Catalyst Insights

Capitalizing on Stagflation

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Catalyst Insights.

A deep dive into stagflation and what it means for the financial market.

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01.

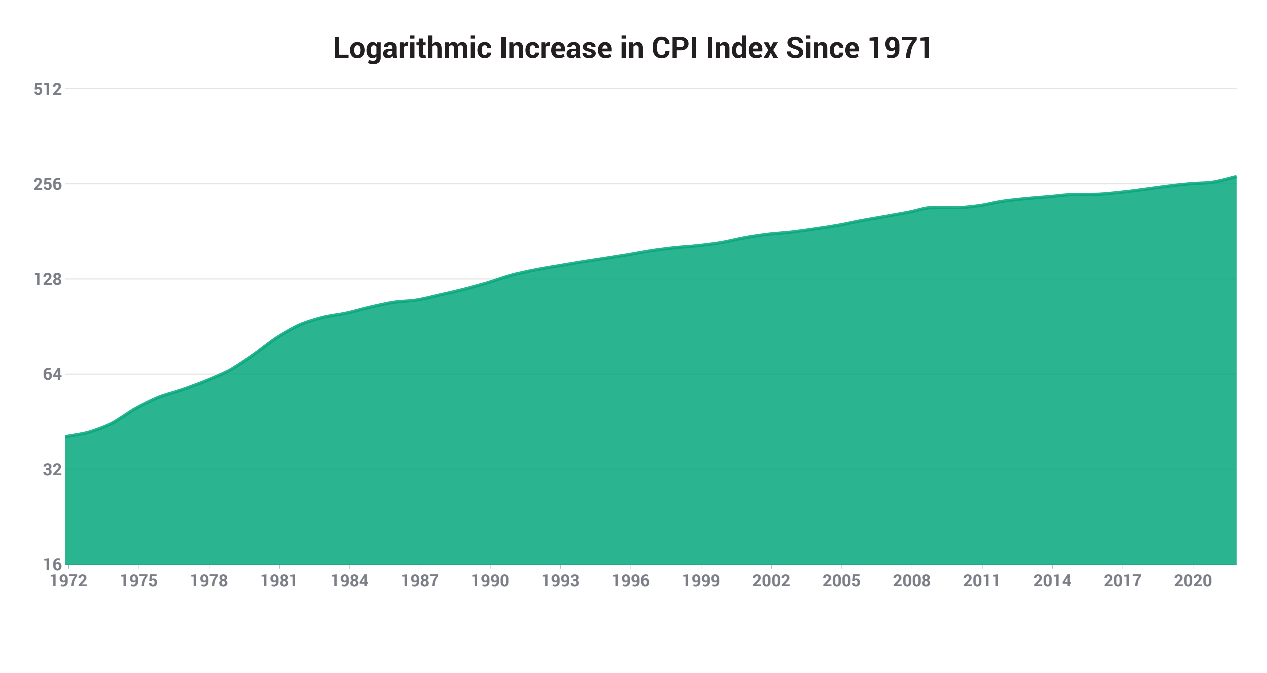
Introduction

Stagflation, or recession-inflation, is an economic situation with high inflation, slowing gross domestic product (GDP) growth, and stubbornly high unemployment rates.

