TAKING STOCK: STAGFLATION TRENDS

An NEPC 2023 Key Investment Theme

By NEPC Research

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NEPC Key Investment Themes represent our view of important macro-economic drivers of the global economy in 2023. Themes evolve and interact, influencing asset values, allocations, portfolio implementation and opportunities. A disruption of a theme likely alters market dynamics and our investment outlook.

STAGFLATION TRENDS

With an investment landscape marked by elevated inflation levels, economic growth risks and tight monetary policy, the U.S. economy is a fertile breeding ground for stagflation…with one key distinction: a strong labor market.

Robust employment numbers and low unemployment have so far prevented the U.S. economy from exhibiting the classic signals of stagflation. Still, dangers persist. These stagflation trends foreshadow a challenging economic environment, leaving all asset classes more vulnerable to downside risk. The risk of stagflation depends on the future path of inflation, wage gains, and the extent the Federal Reserve holds interest rates at elevated levels. The U.S. economy will be tested as history shows central banks need to keep interest rates higher for longer to subdue wage pressures and find balance in labor markets so as to bring core inflation down to policy targets. These conditions are complicated further due to the substantive lag effect on economic activity from monetary policy actions. To that end, the duration of tight Fed policy is likely to continue to weigh on capital markets.

This tumult comes amid a paradigm shift in markets in 2022 as rising inflation forced central banks to raise interest rates, a dramatic about turn from their emphasis on supporting investor sentiment and market liquidity. This change in priorities not only triggered a broad re-pricing across all financial assets, but also challenged the norms investors had come to expect over the last decade.

At NEPC, we believe these stagflation trends call for a more defensive portfolio bias. In this environment, fixed-income assets are relatively more attractive. The outlook for investment-grade bonds has improved and is additive relative to existing strategic allocation targets for safe-haven fixed-income exposure. As equities lose some of their shine amid lower valuations and eroding profit margins, we recommend value-oriented stocks for their strong relative gains. Furthermore, we encourage assessing the benefit of diversifying assets as they offer greater efficiency and value for a portfolio especially with the uptick in macro-economic volatility.

With elevated inflation and stagnant growth levels, we remind clients to hold greater levels of liquidity and to be prepared for the opportunities to rebalance equity that are likely to arise as markets try to make sense of these tumultuous stagflation trends.

IMPORTANT DISCLOSURES

Past performance is no guarantee of future results.

All investments carry some level of risk. Diversification and other asset allocation techniques do not ensure profit or protect against losses.

This memo should not be considered customized investment advice. Please contact NEPC for advice specific to your investment program.

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