June 2022 Client Question of the Month: Stagflation

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The term stagflation has become more prevalent over the past several months as inflation continues to run hot and the economy wrestles with a lot of uncertainty. We thought it would be helpful to define stagflation and look at how the economy and market performed during previous occurrences. We also describe how we are positioning portfolios and how we would manage during a potential recession. Note that while an upcoming recession is not set in stone, it is still prudent to think about how to manage during these inevitable periods. Please see below for the Winthrop Wealth Framework for Navigating Volatile Markets where we outline that the mindset paired with a comprehensive financial plan and a thorough investment process can provide confidence in working towards your long-term financial goals, especially during challenging periods.

We understand that market volatility is stressful and there is a lot of noise out there. Please do not hesitate to contact us if you have any questions or you would like to discuss your individual circumstances.

What is stagflation?

Stagflation is defined as a period with a significant slowdown or decline in economic growth combined with high inflation. An easy way to measure stagflation is through the misery index, which is simply the sum of the unemployment rate and CPI inflation. Typically, the unemployment rate and inflation move in opposite directions. A stagflationary environment occurs when the misery index spikes to higher-than-normal levels. The word stagflation has not been around for very long, British politician Iain Macleod coined the term in 1965.

When has stagflation occurred in the United States?

The Federal Reserve characterizes 1965 to 1982 as the Great Inflation period in the United States. Many economists point to the 1970's as the most famous example of stagflation in this country.

Bloomberg News provides a great summary of the period: In 1971, President Richard Nixon reacted to balance-of-payments pressures by taking the US off the gold standard. The decision set the stage for a decline in the value of the dollar against other currencies throughout the decade, which added to inflationary pressures at home. Nixon tried imposing wage and price controls to combat inflation without much success. Then in 1973, Arab members of OPEC placed an oil embargo on nations they blamed for supporting Israel in the Yom Kippur War, leading to skyrocketing oil prices. As a result of a supply shock, US businesses not only passed along those costs but also cut back on production. That made goods scarcer, adding to a rise in inflation. At the same time, cutbacks in production led to increased unemployment. (Source: Why War and Its Oil Impact Revive Stagflation Fears, Bloomberg News)

The following table shows economic and stock market data for the 1970's. Economic data started to deteriorate with a spike in inflation starting in 1973. By the end of 1974, the misery index reached 19.5%. The stock market especially struggled from 1973 to 1974, when the S&P posted a peak-to-trough total decline of nearly -45% from January 1973 to October 1974. Note that if an investor had awful timing and put money in the S&P 500 in January of 1973, they were back to even in about three and a half years. We will also continue to highlight the power of maintaining a long-term viewpoint as stock market still produced a decent return for the entire decade of the 1970's, with the S&P's total and annualized return at +77.0% and +5.9% respectively.

1970's United States Economic and Stock Market Data												
Data	1970	1971	1972	1973	1974	1975	1976	1977	1978	1979	Total Return	Annualized
Real GDP Growth (Y/Y)	0.2%	3.3%	5.2%	5.6%	-0.5%	-0.2%	5.4%	4.6%	5.6%	3.2%		
Unemployment Rate	6.1%	6.0%	5.2%	4.9%	7.2%	8.2%	7.8%	6.4%	6.0%	6.0%		
CPI Inflation (Y/Y)	5.6%	3.3%	3.4%	8.7%	12.3%	6.9%	4.9%	6.7%	9.0%	13.3%		
Misery Index	11.7%	9.3%	8.6%	13.6%	19.5%	15.1%	12.7%	13.1%	15.0%	19.3%		
S&P 500 Total Return	3.94%	14.30%	19.00%	-14.69%	-26.47%	37.23%	23.93%	-7.16%	6.57%	18.61%	77.0%	5.9%

Source: Bloomberg

Are we entering a period of stagflation?

The current period can be characterized by high inflation, still solid economic growth, and a lot of uncertainty. Recent inflation readings have reached their highest levels in decades due to supply chain bottlenecks, surging energy prices, massive amounts of stimulus, and pent-up demand. The economy is expected to increase by +3.1% in 2022 due to a strong labor market and consumer. However, there is a tremendous amount of uncertainty caused by Fed tightening expectations, the Russia/Ukraine War, and China's covid lockdowns. Both the war and China's covid policies are putting more pressure on global supply chains and upward pressure on already elevated inflation. The Fed has started tightening monetary policy by raising interest rates and decreasing the size of their balance sheet. The longer inflation stays elevated, the more likely it becomes that the Fed will have to overtighten monetary policy and potentially cause a recession to finally bring it down.

