Stagflation Nation:
How to Beat Flat Markets and Inflation This Summer

WEALTH DAILY

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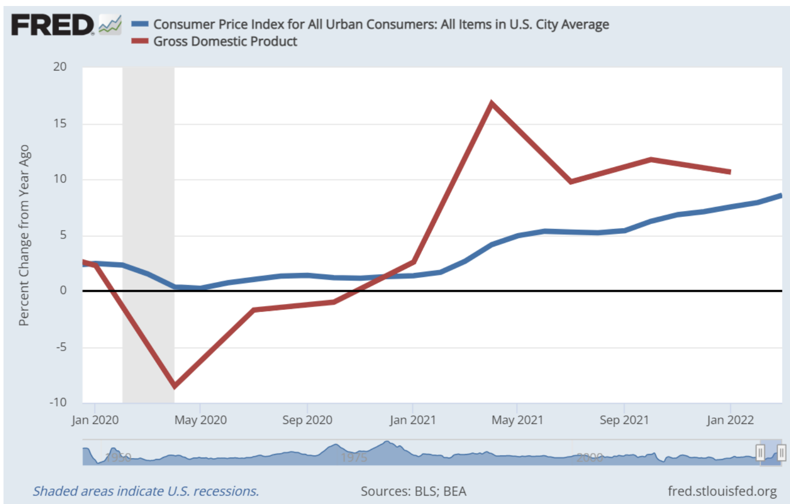
You've seen the headlines — and you've seen the prices at your local stores. After decades of stable consumer prices, inflation is back with a vengeance.

The latest reading of the consumer price index (CPI) showed a year-over-year increase of more than 8.5% — nearly three times what economists consider a healthy level of inflation.

Normally, strong inflation comes with a strong economy. And to be sure, U.S. GDP has rebounded considerably from the COVID-19 depression in recent years. *But not quite fast enough to keep up with inflation.*



Source: https://fred.stlouisfed.org/series/CPIAUCSL#0

As you can see, annual GDP growth peaked in the spring of 2021 — and has visibly faltered since then. Meanwhile, CPI growth keeps gaining steam over time — and looks set to overtake GDP growth by the end of 2022.

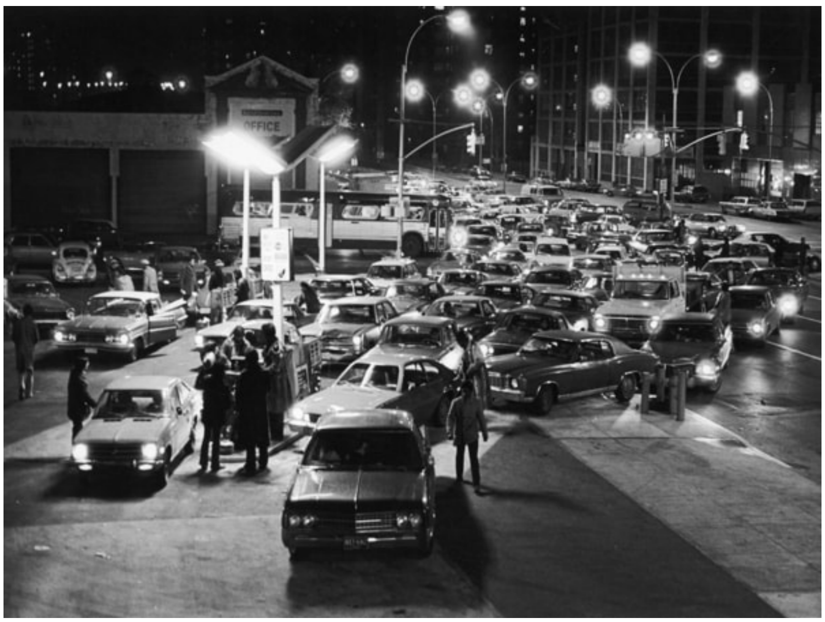
When rising inflation combines with stagnating economic growth, the result is what economists fittingly call *stagflation*.

WHAT CAUSES STAGFLATION?

That term may be familiar to our readers who were around in the 1970s; stagflation defined the economy of that decade. The causes of 1970s stagflation are quite similar to the causes of 2020s stagflation — and so it's reasonable to expect that the effects will be similar, too.

Economists generally agree that stagflation is caused by *supply shocks* — sudden supply decreases and/or price increases of vital industrial inputs. And the stagflation of the 1970s was caused by a supply shock in one particular input: oil.

Oil prices were already on an uptrend at the beginning of the decade. They skyrocketed in 1973 when Middle Eastern geopolitical tensions led to an Organization of Petroleum-Exporting Countries (OPEC) embargo against the .US. and several other Western countries.

