Why Investors Should Worry About Stagflation

Slow economic growth, high unemployment and rising inflation = misery

On July 13, 2021, the U.S. Bureau of Labor Statistics reported that the Consumer Price Index for All Urban Consumers increased 0.9% in June after rising 0.6% in May. Not only was this the largest 1-month change since June 2008, but the Consumer Price Index has been up every month since January 2021.

Maybe worse was that the BLS reported that over the last 12 months, the all items index increased 5.4% – the largest 12-month increase since a 5.4% increase for the period ending August 2008.

Then 3 days later, the University of Michigan's gauge of consumer sentiment fell back to its lowest level since February, driven mostly by – you guessed it – inflation worries.

Inflation, Hyperinflation and Stagflation

In simple terms, inflation is defined as an increase in the general level of prices for goods and services. Deflation, on the other hand, is defined as a decrease in the general level of prices for goods and services. If inflation is high, at say 10% – as it was in the 1970s – then a loaf of bread that costs $1 this year will cost $1.10 the next year.

Inflation in the United States has averaged around 3.3% from 1914 until 2021 and it has averaged about 3.7% for the past 60 years. For perspective, inflation reached an all-time high of 23.70% in June 1920 and a record low of -15.80% in June 1921. Many will remember the high inflation rates of the 70s and early 80s when inflation hovered around 6% and occasionally reached double-digits.

Hyperinflation, by extension, is exactly what it sounds like – inflation that is increasing at super-sonic speed. In technical terms, hyperinflation is described as inflation exceeding 50% per month. Although the U.S. has never experienced hyperinflation, other countries have. In fact, in October of 2019, the International Monetary Fund estimated Venezuela's annual inflation rate for 2019 would be an astounding 200,000%. That's hyper.

But while we are clearly in an inflationary period, it's unlikely that we are heading towards hyperinflation – but we might be headed towards something just as bad: stagflation.

The Risk of Stagflation is Very Real

The term stagflation was first used by UK politician Iain Macleod in the 1960s when he was discussing current inflation that was accompanied by stagnation, calling it a "stagnation situation."

Stagflation is defined as slow economic growth overall, high unemployment and rising inflation. Some might combine the economic growth and unemployment data into GDP and instead define stagflation as a period that sees declining GDP along with rising prices (inflation).

The last time the U.S. saw stagflation was in the 1970s, when we witnessed:

- Five quarters of negative GDP growth;
- Inflation double in 1973;
- Inflation hit double digits in 1974; and
- Unemployment hit 9% in May 1975

This period of time also led to the creation of the Misery Index.

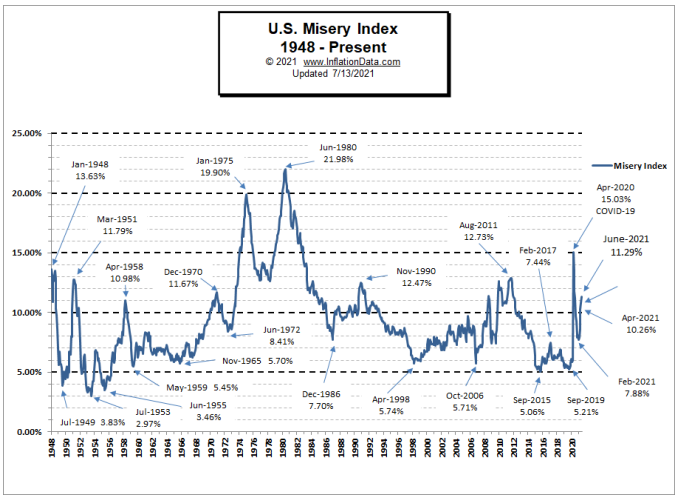
The Misery Index

The Misery Index is an easy to understand measure of America's economic health. Equal to the sum of inflation and the unemployment rate, the original Misery Index was created by Yale economics professor Arthur Okun.

In the 1960s, professor Okun researched the relationship between unemployment and production and his findings became known as Okun's law, which states that when the U.S. unemployment falls by 1%, our Gross National Product will increase by 3% (this was apparently only true for the U.S. economy and only when unemployment was between 3% and 7.5%).

Professor Okun also served on President Lyndon Johnson's Council of Economic Advisors and he coined the Misery Index as a way for President Johnson to easily communicate the relative health of the U.S. economy. The higher the Index, the greater the misery felt by the average American. Simple.

During the presidential campaigns of 1976 and 1980, the Misery Index became more popular. In 1976, then-candidate Jimmy Carter criticized President Ford and in 1980, then-candidate Ronald Reagan pointed out that the Misery Index increased under President Carter. For the most part, the Misery Index has been relegated to an abstract index – for now.



Since the 1970s, the original Misery Index has been modified several times, including by Harvard economist Robert Barro in 1999 and in 2011 by John Hopkins economist Steve Hanke.

Barro included much more data – and called it Barro's Misery Index – and he included interest rates and economic growth and looked at countries other than the United States. Hanke took Barro's Misery Index and added more data, including "the sum of the unemployment, inflation and bank lending rates, minus the percentage change in real GDP per capita." And yes, he called it Hanke's Misery Index and updates it yearly for close to 100 countries.

Remember the 1970s

The truth is that there are consequences born from the coronavirus pandemic and resulting actions taken by the federal government and the Federal Reserve that are difficult to predict. But it should be no surprise that production would be negatively impacted as the unemployed slowly rejoin the workforce and supply chains remain under severe pressure. As such, the risk that we see slow economic output and higher unemployment as prices (inflation) increase – the very definition of stagflation – is very real.

One more thing: did you know that the Dow Jones Industrial Average opened in 1970 at 809 points and ten years later (December 1979) it closed at 839 points for almost no gain? And when adjusted for inflation, stock market investors lost about 49% during the 1970s?

That's misery.