There is some evidence that inflation peaked around March of 2022, but the more important question will be how fast the readings decelerate to more normalized levels. If inflation stays stubbornly high over the next several months, the economy will likely officially enter a stagflationary environment. If inflation starts to moderate, the Fed can back off tightening and the economy will likely avoid a recession or severe slowdown. Right now, our sense is still that the economy will avoid a stagflationary environment. However, we will reiterate that the present environment is highly uncertain.

How are we positioning portfolios in an inflationary environment?
For over a year, we have been positioning portfolios to try and combat the rise in inflation.

- Holding little cash in portfolios: Inflation has the most destructive impact on cash as the purchasing power is eroded over time. Assume that a savings account yields zero while inflation is about 2% each year. This means that after one year, the purchasing power of the cash in the savings account is worth 2% less. Assuming the same variables, after ten years, the purchasing power is worth about 22% less. We do not recommend holding large sums in cash unless it is to fund an upcoming expense.
- Avoiding long-term bonds: Long-term bonds have the highest interest rate sensitivity (duration). Typically, interest rates also increase in an inflationary environment, which puts downward pressure on bonds (interest rates move inversely to bond prices). As interest rates move higher, long-term bond prices decrease more than intermediate or short-term fixed income securities. Note that while we have avoided long-term bonds for a while, they have become more attractive recently after the increase in interest rates and corresponding rise in yield-to-maturity.
- Overweight equities of companies that are able to grow their cash flows, earnings, and dividends: When you buy a share of stock, you are purchasing an ownership stake in the underlying company. Your ownership stake represents a claim on the firm's cash flows, earnings (profits), and dividends. Stock prices reflect the present value of the company's expected future earnings. Some inflation can benefit stock prices if companies can raise prices higher than costs, thereby increasing earnings. One of the major benefits of stocks over bonds, is that a company's earnings and dividends are not fixed. We have tilted toward quality companies with strong balance sheets, cash flows, and pricing power than can best help navigate a volatile and inflationary environment.

How will the markets and economy perform in a recession?
The following actions will probably occur during a recession: equity markets will decline by more than -20% from their peak, credit spreads will widen, yields on government debt will fall as investors flock to safety, consumer confidence and spending will decline, aggregate demand will decrease, the unemployment rate will increase, eventually inflation will decelerate, and the Fed will reverse course from tightening to easing monetary policy to attempt to stimulate the economy.

How will we manage portfolios during a recession?
Note that a recession does not necessarily have to be a scary event. According to the NBER, since 1945 there have been 12 recessions in the United States lasting an average of 10 months each. There will be more recessions in the future. This is not a bold prediction. Recessions are part of the natural ebb-and-flow of the business cycle. Rather than getting stressed out about a potential recession, we believe the best course of action is to have a playbook and process to help manage through recessions and volatile periods.

At Winthrop Wealth our investment philosophy is based on maintaining a long-term viewpoint while our process is designed to provide well-diversified portfolios constructed with a methodology based on prudent risk management, asset allocation, and security selection. Our approach has helped our clients navigate through challenging financial markets and ultimately pursue their goals and objectives.

- *For clients withdrawing money*: Defining and accounting for upcoming cash flow needs are critical components of our financial planning process. We will generally invest at least two years' worth of estimated cash flows in short duration, high quality, liquid, fixed income securities. No matter what occurs in the markets, these holdings are readily available to fund cash flows as needed. This helps to ensure that clients will not need to sell equities to fund cash flows after a significant market decline. Please see our ***Client Question on Withdrawing Money***.

- *For taxable investors*: We can dynamically tax-loss harvest by selling an investment with a loss and immediately purchasing a different security with similar (but not identical) exposure. The loss on the sold security can be used to offset taxable gains. Please see our ***Client Question on Tax Loss Harvesting***.

- *For all investors*: Repositioning portfolios means that we can increase the overall equity allocation and/or we can reallocate among various asset classes. Keep in mind, some of the best buying opportunities can occur during periods of market turmoil.

Our framework for navigating current conditions:

During periods of market volatility, we follow the same playbook and convey the same messages. At Winthrop Wealth, we believe the right mindset paired with a comprehensive financial plan and a thorough investment process can provide confidence in working towards your long-term financial goals, especially during times of heightened market volatility.

