Sevens Report Alpha Webinar:

Stagflation vs. Reflation

Thursday, August 26th, 2021

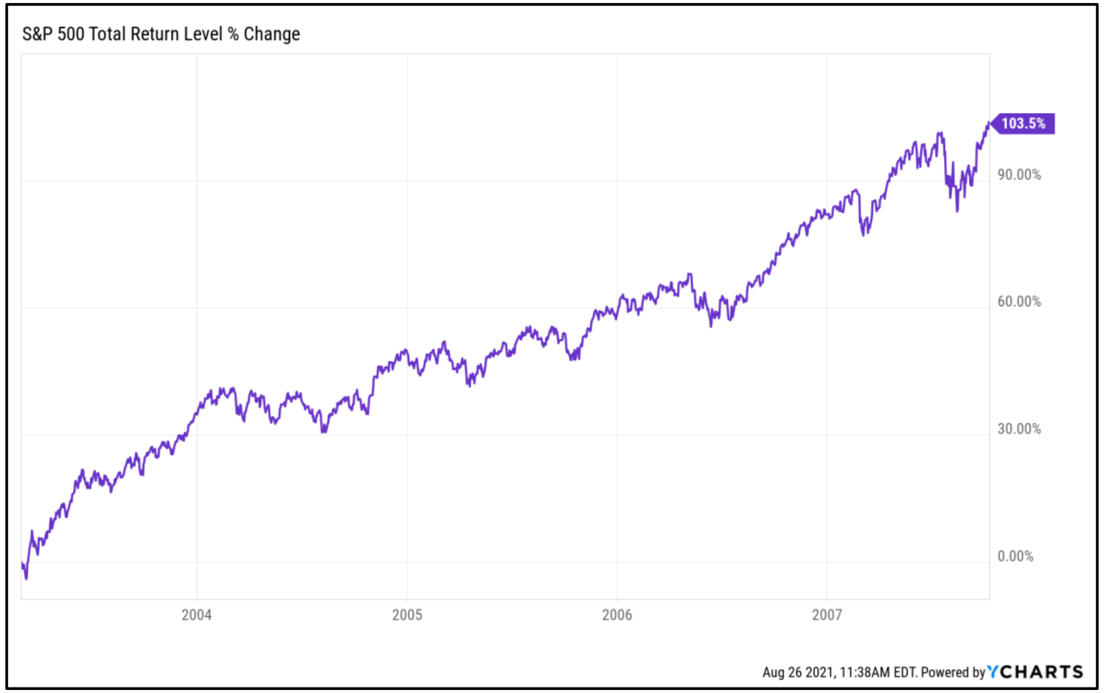
Tom Essaye, President Sevens Report Research

Reflation vs. Stagflation Characteristics

- Reflation (Bullish for Stocks/Neutral or Bearish for Bonds).
  - Accelerating economic growth (High PMIs, low unemployment, rising wages and asset prices).
  - Rising price and asset inflation (CPI towards 3%, stocks, real estate, cars, boats, RVs, etc. all higher).
  - Fed eventually kills the reflation through rate hikes– but it takes years (usually).
  - Reference timeframe: 2003 – 2007.

- Stagflation (Bearish for stocks, bonds, cash).
  - Slowing economic growth (Falling PMIs, high unemployment, falling wages and asset prices).
  - Rising inflation, but only price inflation (CPI towards 3%). Assets decline in stagflation.
  - Fed takes rates higher quickly to kill inflation, crushing asset prices (stocks, real estate, cars, boats, RVs, etc.)
  - Reference timeframe: Late 1970’s – Early 1980’s.

Reflation vs. Stagflation Characteristics



Reflation vs. Stagflation: How Will Stocks Trade?

- Reflation
  - Higher (possibly sharply higher).
  - Numerous tailwinds:
    - General asset inflation
    - Pricing power (strong employment will provide pricing power despite rising consumer inflation. We're seeing that now).
  - Yields rising so defensive sectors to lag.
  - Financials, Commodities/Resource Stocks, Consumer Discretionary/Retail, Small caps outperform.

- Stagflation
  - Lower (possibly sharply lower).
  - Numerous headwinds:
    - Rising rates hurt asset inflation absent strong growth.
    - Rising consumer prices coupled with poor employment squeeze margins.
    - Borrowing costs rise.
  - Select sectors can weather storm. Staples is the key. Tech staples (internet via FDN) and consumer staples (RHS).

Reflation vs. Stagflation: How Will Bonds Trade?

