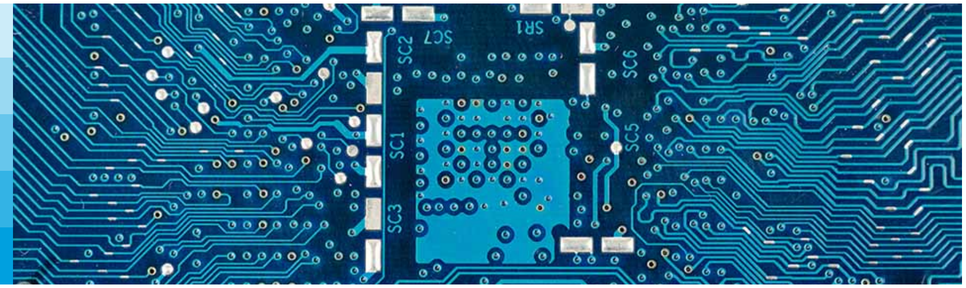
Asset Management

Is Stagflation Back?



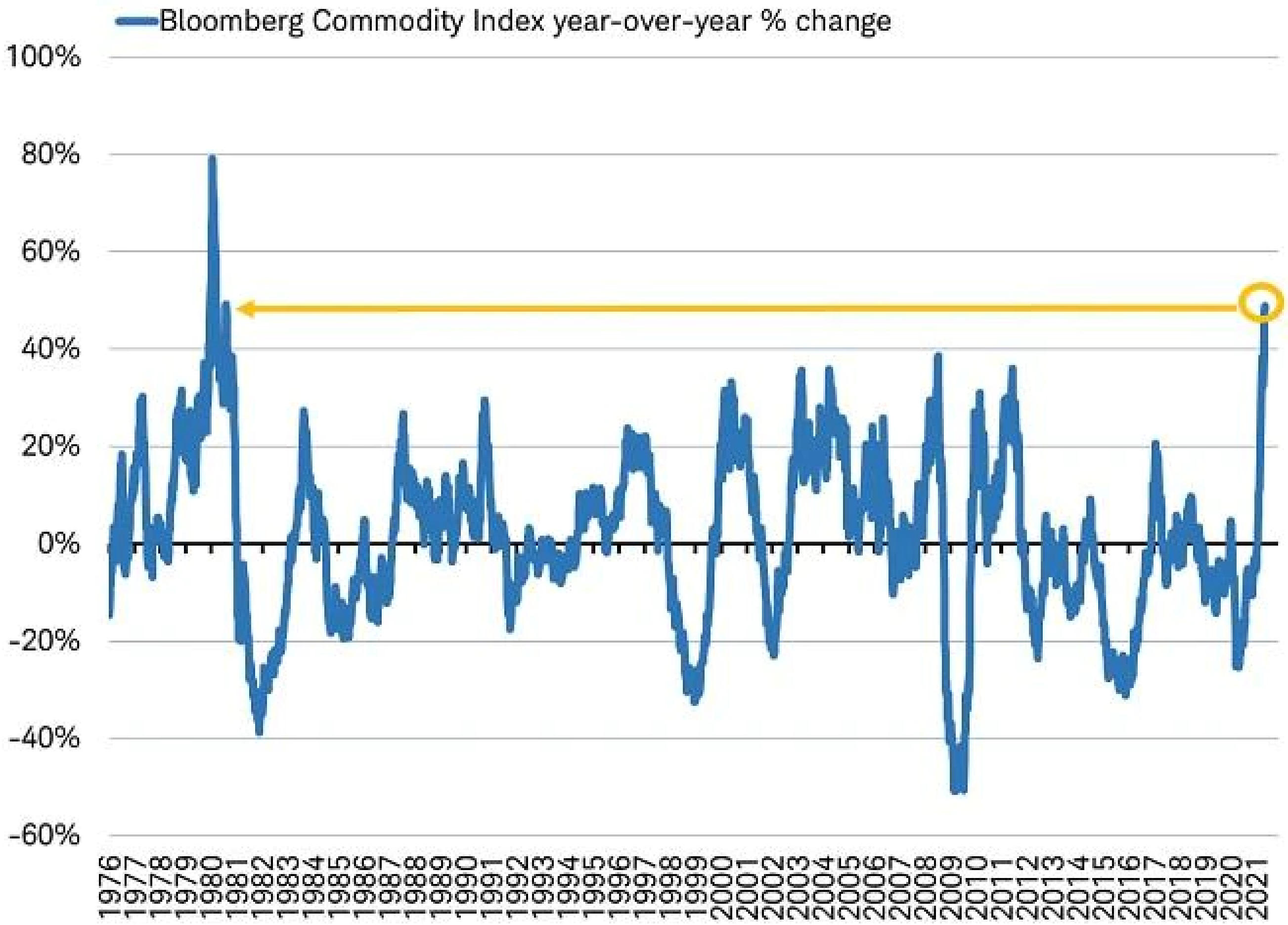
May 10, 2021

Key takeaways

- The constraint on global growth this year has evolved from the supply of vaccines to the supply of nearly everything else.
- The shortage of supplies indicates risk of economic weakness coupled with rising prices.
- Yet, these forces of stagflation may be offset through prompting central banks to continue stimulus, lawmakers to rollout additional fiscal stimulus in the U.S. and Europe, and business leaders to invest in a wave of capital spending, accompanied by a sharp rebound in output by the service sector.

