittedly — and fortunately — the U.S. has not had to battle stagflation since the 1970s, which has been beneficial for growth and portfolios but leaves a limited playbook in terms of investor expectations. Nonetheless, the composition, exposures, and elements of each asset class make this a relatively straightforward exercise.

CONSUMER SENTIMENT SOURS WHILE INFLATION FORECASTS SURGE



Source: Bloomberg as of March 31, 2025

ODDS OF A RECESSION HAVE TICKED HIGHER



Source: Bloomberg as of March 31, 2025. Displays the median forecasted probability of recession based on forecasts derived from the latest monthly & quarterly surveys conducted by Bloomberg and from forecasts submitted by various banks.

FIXED INCOME: *Fixed rate bonds would likely face headwinds*

If the Fed is forced to raise rates in response to higher inflation, bonds are likely to struggle. Interest rates are the primary fixed income risk factor, and rates rise with elevated inflation. Moreover, lower growth signals wider spreads, which would also be a headwind for bond returns. Since March 31, rates — as measured by the 10-year Treasury yield — have increased 25 basis points, equating to a 1.7% loss[1] for the Bloomberg Aggregate Index, the bellwether bond index for institutional investors. If growth does stagnate, there will be a lot of pressure on the Fed to cut rates to stoke growth. However, this would not address inflation and back-end rate rises, and the Fed will need to control inflation first before tackling growth. Furthermore, going to cash is also not an option because wealth will be inflated away. One mitigating factor to note is that current yields of bonds — again measured by the Bloomberg Aggregate Index —are sufficiently high so that even in most rate and spread increase scenarios, returns should remain positive, albeit lower than prevailing yields.

FIXED INCOME: TOTAL RETURN 12 MONTHS FORWARD

TREASURY YIELD MOVEMENT (BPS) \ SPREAD MOVEMENT (BPS)	-100	-75	-50	-25	0	25	50	75	100
-100	16.6%	15.2%	13.7%	12.2%	10.7%	9.2%	7.7%	6.2%	4.7%
-75	15.1%	13.6%	12.1%	10.7%	9.2%	7.7%	6.2%	4.7%	3.2%
-50	13.6%	12.1%	10.6%	9.1%	7.6%	6.2%	4.7%	3.2%	1.7%
-25	12.1%	10.6%	9.1%	7.6%	6.1%	4.6%	3.1%	1.7%	0.2%
0	10.6%	9.1%	7.6%	6.1%	4.6%	3.1%	1.6%	0.1%	-1.4%
25	9.0%	7.5%	6.1%	4.6%	3.1%	1.6%	0.1%	-1.4%	-2.9%
50	7.5%	6.0%	4.5%	3.0%	1.6%	0.1%	-1.4%	-2.9%	-4.4%
75	6.0%	4.5%	3.0%	1.5%	0.0%	-1.5%	-2.9%	-4.4%	-5.9%
100	4.5%	3.0%	1.5%	0.0%	-1.5%	-3.0%	-4.5%	-6.0%	-7.4%

Source: Bloomberg as of March 31, 2025

EQUITIES: *Overall, performance will be challenged*

The combination of low growth and higher prices figures to be an uphill battle for equities, but there are nuances to the asset class, with relative winners and losers across the space.

In terms of possible outperformers, low volatility strategies leap to the front of the line. Indeed, through April 11, the S&P 500 Low Volatility Index is up 2.7% year to date, compared to the commonly cited S&P 500 index which is down 8.5% for 2025.[1] This should not be surprising given that low vol strategies tend to be more defensive and perform well during risk-off environments. More thematically, pockets of value such as cyclicals with commodity exposure (energy) and defensive sectors (utilities, REITs, high dividend stocks) can be expected to outperform. Higher quality stocks — particularly companies that exhibit stable earnings — should also offer some relative protection. Finally, active management in the U.S. small-cap space could provide alpha beyond the benchmark. The small-cap universe is relatively low quality with a higher percentage of negative earners which should allow active managers to separate the winners from the losers.

Defensive value sectors — particularly Healthcare and Consumer Staples — face external headwinds which makes their outlook more of a mixed bag. For Healthcare, trends in the sector including future policy uncertainty and disruption at the Food and Drug Administration as a result of job and spending cuts make the outlook less clear. Additionally, the ever-changing tariff plan and general overhang of uncertainty threaten the outlook and stability of earnings for healthcare stocks.

Non-U.S. developed stocks also face a varied outlook. On the positive side, they are less exposed to growth and IT while more heavily weighted to defensive sectors relative to U.S. indices. Furthermore,

[1] Source: Bloomberg as of April 11, 2025

valuations are materially lower for non-U.S. which provides more upside potential, with the caveat that earnings growth still needs to meet or beat market expectations. Finally, the EU may be more unified going forward as a result of the recent tariff announcements, leading to better coordination on spending and other stimulus measures.

