



**CIO Insights**

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# **From Inflation To Stagflation**

*What-if Possibilities Become Realities*

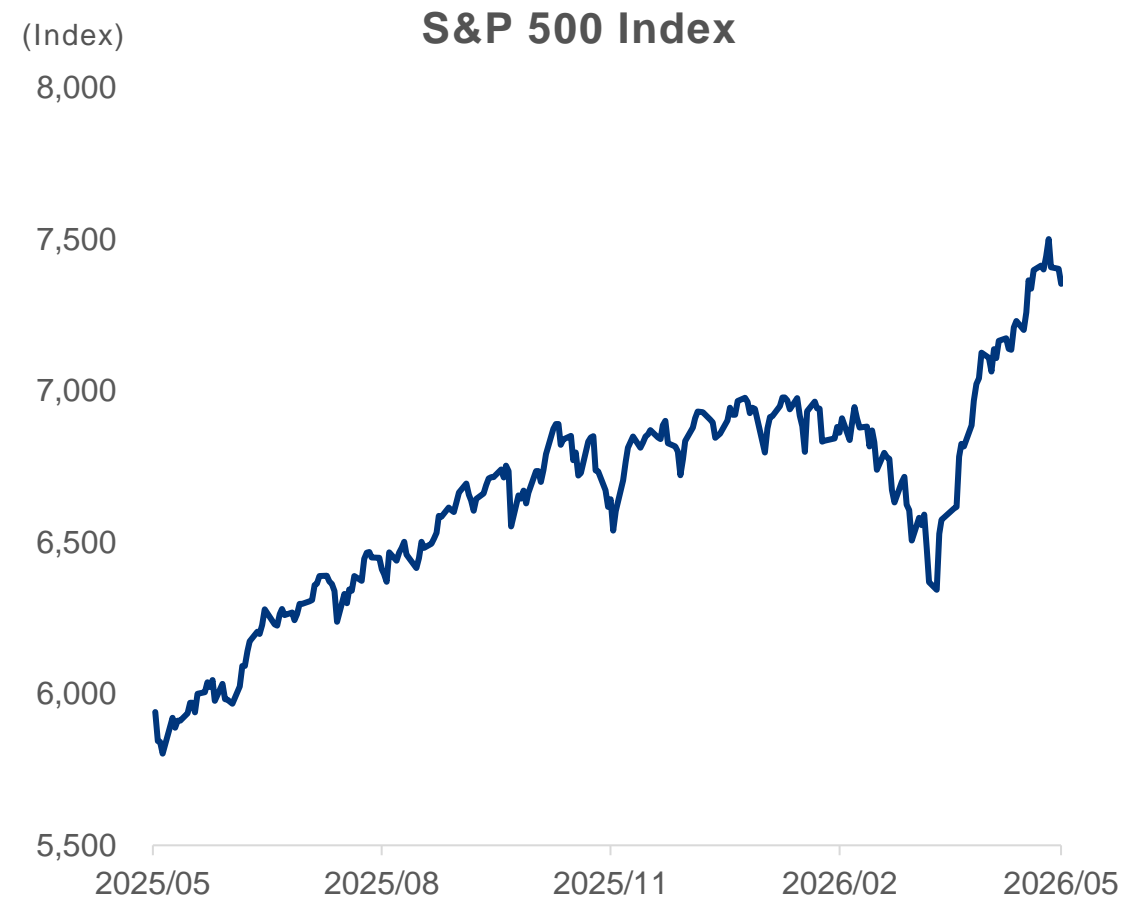
22 May 2026



# 70+ Days of Closure of the Strait of Hormuz

## The Global Stock Market Is Still Acting Like This Is of Transitory in Nature

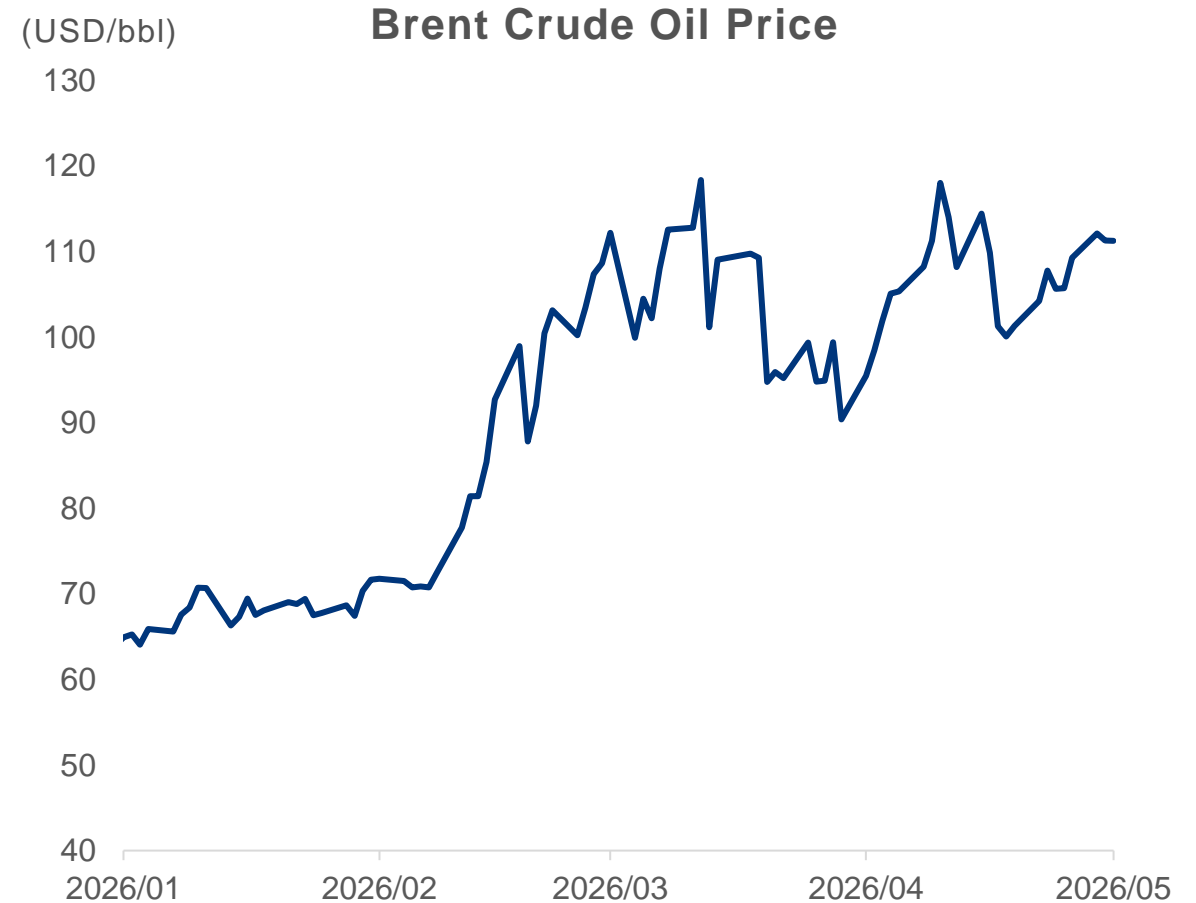
- The Strait of Hormuz is the world's most critical oil chokepoint, handling approximately **21 million barrels per day (bpd)** – roughly 21% of global petroleum liquids consumption.
- Global oil inventories are on a steep drawdown trajectory; current models project inventories reaching **critical threshold levels by June 2026**, contingent on the pace of austerity measures adopted by consuming nations.
- OECD commercial oil stocks, which typically buffer 90+ days of demand, are being depleted at an estimated rate of **1.5–2 million bpd** above normal seasonal drawdowns.