The constraint on global growth this year has evolved from the supply of vaccines to the supply of nearly everything else. Raw materials, intermediate goods including semiconductors, and even labor seem to be in short supply. This environment risks a stall in output, earnings and job growth while pushing prices higher. Commodity prices are soaring at a pace not seen since the Carter administration.

Welcome back, Carter



Source: Charles Schwab, Bloomberg data as of 5/5/2021.

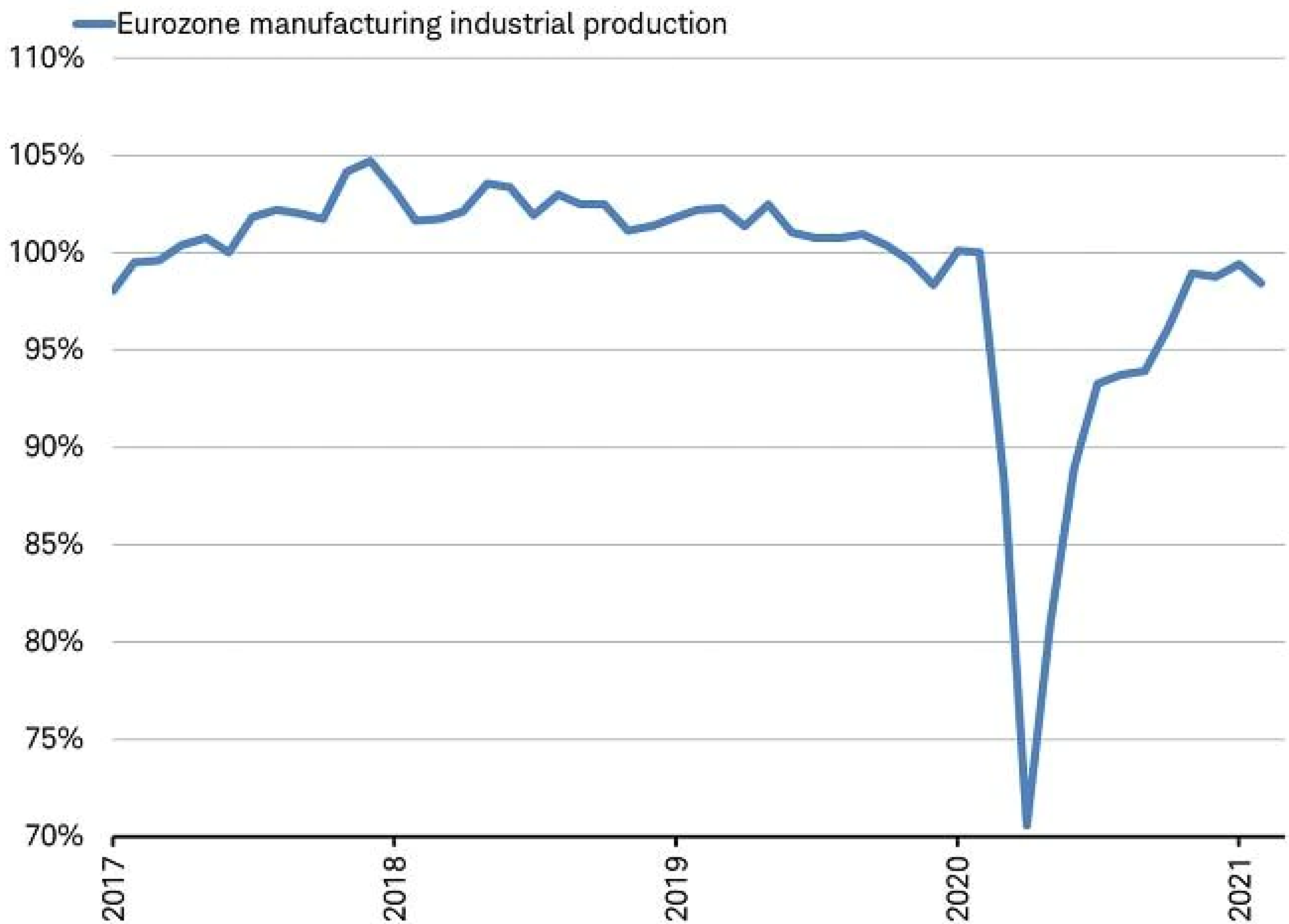
Although it's an important new risk to the current economy and markets, stagflation—a term applied to the high inflation/low growth economic environment of the 1970s—is not our base case, thanks to the rise of several offsetting factors.