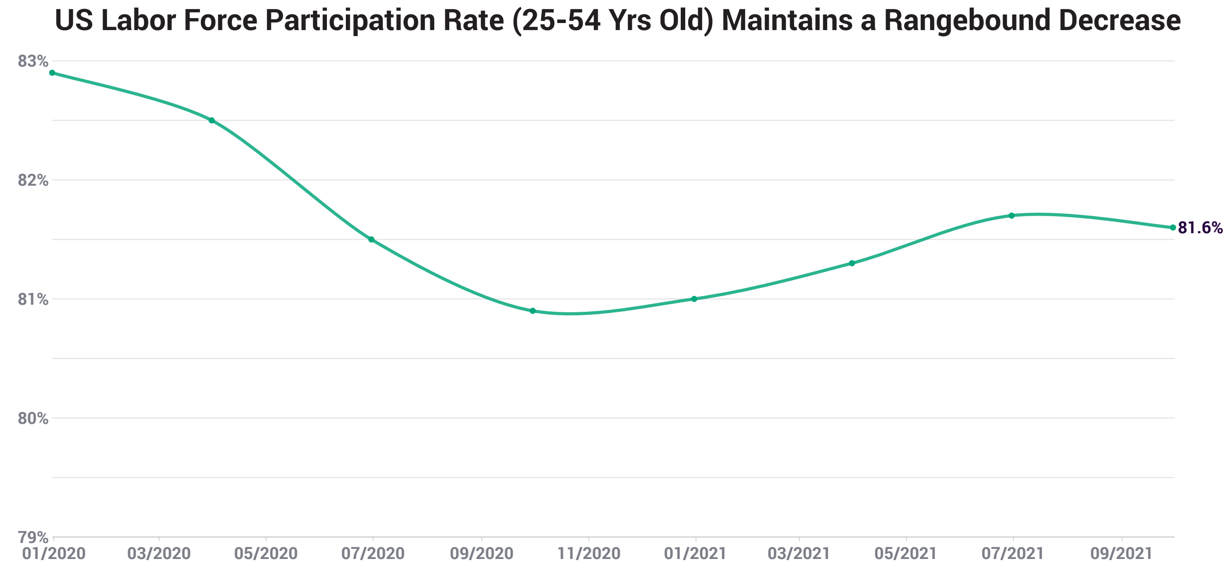
Stagflation, or "recession-inflation", is an economic situation with high inflation, slowing gross domestic product (GDP) growth, and stubbornly high unemployment rates. Traditionally, stagflation is caused by a negative supply shock that creates a policy nightmare for the Federal Reserve (Fed). For example, if oil supply output decreases significantly, oil prices will increase. Since oil's availability is muted, the Fed has limited ability to recalibrate the economy since their policies to manipulate demand would never offset supply constraints. Thus, oil prices will remain high until supply increases. The Federal Reserve (Fed) can only economically impact either inflation or unemployment. In theory and practice, the Fed does not have the ability to combat stagflation as any policy implementation will be counterintuitive since the Fed can only impact demand. For instance, if the Fed raises interest rates to tame inflation, unemployment will increase, and GDP growth will decrease. Alternatively, if the Fed attempts to stunt unemployment through stimulus, inflation could start to run away. Therefore, historically, stagflation ideally must correct itself "naturally". As described below, early signs highlight that stagflation may become a real and tangible economic headwind for investors.

02.
Stagflation Signals

Inflation has logarithmically increased since the 1970s and continues to logarithmically grow post COVID-19 due to policy uncertainty, supply constraints, weaker consumer sentiment, and continued COVID-19 uncertainty.