On the other hand, however, non-U.S. indices feature more exposure to banks and Financials, which could drag as growth slows and inflation persists. Luxury goods are also likely to be hurt by low growth and tariffs. Given these dynamics for non-U.S. stocks, their performance is also likely to be mixed in a stagflationary environment.

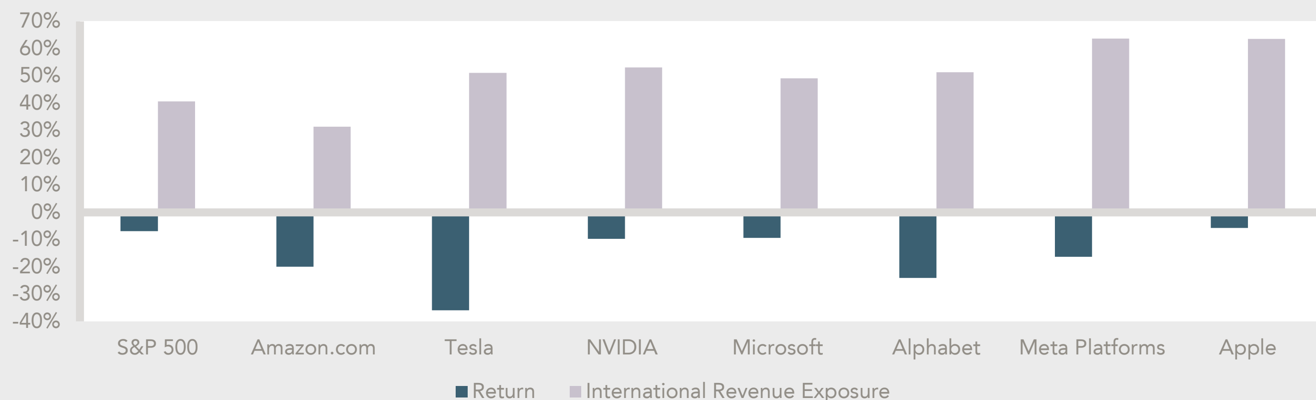
NON-U.S. STOCKS ARE PRICED MORE ATTRACTIVELY

	S&P 500		MSCI EAFE		MSCI EM		MSCI EAFE SC	
VALUATION METRICS	CURRENT	HISTORICAL PERCENTILE (%)	CURRENT	HISTORICAL PERCENTILE (%)	CURRENT	HISTORICAL PERCENTILE (%)	CURRENT	HISTORICAL PERCENTILE (%)
P/E	24.8	90	16.3	65	13.4	70	14.5	39
Forward P/E	18.5	84	13.5	49	10.9	48	10.7	14
P/B	4.8	96	2	74	1.8	63	1.4	41
P/S	2.9	93	1.5	96	1.4	80	0.9	65
P/CF	19.1	93	12.8	91	7.8	46	7.6	23
EV/EBITDA	15.7	94	9.6	12	9.5	88	9	12
Average		91		65		66		32

Source: Bloomberg as of March 31, 2025, data compiled on April 3, 2025. P/E is adjusted for negative earnings; percentiles are based on data dating back to 2000 (except for FP/E, which goes back to 2006).

More broadly across both U.S. and non-U.S. stocks, sectors that figure to be most challenged are banks (as described in the prior paragraph), high growth stocks, and emerging market equities. Growth stocks with negative, low, or volatile earnings streams as well as those with already high multiples are the most vulnerable; the Information Technology sector may face the most damage.

THE MAGNIFICENT 7 ARE MORE EXPOSED TO WORLD MARKETS



Source: FactSet as of March 31, 2025. Returns reflect the period since February 1, 2025, when Trump signed an executive order to implement tariffs.

Emerging market equities tend to do better in a higher growth environment and rely on global trade activity, both of which will be limited in a stagflationary setting. In all likelihood, this would create material headwinds for emerging market stocks.

REAL ASSETS: *Real Estate and Infrastructure should help buoy portfolios*

Tariffs will likely exacerbate already constrained supply and construction pipelines, which is ultimately supportive of pricing for real estate assets. This dynamic could be especially beneficial for strategies focused on multifamily, single-family rentals, and retail. Retail that is necessity-based and/or grocery-anchored offers sticky demand regardless of economic conditions. As such, rent rolls can be maintained while input costs remain stable. Single-family rentals should also support returns as a result of continued household formation and unaffordable home ownership due to high borrowing costs. The low turnover costs within single-family also enhance margins for the sector.

