Is 1970s-Style Inflation Coming Back?

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With commodity prices soaring, money supply growth exploding, and government spending surging, there is a palpable fear of a return to 1970s-style inflation. I get it. I remember those times. Bell bottoms, long hair, aviator glasses, and disco music were popular. (Although I confess to embracing the fashions of the era, I was never a disco fan.)

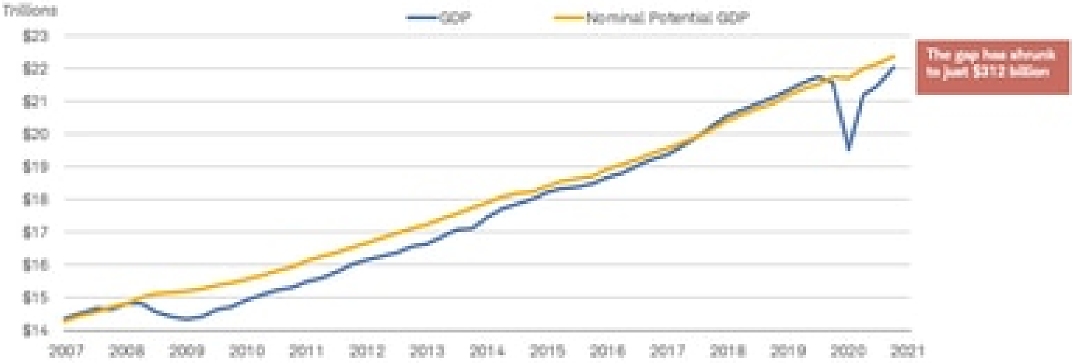
It wasn't all frivolous, though. In fact, it was a tumultuous time both socially and economically. The era opened with the Kent State shootings, unfolded into Watergate and President Richard Nixon's resignation, hit a crescendo with the fall of Saigon, and ended with the Iranian hostage crisis. In the middle, there was an economically crippling oil price spike, a deep recession, and high inflation. It's the memory of high inflation that seems to strike a nerve with investors.

What causes inflation?

Inflation results when demand exceeds supply in an economy. Economists use the "output gap" to capture this phenomenon. When the economy grows faster than its ability to provide goods and services demanded by consumers, prices rise. When the economy grows more slowly than its potential growth rate, prices tend to fall. Factors that affect an economy's growth rate include the supply of labor and the productivity of those workers.

Due to the pandemic, there was a huge widening of the output gap last year, but the economy's rapid rebound has caused the gap to narrow but not yet fully close. With more fiscal stimulus on the way, it's likely that the gap will close later this year and potentially move above trend in 2022, signaling inflation risk.

Gross domestic product growth is picking up, but the output gap isn't closed yet



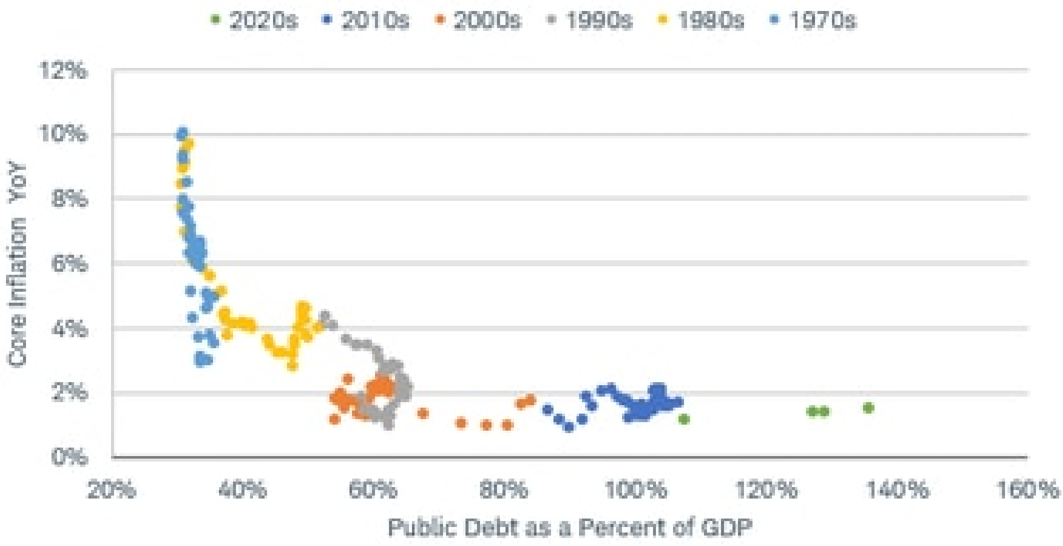
Source: U.S. Bureau of Economic Analysis, Gross Domestic Product (GDP) and Nominal Potential Gross Domestic Product (NGDPPOT). Quarterly data as of Q1-2021.