Source: Bloomberg



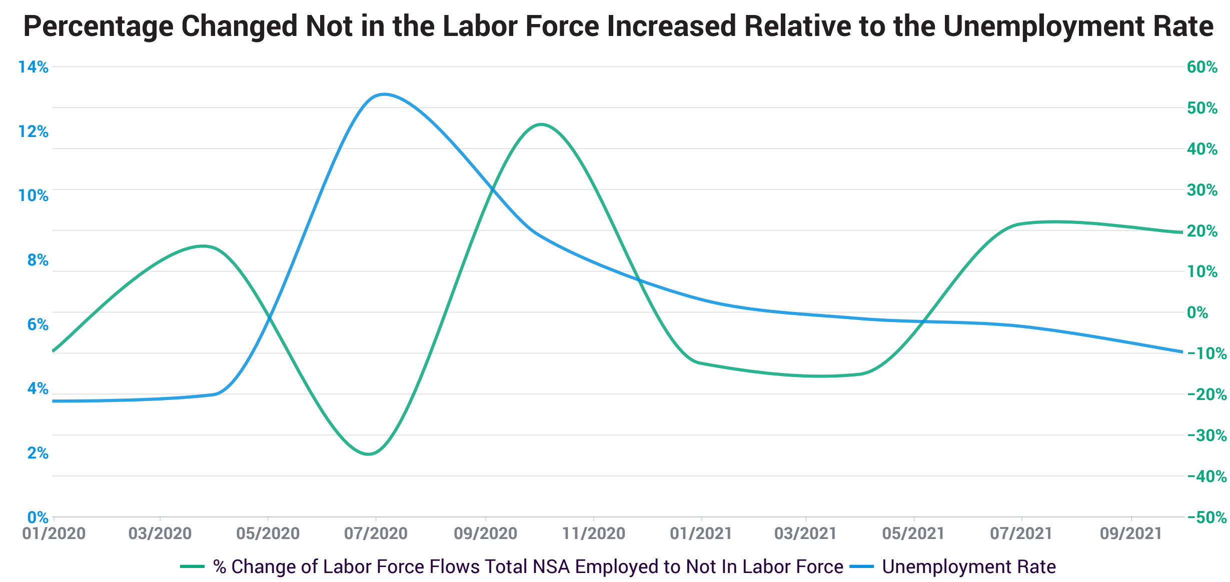
Source: Bloomberg

5.13%

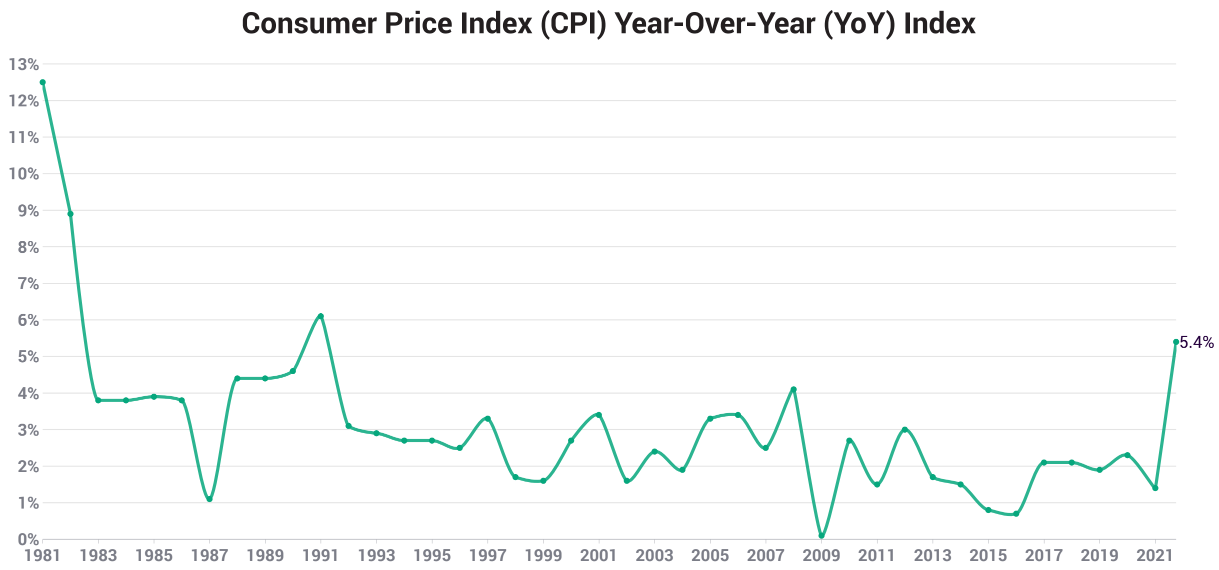
Unemployment Rate

Based off a decreased labor force participation rate (LFPR) and increased flows to "not in the labor force", the unemployment rate (of 5.13%) seems to have an ill-informed positive bias towards a structural improvement.

The unemployment rate remains structurally higher than pre-COVID-19 levels while the Labor Force Participation Rate (LFPR) -- 25 to 54 yrs. old -- has decreased. The LFPR is a measure of an economy's active workforce calculating the number of all employed workers and those actively seeking employment divided by the total civilian population. The flows from "Employed" to "Not in the Labor Force" has also increased, potentially illustrating a false indication of full employment. Based off a decreased labor force participation rate and increased flows to "not in the labor force", the unemployment rate (of 5.13%) seems to have an ill-informed positive bias towards a structural improvement.

