ECONOMIC AND FINANCIAL DIGEST

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Stagflation Redux?

Whether or not the Mideast conflict is resolved by the time you read this, the scars from the war will linger and create headaches for policy makers, investors and the average man and woman on Main Street. The betting on Wall Street is that the war will not last long enough to do serious damage to the economy, and the short-term hit will be recouped over the second half of the year. By 2027 when the geopolitical landscape returns to normal, the odds become more favorable for a resumption of an enduring and balanced expansion.

We generally agree with that bet, but it is a gamble that many are understandably not willing to take. Even absent the current war, the economy has hardly operated in a normal environment in recent years, beginning with Russia's invasion of Ukraine that stoked the first round of oil price spikes, an unprecedented tariff blitz, a government shutdown and a volatile political setting, featuring a highly polarized Congress that stifles the advancement of meaningful legislation. And while the headline economic data looks generally positive – with a historically low unemployment rate, decent GDP growth, and healthy corporate profits – the public's mood has been in the dumpster, with a high percentage of households having a dim view of their jobs and income prospects.

Most immediately is the pain from higher oil prices, particularly for lower-and middle-income families who devote a larger share of their budgets to gasoline and utility bills. The timing for motorists is particularly bad, as the increased cost of filling up at the pump comes less than a month before the peak driving season gets underway. For many that means fewer trips or sacrificing other purchases. True, when the conflict ends – it will sooner or later – oil prices will come down. But as we have pointed out before, gas prices go up the elevator and down the staircase so the relief on budgets will not come as swiftly as the pain that was delivered. Simply put, the economy will be squeezed on both sides of the ledger – higher inflation and slower growth – at least through the spring and early summer.

Stagflation Echoes

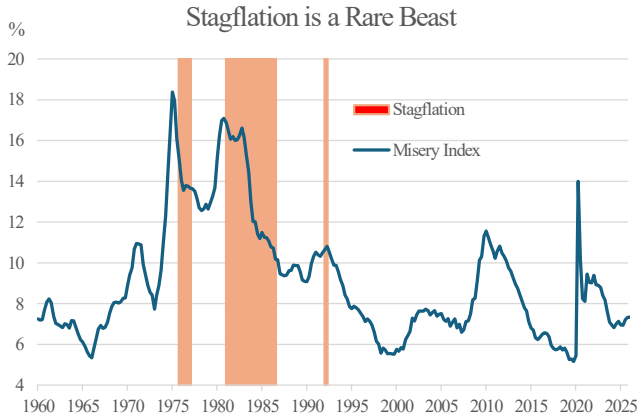
Clearly, the dramatic climb in oil prices and the slow retreat that lies ahead mean that inflation this year will be significantly higher than thought before the outbreak of the war. At the same time, the increasing bite inflation is taking out of incomes, particularly for lower income households, means that spending and overall growth will also be lower than expected, particularly over the near term. Many view that unenviable combination – slower growth and rising inflation – as a sign that the dreaded stagflation of the 1970s is poised to return, giving the Federal Reserve a severe case of migraine.

But while that combination is unfolding and making life difficult for the Fed, labeling it as stagflation would, in our view, be off base. While there is no universally agreed upon definition of stagflation, rising inflation while growth is slowing is too loose of a definition – the U.S. has seen that combination about thirty percent of the time since 1960. A better approach is to assign thresholds for inflation and unemployment that can be used as a barometer of the condition. The simplest and most commonly used yardstick to track the progress of stagflation is the so-called misery index – a combination of inflation plus the unemployment rate. That index surged in the 1970s and remained elevated through the early 1980s.

But at what level does the index tell us we are experiencing a stagflation episode? A lot of research has been devoted to that question. One measure that many agree best describes the condition is when the unemployment rate is 1 percent above where it would be at full employment, and inflation is 1 percent above its 2 percent target — and that combination lasts for at least a year. On that basis, stagflation has rarely been seen outside of the three episodes in the 1970s and early 1980s. The question is, what causes that condition to come about, which almost always leads the economy into a recession.

The Catalysts Are Not in Place

While the causes of stagflation in the 1970s are still being debated, three crucial features played commanding roles. First, the quadrupling of oil prices in the wake of the OPEC embargo in 1973 and a further tripling of prices following the Iranian revolution in 1979. Second, a politically motivated Federal Reserve began setting monetary policy too loose in the late 1960s. That



allowed inflation expectations and wage demands to spiral upwards. Third, a slowdown in productivity growth, as postwar technology gains waned and the oil shocks themselves forced painful structural change.