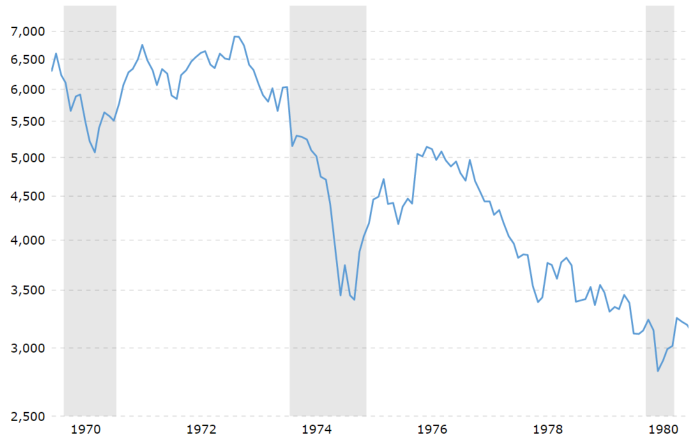


Source: https://www.cnn.com/2016/04/21/opinions/when-americans-fought-over-gasoline-opinion-jacobs/index.html

The resulting gas shortages — and gas lines, like the one shown above — devastated consumers across the U.S. And the longer-term effects of the oil shock hamstrung the economy for years.

Since oil is used in the production of so many goods, the sharp increase in oil prices simultaneously raised consumer prices and dented corporate profits — leaving consumers to grapple with an increasing cost of living, rising unemployment, *and* falling asset values.

For investors, the results were not pretty. The chart below shows the Dow Jones Industrial Average between 1970 and 1980…



Source: https://www.macrotrends.net/1319/dow-jones-100-year-historical-chart

In the waning days of the COVID-19 pandemic, the U.S. is facing a similar supply shock — except that rather than oil, the affected input is… well, *everything*.

Some of the most iconic images of the early pandemic looked remarkably similar to those from 1973 — lines of cars snaking around blocks, waiting to buy things.

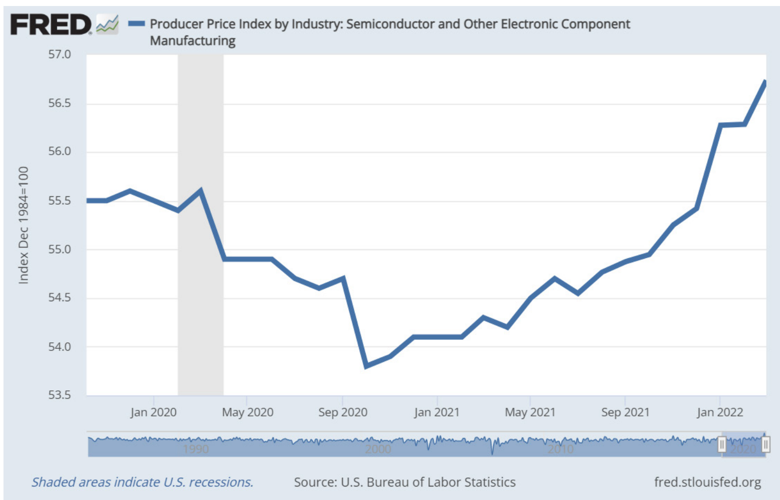
Source: https://www.motherjones.com/food/2020/04/these-photos-show-the-staggering-food-bank-lines-across-america/

But these 2020 car lines weren't for gas — they were for food, paper products, and other basic essentials.

COVID-19 lockdowns had frozen the economy, causing production disruptions, shortages, and price spikes in basic consumer goods — while simultaneously throwing millions of Americans out of work. People's survival instincts kicked in — and they stocked up on whatever they could.

As in the 1970s, the effects of this sudden supply disruption are lasting longer than the initial crisis. There are no more COVID-19 lockdowns here in the U.S., but they are still widespread in China and many other important trading partners (in part due to less access to Western-made vaccines).

As a result, many imported industrial components — like semiconductors and plastics — remain scarce and expensive, leaving consumers in the 2020s to deal with still-rising prices and a tepid economic recovery.