The Right Mindset – Take a long-term viewpoint and avoid the impulse to market time

"Don't try to buy at the bottom and sell at the top. It can't be done - except by liars."
Bernard Baruch

Market volatility is stressful and controlling your emotions during these periods is critical. Market timing decisions are often emotional rather than rational and data based. Making sudden large adjustments to portfolios is value destructive over time and a major reason for poor investor performance. Our investment philosophy is, never time the market. Please see our Client Question titled Market Timing Does Not Work, where we demonstrate that: the stock market goes up over time despite frequent drawdowns, the average investor underperforms due to market timing mistakes, and the benefit of a diversified portfolio and a long time horizon.

Financial Plan

"The Best way to measure your investing success is not by whether you're beating the market but by whether you've put in place a financial plan and behavioral discipline that are likely to get you where you want to go."
Benjamin Graham

Financial planning drives the investment strategy and provides a roadmap to each client's unique goals and objectives. The comprehensive financial plan defines cash flow needs, optimizes account structures, considers tax minimization strategies, and continuously evaluates financial risks as circumstances and/or goals change.

We also stress test the financial plan for many different environments including extreme volatility and market declines. The financial plan does not assume perpetually strong markets and linear returns. Rather it assumes that your portfolio will go through periods of weakness throughout your investment time horizon. We often update financial plans during and after volatility to quantify the impact that the market decline had on the probability that the client will reach their long-term goals and objectives. Since we account for market volatility and declines, the financial plan is less likely to be damaged when these periods inevitably occur.

Investment Process

"Good times teach only bad lessons: that investing is easy, that you know its secrets, and that you needn't worry about risk. The most valuable lessons are learned in tough times."
Howard Marks

Our investment management process is designed to provide well-diversified portfolios constructed with a methodology based on prudent risk management, asset allocation, and security selection. We help our clients navigate challenging markets by ensuring their short-term cash flow needs are met while managing the rest of their investments in a globally diversified portfolio.

Market volatility can be used to our advantage by tax-loss harvesting or reallocating to more attractive securities:

- **Tax-loss Harvesting**: Tax-loss harvesting is achieved by selling an investment with a loss and immediately purchasing a different security with similar (but not identical) exposure. The loss on the sold security can be used to offset taxable gains. Since we simultaneously sell a security to capture a loss and purchase a different holding with similar exposure, the client is never out of the market. We can capture losses during declines, and as the market recovers the new position also recovers PLUS the client has a tax-loss to offset future gains. Please see our ***Client Question on Tax Loss Harvesting***.

- **Repositioning Portfolios**: Repositioning portfolios means that we can increase the overall equity allocation and/or we can reallocate among various asset classes. During a market selloff, portfolio equity allocations often fall below their target levels. For example, assume a portfolio is invested to its target allocation of 60% equities and then the stock market declines -10%. The new allocation would be about 54% or -6% below the target level. We can use the market decline as an opportunity to buy stocks at lower prices to bring the allocation back to the 60% target level. Furthermore, we can rotate to the equity asset classes that have become more attractive (for equities, we allocate across regions, countries, market caps, factors, styles, sectors, and industries). Keep in mind, some of the best buying opportunities occur during periods of market turmoil.

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The economic forecasts set forth in this material may not develop as predicted and there can be no guarantee that strategies promoted will be successful.

All indexes mentioned are unmanaged indexes which cannot be invested into directly. Unmanaged index returns do not reflect fees, expenses, or sales charges. Index performance is not indicative of the performance of any investment. Past performance is no guarantee of future results.

The Standard & Poor's 500 Index is a capitalization weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

Financial planning is a tool intended to review your current financial situation, investment objectives and goals, and suggest potential planning ideas and concepts that may be of benefit. There is no guarantee that financial planning will help you reach your goals.

Rebalancing a portfolio may cause you to incur tax liabilities and/or transaction costs and does not assure a profit or protect against a loss.

Likewise, it is important to remember that no investment strategy assures success or protects against loss. Asset allocation does not ensure a profit or protect against loss. There is no guarantee that a diversified portfolio will enhance overall returns or outperform a non-diversified portfolio. Diversification does not protect against market risk. All investing involves risk which you should be prepared to bear.

This information is not intended to be a substitute for individualized tax advice. We suggest that you discuss your specific tax situation with a qualified tax advisor.

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