Following last week's real GDP report for 1Q24, news reports discussing stagflation started to hit the screens. In our view, stagflation headlines appear to be more noise than substance. (UBS)

What is stagflation? And are we currently experiencing it?

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Stagflation can be defined as an environment in which the economy decelerates and/or contracts, coupled with upside inflation pressures and a rise in unemployment. In the current milieu of low unemployment and strong domestic demand, we think stagflation concerns are unwarranted.

An attempt to define stagflation

Stagflation, unsurprisingly, is a mix of the words stagnation and inflation. The World Bank has highlighted[1] that: "While there is no precise definition of stagflation, the term has been used to refer to a combination of high inflation and low growth (or high unemployment). Some researchers have focused on output growth and considered stagflation as a "combination of low or negative output growth, and inflation that is high by historical standards" (Barsky and Killian 2002). Others have focused on unemployment, and defined stagflation as combinations of either increasing or persistently high levels of unemployment and inflation"

Why has the stagflation discussion popped up?

The US GDP report for 1Q24 released last week had two clear interpretations: (1) the economy performed weaker than expected; and (2) core PCE inflation was higher than expected. Somewhat predictably, reports discussing stagflation starting flashing up on screens soon after.

We are not in stagflation, neither from the growth, nor from the unemployment standpoint

However, the current environment is one in which economic data have continuously surprised us to the upside. While the annualized real GDP growth print for 1Q24 was 1.6% q-o-q, below expectations of 2.4% q-o-q and nowcasts near 3.0% q-o-q, the reason why the result was weaker than expected was due to particularities in GDP accounting involving inventories and imports[2]. Note that domestic demand[3] – a good measure of underlying performance – actually expanded 2.4% q-o-q (annualized) in 1Q24, a solid result.

Robust economic activity is consistent with the resilience in the labor market. Non-farm payrolls showed an average monthly creation of 310,000 jobs in 1Q24. Meanwhile, the unemployment rate has not crossed the 4% threshold in over two years. Both activity and the labor market are just fine; in fact, some of the economic strength is actually what could be behind the inflation stickiness we've been experiencing, owing to the demand-side pressures of consumers on services.

Perhaps what we are facing is a bit of reflation

The UBS CIO Head of Asset Allocation - Americas, Jason Draho, recently stated that "for all that debate, the overarching macro theme for the past few months is reflation, led primarily by upward revisions to the US growth outlook."

"Reflation is defined as higher growth accompanied by more inflation, usually the result of policy stimulus," he noted.

Bottom line

The bumpiness in consumer prices at the beginning of the year, might just be the byproduct of the macro dynamism of the past few quarters. Thankfully, reflation is a transient situation. Hence, we stand by our base case that the Fed's current level of monetary tightness will be enough to normalize domestic demand and the price formation process. We recommend investors to look past stagflation headlines; they appear to be more noise than substance.

Please see our recent reports:

Growth appears to be moderating, published on 29 April, 2024,

More than meets the eye, published on 28 April, 2024.

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[1] Global economic prospects: June 2022. Available here: https://www.worldbank.org/en/news/press-release/2022/06/07/stagflation-risk-rises-amid-sharp-slowdown-in-growth-energy-markets
[2] Net exports and the inventories variation jointly subtracted 1.2 percentage points (p.p.) to the GDP print.
[3] A measure that adjusts GDP for the external sector. Mathematically it is: GDP – exports + imports.