# The Bet on Transitory Inflation Is Failing

**When a Supply Shock Lasts > ~60-90 Days It Shifts From a Temporary Spike to a Structural Reset**

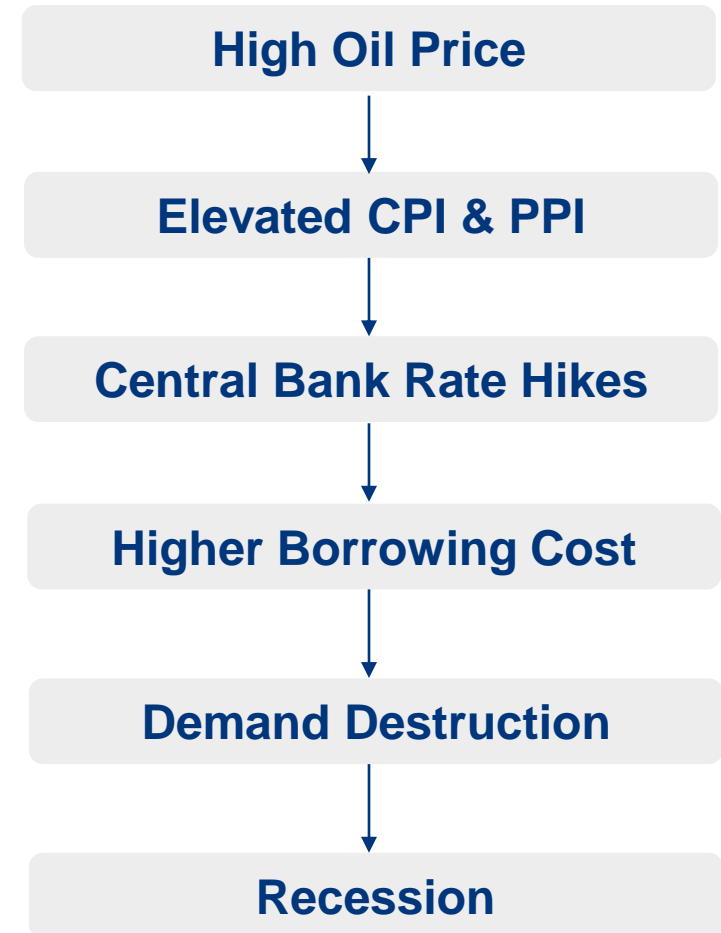
- For the first weeks of the crisis, market positioning reflected a "transitory" view – disruption was expected to be brief and oil spikes self-correcting.
- This echoes the 2021-2022 error when central banks labeled inflation transitory, delaying policy and allowing expectations to drift.
- Corporate guidance increasingly reflects input-cost pressure; freight, petrochemicals, plastics, and fertilizer sectors are repricing.
- Sustained closures embed higher energy costs into supply chains and transport – producing second-round inflation effects.



# Stagflation Is No Longer a Tail Risk

## Cost-Push Stagflation Leaves the Fed With Tools That Will Cause Collateral Damage

- Stagflation is defined as the simultaneous occurrence of high inflation, stagnant or negative economic growth, and elevated unemployment – a combination that defies conventional monetary policy remedies.
- At the same time, the supply-side shock constrains output independently of demand, meaning the economy faces both a cost-push inflation problem and a growth contraction simultaneously.
- The Federal Reserve faces a classic policy dilemma: raise rates to fight inflation (risking deeper recession) or cut rates to support growth (risking further inflation entrenchment).
- Current projections suggest US CPI could breach 5-7% on a sustained basis if oil remains elevated, while GDP growth forecasts have already been revised downward toward 0-1% for 2026.