Source: https://fred.stlouisfed.org/series/PCU33443344#0

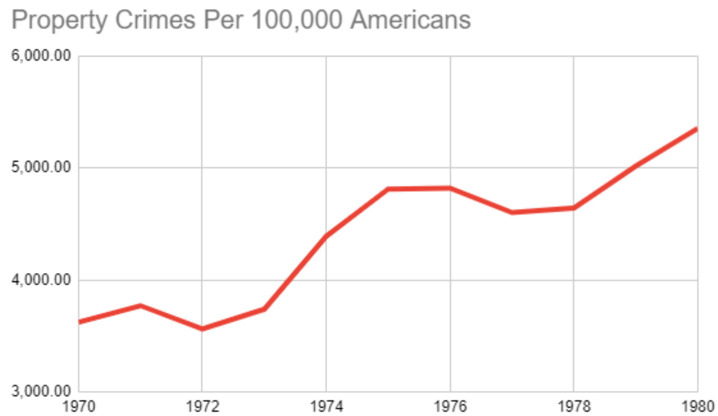
If the 1970s are any example, that doesn't bode well for the stock market as a whole. But certain stocks could actually benefit from stagflation-related changes in consumer behavior…

STAGFLATION INCREASES PROPERTY CRIME — AND ADT (NYSE: ADT) COULD BENEFIT

One of the most dramatic effects of stagflation is an increase in property crime. A 2016 study published in the *Journal of Quantitative Criminology* by University of Missouri professors Richard Rosenfeld and Aaron Levin found that "only inflation has consistent and robust short- and long-run effects on year-over-year change in the offense types under consideration."

Those of you who lived through the 1970s stagflation probably knew that already. The rate of property crimes per 100,000 people increased by nearly 50% between 1970 and

1980 — an even sharper increase than during conventional downturns like the Great Depression and Great Recession.

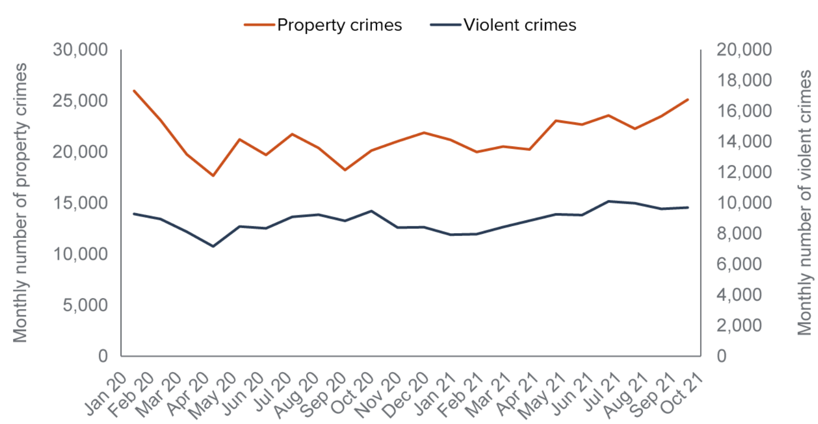


Source: Author, with data from https://www.disastercenter.com/crime/uscrime.htm

History appears to be repeating itself during the 2020s stagflation.

As you can see in the below chart from the Public Policy institute of California, crime — and property crime in particular — rapidly recovered to pre-pandemic levels over the course of 2021 and looks set to continue its uptrend in 2022.

Reported violent and property crimes are now similar to pre-pandemic levels



FROM: PPIC Blog, December 2021.
SOURCE: The figure shows monthly number of reported crimes calculated from data downloaded from each city's crime data website.
NOTE: Property crimes include burglary, larceny, and motor vehicle theft while violent crime includes homicide, rape, robbery, and aggravated assault. While we attempted to include the same type of crimes for each city, there may be some variation due to reporting differences across cities.

Source: https://www.ppic.org/blog/after-decreases-in-2020-both-property-and-violent-crimes-are-up-in-2021/

With this in mind, home security systems are likely to see increased demand over the coming years of stagflation.

Research firm Mordor Intelligence expects the North American market for home security systems to register a compound annualized growth rate (CAGR) of 7% through 2026 — and the market leader in home security could benefit handsomely from this trend.

Founded in 1874 and based in Boca Raton, Florida, ADT is the largest home and business security company in America by revenue, having taken in $5.31 billion in the last 12 months from more than 6 million customers. That revenue has steadily grown in recent quarters.

As you can see above, ADT shares have taken a tumble over the last year, as the company briefly lost profitability in 2019 due to rising research and development costs. But it is expected to return to profitability in the next year; it has a forward price-to-earnings (P/E) ratio below 15.

It also pays a dividend with a yield just under 2% at the time of writing.

PEOPLE MAY TRY TO DRINK AWAY STAGFLATION WITH DIAGEO (NYSE: DEO) PRODUCTS

One of the first subjects taught to economics students is the difference between *elastic* and *inelastic* demand. Consumers will reduce purchases of goods with elastic demand — typically luxury goods like sports cars — if the prices of those goods increase or if consumers' income drops.

