

## Stagflation Nation? Preparing for the Uncomfortable Middle Ground: An OCIO Perspective

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APRIL 2025



Even before the announcement of the Liberation Day tariffs on April 2, 2025 and the following week-long global market sell-off, the Federal Reserve had downgraded its growth outlook for the US economy in its March summary of economic projections (SEP). In the same report, the Fed also raised its year-end inflation estimate.<sup>1</sup> The Fed's preferred measure of inflation – the Personal Consumption Expenditure (PCE) Index – has remained stubbornly elevated in the first months of 2025.<sup>2</sup>

The SEP's combined downgrade of growth with higher inflation marks a shift from last year's "goldilocks" economic path of resilient growth and falling inflation.<sup>3</sup> The sweeping global tariffs announced in the Liberation Day schedule has roiled global markets as investors repriced lower growth, compressed margins, and goods-price inflation.<sup>4</sup>

Although President Trump delayed the full implementation of the reciprocal tariffs for 90 days, China and the US are now in a full blown trade war with tariffs well over 100%. In a social media post, President Trump stated "Nothing is over yet."<sup>5</sup>

<sup>1</sup> Source: Federal Reserve, "Summary of Economic Projections," March 2025.

<sup>2</sup> Ibid.

<sup>3</sup> Source: Financial Times, H. Clarfelt, "Fed Has Signaled We Are in A Stagflation Economy," March, 2025.

<sup>4</sup> Source: Financial Times, C. Giles, "The Unmistakable Wiff of Stagflation on the Eve of Tariff Day," April 1, 2025.

<sup>5</sup> Source: Wall Street Journal, G. Bade, "Trump Pauses Reciprocal Tariffs, But Hits China Harder," April 9, 2025.

## Uncomfortable Questions in an Uncomfortable Middle Ground

It may take an extended period of time to fully understand the financial and economic repercussions of the new tariff regime announced by the Administration. Financial markets may find their footing more quickly than policymakers, businesses, and consumers. However, the new tariffs, if fully enacted, could increase the risk of a recession or potentially even stagflation here in the US.

Economists have substantially downgraded their economic outlook in response to the Liberation Day tariff regime. Recession now appears to be more likely.<sup>6</sup> Federal Reserve Chair Jerome Powell warned that the US could experience weaker growth and higher prices as the result of Liberation Day tariffs.<sup>7</sup> Some estimate that growth in the US could fall by as much as 100 bps as higher prices for goods at once depress consumer demand while prices rise.<sup>8</sup>

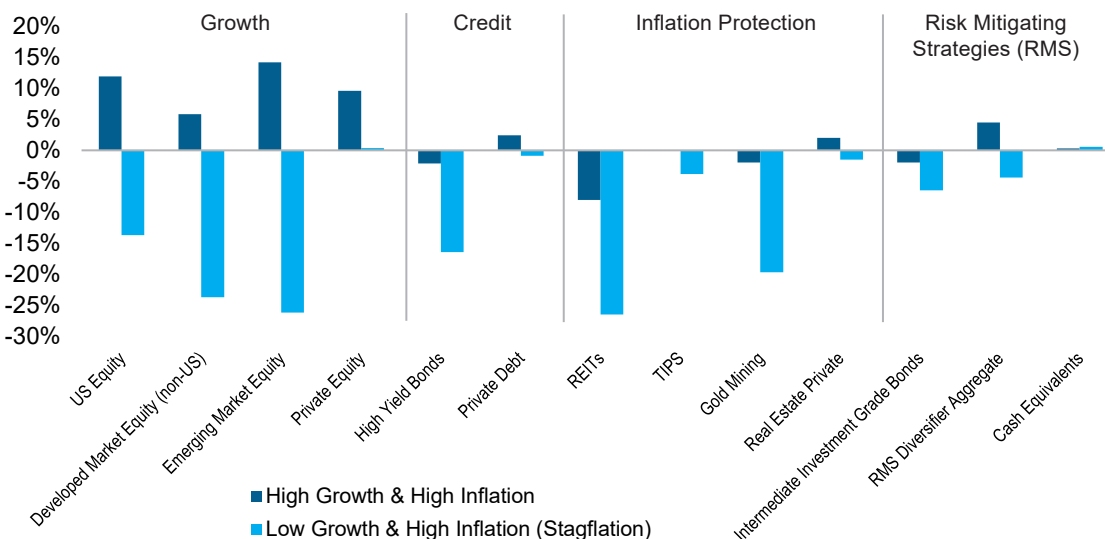
Importantly, while full-blown stagflationary conditions have yet to materialize, the ground work is being laid:

- The imposition of approximately 125% tariffs on all Chinese imports
- A unilateral 10% import tariff remains in effect.<sup>9</sup>
- Selective exemptions to certain industries

For the US consumer, tariffs on imports seem likely to lead to higher prices for consumer goods in the US.<sup>10</sup>

## What it May Mean for Portfolios

Stagflation is difficult terrain for investors. Slowing growth weighs on corporate earnings and equity valuations, while rising inflation can erode the value of nominal fixed income instruments. In such an environment, traditional 60/40 portfolios may struggle to meet return and risk expectations. However, in situations when equity and bond returns are positively correlated, there are inflation-linked asset classes that may offer investors some cover (see Figure 1). A diversified basket of inflation hedges (e.g., natural resources, real assets, commodities, and short-term TIPS) has historically served as a prudent way to protect against different inflationary environments.



<sup>6</sup> Source: TS Lombard, F. Bremish, "Little Bear, Big Bear," April 2, 2025. Bridgewater, G. Jensen et al., "Modern Mercantilism Chaos: What We Make of Liberation Day," April 3, 2025 has a 50% likelihood that the US will enter into a recession.

<sup>7</sup> Source: Wall Street Journal, N.Timiraos, "Powell Warns of Higher Prices, Weaker Growth After Tariff Plan," April 4, 2025.

<sup>8</sup> Source: Bridgewater, G. Jensen et al., "Modern Mercantilism Chaos: What We Make of Liberation Day," April 3, 2025.

<sup>9</sup> Source: Wall Street Journal, G. Bade, "Trump Pauses 'Reciprocal' tariffs, But Hits China Harder," April 9, 2025.

<sup>10</sup> Source: TS Lombard, S. Blitz, "Markets Spooked by More Than Market Risk," April 2, 2025.

**FIGURE 1**  
Historical Annualized Returns Under Inflation and Growth Scenarios (Assets Grouped By Functional Framework)

Source: Meketa analysis, 2025.

Meketa's Functional Framework organizes investments by their role in a portfolio—such as growth, income, or risk mitigation—rather than by asset class. This may help make clearer, more strategic allocation decisions aligned with investment objectives.

Functional framework for illustrative purposes only.

See appendix for methodology. Note that Stagflation scenario includes monthly economic data where inflation and growth are below rolling averages in a probability scenario threshold. Other Meketa inflation scenarios include inflation shocks, surprises and duration of inflationary periods.

## Preparation Over Prediction

At Meketa, we emphasize preparation over prediction. While no one can forecast every policy twist or geopolitical headline, we believe that a resilient portfolio is one that can adapt across a range of scenarios—including this “uncomfortable middle ground” of stagflation risk.

Back in 2021, we published a research piece titled “Inflation: Is It Coming and Should You Care?”—an exploration of how inflationary regimes can reshape investment outcomes. Since then, we’ve continued to refine our approach, developing a proprietary big data model designed to stress-test portfolios under scenarios including stagflation, severe inflation, and global trade disruption.

Today’s investment environment calls for more than tactical reaction—it requires strategic foresight and an institutional mindset. As stewards of client capital, we work to construct diversified portfolios that aim to deliver long-term outcomes, even when short-term conditions grow more complex.

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For more information on the sustainability of US earnings growth , what we are watching in 2025 , or our views on timeless asset allocation, please visit the [Thought Leadership](#) section of our [website](#) or click the links here to learn more.

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## Appendix A: Model Approach and Limitations

The Scenario Analysis tool estimates average, annualized returns for a broad array of asset classes under different kinds of inflationary scenarios. We run a multivariate regression model to estimate the effects of realized and surprise inflation on monthly asset returns, controlling for the economic environment. Quadratic independent variables are added to the regression model to account for potential non-linearity between an asset class and inflation. Estimated returns are then calculated as the expected value of asset class returns, conditional on the inflation scenario.

The reasons for this model approach are detailed below.

*Control for the Economic Environment.* Meketa wanted to control for the economic environment when looking at an asset's inflation hedging ability. Economic theory holds that inflation and growth are tightly related – low levels of inflation tend to spur economic activity, but when economic activity heats up too quickly, inflation grows. A regression model allowed us to estimate how much an asset's performance is due to the economic environment compared to its actual inflation-hedging ability.

*Avoid Mis-specification.* An asset class' inflation hedging ability is typically measured through the correlation of asset performance and inflation levels in historical periods. However, the real relationship between inflation and many asset classes is likely non-linear. Hence, inferring the relationship of inflation and asset returns with linear correlations could mis-specify their real relationship.