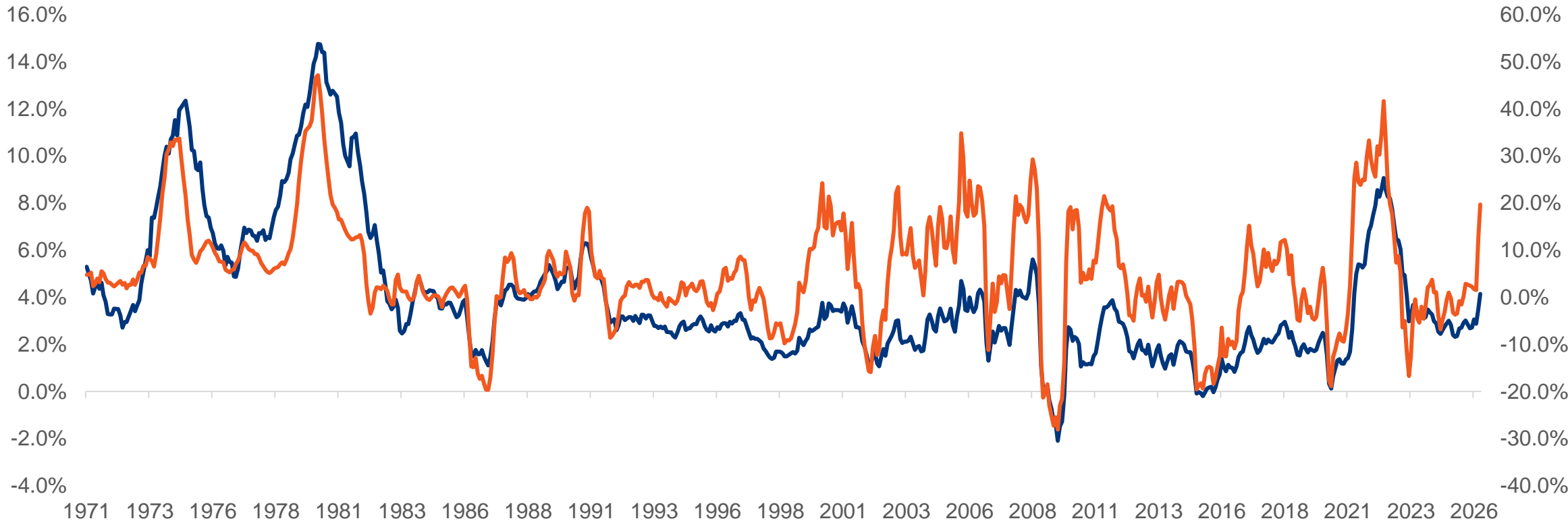


# Us Inflation Is Highly Dependent on Rise in Energy Cost

The 70s and 80s Are the Two Perfect Examples of Stagflation Led by Surge in Energy Cost

The US CPI and Energy Cost Inflation

— US Inflation (LHS) — US Energy Inflation (RHS)



Source: Bloomberg, KGI

# Two Oil Shocks, Two Recessions, and One Decisive Policy

## Decisive, Credible Tightening – Though Painful – Is the Only Proven Cure

Period	Trigger	Peak CPI	Fed Response	Outcome
1973-1975	OPEC embargo; Nixon closes gold window; monetary expansion	~12% (1974)	Arthur Burns: accommodative, then tightening; wage & price controls	Recession 1974-75; inflation not fully tamed
1979-1982	Iranian Revolution (1979 oil shock); second OPEC supply cut	~15% (1980)	Paul Volcker: aggressive rate hikes to 20% Fed Funds Rate	Deep recession 1981-82; inflation decisively broken by 1983

### ARTHUR BURNS (1970–1978)

- Mistakenly attributed inflation to "special factors" (unions, food, oil) rather than monetary policy.
- Accommodative stance allowed inflation expectations to become entrenched; wage-price controls provided only temporary relief.

### PAUL VOLCKER (1979–1987)

- Implemented a radical "monetarist experiment" – targeting money supply growth, driving the Fed Funds Rate to nearly 20% by June 1981.
- Deliberately induced a severe recession (10.8% unemployment in Dec 1982) to break inflationary psychology, reducing CPI to below 3% by 1983.

# The Stagflation Spiral: Oil Shock to Recession in Four Stages

**The US Economy Is Transitioning From Stage 2 to Stage 3, With Stage 4 Risks Rising Materially as the Strait of Hormuz Closure Extends.**

## 1. Energy Price Shock.

Oil price surge raises gasoline, heating fuel, and electricity costs for households and businesses; transportation and logistics costs spike across all supply chains.

## 2. Broad Inflation.

Energy costs feed into CPI (direct) and PPI (indirect) across food, manufacturing, chemicals, and services; core inflation rises with a 3-6 months lag.

## 3. Central Bank Response.

Fed raises interest rates aggressively to anchor inflation expectations; mortgage rates, corporate borrowing costs, and consumer credit rates all rise; the yield curve inverts or flattens. (The market is starting to build in this possibility.)

## 4. Demand Destruction & Recession.

Higher borrowing costs reduce capital expenditure, housing activity, and consumer spending; real wages turn negative as nominal wage growth lags inflation; unemployment rises; GDP contracts.

# Energy, Commodities and Defensive Sectors Under Stagflation

## Gold Was the Perfect Stagflation Hedge Assuming It Turns Back Into a Safe-Haven Asset

- **Energy.** Direct revenue benefit from elevated oil & gas prices; upstream producers, refiners, and integrated majors see significant margin expansion.
- **Healthcare.** Defensive sector with highly inelastic demand; pricing power remains independent of the economic cycle due to non-discretionary spending.
- **Utilities.** Regulated pricing and inflation pass-through mechanisms; dividend yield becomes attractive vs. bonds in early stagflation phases.
- **Commodities And Materials.** Broad commodity price inflation benefits miners, agricultural producers, and chemical companies with strong pricing power.
- **Consumer Staples.** Essential goods with pricing power; consumers systematically cut discretionary spending before reducing staples consumption.
- **Infrastructure.** Hard assets appreciate with inflation; toll roads, pipelines, and real estate benefit from inflation-linked lease structures.

