Investor’s Outlook

Quarterly edition of investment ideas from the research experts at Francis Investment Counsel

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Welcome to this quarter’s edition of Investor’s Outlook

The research team at Francis Investment Counsel is a productive group of investment professionals. The depth of our investment research, however, goes far beyond what is seen in quarterly reports and heard in meetings alone.

For this reason, we created the Investor’s Outlook. The vision of this quarterly newsletter is to climb up, zoom out, and provide a higher level view of investing trends, philosophies, and practices that formulate our investment discipline. It’s our goal to give you a deeper understanding of the capital markets, share research resources we find particularly useful, and to deliver to you a source of new ideas.

In this issue, you’ll read:

- **The Second War on Inflation**
  - Fed Chair Jay Powell endorsed “inflation targeting” and loose monetary policy in September 2020 but has since discarded that script, now seeking to assure the public the Fed is committed to bringing the surge in inflation under control.
  - We look back into the economic history of the Great Inflation from the 1970’s and early 1980’s to glean insights from the first war on inflation.
  - A comprehensive review of the economic history of the Federal Reserve during the Great Inflation can be found in Allan Meltzer’s, *A History of the Federal Reserve*, Volume 2, Book 2, 1970-1986, a definitive work on the epoch.

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The Second War on Inflation

Revisiting the Olden Days

Market pundits readily compare today's economic environment to the 1970's. Themes which prevailed decades ago such as higher inflation and interest rates, slower economic growth, and simultaneous volatility in both the stock and bond markets have returned in force. By the numbers, the Consumer Price Index (CPI) recently exceeded 9%, WTI crude oil topped $123 this past March, and U.S. real GDP was negative for the first half of 2022. As of September 2022, a typical diversified portfolio of 60% U.S. stocks (S&P 500) and 40% bonds (Bloomberg US Agg) lost over 20% and the S&P 500 is down nearly 24%.

High inflation makes for unhappy consumers and the policy makers know it. According to a Pew Research survey taken earlier in 2022, inflation was the top concern on voters' minds and by a wide margin. Giving up vacationing at the beach or rounds of golf in order to pay 50% or more for soda, gasoline, and cereal is no doubt exasperating. It's significant how weighty inflation is on the psyche these days even as unemployment remains low and consumer finances are generally holding steady. As measured by the University of Michigan this past June, the consumer sentiment readings were worse than even at the lowest point during the Great Financial Crisis in 2008. Sentiment has since improved, but only on the margin.

While economic history is usually just an elective class for economics geeks, the redux of inflation has brought the importance of historical study to the forefront. Truly, a review of some economic history is just what investors need right now. Fortunately, addressing this topic in a succinct manner is doable as a group of historians went through the Fed's archives from the 1970's. A comprehensive review of the economic history of the Federal Reserve during the Great Inflation can be found in Allan Meltzer's, *A History of the Federal Reserve*, Volume 2, Book 2, 1970-1986. The lessons from this period are instructive, and this Investor's Outlook aims to provide some useful takeaways from history while recognizing it is best to stay on point as it relates to your portfolio. This may be one of the only times you are willing to endure this topic, and we aim to make it worthwhile.

Reminiscences from the Great Inflation

Paul Volcker's appointment to Chair the Federal Reserve in 1979 was the beginning of the end for the period known as the "Great Inflation," an epoch which came about from decades of combining loose monetary policy and excessive Congressional spending. Deficit spending to ramp-up the economy became popularized via the theories advocated by the late economist John Maynard Keynes. Keep in mind Congress had passed the Employment Act of 1946 defining full employment as an unemployment rate at 4% or less. The goal of full employment anchored policy making, and the Keynesian economic model was deployed in hopes of achieving an optimal economic expansion.

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The tenets of Keynesian economics amongst academics, politicians, and the public, were as mainstream as apple pie. The public expected the Fed to support the 4% unemployment goal, so the Fed's mandate to maintain price stability was usually a distant concern. If economic growth continued and wages rose at a faster rate than the costs of goods and services, the public was generally content.