The closure of the Strait of Hormuz echoes the first point, although the jump in crude oil prices since the beginning of the war has not yet rivalled those prior shocks. The disruption would have to persist for far longer to ignite a similar sized climb, and even then, the declining oil intensity of the U.S. economy means it is less vulnerable today. On the second point, the risks of a politically motivated central bank have increased, but that still appears to be highly unlikely. Fed Chair nominee Kevin Warsh, who is now on the road to confirmation, will only be able to lower interest rates with the support of a majority of the 12-voting members of the Federal Open Market Committee.

Most Fed officials have steadfastly reaffirmed the importance of independent monetary policy making and have repeatedly made statements that they seek to guard against a rise in inflation expectations, unlike that which occurred alongside the Fed's declining credibility in the 1970s. The last tightening cycle in 2022 was a prime example of that in action, with the Fed tightening even as most economists forecast that it would push the economy into a mild recession.

Productivity is Key

The productivity outlook is the complete reverse of the situation in the 1970s. Whereas productivity growth stalled in that decade, the outlook today appears strong. Labor productivity, or output per hour worked, has been rising at an average annual pace of roundly 2.5 percent,over th e past three years, up from 1.5 percent from 2010 to 2020. The acceleration has reflected a combination of capital deepening, as firms invest more in R&D and software, as well as the increased efficiency with which the investments are being used.

Importantly, the rapid adoption of AI technology should give productivity another boost over the next decade. Most research indicates that improved productivity will add around 0.3 percent to the annual growth rate in GDP. That's particularly important because the labor force is stagnant and not expected to grow much, if at all, in coming years owing to an aging population and less migration. Keep in mind that economic growth depends on two drivers – the increase in the labor force, including those employed and those looking for work, and the output generated per hour of work, or productivity. The productivity boost would offset the slack from the slower growth in the labor force.

Even as productivity boosts growth, it also provides a big check on inflation. With the limited supply of workers coming on stream, their bargaining power for higher wages would ordinarily increase if the demand for workers stayed the same. But productivity improvements mean that employers need less labor to generate output, so the demand for workers would be correspondently reduced. Even better, since each worker would generate more revenue per hour, employers would be able to increase wages without cutting into profits. Simply put, productivity improvements are a time-honored vehicle that lifts living standards.

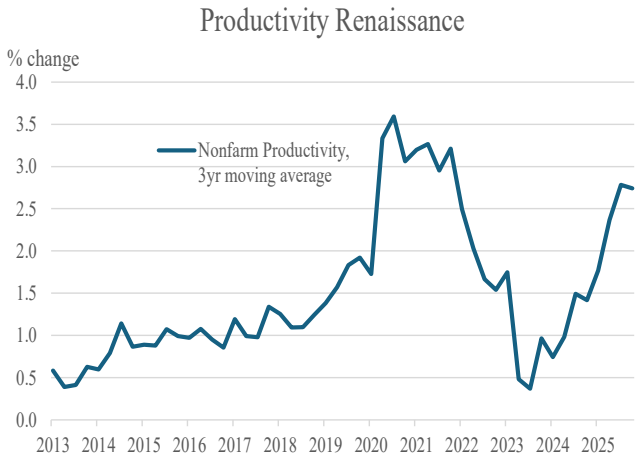
A Shared Risk with 1970s: Huge Deficits

For stagflation to become a reality in today's economy, we would need to see a confluence of factors shift. First, the current disruption to the global energy supply would need to persist far longer than is likely under the temporary closure of the Strait of Hormuz, or for similarly large shocks to supply to become commonplace over the coming years. Second, if that were to happen and bleed through to stronger wage growth and inflation expectations, we would need to see evidence that the Fed is turning a blind eye, entrenching higher inflation for longer. Finally, higher inflation alone would not drive the economy into stagflation. We would need to see some signs of economic stagnation as well, which would require a rapid turnaround in the strengthening of productivity growth in recent years.

The biggest vulnerability that the economy today shares with the 1970s is the large and persistent fiscal deficit. That was a key failure in the 1970s when every expansion of government social and military spending created inflationary pressure the Fed felt obliged to accommodate. As Arthur Burns, the Chair of the Federal Reserve for most of the 1970s later admitted the Fed did not want to be seen as "frustrating the will of Congress".

It remains to be seen if the incoming Federal Reserve Chair, Kevin Warsh, will bend to political pressure like Burns and strive to shape policy in a way that is not warranted by economic conditions. In his confirmation hearing, Warsh strongly defended the need for Fed independence and as noted earlier, he would need the collaboration of other Fed officials to successfully put through ill-advised decisions; that's highly unlikely given the current makeup of the voting members on the rate-setting committee. Besides, the financial markets are highly sensitive to misguided policy decisions and would manipulate market prices – on stocks and bonds — to counter their effects. The so-called bond vigilantes are very good at policing these things.