- Reflation
  - Lower, but gradually.
  - Longer dated bonds (so > 5 years) should see gradual declines that send yields higher as asset and consumer inflation sticks.
  - But, credit quality will remain strong given the strong economy so can go out on risk curve for yield.
  - Shorter duration bonds also decline but slowly as the Fed is patient raising rates.
  - Yield curve steepens (helping financials).
  - Floating rate debt the key in the fixed income markets.

- Stagflation
  - Lower (possibly sharply lower).
  - Longer dated bonds (> 5 years) drop on inflation fears and on general asset declines.
  - Credit quality falls as the economy slows, hurting junk debt especially.
  - Longer dated fixed debt the biggest losers (AGG?).
  - Shorter duration debt also gets hit on expectation of aggressive Fed rate hikes.
  - Floating rate debt the key to weathering the storm.

Reflation vs. Stagflation: How Will Commodities Trade?

- Reflation
  - Higher. Possibly best performing asset class.
  - Commodities will benefit from strong demand (global reflation) combined with tailwind of asset price inflation.
  - PDBC over BCI.
    - Energy and industrial metals will likely outperform other commodities due to 1) Strong demand from growth and 2) inflation.

- Stagflation
  - Mixed but still possibly best relatively performing asset class.
  - BCI over PDBC.
    - Agricultural commodities and gold (those with less elasticity of demand) should outperform.
    - Energy and industrial commodities will be hit by reduced demand due to slowing economic growth.

Reflation vs. Stagflation: How Will the Dollar Trade?

- Reflation
  - Slow rise higher on better growth and as the Fed gradually raises rates.
  - The dollar *and* commodities can rise together, like they did in mid 2000's.
  - Dollar Index rises gradually into the upper 90's.
- Stagflation
  - Sharp increase that further pressures economic growth.
  - The dollar will surge as markets anticipate aggressive Fed rate hikes.
  - That strong dollar will hurt commodities (especially industrial commodities) along with corporate earnings due to reduced foreign demand.
  - Dollar Index above par possible/likely.

Key Inflation Indicators to Watch

- This is all about the Fed's response, so we need to watch the inflation indicators the Fed watches.
- This also puts more of an emphasis on consumer price inflation vs. asset price inflation.

- Core PCE Price Index: > 2.5% for the remainder of 2021 and into early 2022 will likely spook the Fed on inflation.
- 5 Year Inflation Expectations.
  - 5-year TIPS/Treasuries Break evens > 3.0% for months.
  - 5 – year U-Mich Inflation Expectations > 3.0% for months.

Key Economic Indicators to Watch

- Major economic reports.
  - This isn't about COVID. The Fed considers COVID a "blip" and as such things like TSA Throughput and outdoor dining trends aren't important.
- ISM Manufacturing PMI: Drop below 50?
- Monthly jobless claims/unemployment. Do job adds fall to zero or turn negative? Does the UE rate rise back towards 7%?
- Consumer Spending: Personal Consumption Expenditures (in the GDP report) and Retail Sales (monthly).

Reflation vs. Stagflation: Inflation and Economic Data Quick Reference Table					
	Manufacturing PMI	Unemployment Rate	PCE/Retail Sales	Core PCE Price Index	5 Year Inflation Expectations
Reflation	>50	<7.0%	Rising Monthly	2.5% - 3.0% yoy	2.5% - 3.0% yoy
Stagflation	<50	> 7.0%	Flat or Falling Monthly	3.0%ish	3.0%ish.

Reflation vs. Stagflation Asset Price Performance Quick Reference Table

	Stocks	Treasuries/Yield Curve	Commodities	Dollar
Reflation	Higher, led by cyclicals: Financials/banks, commodities/materials, consumer spending, etc.	Longer dated yields gradually rise over coming months and quarters (ultimately towards 3%). Yield curve gradually steepens.	Higher. Possibly best performing asset class. Energy and industrial metals (copper) outperform. PDBC.	Gradually higher into the mid to high 90’s (97.50).
Stagflation	Lower, tech and consumer staples more resilient.	Curve ultimately inverts as short duration yields rise on rate hike fears.	Mixed. Possibly relatively best performer. Agricultural commodities and gold outperform. BCI.	Sharply higher on rate hike fears (>100).

Key Economic Indicators to Watch

- Reflation Alpha Ideas
  - Inflation Playbook 2.23.21. PDBC/GNR/RTM
  - Small Caps for the Recovery. 4.20.21. PSCD/FXG/RWJ/ISCV.
  - Reflation Playbook. 9/24/19.

- Stagflation Alpha Ideas
  - Stagflation Playbook. 8.24.21. FDN/RHS/FLTR/BCI.
  - How to Allocate to Gold. 7.2.19. GLD/SGOL/GDX.
  - Hedged Equity ETFs. 3.10.2020. DMRL/CCOR/JHEQX.