Key takeaways

- While we expect US inflation to stay elevated next year as growth slows, 1970s-style stagflation is not our base case.
- We expect US inflation to be structurally higher post-COVID-19 than before.
- Stagflation risks are rising from a cyclical view and there are growing chances of persistent supply shocks.
- A severe stagflation scenario would hurt insurers via weaker premium revenues, higher claims inflation and investment losses.

In a nutshell

High US inflation is sparking flashbacks to the stagflation of the 1970s: low growth and high unemployment with persistently elevated inflation. Such a scenario is not our base case, but we do see increased risks of it and hold an above-consensus outlook on US inflation and a below-consensus view on US growth. This risk scenario has seriously potential negative impacts for insurers.

A surge in US Consumer Price Index (CPI) inflation to 6.2% year-on-year (y-o-y) last month – the highest print for over 30 years – has revived fears of a repeat of the "stagflation" of the 1970s, but such a scenario is not our base case. Stagflation is defined as persistently high inflation coinciding with weak economic growth and high unemployment. In contrast, our US real GDP growth forecasts for this and next year are well above the long-term average. We believe data suggest an overheating economy more than a stagnating one. US goods consumption as of October was 15% above the level in 2019, a sign that higher prices are being driven by excess demand following fiscal stimulus and the post-COVID-19 economic reopening, as well as supply chain bottlenecks. We also expect the US labour market to continue its recovery, after the unemployment rate hit a new post-crisis low of 4.6% in October.

However, stagflation risks are rising for the second half of 2022 and beyond, when we forecast US growth to slow materially, due to cyclical forces and the large fiscal drag from lower government spending. The natural cyclical slowdown in economic growth could prove less disinflationary than typically expected if high prices become more entrenched in long-term inflation expectations and wages, which are already rising (see Figure 1). A wage-price spiral could trigger stagnation, as in the 1970s. While the peak in US headline CPI month-over-month (m-o-m) rates is behind us, we expect US headline CPI y-o-y rates to only peak in early 2022 and stay elevated through 2022. We expect inflation will be structurally higher post-COVID-19 than before.

There is also a rising stagflation risk from external (exogenous) supply shocks having persistent negative impacts on economic activity and prices. Top of mind is today's protracted supply-chain disruptions from COVID-19. These may have longer lasting stagflationary effects by encouraging businesses to re-shore or invest in parallel supply chains. This deglobalisation trend is likely to be accelerated by (geo)political currents and shifts to green the economy (shifting preferences to "localisation"). This will lead to structurally higher prices and could also weigh on household consumption in the long term if the move towards less cost-efficient production causes prices to rise faster than wages. The global energy price crisis is another key supply shock, especially

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1 We forecast US real GDP growth at 5.5% for 2021 and 3.7% in 2022, versus a long-run potential GDP growth rate assumption of 1.9%.
2 "Even after a weak patch, America's economy is still in high gear", The Economist, 2021.
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as it is due to longer term structural drivers such as decarbonisation efforts besides short-term supply-demand imbalances. This implies energy prices could remain high for a protracted time. Finally, the physical and transition risks from climate change, like economic losses from weather events to input shortages in agriculture, or the cost of funding green transitions, may also risk persistent stagflationary supply shocks. That said, technology – a key source of disinflation and productivity growth – should partially offset these risks.

Beyond the US, we see the greatest risk of stagflation in Brazil. We forecast real GDP growth to slow substantially to 0.8% in 2022 as export growth moderates and monetary policy tightens, and we expect unemployment to stay above 10% and CPI to average 7.5% due to supply shocks and exchange rate volatility. In China, we believe near-term stagflation concerns should ease as the record-high producer price inflation will likely soon peak. We expect the CPI rise next year to remain moderate, as supply chain bottlenecks gradually ease. Meanwhile, our above-trend growth forecasts for other major advanced economies (US, euro area, UK) in 2022 suggest these too will steer clear of a stagflation scenario, despite elevated inflation.\(^4\)

A severe stagflation scenario similar to the 1970s\(^5\) would be challenging for the insurance industry. Premium revenues would weaken in a stagnant US economy, while persistently high inflation would pass through to insurers as claims inflation, particularly in long-tailed non-life business. Investment returns would also suffer, due to negative real returns across major asset classes. However, profitability would improve for in-force life savings products with guarantees, assuming central banks would raise interest rates in this scenario.

Figure 1
Long-term inflation expectations (left axis) and US wages (right axis), %

\(^4\) sigma 5/2021, op. cit.
\(^5\) D. Randall, "Analysis: The 1970s all over again? Stagflation debate splits Wall Street", Reuters, October 2021. During this period (including early 1980s), US CPI topped 14% YoY, the unemployment rate topped 10% and the US economy went into recession.

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