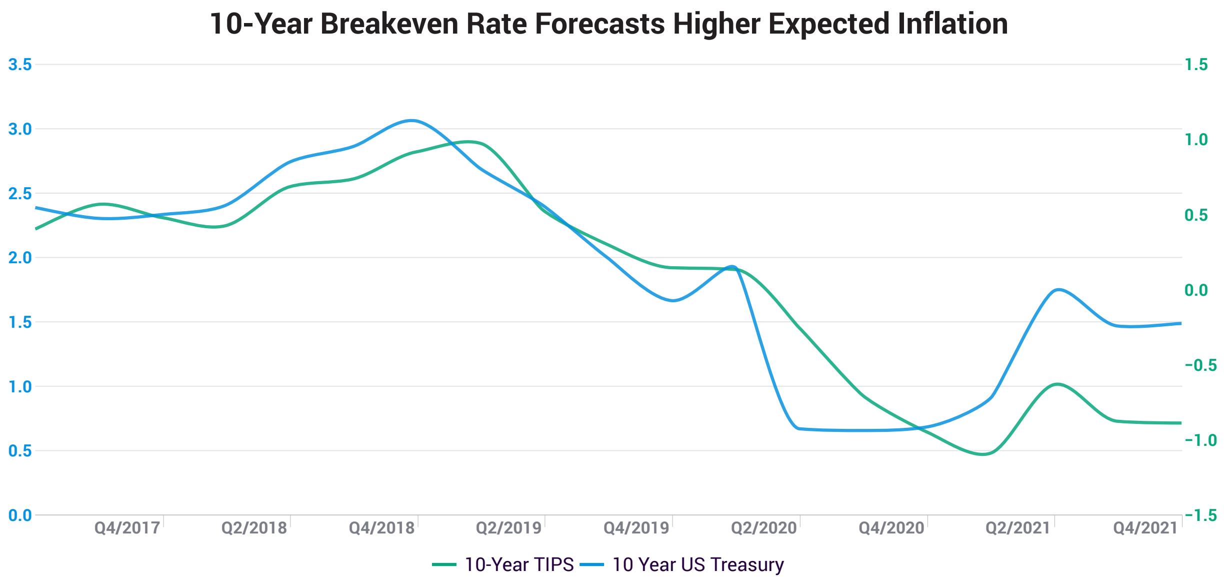


Source: Bloomberg



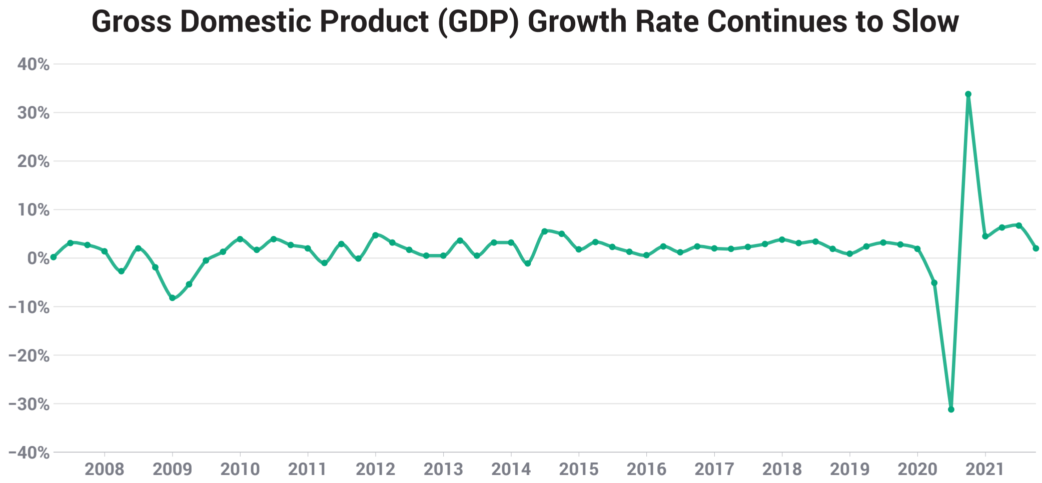
Source: Bloomberg

The Breakeven Rate of Inflation (or the measure of expected inflation) is calculated by the difference between the nominal yield of the Treasury and the Treasury Inflation Protected Securities (TIPS). TIPS are a type of Treasury security that has a principal value that rises as inflation rises and decreases as inflation or inflation adjusted income securities decrease. In practice, the 10-Year Breakeven Rate of Inflation (10-year expected inflation rate) illustrates an expected 10-year inflation of 2.52% (10-Year Nominal Treasury of 1.55% minus the 10 Year TIPS yield of -0.97%). However, intermediate term (3-7 years) breakeven rates indicate an almost 2.9% inflation rate and near-term (0-3 years) breakeven rates indicate an almost 3.2% inflation rate.



Source: Bloomberg

The gross domestic product (GDP) growth has stalled and has started to slow to around 2.0% amid the current thematic backdrop.



Source: Bloomberg

03.

The Current Recipe for Stagflation

Ingredients		Measurements
1.	Heightened Inflation	Caused from monetary policy injecting cash into the economic and financial system due to COVID-19 headwinds coupled with supply bottlenecks
2.	Increasing Bond Yields	Inflation has driven up bond prices, real yields continue to drop, and the market demands higher prices for lending out further. Higher bond yields seem to align with the market pricing in a Fed Taper.
3.	Federal Reserve (Fed) Scaling Back Pandemic-Era Stimulus Programs	Caused a behavioral shock where individuals who have been flush with cash want to spend.
4.	Supply Chain Bottlenecks	Caused by lower labor participation rates and undervalued demand projection from companies.
5.	COVID-19 Booster Shots	The remaining uncertainty regarding the delta variant with COVID-19 booster shots increase excuses for individuals to remain in their COVID-induced status quo (the "new normal" verbage)