Every President wants the Fed to cut interest rates, as it boosts economic activity and job growth, and the current President is no exception. The Fed's job is to make sure that rate cuts would do more good than harm, i.e. stoking higher inflation. So far, that's not the case as the economy is holding up, unemployment is historically low, and inflation is stubbornly above the Fed's 2 percent target. However, the biggest inflation driver, the oil shock, should soon fade and with productivity advances checking inflation, the stage should be set for a more accommodative policy over the second half of the year.



KEY ECONOMIC AND FINANCIAL INDICATORS

Financial Indicators *

	March	February	January	December	November	October	September	12-Month Range High	12-Month Range Low
Prime Rate	6.75	6.75	6.75	6.83	7.00	7.23	7.38	7.50	6.75
3-Month Treasury Bill Rate	3.61	3.57	3.57	3.59	3.78	3.82	3.92	4.25	3.57
5-Year Treasury Note Rate	3.85	3.78	3.78	3.70	3.67	3.65	3.66	4.02	3.65
10-Year Treasury Note Rate	4.25	4.21	4.21	4.14	4.09	4.06	4.12	4.42	4.06
30-Year Treasury Bond Rate	4.85	4.84	4.84	4.80	4.70	4.64	4.74	4.92	4.64
Tax-Exempt Bond Yield	4.84	4.77	4.79	4.80	4.77	4.77	4.96	5.27	4.77
Corporate Bond Yield (AAA)	5.48	5.34	5.34	5.31	5.26	5.13	5.21	5.54	5.13
Conventional 30-Year Mortgage Rate	6.18	6.10	6.10	6.19	6.24	6.25	6.35	6.82	6.10
Dow Jones Industrial average	46860	49138	49138	48119	47016	46710	45908	49138	39876
S&P 500 Index	6654	6929	6929	6853	6741	6736	6584	6929	5370
Dividend Yield (S&P)	1.21	1.16	1.15	1.15	1.16	1.16	1.19	1.43	1.15
P/E Ratio (S&P)	25.6	26.9	27.7	27.3	27.2	28.4	27.8	28.4	23.8
Dollar Exchange Rate (vs. Major Currencies)	119.9	119.2	119.2	120.6	121.8	121.2	120.5	124.5	119.2

* Monthly Averages

Economic Indicators

	March	February	January	December	November	October	September	12-Month Range High	12-Month Range Low
Housing Starts (Thousands of Units)			1487	1387	1324	1272	1328	1490	1272
New Home Sales (Thousands of Units)			587	712	764	650	719	764	587
New Home Prices (Thousands of Dollars)			401	419	405	404	417	425	397
Retail Sales (% Change Year Ago)	4.0	4.0	3.3	2.4	3.2	3.2	4.1	5.00	2.4
Industrial Production (% Change Year Ago)	0.7	1.2	1.5	1.3	1.8	1.8	1.9	1.9	0.1
Operating Rate (% of Capacity)	75.7	76.1	75.6	75.7	75.4	75.6	76.1	76.4	75.4
Inventory Sales Ratio (Months)		1.33	1.35	1.36	1.37	1.38	1.37	1.39	1.36
Real Gross Domestic Product (Annual % Change)				0.5			4.4	4.4	-0.6
Unemployment Rate (Percent)	4.3	4.4	4.3	4.4	4.5	4.5	4.4	4.5	4.1
Payroll Employment (Change in Thousands)	178	-133	160	-17	41	-140	76	178	-140
Hourly Earnings (% Change Year Ago)	3.5	3.8	3.7	3.7	3.9	3.9	3.8	4.0	3.5
Personal Income (% Change Year Ago)		3.7	4.3	4.5	4.6	4.7	5.4	5.6	3.7
Savings Rate (Percent of Disposable Income)		4	4.5	4	4.0	4.0	4.3	5.5	4
Consumer Credit (Change in Blns. Of Dollars)		9.5	7.7	15.8	3.2	7.9	13.5	64.0	-4.3
Consumer Prices (% Change Year Ago)	3.3	2.4	2.4	2.7	2.7	2.7	3.0	3.3	2.3
CPI Less Food & Energy (% Change Year Ago)	2.6	2.5	2.5	2.6	2.6	2.6	3.0	3.1	2.5
Wholesale Prices (% Change Year Ago)	3.6	3.5	3.4	3.4	3.6	3.4	3.0	3.6	2.4

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