Stagflation and Goldilocks

The unstoppable ride of financial markets and risky assets marked a significant slowdown in September. The narrative of effervescent markets, from Goldilocks, impervious to any sign of danger, is enriched by a new tale whose protagonists are inflation, with rising energy prices, and the slowdown in growth. A term that has long disappeared from the vocabulary of economists has suddenly come back into fashion: "stagflation". Among the authoritative voices that have recalled with concern that phase of the 1970s, characterized by two oil crises, sharp increases in energy and food prices, and the resulting paralysis of economic growth, is that of Jerome H. Powell. The flagship index of the world's stock exchanges, the S&P, fell by 5.8% in September, albeit with an increase of 1.7% in the quarter. Europe also reacted badly: the Eurostoxx fell by 3.8% in the month and by 0.5% in the quarter, while the Swiss SMI fell by 6.65% (-2.9% in the quarter). On average, however, the main world indices have recorded positive performances of over 10% since the beginning of the year. Does September, therefore, represent the end of a growth cycle for stock exchanges and risky assets, or is it a healthy correction that may allow those who were left out of the market to get in? Ignorance about the future can only be partially mitigated by rationalizing certain aspects of the present and past that are presumed to be relevant: this operation is the basis of what is still an opinion. The significant elements to be considered are: the course of the pandemic, its influence on growth and therefore inflation, employment, central bank policy (liquidity on the markets), public debt and the energy transition.

The fight over the Delta variant of COVID-19 has fueled uncertainty in the global economy contributing to a drag on growth. This issue is likely to remain important in the fourth quarter. However, the increase in vaccinated people should prevent true lockdowns. In this context of uncertainty, it is possible that the bottlenecks that have been created in the supply of certain products and raw materials (semiconductors and energy) will remain

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present as well as the difficulty in finding personnel. This situation is already reflected in the September surveys among purchasing managers of industrial companies (SMEs), which serve as a track to anticipate the direction of Gross Domestic Product (GDP). The data collected lead to the conclusion that the growth of the global economy is gradually slowing down in many countries, although it remains in the expansion zone: globally, however, the indicator remained stationary between August and September because American, Indian, Brazilian and South Korean growth substantially balanced out the Chinese crisis. But the cause of the slowdown lies primarily on the supply side and not on the demand side. Although orders to companies remain strong, delivery times are lengthening, product prices are rising and in some sectors it is also difficult to find suitable labour. The effects are immediately reflected in inflation. In the eurozone, prices rose by an estimated 3.4% in September, compared with 3% in the previous month, reaching the highest level since 2008. In the USA an annual inflation of 4.2% is expected. This forced Jerome Powell to state before the Senate Banking Committee on September 21 that "as the reopening continues, bottlenecks, difficult hiring and other constraints may be more important than anticipated, causing risks of higher inflation."

This consideration and the finding that "employment is reasonably strong" led the markets to believe that the financial facilities (Quantitative Easing), i.e. the purchase of 120 billion a month of bonds by the FED (thus with a parallel injection of liquidity) could begin to taper off much earlier than expected, also anticipating the start of interest rate increases: the yield on the 10-year US treasury bond in the month rose from 1.3% to a maximum of 1.55% and therefore the dollar also strengthened, even falling below 1.16 against the euro. Making the scenario gloomy for stock exchanges was the increase in the cost of energy: oil (Brent) rose from just over 70 dollars a barrel to close to 80 dollars, while the price of natural gas rose by 25%. This brings together all the elements needed to cry out the dreaded term "stagflation".

In fact, the markets probably gave less weight to another statement by Powell and that is that "the economy's strong growth will continue this year, although some sectors have been slowed by the Delta variance." The underlying message remains that tapering (tightening of monetary conditions) can only occur if the economy is growing more than inflation. This consideration is, with different sensitivities, shared by the International Monetary Fund (IMF) and the major central banks. Taking the Economist's estimates, in 2021 the United States will grow by 6% with inflation at 4.2% and negative real rates (10-year at 1.5%), the Eurozone's GDP will rise by 4.8%, with inflation at 3% and negative rates both nominal (-0.2%) and real. Given that global liquidity on the markets is still at extreme levels and even increased in October, [1] it is difficult, for the time being, to think of a substantial change in market direction. In the current scenario it seems at least premature to speak of "stagflation". Tactically, therefore, corrections are still a prudent buying opportunity.

But, as Powell said about the price increases that resulted from the oil crises of the 1970s, then, "when the direct effects on headline inflation subsided, core inflation continued to be consistently higher than before. A contributing factor was that the public generally expected higher inflation; that's one of the reasons we monitor inflation expectations so carefully now." [2] But, if we look at the 5-year inflation forwards in the U.S., the rate is at 2.47% and at 10 years it is even lower (2.41%); while in Europe we are at 1.79% and 2.07% respectively. The signs of weakening growth and rising inflation in September are, for the time being, still linked to an adjustment phase. Quantitative Easing, which in 2008 was designed to save the financial system, is now clearly the instrument for financing digitalization and the energy transition.

But the sudden rise in the price of oil, and especially gas, has highlighted something that has been underestimated by the markets until now. The energy transition will be very complex. Investments must focus on new energies, but for now their prospective capacity is insufficient to support a fully electrified world. Either new roads are found soon, or there is a risk of frequent blackouts in the coming years, when cars will be predominantly electric, and investment in infrastructure (with the

[1] Edward Yardeni, Debbie Johnson, Mali Quintana, *Global Economic Briefing: Global liquidity*, 30 september 2021, p. 1.

[2] Jerome H. Powell, *Monetary Policy in an Uneven Economy*, economic symposium sponsored by Federal Reserve Bank of Kansas City, Jackson Hole, Wyoming, 27 august 2021.

associated increase in energy demand) will produce the growth-supporting effects. It is at this level that the markets could revise their inflation expectations, putting the central banks in real difficulty, as they would also have to evaluate differently the burden of debt accumulated in recent years. But if we look at the fourth quarter of 2021, we will see settlements that will still produce volatility probably in October. But then, a clarification from the Federal Reserve, resolve on the Evergrande case in China, and the unveiling of the infrastructure investment phase should support markets with economies still growing and inflation expectations under partial control. The Goldilock phase is probably over, but we are not on a stagflation trajectory. At least in the next three months, barring any mishaps which, from current levels, cannot be ruled out a priori.

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