Though the decade of the 1970's is nowadays viewed as an era of inflation, it wasn't perceived as such at that time. In fact, it wasn't until nearly the end of the decade when CPI breached 13% that public opinion shifted, and in rapid fashion, to label inflation as one of the biggest problems requiring attention. When that happened, and the pitchforks came out, the policy makers acquiesced, even if it meant an unemployment rate exceeding 4%. Volcker's anti-inflation policies largely succeeded in part due to his ability to navigate the political landscape and the inclination of both President's Jimmy Carter and Ronald Reagan to leave him alone. Previous administrations all too often influenced the Fed to ramp-up money supply and alter policy when it was convenient to do so.

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The role of the U.S. Dollar and the Relationship to Global Inflation

There are other historical lessons which may seem ambiguous but are pertinent. Take a step back further from the 1970's to the establishment of the Bretton Woods system created in 1944. The system established foreign exchange rates from 44 countries all pegged to the U.S. dollar. The dollar was in turn backed by gold and every ounce of the precious metal could be exchanged for $35. Bretton Woods was designed to keep the global economic environment from experiencing another deflationary disaster from the 1930's.

What was unexpected by the creators of Bretton Woods, however, was the popularity of international trade following WWII. The world shifted from needing to fight deflationary forces to grappling with the inflationary pressures resulting from significant economic expansion. Nations like Germany, France, and Japan built-up sizeable trade surpluses with the United States over time which created pressure points within the currency markets. To this end, foreign intervention was common to maintain currency values favorable to their economic interests. Usually, this resulted in the U.S. dollar maintaining an artificially strong position as neither France nor Germany desired a weaker dollar at that time. A weaker dollar meant less customers for their exports and fewer tourists vacationing in Paris and Munich.

What should happen over time, in theory, is when a country is in deficit versus another, the currency of the country in deficit (in this case the U.S.) should weaken relative to the one in surplus as capital markets ebb and flow. But as was the case then and now, central bank intervention disrupts the theoretical academic world.

A monetary system designed to contain deflation was ill-equipped to handle the forces of inflation. As the inflationary pressures ramped-up, one-off fixes were increasingly deployed to keep the foreign exchange markets from choking. As the U.S. did not have enough gold in stock to keep up with the demand for the dollars needed to conduct international trade, more dollars got pumped into circulation which far exceeded the gold stock as required under Bretton Woods to maintain the peg. The U.S. eventually went off the gold standard in 1971 which set the dollar on a course to weaken by 30% throughout the rest of the 70's. A weaker dollar during the decade was another force driving inflation higher around the globe.

Inflation Hurts Today and Steals from the Future

Contemplate inflation not just in terms of lost purchasing power, but also in terms of the negative impact on innovation and overall wealth creation. Persistently high inflation keeps consumers from enjoying the goods of today and precludes them from experiencing innovation to further the cause of life, liberty, and the pursuit of happiness. This better explains the death spiral of public opinion as the momentum of inflation makes life harder today and steals resources from building a better future. The epitome of these conditions occurred in Weimar Germany (1920's) and Zimbabwe (2000's).

Come the end of the 1970's, the U.S. and the rest of the global community shared the characteristics of a 'shortage economy.' The amount of money in circulation exceeded the amount of goods and services available as well as the ability of the economy to innovate. Then on the fiscal side, deficit spending stoked economic activity, and it too added to the inflationary upswing coincident with more money creation.

More on the U.S. Dollar, Add in Some Government Intervention

International trade is complicated. It gets even harder when the value of the U.S. dollar is volatile. A stable dollar is a must for the world's FX (foreign exchange). There are solutions within the esoteric bowels of currency trading that can disguise the problems when trouble hits. How is this done? In short, central banks have a history of using derivatives known as currency swaps. Currency swaps enable central banks to make agreements amongst each other to alter balance sheets. Essentially, the swap is akin to giving foreign central banks an ability to 'rent' dollars when they are needed most to help resolve imbalances. Renting something is far more practical just like when you travel and need to rent a car. It would be impractical for most people to buy one or ship your own car to where you need it most for a short period of time.