But consumers will *always* keep buying goods with inelastic demand, even if those goods cost more or consumers have less money. Alcohol is a classic example of a good with inelastic demand. It's difficult to substitute with other goods, it can be addictive, and people use it as a stress release during times of economic malaise.

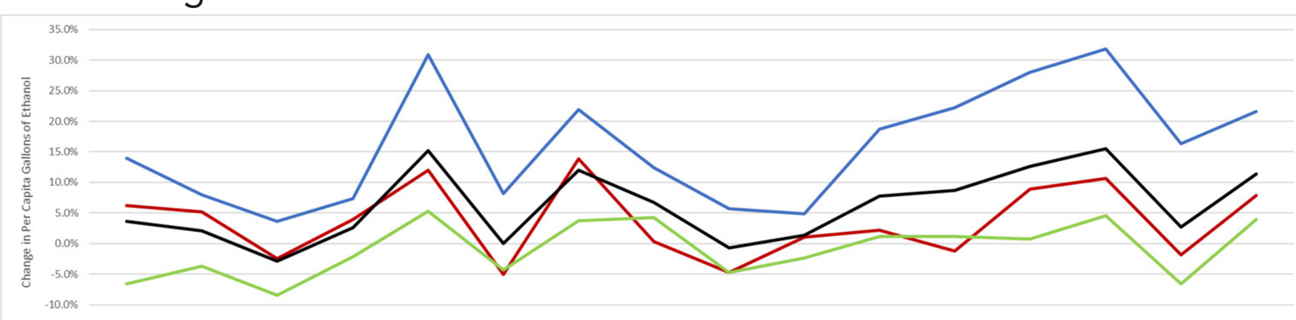
Stagflation is a situation in which goods cost more *and* consumers have less money — but history validates the inelasticity of alcohol demand, even under such dire conditions.

Data from a long-running Gallup poll suggest that alcohol consumption in the U.S. increased by roughly 10% over the course of the 1970s…

Source: Author, with data from https://news.gallup.com/poll/1582/alcohol-drinking.aspx

And the same appears to be happening in the 2020s. Data from the National Institutes of Health show that per capita sales of alcoholic beverages have been increasing ever since the start of the pandemic, with liquor posting the biggest gains by far.

As of summer 2021, liquor sales were up more than 20% over their average during the 2017–2019 period used as the base value, and look set to continue their increase in the years ahead. Mordor Intelligence expects the U.S. liquor industry to grow at a CAGR of 5.02% through 2026.



	March '20	April '20	May '20	June '20	July '20	August '20	September '20	October '20	November '20	December '20	January '21	February '21	March '21	April '21	May '21	June '21
Spirits	14.0%	8.0%	3.6%	7.4%	30.9%	8.2%	21.9%	12.4%	5.7%	4.9%	18.7%	22.2%	28.0%	31.8%	16.3%	21.6%
Wine	6.2%	5.2%	-2.5%	3.9%	12.0%	-5.0%	13.9%	0.3%	-4.7%	1.1%	2.2%	-1.2%	8.9%	10.7%	-1.8%	7.9%
Beer	-6.6%	-3.7%	-8.4%	-2.1%	5.3%	-4.3%	3.7%	4.3%	-4.7%	-2.3%	1.2%	1.2%	0.8%	4.6%	-6.6%	3.9%
All	3.6%	2.1%	-2.9%	2.6%	15.2%	0.0%	12.0%	6.7%	-0.7%	1.4%	7.8%	8.7%	12.6%	15.5%	2.7%	11.4%

Source: https://pubs.niaaa.nih.gov/publications/surveillance-covid-19/COVSALES.htm#fig1

That's bad news for our livers — but good news for one of the world's biggest liquor producers.

Founded in 1997 and based in London, Diageo is a conglomerate of alcohol producers and the world's second-largest distiller after China's Kweichow Moutai (which mostly produces baijiu for the Chinese market).

Diageo owns many of the world's most recognizable liquor brands, including Johnnie Walker, Smirnoff, Captain Morgan, Don Julio and Tanqueray.

Although it owns a few beer brands (most notably Guinness, Harp Lager, and Smithwick's), it is more liquor-focused and less beer-centric than competitors like AB InBev, which could give it an advantage in the current market environment. Per the above graph, beer and wine sales have actually decreased at several points in recent years.

Diageo shares have enjoyed a modest increase over the last year, and there's reason to believe that increase could continue.

The company is profitable on an earnings basis, has steadily grown revenue in recent quarters, and pays a modest dividend equal to a bit under 0.50% at the time of writing.

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