Manufacturing's stall

Manufacturing has been the primary driver of the global economic and earnings rebound over the past year. But now, a stall in manufacturing momentum is becoming obvious. The stall in Europe's manufacturing PMI (from 62.5 in March to 62.9 in April) and the drop back in the U.S. ISM Manufacturing Index (to 60.7 in April from 64.7 in the prior month) and China's official manufacturing PMI (from 51.9 to 51.1 during the same period), appear to reflect widespread supply constraints rather than slowing demand. This is evidenced by new and backlogged orders rising along with input and output prices.

Looking beyond surveys for evidence, output from Europe's factories appears to have stalled. By November 2020, industrial production had recovered to 98.9% of its pre-recession level (February 2020), rebounding from its low of 70.6% in April. As of February 2021, industrial production slid to 98.5%, as you can see in the chart below. Specifically, the semiconductor shortage has continued to hurt the European car industry with monthly production falling -16% between November 2020 and March 2021. Europe's biggest auto producer, Germany, has seen its entire economy contract -1.7% in the first quarter from the end of last year.

Industrial production stalls in 2021



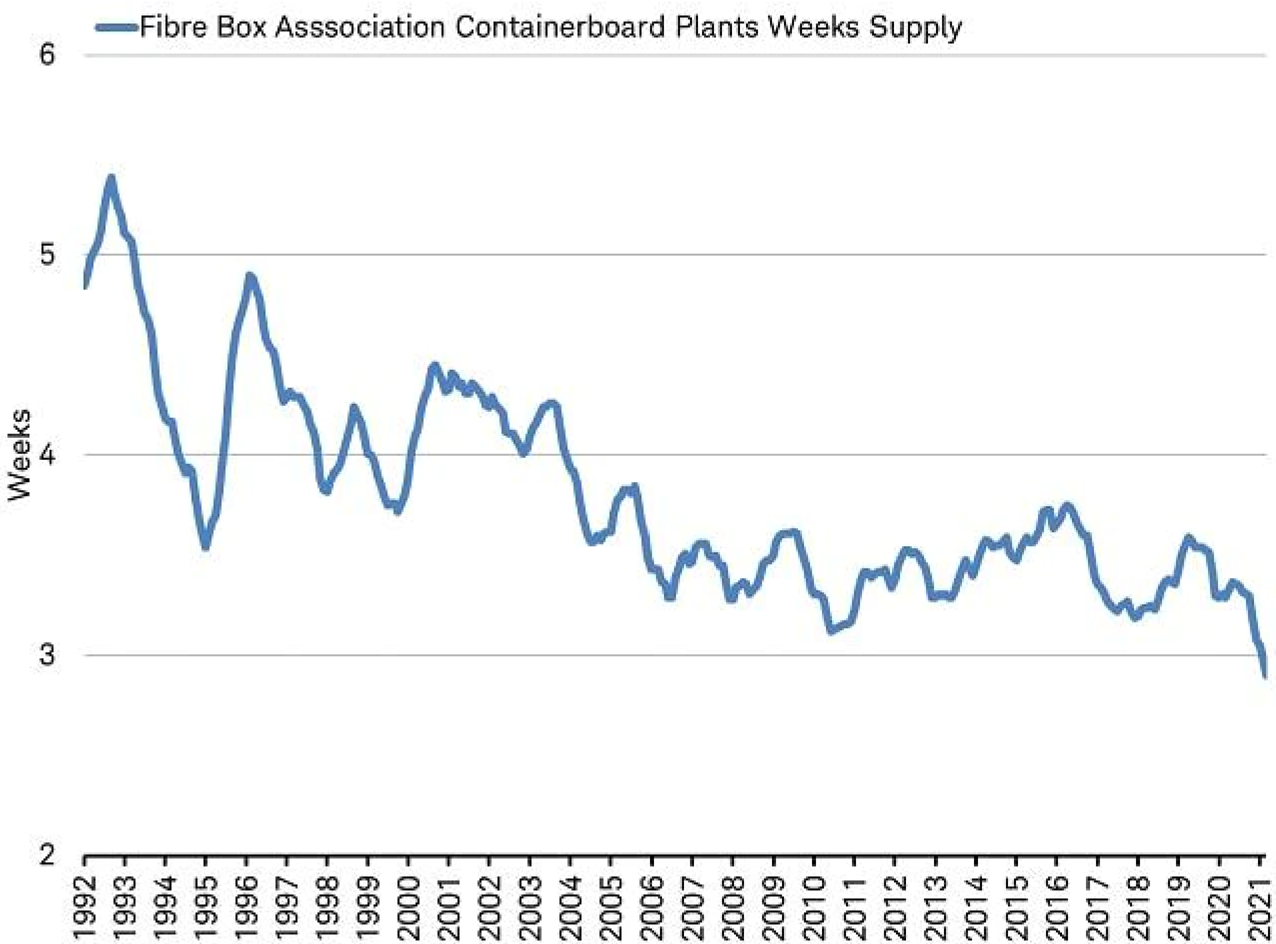
Indexed to 100% on February 2020. An indexed number is a figure reflecting price or quantity compared with a base value. The base value always has an index number of 100. The indexed number is then expressed as 100 times the ratio to the base value.
Source: Charles Schwab, Bloomberg data as of 5/7/2021.

