BACK TO THE FUTURE?

Inflation has been dubbed “public enemy number one” by the President, with hopeful plans to combat the problem with campaigns like “Whip Inflation Now.” Facing recession fears, very accommodative monetary policy has been in place, with the Federal Reserve keeping rates low despite indications of rising inflation levels. At the same time, fiscal policy has also been generous with dramatic expansionary spending from Congress. Geopolitical supply shocks to oil have caused surging gasoline prices for consumers and businesses, while food prices also continue to climb. This has put pressure on American spending habits, while driving consumer confidence to historically low levels. The year is 1974. Muhammad Ali just knocked out George Foreman in the Rumble in the Jungle, and Bad Company’s self-titled debut album just reached number one on the Billboard 200.

Now back to the future. While President Ford pitched the “WIN” campaign, President Biden called inflation his “top domestic priority” (also used by President Carter) with a backdrop reading “Lowering Costs, Tackling Inflation.” Although the general description in the first paragraph could apply to today’s environment, the underlying causes of today’s inflation and the Great Inflation of the 1970s are different. In both cases, however, expansionary monetary and fiscal policies drove excess demand over supply.

- The Federal Reserve kept rates low in early and later parts of the 1970s, with a “stop-go” monetary approach of dramatically fluctuating the fed funds rate, which worsened inflation through the decade, instead of addressing it head on. Today’s Fed maintained a near zero fund rate and provided liquidity to the markets despite inflation approaching forty-year highs. A pivot to a tighter monetary approach did not come until March 2022, considered too late by many.

- The impact of expansionary spending of the 1960s, including the costs of President Johnson’s Great Society and escalating costs of the Vietnam War, was similar to the excess spending in pandemic relief payments. Through the CARES Act (passed March 2020) and American Rescue Plan (passed March 2021), more than $2 trillion in stimulus checks, unemployment benefits and Paycheck Protection Program loans was distributed to replace lost income for individuals and businesses, in addition to another $1.5 trillion in general pandemic relief funds. Although these were unprecedented times, this $3.5 trillion dwarf the $800 billion spent in response to the Great Financial Crisis in 2008 and 2009.

- The geopolitical shocks were different – the Arab oil embargo in 1973 (oil prices increased ~4x) and Iranian Revolution in 1979 (oil prices doubled) – compared to Russia’s invasion of Ukraine (oil prices increased ~30% but have pulled back since). Prior to the start of the war in late February, however, oil prices steadily increased about 50% year-over-year, caused by the “reopening” of economies shut down during the pandemic. Economically speaking, the pandemic created a “war time” environment, which was exacerbated further by the actual war in Europe.

The Federal Reserve's "dual mandate" is to achieve stable prices and maximum employment, thus keep the rate of inflation at low and predictable levels while attaining the maximum potential growth rate of GDP. During the 1970s, full employment was deemed the priority, as fighting inflation would be economically and politically damaging. The Fed also maintained a view that rising rates to restrain demand would be ineffective for inflation control. In 1965, 1975 and 1980, the annual rate of inflation was 1.6%, 9.1% and 13.5%, respectively, while the unemployment rate climbed from a low of 3.6% to a high of 10.8% from 1965 – 1982.[i] After Paul Volcker was appointed Federal Reserve chair in 1979, he said, "My basic philosophy is over time we have no choice but to deal with the inflationary situation because over time inflation and the unemployment rate go together…Isn't that the lesson of the 1970s?" Led by Volcker, the Fed aggressively raised interest rates, pushing the economy into the double dip recessions of 1980 and 1981-1982, however, inflationary pressures subsided. Now back to the future, where the degree of inflation and oil shocks is not only not as severe as the 1970s, but the present-day Fed has the hindsight of the failed macroeconomic theory of that time. Fed Chair Powell abandoned the long-insisted "transitory" label for inflation last November, but inflation was allowed to run high through the start of 2022. The most recent reading of CPI (consumer price index) from June showed an annual rate of 9.1%, the highest since 1981, thus consensus expectations are a 75 or 100 bps increase to the funds rate at the Fed's July meeting. Many market pundits, including investment strategists, economists and even Fed governors, underestimated inflation as recently as year-end 2021, projecting the fed funds rate would only be increased one or two times. Those increases imply a rate of 0.25% - 0.50%, far below the current 1.75% rate, which could be as high as 2.50 – 2.75% by the end of July.

Market pundits are now debating the possibility of a recession, and if so, how long or how severe it could be. While economic indicators and fluctuations in the financial markets will reflect changes in the other, they oftentimes do not reflect the state the other is in. Economic indicators are typically backward looking, reflecting measures such as inflation, GDP (gross domestic product) and employment. The stock market is typically forward looking, reflecting investors' expectations in the future earnings of companies. There are some factors that define a recession, such as consecutive quarters of negative GDP growth, and some that possibly indicate a recession, such as a yield curve inversion. The U.S. economy contracted 1.6% in Q1 and projections for Q2 are skewing negative as well. The yield curve is inverted, as measured by the 2 / 10-year treasury spread, yet the 3 mo / 10-year spread more closely watched by the Fed is not. Consumer sentiment is also notable, as consumer spending accounts for nearly 70% of GDP, and is at lows only seen in 1975, 1980 and 2008. Conversely, however, the labor market is tight, with two job openings for each job seeker, an unemployment rate at 3.6%, and year-over-year wage growth at 6.5% (50-year average of 4.0%).[ii]

While it is unknown if the impacts of the Fed's prolonged accommodation will steer the economy into a recession, what is known is that the S&P 500 is in a bear market, already down 20.6% through June 30. The fall in share prices is broad based at this point, but led by technology companies, which is reflected in the Nasdaq's first half loss of 29.5%. The forward P/E ratio (price/earnings) of the S&P has contracted in this period from 22x to 16x, which is roughly in line with the 25-year average. Individual stocks have seen multiple contraction greater or less than the index, and with Q2 earnings season approaching, company earnings reports will provide further clarity on whether valuations have come down enough. While valuations are starting to be attractive for many companies, others likely have more room to fall. The stock market is not immune to downturns, and uncomfortable investing environments like today may offer valuable long term investment opportunities despite short term headwinds.

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[i] U.S. Bureau of Labor Statistics
[ii] U.S Department of Labor