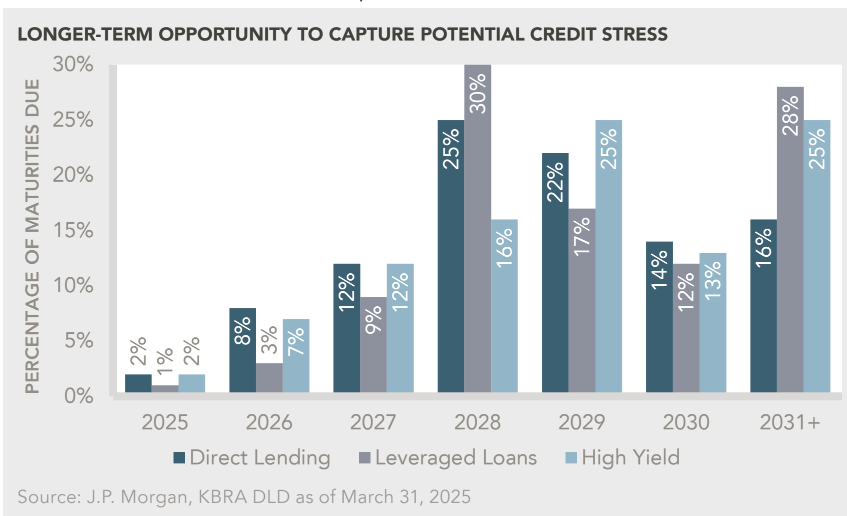
Infrastructure is also attractive and should perform well on a relative basis given its yield-oriented and inflation-hedging nature. Broadly speaking, global developed exposure, stable assets, direct inflation correlation, and investment opportunities as far as the eye can see should help offset struggles from other asset classes. Of particular note is that many of the underlying pricing structures are regulated and indexed to inflation. Demand for infrastructure assets tends to be inelastic which also ensures cash flow durability.

Collectively, the attributes of both real estate and infrastructure assets should help insulate portfolios from a low growth, high inflation/rates backdrop. While not the dominant players in a portfolio — those tend to be bonds and stocks — elements of portfolio diversification like real assets should be accretive from both a return and income perspective.

PRIVATE MARKETS: *Beware funds that employ high leverage*

Given the long-term nature of most private market funds, it will be difficult to gauge immediate fund reactions to stagflation. That said, the very nature of stagflation — higher inflation (and rates) coupled with lower growth — would have a negative impact on borrowers that are highly levered or have weak balance sheets. This dynamic is most common in the upper middle market and large cap space where borrowers are more highly levered. Investors should focus on lower- to mid-market firms that employ minimal leverage and are properly diversified across subsectors, with a word of caution on funds centered around cyclical sectors. Exits could be challenging for larger funds, and the IPO market will almost assuredly remain quiet.

From an opportunity angle, secondary and distressed credit funds would be the most attractive. Market dislocation typically benefits secondary funds, and it should also be noted that mega funds are still sitting on a lot of dry powder which will need to be deployed in the next few years, thus an exit opportunity for small- and mid-market funds. Large funds will pay up for high quality companies from smaller private equity sponsors. On the credit side, distressed, opportunistic, and special situation funds would be the most compelling opportunities to capture mounting stress. This would be more of a longer duration opportunity due to a lack of maturities in 2025 and can be accessed through a variety of channels including credit hedge funds, closed-end drawdown funds, and flexible private credit mandates.

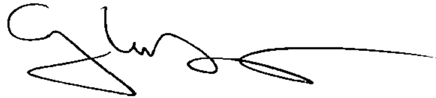


Source: J.P. Morgan, KBRA DLD as of March 31, 2025

Not market consensus, but expectations are important

While stagflation is not a certainty, it is important for investors to understand their portfolio exposures and the likely reactions across asset classes should such an environment take hold. We have worked closely with our clients to build diversified portfolios that can weather market stress across a variety of environments. Generally speaking, stagflation could prove troublesome for traditional portfolio anchors — fixed income and equities — but alternative asset classes and even pockets of traditional asset classes can help shield portfolios from the adverse impacts of low growth coupled with higher rates and inflation. And like any other market dynamic, stagflation would only be temporary before a more "normal" market returns. Again, we stress that stagflation is not a consensus outlook but given the recent tariff announcements and trending economic data, it is not out of the question. Investors are better off understanding what market reactions could look like before finding themselves in such an environment. Similar to other market stress events, rebalancing and adherence to a long-term investment horizon will best position portfolios to rebound from a market slowdown.

Until next time,



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