6.	Soaring Oil Prices	A product of higher demand from economic reopening, constrained supply from OPEC, and high natural gas prices (oil as the substitute). Higher oil prices make shipping more expensive (spawning unemployment), adding fuel to the stagflation fire.
7.	Slowing Consumer Spending	Consumer spending has recovered from COVID-19 lows, but the supply shortages have caught up to the consumer's spending habits. Higher prices and lack of product availability has stunted behavioral spending (despite US consumers historically robust spending habits).
8.	Retreating Real Yields	Have breached new record lows as concerns mounted over the outlook of economic growth
9.	Uncertain Economic Growth Prospects	A residual integration, COVID-19 uncertainty looming, reduced consumer spending, slower GDP growth, lower labor participation rates, stagnant fiscal policy and challenging monetary policy coupled with behavioral shifts in individuals puts economic growth in uncharted waters.

04.

Risks of Current Stagflation

Market Inconsistencies

Market moving inconsistencies caused by the stock market's "re-valuation" post-COVID-19. Some (but not all) of the market moving inconsistencies are:

- Non-linear stock market overvaluations
- Unpredictable shifts in consumer behaviors (COVID-19 changed individual status quos)
- Uncapped equity volatility rooted in sluggish returns from traditional growth and large cap stocks
- Inconsistent economic data constrains predictability of macro guidance

Fed Policy Mismatch

Fed's monetary policy only impacts demand-side inflation, causing a mismatch between policy and the current economic situation

Unprecedented Consumer Spending

The persistent delta variant uncertainty, fiscal and monetary policy headwinds, increasing inflation, decreasing personal incomes (in September) and worsening supply constraints have muddled consumer spending potentially causing unforeseen impacts on a wide variety of industries and subsectors.

05.