So how does this work? Consider this example involving Mexico where they were running short on dollars in the early 1980's. Chairman Paul Volcker got approval of a $700M million loan to Mexico under a currency swap line, and the FOMC had made overnight swaps to give the appearance that Mexico had sufficient dollar reserves to maintain its bond payments. "We would transfer the money each month on the day before the reserves were added up and take it back the next day…. the 'window dressing' disguised the full extent of the pressures on Mexico from the bank's lenders and from the Mexicans themselves." [1]

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History shows that when push comes to shove, derivatives markets have been frequently used among the world's central banks to temporarily alleviate pain by reducing dollar price volatility. These markets are complex and highly sophisticated meaning the use of derivatives to create an accounting solution is just that, usually something that is on paper. Where the rental car analogy we used breaks down, is that unlike the situation where you exchange money to use a tangible asset for an economic purpose, currency swaps rarely represent a transfer of economic benefits between central banks.

In fact, very recently the world's major central banks such as the Bank of Canada, Bank of England, Bank of Japan, European Central Bank, Federal Reserve, and Swiss National Bank took coordinated action to enhance the provision of liquidity via the standing U.S. dollar liquidity swap line arrangements when the pandemic hit. To this end, the "Federal Reserve…established temporary dollar liquidity swap lines with nine additional foreign central banks"[2] in the first half of 2020. According to the Fed, these instruments helped mitigate the effects of strains to the supply of global credit for households and businesses.

If you are wondering why allowing one country to adjust its balance sheet with something out of thin air is permitted, just remember this: if the average person went into their basement and printed money, it would be a crime but for the Federal Reserve and other central banks, this is monetary policy. It's what we can satirically refer to as a type of golden rule, the country with the 'gold' makes the rules. As such, investors must accept the potential for these kinds of arbitrary decisions.

"Contemplate inflation not just in terms of lost purchasing power, but also in terms of the negative impact on innovation and overall wealth creation.

Bringing it All Together – So What?

To be evenhanded, the inflationary run-up in 2022 is not entirely the Fed's doing as fiscal spending has ballooned over several years. In just two years' time, Fed Chair Jay Powell has changed the script is his stump speech from justifying "inflation targeting" and loose monetary policy to acknowledging the woes of inflation and his commitment to get it under control.

Flooding the economy with money and significant government spending, such as what happened in 2020, brings us back to some of the approaches from the 1940's-1970's which were inspired by Keynesian economics. True today as it was then, this combination of monetary and fiscal expansion is inherently inflationary and carries with it a long duration.

"While inflationary forces likely have less upward momentum, we nevertheless remain in a period of higher-for-longer inflation."

At the onset of such aggressive policies, financial and real asset prices responded favorably. Today, just as it was the case decades ago, we've reached a point where the costs outweigh the benefits as evidenced by deteriorating economic growth.

While inflationary forces in 2022 likely have less upward momentum than those of the 1970's, we nevertheless remain in a period of higher-for-longer inflation. The two problems which make inflation "sticky" in the near-term include the Fed's massive balance sheet at $9T and the risk of central bank coordination to force the U.S. dollar off its recent highs. The Fed is busy raising short-term interest rates, which naturally slows inflation, but the balance sheet run-off will take years to complete so the liquidity which remains keeps inflation upward biased. And, despite overtures about the U.S. dollar's imminent demise over the last 20-years, its impact on global trade looks to be as powerful as ever. Nowadays, the most probable outcome of central bank intervention in the foreign exchange markets is for a weaker dollar, which in turn fuels risk asset prices and further stokes inflationary pressures.[3]

We believe the rubric that spelled the end of the Great Inflation from the 1970's was first the shift in public opinion leading to anti-inflation political rhetoric leading to the anti-inflation policies implemented by Paul Volcker. Realistically, Fed chairs such as Volcker and Powell can not be successful in their determinations without the support from Capitol Hill. Looking forward, the Fed clearly has all the public and political support it needs to focus on price stability with scarcely a concern about unemployment which remains at 3.5% as of October 2022. As such, the Second War on Inflation is likely to be 'won' sooner rather than later as the public has decried current conditions. The exact timeframe for victory is of course vague.