What about money supply and budget deficits?

At some point, most of us learned that inflation is, "always and everywhere a monetary phenomenon," to quote economist Milton Friedman. Money supply growth is a requirement, but in and of itself, it's not enough to cause inflation. The money needs to find its way into the economy and turnover rapidly to generate inflation. (This is referred to as the velocity of money or ratio of M2 money supply to gross domestic product, or GDP.) In recent years, the velocity of money has fallen sharply.

Rising budget deficits are not necessarily linked to inflation, either, but can contribute to an overheating economy. It all depends on whether it stimulates demand to exceed supply. From a long-term perspective, there has been little correlation in recent years between the level of debt in the economy and inflation. As illustrated in the chart below, since 2000 public debt as a percentage of GDP has been high. However, inflation has held mostly below 2% during that time.

In recent decades, high public debt vs. GDP has not led to surging inflation



Source: Bloomberg, using quarterly data as of 12/31/2020. Federal Debt Total Public Debt as Pct of GDP Quarterly Seasonally Adjusted (FDTGATPD Index) and US Personal Consumption Expenditure Core Price Index YoY SA (PCE CYOY Index).

The short, unhappy history of modern inflation

During the first half of the 20th century, inflation was usually associated with wars, which caused shortages of goods and price spikes. The post-war periods were generally followed by periods of deflation as supply caught up with demand. In fact, there were more years of deflation than inflation. It wasn't until the late 1960s and the 1970s that inflation became a long-lasting problem. While it's often thought that spiking oil prices and excessive government spending were the leading causes of inflation during the era, there was a lot more to it than that.

In the early 20th century, inflation was usually associated with wars

Source: Bloomberg, using monthly data as of 1/31/2021. US CPI Urban Consumers YoY NSA (CPI YOY Index).

During the first half of the 1960s, inflation averaged only 1.1% despite rising spending on social programs. However, in 1965, the U.S. increased its spending on the war in Vietnam. As with most wars, demand for industrial goods rose, pushing up prices. At the same time, there was more money in the hands of consumers, benefit of higher spending on social programs. By 1969, consumer price inflation was running at more than 5%. In response, the Federal Reserve, led by Fed Chair William McChesney Martin, raised interest rates, which sent the economy into recession. Inflation declined.

Inflation is a policy choice

When Nixon took office, he was eager to see the economy rebound. He replaced long-serving Fed Chair Martin with Arthur Burns in 1970. At the same time, the dollar was under pressure due to expanding trade deficits, with major trading partners (mostly France) demanding gold in place of currency. Instead, in 1971, Nixon severed the dollar's last ties to the gold standard, effectively ending the Bretton Woods agreement and allowing the dollar to float freely. It fell by about 15% over the next few years, pushing up import prices.

The expansionary spending policies of the 1960s continued, as did the ramped-up spending on the war in Vietnam. Increased government spending fueled increased demand. There were no offsetting tax hikes or spending cuts in other programs to offset the spending. Consequently, demand exceeded supply in the economy for several years and inflation moved up. It was running at 6% in 1970.

To make matters worse, rising tensions in the Middle East led to an oil embargo in 1973, sending oil prices up and the economy down. Overall, inflation averaged 7.1% during the decade, although it hit double-digit levels in both 1974 and 1979. Nixon imposed wage and price controls, but that only contributed to a dismal combination of pent-up demand, weak growth, and inflation. That's when the term "stagflation" became prominent.

A key contributing factor to inflation was the way monetary policy was conducted. Tapes from the Nixon era indicate that the president pressured Fed Chair Burns to keep interest rates low despite rising inflation. Burns gave into the pressure, fearing he would be blamed for another recession and rising unemployment if he raised rates. He judged inflation as the lesser of two evils. In doing so, the Burns Fed made the choice to allow inflation to rise.

That turned out to be a bad decision. He's now remembered as the Fed chair who caved to political pressure instead of the one who avoided a recession. It wasn't until Paul Volcker was appointed chairman of the Federal Reserve by President Jimmy Carter in 1979 that the central bank made its move to squash inflation, despite the heavy toll it took on the economy.

Different era, same choices?

There are some similarities to today. Easy monetary policy and increased government spending are spurring strong demand amid shortages of goods. Pandemic relief payments and economic reopening have sent consumer spending up sharply. Most importantly, the Fed appears prepared to let demand exceed supply without reacting. Even though the output gap is still wide, it is closing quickly.

As in the 1970s, the Fed is making the choice to let inflation rise today. After a lengthy review of its policies of the past few decades, it concluded that it had focused too much on inflation, and consequently had limited the economy's growth and held down job growth and incomes for many workers. That was before the COVID-19 crisis hit. Now, faced with the deflationary impact of the pandemic, the Fed believes it has room to err on the side of being too easy for too long.

