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Stagflation in 2010 May Look Like Reruns of the 1970s

BY DON MILLER, Associate Editor, Money Morning

The rare combination of surging inflation, artificially low interest rates, and a jobless recovery may be setting the stage for *stagflation,* an unpleasant economic malaise not seen in 40 years.

Although uncommon, it's quite possible for the economy to slow and for inflation to rise. It happened in the 1970s, and it could be happening now.

In this case, the definition of stagflation means a stagnant economy that grows well below its potential while both inflation and unemployment are rising.

And just like the global stagflation of the 70s, it begins with a huge rise in oil prices. It then continues as central banks use excessively loose monetary policy to counteract the resulting recession, causing a runaway price spiral.

Those three factors - tepid economic growth, an unacceptable inflation rate and rising unemployment are a lethal combination that central bankers dread. It also changes the game plan for investors, who have to be especially nimble in a stagflation economy.

Feeble Economic Growth in 2010

By any standards, economic growth will be subdued as the United States struggles to emerge from the worst recession since the 1930s. Forecasts from Standard & Poor's Inc. (NYSE: MHP) and Goldman Sachs Group Inc. (NYSE: GS) bear this out.

S&P recently projected average GDP growth of 1.6% for all of 2010, while top Goldman Sachs economists expect to see the U.S. growth rate decline from 3% early in the year to 1.75% by the fourth quarter.

"We don't expect a V-shaped recovery; in fact we think that 2010 is going to be a bit slower in terms of annualized GDP growth than the second half of 2009," Goldman Sachs Chief U.S. Economist Jan Hatzius said during a recent speech in New York City.

Money Morning Chief Investment Strategist Keith Fitz-Gerald is forecasting growth of, at best, 2.0% in 2010. The U.S. economy "will be lucky to do 2.0%" next year, Fitz-Gerald said. "The economy faces some very difficult challenges."

Rising Corporate Earnings Won't Spell More Jobs

The U.S. unemployment rate in October pierced the psychologically important 10% barrier for the first time since 1983, as employers made deeper-than-predicted payroll cuts. Joblessness abated slightly In November, but the rate continues to hover at 10%.

Usually, increased profits push companies to increase hiring as they expand inventories and marketing efforts. But while Standard & Poor's projects corporate operating earnings per share to increase by about 15% in 2010, there's real doubt about whether or not that will translate to an increase in hiring.
Until the economy proves to be in a sustainable uptrend, employers will rely on productivity increases - squeezing current employees to produce more in fewer hours - and will only hire new workers as a last resort.

"Businesses have some room to expand without hiring lots of new employees," Joel Naroff of Naroff Economic Advisors said in a note to investors after the November unemployment report. "It could take four to five years for the unemployment rate to get back to full employment. There is little reason to expect that happy times are here again."

Money Morning Contributing Editor Martin Hutchinson sees more jobs going overseas.

"There will be little U.S. hiring and huge amounts of outsourcing. Capital is almost free right now, while U.S. labor is costly. Thus it's cheaper to buy a plant in, say, Vietnam and make stuff there," Hutchinson said.

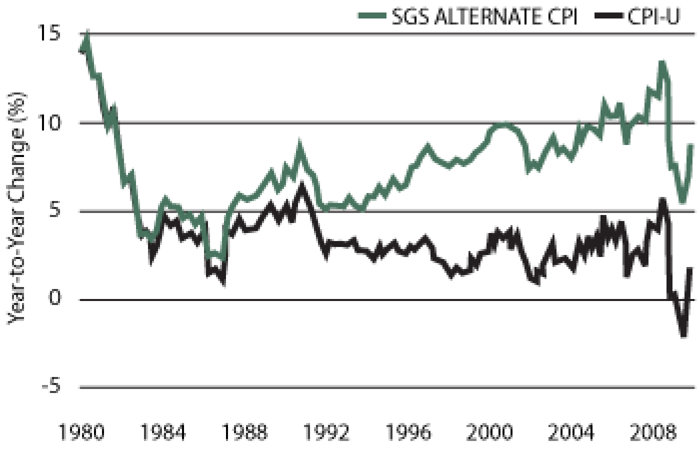
Rampant Inflation in the Pipeline

Remember those WIN (Whip Inflation Now) buttons that former U.S. President Gerald Ford encouraged Americans to wear in the late '70s? Get ready to dig them out of the attic.

According to a report from the U.S. Bureau of Labor Statistics, inflation returned to positive territory in November. The consumer price index (CPI) increased 1.8% from a year ago, the first positive reading since February 2009. Prices increased 0.4% on a month to month basis, and 4.8% on an annualized basis.
That number reflects the jump off the depressed, panic-induced energy prices of a year ago. In the last year, gas has jumped to $2.55 from $1.66 a gallon.
But the government prefers to talk only about core inflation, which excludes food and energy. Core inflation, the government notes, was almost unchanged in November, the smallest since December of 2008.

But excluding energy does not make sense when it is the main driver of inflation. A look at inflation including energy and food gives a different picture, as seen in the graph below:

Annual Consumer Inflation – CPI vs. SGS Alternate
Through November 2009
Concerned about rising inflation, former U.S. Federal Reserve Chairman Alan Greenspan in the 1990s eliminated food and energy costs from the consumer price index (CPI), artificially reducing inflation and reducing the budget deficit by cutting of cost-of-living adjustments for Social Security payments. The SGS Alternate CPI shows the same measures with energy and food inflation included.



Sources: *ShadowStats.com, U.S. Bureau of Labor Statistics, Money Morning staff research*

The underlying theme of this recovery is that *the key to prosperity is more spending.* The world's governments are creating more debt to relieve high unemployment levels and spur economic growth.

"Given that the Fed has been flooding the markets with liquidity over the last 9-12 months, it is unlikely that stocks, bonds, and real estate will adjust significantly downward, but much more likely that commodities will adjust upward, which spells even more consumer price inflation down the line," said to Krassimir Petrov, a ***Casey Research*** economist and contributing editor

Hutchinson, who was an investment banker for 25 years, expects inflation to get much worse.

"Inflation will increase further than people currently except - perhaps 8% per annum (0.7% per month) by the end of 2010," he said.

Investing During Stagflation

At some point, even if the economy is slowing, the Fed will have to step in and fight inflation. The question becomes: How much employment and growth do you sacrifice today in order to not have to deal with inflation in the future?

Unfortunately, the 1970s also give us the formula for solving the inflation problem: Higher interest rates.

Then-Fed Chairman Paul Volcker bled double digit inflation out of the economy in the early '80s by raising the overnight bank lending rate (and thus the prime rate) to as high as 20%. While no one is predicting a repeat of that scenario, there's little doubt interest rates will have to go up.

That raises the question of how to be invested when interest rates are rising, even as the economy struggles to grow and inflation is still running amok.

Once again, if you believe that the coming decade will look a lot like the 70s, you can find reasons to believe all major investment classes will perform similarly.
In a stagflationary environment, stocks, bonds, and real estate are likely to underperform commodities and gold. In fact, during the stagflation of the '70s , bonds were called "certificates of confiscation" by many professionals in fixed income.

From June 1970-1980, the best performing asset classes were oil (+34.7%), gold (+31.6%), U.S coins (+27.7%) and silver (+23.7%). The worst performers were T-Bills (+7.7%). foreign exchange (+7.3%), bonds (+6.6%) and stocks (+6.1%)

In summary, hold only short term domestic bonds. Keep a diversified equity portfolio, but focus on companies that are immune to, or can benefit from inflation. That means favoring growth stocks over value.

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