# Sectors to Avoid Under a Stagflation Environment

## Consumer Discretionary, Financials, and Rate-Sensitive Sectors Face the Sharpest Headwinds

- **Consumer Discretionary will have severe demand destruction.** Real wages turn negative; consumers prioritize essentials; big-ticket spending (autos, appliances, travel, dining) collapses.
- **Financials (Banks) will face increasing credit losses.** Rising rates initially help NIM, but loan defaults rise as recession deepens; commercial real estate exposure becomes toxic.
- **Real Estates (REITS) will face rising cap rates and valuation compression.** Higher interest rates increase discount rates; property values fall; mortgage REITs face funding cost squeeze.
- **Industrials will see input cost inflation and demand slowdown.** Raw material and energy costs rise faster than product prices; order books shrink as corporate capex is cut.
- **Airlines/Transport will see fuel cost explosion.** Jet fuel is the largest operating cost; cannot fully pass through to consumers in a recession environment.

The consumer discretionary sector faces a double blow – negative real wage growth reduces purchasing power while higher borrowing costs eliminate the credit-fueled spending that has sustained consumption in recent years.

# AI Is the Last Line of Defense

## But Its Resilience Depends On Corporate, Not Consumer, Demand

### The Bull Case For AI/Tech

- Unlike the consumer sector, AI revenue is predominantly driven by enterprise and corporate clients – hyperscalers, financial institutions, healthcare systems, and industrial companies – whose spending is driven by productivity ROI rather than consumer confidence.
- In Q1 2026, business investment contributed 1.48 percentage points to US GDP growth, outpacing consumer spending (1.08 pp) for the first time – driven almost entirely by AI infrastructure buildout.
- The "Magnificent 7" have collectively committed to ~\$725 billion in AI capex in 2026, a figure that has been revised upward through earnings season.
- AI offers a genuine productivity offset to stagflation: if AI tools reduce labor costs, automate supply chain optimization, and improve energy efficiency, they can partially counteract the cost-push inflation from oil.

# AI Capex Could Prevent a Full-Blown Recession

## But It Is Not a Complete Antidote

### The Risk to the AI-Save-The-Day Thesis

- AI investment cannot fully offset a deep consumer recession; the multiplier from business investment is lower than from consumer spending.
- The US retail market is 10x larger than the collective US\$725bn capex as announced by the “Magnificent 7”, i.e. every 1 percentage point contraction in retail sales would need to be offset by a 10 ppt increase of the US\$725bn capex.
- The energy intensity of AI (data centers consume enormous electricity) means AI itself becomes more expensive in a high-energy-cost environment.
- If the Fed tightens aggressively, higher long-term rates will eventually compress the valuations and investment appetite of even the most committed AI spenders.

**AI corporate investment is a genuine partial buffer against stagflation-driven GDP contraction – potentially the difference between a mild recession and a severe one – but it is not a complete antidote.**

# Tilting of Investment Strategies

## When Possibilities Become Reality

- Stagflation is not just a risk to the US. This applies to the global economy. We use the US as a general principle for a tilting of our investment strategies.
- On equity, we prefer Energy & Commodities, Miners, Healthcare, Consumer Staples, AI infrastructure and Semiconductors. We will avoid Consumer Discretionary, Long duration and high-multiple stocks as they are most sensitive to rising rates from any Fed tightening. Rising cap rates + recession risk will also be very negative for commercial real estate/office REITs.
- On fixed income, short-duration bonds (1-3 years) are preferred. This is will help to minimize interest rate risk and reinvestment at higher rates as Fed tightens. **Long-duration (treasuries and corporate bonds) and perpetuals are most exposed to inflation expectation repricing.** We would also trim down on the exposure to High Yield bond or fringe investment grade corporate bonds. In time of recession, the fringe investment grade credit will be under severe operating pressure.
- We also recommend Floating Rate Note of which the coupon resets with interest rates which will protect against duration risk.
- Gold will be the perfect stagflation hedge assuming it turns back into a safe-haven asset, i.e. when the current speculative sentiment on the commodities subsides.

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