How to Weather Stagflation

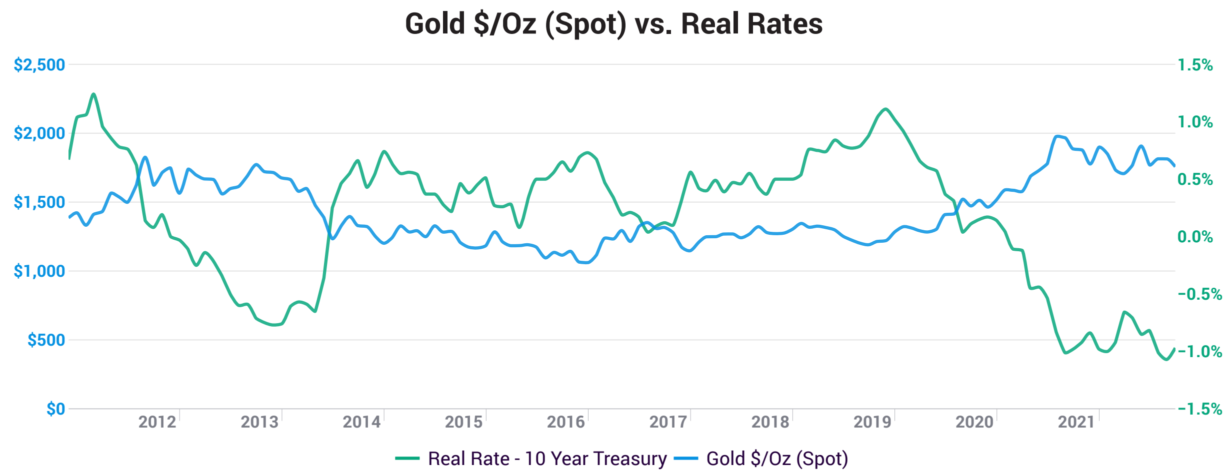
Increase Your Exposure To:

01	02	03	04	05
Gold-Linked Exposure	Soft Commodities	Floating-Rate Securities	Short-Term Corporate Bonds	Legacy Non-Agency RMBS

High supply-side inflation, slow GDP growth and stubbornly high unemployment seems like an investing nightmare. However, that is only if investors do not know where to find opportunities. To weather stagflation and optimize investment performance, investors should increase their exposure to:

01. **Gold-Linked Exposure**

Gold prices are driven by real rates. With real rates at almost historically negative levels, driven by inflationary fears and current thematic backdrop, Gold's 0% interest rate becomes increasingly more attractive for investors.