For investors seeking to position their portfolios given the confluence of forces, our recommendations to navigate these trying times can be found on the following page.

The Second War on Inflation

Investment Implications for a Period of Secular Inflation

- Secular inflation is the theme of the early 2020's and hard assets are the answer for preserving real purchasing power. Demand for natural resources continues to rise at a pace faster than production due to supply chain problems related to deglobalization and geopolitical unrest.

- U.S. equities remain the best of all options, so maintain a slight overweight to this asset class. An allocation to international investments is rational for the sake of diversification but it should be at an underweight in total relative to U.S. equities.

- Pay attention to central bank maneuvers in grappling with the strength of the greenback as at some point, dollar weakness is almost a must for the rest of the globe. In the event the U.S. dollar weakens, it is bullish for your international investments.

- For the first time in years, cash is relatively appealing versus short- and intermediate-term bonds as the Fed Funds rate stands at an upper bounds of 4.00% and is set to go higher.

Investor's Outlook - Summary

- *Market pundits readily compare today's economic environment to the 1970's. There are similarities be it higher inflation, higher interest rates, and higher stock and bond market volatility.*

- *The inflationary run-up in 2022 is not wholly the Fed's doing as fiscal spending has also ballooned in recent years. In just two years' time, current Fed Chair Jay Powell has changed the script from justifying "inflation targeting" and loose monetary policy to acknowledging the woes of inflation and his commitment to get it under control.*

- *Flooding the economy with money and significant government spending brings us back to the strategies of the 1970's for gearing the economy. True today as much as it was then, this combination is inherently inflationary. The onset of such policy coordination causes financial and real asset prices to surge at the onset, but just as it was the case five decades ago, we've reached a point where the costs outweigh the benefits as evidenced by deteriorating economic growth.*

- *A proper understanding concerning the rubric for the unwinding of the Great Inflation of the 1970's was first the shift in public opinion which led to anti-inflation political opinion which in turn led to the implementation of the anti-inflation policies by then Fed Chair Paul Volcker.*

- *The hawkish measures by the Fed of late have yet to bring the inflation rate back to the Fed's 2.0% target. Though it will take time, the Second War on Inflation is likely to be shorter in duration than the Great Inflation of the 1970's as public opinion demands action.*

[1] *Allan Meltzer, A History of the Federal Reserve, Volume 2, Book 2, 1970-1986, p, 1106.*

[2] *https://www.federalreserve.gov/monetarypolicy/central-bank-liquidity-swaps.htm*

[3] *The astute reader will note that inflation has been surging as the dollar has gone higher. So, is a stronger dollar pro- or anti-inflation? It's generally anti-inflation for the U.S., but pro-inflation for the rest of the globe. Importantly, a strong U.S. dollar doesn't mean the elimination of inflation altogether but rather think of this as a brake on inflationary momentum. In contrast, a weaker U.S. dollar adds to inflationary momentum. The relationships between currencies are multifaceted be it the fundamental forces of inflation and interest rate differentials driving trading activity as well as technical analysis. As has been shown, the economic history points to several instances where markets have been subject to intervention and manipulation. Therefore, any definitive conclusions at a moment in time are potentially subject to a host of unobservable forces. For example, it was speculated the Bank of Japan had recently intervened in its currency markets in October 2022 to reduce the weakness of the Yen versus the U.S. dollar.*

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