*Small Sample Size.* Meketa was limited to using regression models to identify the relationship between inflation and asset performance due to the small sample size. Non-parametric models require large sample sizes to perform well, but our sample size was 578 months.

*Easy Interpretation.* The estimated coefficients in a regression model are easy to interpret and validate with theory. Linear regression coefficients are interpreted as elasticities – the effect of Y given one unit increase in X holding all else constant.

As with all regression models, the results of our multivariate regressions depend on the following assumptions to be true:

- The linear functional form represents the true data-generating process.
- The covariance between the error term and independent variables are 0.
- The error term is normally distributed around 0 and has a finite variance.
- The residuals are homoscedastic and are not correlated.

The assumptions need to hold true for our estimators to be unbiased. In addition, by using a model with historical data, Meketa assumes that future asset behavior is similar to past asset behavior.

## Appendix B: Model Methodology

### Inflation Above Expectation

The model examines the effect of surprise inflation on asset returns, controlling for the economic environment and realized inflation:

$$\text{Asset Returns} = \beta_0 + \beta_1 \text{Unemployment} + \beta_2 \text{Unemployment}^2 + \beta_3 \text{Inflation} + \beta_4 \text{Inflation}^2 + \beta_5 \text{Surprise Inflation} + \beta_6 \text{Surprise Inflation}^2$$

where Asset Returns is the monthly asset class return from 1973 to 2020, unemployment is the 3-month rolling average unemployment rate, inflation is the monthly change in CPI from the 3-month rolling average CPI, and surprise inflation is the difference between this month and last month's inflation rate. Unemployment and inflation data are taken from the St. Louis Federal Reserve Bank's FRED database. The independent variables Unemployment2, Inflation2 and Surprise Inflation2 capture the non-linear effects of realized inflation, surprise inflation, and the economic environment on asset returns. For example, the relationship between Long-term Government Bonds and realized inflation may be an upside-down U shape in periods of high economic growth – Long-term Government Bond returns are positive when monthly inflation is low at .2% but returns turn negative when monthly inflation reaches higher levels, such as 0.5%.

The estimate is the annualized return of:

$$\beta_5 * E [\text{Surprise Inflation} \mid \text{Scenario}] + \beta_6 * E [\text{Surprise Inflation}^2 \mid \text{Scenario}]$$

where the scenarios are low (.05%, 25th percentile), medium (.15%, median), and high (.3%, 75th percentile) surprise inflation.

### Inflation and High/Low Growth

The model examines the combined effect of inflation and GDP Growth on asset returns:

$$\text{Asset Returns} = \beta_0 + \beta_1 \text{GDP Growth} + \beta_2 \text{GDP Growth}^2 + \beta_3 \text{Inflation} + \beta_4 \text{Inflation}^2$$

where Asset Returns is the monthly asset return from 1973 to 2020, GDP Growth is the percent change in GDP from the previous quarter, and inflation is the monthly change in CPI from the 3-month rolling average CPI. GDP Growth and inflation data are taken from the St. Louis Federal Reserve Bank's FRED database. Since GDP data is only quarterly, the regression was run on quarterly asset return, GDP and inflation observations.

The estimate is the annualized return of:

$$\beta_1 * E [\text{GDP Growth} \mid \text{Scenario}] + \beta_2 * E [\text{GDP Growth}^2 \mid \text{Scenario}] + \beta_3 * E [\text{Inflation} \mid \text{Scenario}] + \beta_4 * E [\text{Inflation}^2 \mid \text{Scenario}]$$

where the GDP Growth scenarios are high growth rate of 1% (75th percentile) and low growth rate of .3% (25th percentile). The inflation scenarios are low (.07%, 25th percentile), medium (.25%, median), and high (.5%, 75th percentile) realized inflation.

## Inflation Duration

The model examines the effect of inflation duration on asset return, controlling for the economic environment:

$$\text{Asset Returns} = \beta_0 + \beta_1 \text{Unemployment} + \beta_2 \text{Unemployment}^2 + \beta_3 \text{Inflation} + \beta_4 \text{Inflation}^2$$

where Asset Returns is the monthly asset return from 1973 to 2020, unemployment is the 3-month rolling average unemployment rate, and inflation is the monthly change in CPI from the 3-month rolling average CPI. Unemployment and inflation data are taken from the St. Louis Federal Reserve Bank's FRED database.

The estimate is the annualized return of:

$$\beta_3 * E[\text{Inflation} \mid \text{Scenario}] + \beta_4 * E[\text{Inflation}^2 \mid \text{Scenario}]$$

where the scenarios are short (1-2 months), medium (4-8 months) or long-term (12+ months) inflation duration.

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