Source: Bloomberg

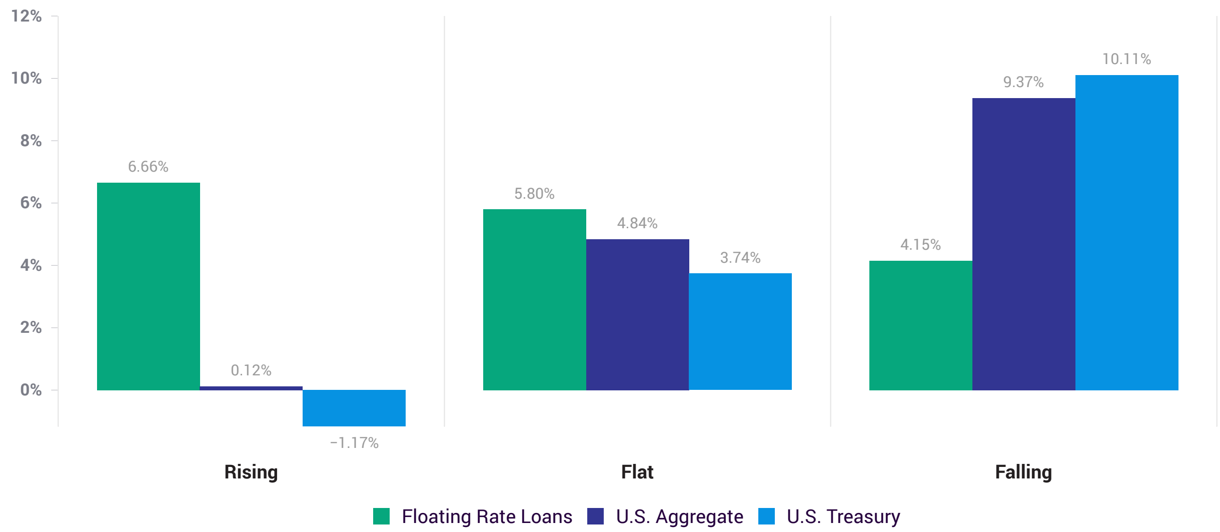
02. **Soft Commodities**

Other precious metals and soft commodities such as coffee, cocoa, sugar, corn, wheat, soybeans, fruit, and livestock (to name a few) do well as demand for consumer staples remain relatively stable during times of inflation. Hard commodities like steel, copper, aluminum etc. tend to underperform during slower economic activity and slower demand. Therefore, active commodity strategies that integrate macroeconomic effects on commodities remain essential for outperformance.

03. **Floating-Rate Securities**

Floating-rate securities or leveraged loans perform well during all rate environments but perform best during rising-rate environments (or stagflation pressures) when compared to the Barclays Bloomberg US Aggregate Bond Index and U.S. Treasury Bonds. Fundamentally, floating-rate bonds' interest payments "float" or move with interest rate movements, weathering interest rate fluctuations.

Senior Secured Notes Perform in Rising, Flat and Falling Rate Environments



Source: Credit Suisse and Bloomberg Barclay Indices. "Rising" indicated by an increase of more than 50 bps. "Falling" indicated by a decrease of more than 50 bps. Data reflects rolling 12-month periods from 01/31/93 through 09/30/2021

04. **Short-Term Corporate Bonds**

Short-term corporate bonds outperform their long-term corporate bond counterparts during stagflation as the Fed normally tries to contain runaway inflation by increasing interest rates on the shorter end of the yield curve. This makes longer term bonds with lower yields less valuable, thus, pushing the long-term bond prices lower. Sub-sequentially this causes funds with longer durations to underperform. Short-term corporate bonds have less inflation and interest rate risk, which remain pivotal to optimize fixed income returns during the current economic environment.

05. **Legacy Non-Agency RMBS**

Legacy non-agency RMBS (or non-agency RMBS transactions that were completed prior to the 2008 financial crisis – primarily in 2005 and 2007) indirectly hedge inflationary pressures and bond price drawdowns amid low correlations with the overall market. Complex, astute RMBS managers can utilize agency mortgage Interest Only (IOs) securities to capitalize on a rising rate environment (a normal reaction from heightened inflation or stagflation). Agency Mortgage Interest Only Securities (IOs) are mortgages that strip the interest from the principal portions, generating income from just the interest payments. An increase in interest rates (currently rate hikes are looming in the near future) would cause borrowers to prepay slower, extending the duration of the mortgage pool and increasing the value of the IOs. Therefore, a rising rate environment (like we anticipate over the next few years) helps agency mortgage IOs outperform. Furthermore, legacy non-agency RMBS' also have an opportunity bias; lower interest rate sensitivity, robust cash flows, underlying mortgages with baked in credit strength (survived housing market collapse of 2007), low loan-to-value ratios and structural support by the current robust and resilient residential U.S. housing market (where demand remains relatively stable when compared to other current consumer spending habits) provide fundamental strength.

06.
Conclusion

Even though the term "stagflation" remains an unconfirmed fear for investors as they try and draw parallels to the 1970s, that does not mean that opportunity does not exist. Rather, it is quite the opposite. A proper understanding of the intricacies of stagflation would indicate that gold, soft commodities, floating-rate bonds, short-term corporate bonds, and legacy non-agency RMBS remain the key asset classes that investors should seek to gain exposure to not only mitigate stagflation risk but to generate higher risk-adjusted returns as well.

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Hunter Frey is an Analyst at Catalyst Capital Advisors, LLC and Rational Advisors Inc. covering all in-house equity strategies and an insider buying income-oriented strategy at Catalyst Funds. Mr. Frey received a Bachelor of Science degree in International Business with a focus in Spanish from Gardner-Webb University, Godbold School of Business, and is in pursuit of a Master of Business Administration in Economics and Finance from New York University, Stern School of Business.

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7415-NLD-11162021