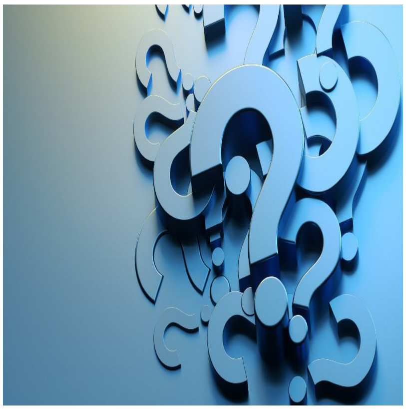

What to Make of the Stagflation, Deflation, and High Inflation Chatter?

Description

It's a pretty weird time to be an investor, with a considerable slate of risks, including COVID, stretched valuations in the states, and the potential for U.S. Fed surprises. Indeed, with rates at the floor, there's really only one direction that rates can go as the Fed begins to take the punch bowl of QE away, tightening its balance sheet. Undoubtedly, markets don't react kindly to that or higher interest rates.

After the 2008 Financial Crisis, it's been tough to reduce the Fed's balance sheet. Undoubtedly, the Fed has a difficult choice, as it looks to undo accommodative measures implemented in response to two horrific crises that occurred in less than a decade and a half.

It's not a great situation to be in. Still, one must not discount the deflationary pressures of the many incredible tech innovators. Such deflationary forces could drive down inflation considerably over the next several years, giving the Fed a bit more wiggle room to slowly and steadily taper without causing Mr. Market to have some sort of tantrum.

As for rates, many investors may believe that there's only one direction to go from here: up. Rates are essentially at zero. Still, negative rates must not be ruled out, especially should higher levels of inflation be preceded by considerable disinflation that would nullify the Fed's case for raising rates to keep prices low.

Undoubtedly, if 4-6% inflation is transitory, the economy could be right back to sub-2% inflation and the prospect of negative rates. Negative rates have been introduced in places like Germany, and with the long-term rate trajectory still moving lower, investors should not try to profit from fast and furious rate hikes.

Any rate hikes from here are likely to be modest. If anything, disinflationary pressures could allow central banks to keep rates at or near the floor, reinforcing the case for owning high-growth stocks like **Shopify**.

Should Canadian investors expect high inflation, low inflation, stagflation or deflation?

Undoubtedly, many pundits are quite divided over inflation's next move. Some people think high inflation could persist for longer. Others, like the Fed, think high inflation is transitory and that a "just right" level of inflation could be reached at some point down the road. Some extreme views like hyperinflation, stagflation, and deflation have also been thrown into the mix.

While such extremes are arguably the least plausible, I'd argue that the latter—deflation—is the likeliest of the three, even though it seems to be the least likely, given where inflation finds itself today. Add slowed earnings this season into the mix, and it seems like stagflation is the most plausible outcome.

In any case, investors shouldn't attempt to pivot their portfolios too much in response. Whether it be subscribing to the deflation thesis by going overweight on high-growth, high-multiple stocks like Shopify or going overweight in financials to prepare for elevated levels of inflation and potential rate hikes.

Instead, investors should continue as planned, with proper diversification. That means owning the financials *and* high-growth stocks like Shopify, preferably on dips. In any case, savers are likely to lose out to investors as inflation continues over the coming quarters. As long as you're not hoarding excessive amounts of cash (i.e., over 30% of your wealth), investors need not worry about what inflation's next move will be.

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Date
2025/07/26

Date Created
2021/11/01
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