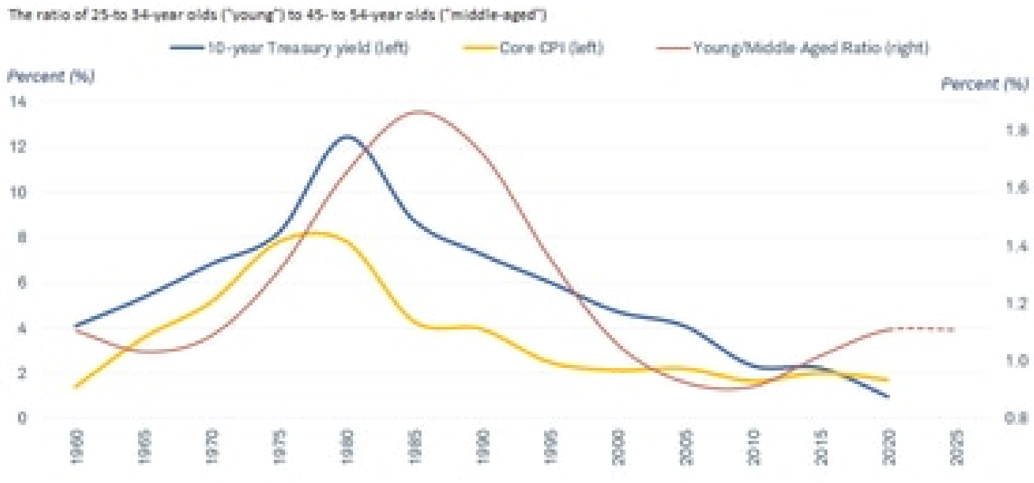
No wonder investors are worried. However, there are also significant differences between the economy today and in the 1970s that suggest inflation is not likely to return to those high levels:

1. Demographics have changed.

The chart below provides a useful way to envision the impact of demographic changes on the economy, by showing the ratio of young to middle-aged workers. As you can see, the ratio is considerably lower now than it was when I was sporting bell bottoms and aviator glasses. In those days, baby boomers were entering their prime working and spending years. Demand for everything from cars to housing rose, putting upward pressure on inflation. The ratio began to decline in the early 1990s as baby boomers transitioned to their saving years. It bottomed out in about 2010.

Today it's the millennials—a bigger generation than the baby boomers in numbers—who have entered their spending years. Predictably, household formation is increasing and demand for goods and services is rising. However, until recently, the expected boost to growth from the millennials has been dampened by the double whammy of the financial and COVID-19 crises. Also, while the ratio hit its low around 2010 and is rising, it isn't likely to have anywhere near the impact on the economy that the baby boomer generation did. Consequently, while there appears to be a sustainable wave of demand taking place, it's not as big as the tsunami that hit in the 1970s.

The demographic wave appears to have crested



Source: Bloomberg and Organisation for Economic Co-Operation and Development (OECD). US Generic Govt 10 Yr (USGG10YR Index) and US CPI Urban Consumers Less Food & Energy YoY NSA » (CPI XYOY Index). The 10-year yield and inflation lines represent the 5-year averages beginning with the each 5-year cohort shown, using monthly data as of 3/31/2021. OECD historical population data and projections, annual averages, projections 2015-2025. “Young” is represented by the 25-to 34-year old cohort and “Middle Aged" is represented by the 45- to 54-year old cohort. **Past performance is no guarantee of future results.**

2. Labor market structure is different.

A second key difference is the structure of the labor market. In the 1970s, workers had much stronger bargaining power than today. Unionization was higher and strikes were more frequent and successful. Union wages tended to keep pace with inflation and even non-union workers were routinely given cost-of-living increases.

Today, unionization is low, limiting the bargaining power of labor. The majority of states are considered “right to work” states, and political pressure to boost wages has diminished. There are plenty of other structural changes that affect wage growth, such as the rise of the service sector, global competition, technological change, and educational gaps. For all these reasons, real wages have not risen much for workers in the bottom half of the income distribution, keeping a lid on aggregate demand relative to supply. It may change going forward given the current focus on income inequality, but today’s starting point is a long way from where things stood in the 1970s.