Widespread shortages

A broadening mix of input shortages, not just semiconductors, is alluded to in the latest European Commission survey of industrial businesses. Businesses responding to input shortages by curbing production rose to an all-time high of 21.7% in April. 45% of companies in Germany reported bottlenecks in intermediate products.

Last week's April U.S. ISM manufacturing report echoes trends seen in Europe but offers more detail, clarifying just how broad the shortages in the global supply of key commodities and intermediate inputs has become. Shortages were reported in widely followed inputs like lumber and semiconductors but also in boxes and plastic, used to make or package nearly everything.

Containerboard—used to make cardboard boxes—at record low weeks of supply



Data represents the industry total for weeks of inventory based on shipments of corrugated products in millions of square feet, as reported in the Fibre Box Association Statistical Bulletin.
Source: Charles Schwab, Bloomberg data as of 5/7/2021.

Supply shortages are affecting almost every industry, leading companies in many sectors to report difficulties finding workers to fill open positions. This may have contributed to Friday's much weaker-than-expected April job reports in the U.S. and Canada.

Manufacturers around the world are seeing strong orders on improved demand, but inventories near all-time lows and very tight supplies of many inputs from semiconductors to workers may increasingly act as a constraint on output. At the same time, higher prices on a broadening number of inputs may flow through and push consumer prices higher.

Stagflation offsets

The forces of stagflation may be offset by prompting central banks to continue stimulus, lawmakers to rollout additional fiscal stimulus in the U.S. and Europe, business leaders to invest in a wave of capital spending, accompanied by a sharp rebound in output by the service sector.

- **Central bank stimulus** - In the 1970s, central banks reacted to slowing output and rising prices with tighter monetary policy. Today's response sharply contrasts this historical approach. The Fed and European Central Bank (ECB) continue to insist that the ongoing rise in inflation will be "largely transient" and intend to be very slow to tighten policy.
- **Fiscal stimulus** – President Biden's plans for yet another huge U.S. stimulus program and Europe's massive rescue spending rolling out this summer may further feed demand, rather than lift supply. Besides being inflationary, these programs may also support business, consumer, and investor confidence through any soft patch in output or jobs.
- **Capital spending** - Supply constraints may compel more capital investment by businesses. For example, Intel announced in March the opening of a foundry in Arizona to provide US/European capacity to semiconductor production (75% is currently manufactured in Asia). According to the European Commission's bi-annual investment survey, carried out in March/April this year, real investment in the manufacturing industry is expected to increase by 5% in the European Union in 2021, up from the 0% reported in the prior survey dated October/November 2020.
- **Services rebound** – The EU's services sector may snap back on re-openings in the coming months. The Global Service PMI rose above manufacturing in April for the first time since August, by the widest amount since before the pandemic, reflecting the rebound already seen in the United States. In Europe, the service sector is lagging the recovery at a reading of 50.5 in April, versus a reading of 62.9 for manufacturing. Because this year's virus restrictions in Europe focused on services rather than the manufacturing sector, the economic re-opening should help the larger service portion of the European economy offset any weakness in manufacturing.

While the current environment does have some resemblance to the 1970s, the differences are likely powerful enough to keep investors focused on the positives of reflation, defined by solid growth accompanying inflation, rather than the negatives of stagflation.

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