

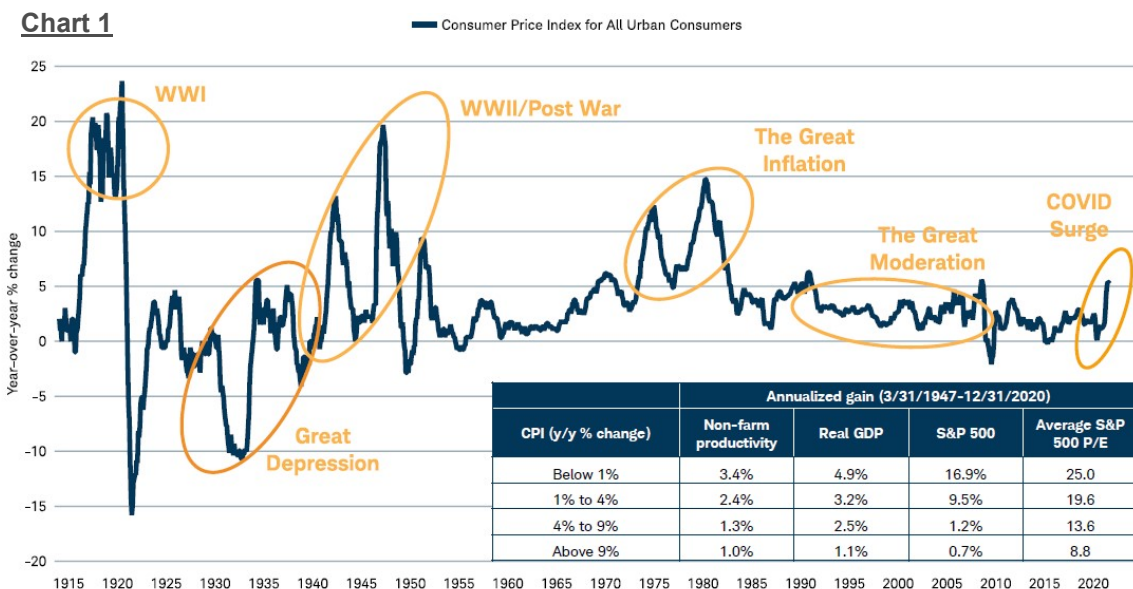
Stagflation, what's that?

Stagflation is the topic du jour in the financial media. Did you know the word “stagflation” is a portmanteau? That is, a blending of two other words, stagnation, indicating slow growth, and inflation, higher costs. It describes a bleak economic environment for investors as last experienced in the 70's. The cost of goods and services go higher but investment returns are stagnant; as a result, you have to spend more, but investment returns don't keep pace with rising costs. So, why all the attention on stagflation?

The Federal Reserve measures changes in consumer prices by publishing the Consumer Price Index (CPI). The recent CPI index is up about 4% but it doesn't include the cost of food and energy; try to live without those for a short time. Observe Chart 1 below, it shows consumer prices have recently increased about 5%. For individuals paying their own fare for everyday living, examples of higher prices abound including lumber, gasoline, used automobiles and of course the cost of dining to name a few. Should we expect prices to continue to rise in the future or is the current inflation “transitory?” An excerpt from Fed Reserve Governor Lael Brainard's September 27, 2021 speech embodies the Fed's position:

“The currently elevated level of inflation is driven by COVID-related disruptions. As these COVID-related disruptions subside, most forecasters expect inflation to move back down toward the Federal Reserve's 2 percent long-run objective on its own. That is the sense in which currently high inflation is likely to be transitory. In that regard,”

Of course, only the future will prove the Fed's prognostications right or wrong but the conundrum for investors is what if inflation stays with us for a while?



Source: Charles Schwab, MacroBond, Ned Davis Research using monthly data available as of 9/30/2021. U.S. CPI Urban Consumers YoY NSA (CPI YoY Index). Past performance is no guarantee of future results.

Chart 2 ■ YoY Percent Change in Earnings Estimates (Right scale)
 ■ S&P 500 Forward Earnings Estimates (Left scale)



As for growth, the conspicuous question is at what rate will corporate earnings grow? In past issues of our newsletter we asserted stock prices follow earnings over time (Chart 2 reflects year over year change in earnings estimates vs the S&P 500 forward earnings estimates). However, during different time frames investors are willing to pay more or less for earnings. This is seen in

Chart 3, P/E (Price/Earnings) ratios. Since 1995, on average, investors were willing to pay about 16 times earnings—\$16 (Price) for \$1 (Earnings). Currently investors are paying about 21 times earnings for S&P 500 companies; this is near historic highs. For the market to continue to go up either earnings have to increase, or investors must pay a higher valuation or both. Historically, there comes a point when investors refuse to pay a higher valuation for stocks and stock prices (the P in P/E) correct to a lower level. Inflation can also be a factor. As costs to businesses rise – due to many factors such as higher borrowing costs, wages, materials, etc. – they raise prices for goods and services offered. As prices rise, consumers tend to spend less which of course reduces earnings to companies. Notice the box in the bottom of Chart 1 showing the correlation of CPI, which measures the price of consumer goods and how they’re trending to both S&P returns and Average S&P 500 P/E.

Chart 3 ■ Forward P/E ■ Average P/E since 1995



In summary, we believe the conditions exist for stagflation to take place. Not that it will but it certainly could. The best course or action for investors is to continue to monitor economic conditions and adjust portfolios accordingly. There is a saying that you don’t get hit by the bus you see coming. Be vigilant and watch or hire someone who will.

Private Asset Management—3740 Carillon Pt. Kirkland, WA

Unless otherwise noted, data presented in this report is from recognized financial and statistical reporting services or similar sources including but not limited to Reuters, Bloomberg, the Bureau of Labor Statistics, or the Federal Reserve. *While the information in this newsletter is obtained from reliable sources, we do not guarantee its accuracy. This report is limited to the dissemination of general economic and market conditions. This communication contains information that is not suitable for everyone and should not be construed as personalized investment advice. Past results are not an indication of future performance. Any reference to market index is included for illustrative purposes only, as it is not possible to directly invest in an index, indices are unmanaged, hypothetical vehicles that serve as market indicators. Index performance does not include the deduction of fees or transaction costs which otherwise reduce performance of an actual portfolio. This information is subject to change without notice.*