Labor compensation is a relatively low share of GDP

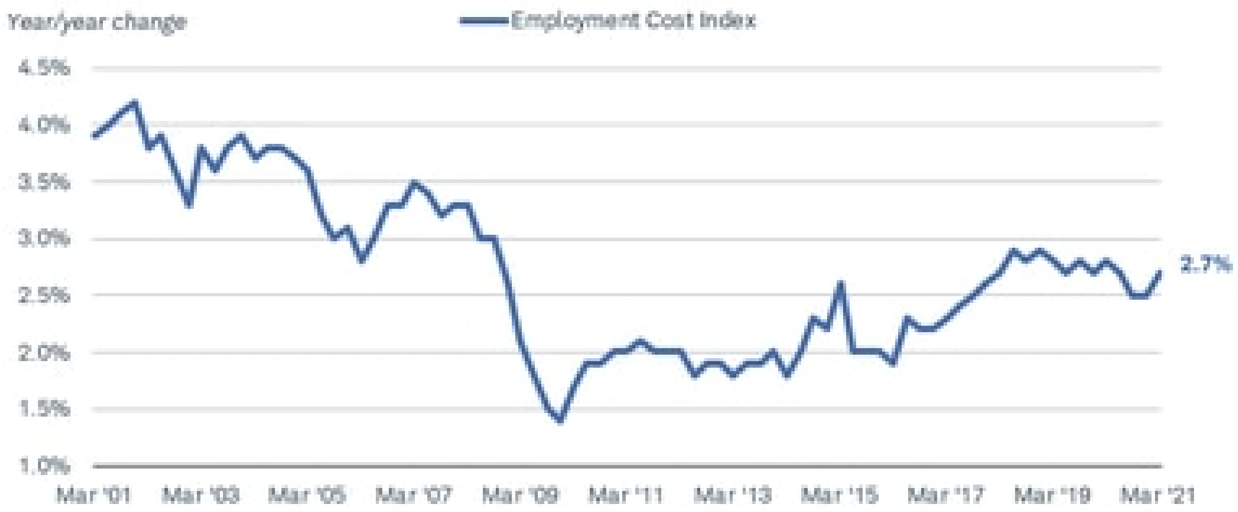
Source: St. Louis Federal Reserve FRED database, using annual data as of 2019. Share of Labor Compensation in GDP at Current National Prices for United States (LABSHPUSA156NRUG).

3. Globalization may be slowing, but it hasn't stopped.

The U.S. is still a relatively closed economy, with only about 15% of goods and services consumed coming from abroad. However, that compares to only 4% in the 1970s. Moreover, the composition of imports has changed. Despite all the talk about "re-shoring" and the imposition of tariffs, most of the imports to the U.S. are goods, with the prices set in a far more open and competitive global market than in the past.

On the wage side, the opening up of Eastern Europe after the fall of the Berlin Wall and China's emergence into the global economy have combined to increase the supply of labor and dampen growth in wages in the U.S. The current mood in Washington has shifted its focus to address the issue, but if Congress can't agree on a minimum wage hike, it seems unlikely that it will take more significant action. Even if it tried, it's not likely to turn the clock back 50 years.

Employment costs are still low



Source: Bloomberg, using quarterly data as of 1Q 2021. Bureau of Labor Statistics Employment Cost Compensation Civilian Workers YoY NSA (ECICCVYY Index). The Employment Cost Index (ECI) is a quarterly economic series published by the Bureau of Labor Statistics that details the growth of total employee compensation. The index is prepared and published by the Bureau of Labor Statistics (BLS), a unit of the United States Department of Labor.

Strategy: Don't fight the Fed

How should investors navigate this tricky situation? Although we don't believe a return to 1970s-style inflation is likely, we see upside risk to inflation over the next few years. To some extent, it is already reflected in the sharp rise in the compensation investors are requiring for inflation risk.

Market-based inflation expectations have reached the highest point since 2013

Source: Bloomberg. U.S. Breakeven 10 Year (USGGBE10 Index). Daily data as of 5/6/2021.

There is also execution risk. What if the Fed waits too long and inflation isn't "transitory"? In that case, it will need to tighten policy more aggressively than anticipated, which could potentially trigger a steep rise in yields and/or drop in riskier asset prices.

Investors are in a difficult spot. Bond yields have moved up sharply, but real (inflation-adjusted) yields are still negative and if the Fed succeeds in raising inflation, then long-duration bonds don't look attractive. However, with short-term rates anchored near zero for the foreseeable future, cash isn't a good alternative.

We believe investors should consider keeping the average duration of the bonds in their portfolios low to mitigate the risk of rising interest rates. If you normally target an average duration consistent with a broad index, such as the Bloomberg Barclays Aggregate Bond Index, you might consider moderately reducing it. With the yield curve steep, bond ladders can make sense. Allocating some of the portfolio that normally would be invested in Treasuries to Treasury Inflation Protected Securities (TIPS) can help protect against inflation risk—although TIPS yields are low or even negative.

Income investors may need to take some sort of risk to get yield. We suggest considering a diversified portfolio of corporate and/or municipal bonds. However, with the lowest-rated bonds now "priced to perfection," we would be cautious about valuations.

Our outlook for the rest of the year is for 10-year Treasury yields to rise to the 2% to 2.5% level, but we don't expect a repeat of the 1970s era. Although I am told that disco music is making a comeback, I'm going to guess that's a fad that is likely "transitory."