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Choosing wisely from the archives

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"History doesn't repeat itself, but it often rhymes." *Mark Twain*

Sometimes market conditions are beyond one's own experiences. It is during these times that market participants need to go back into the archives and investigate similar historic phases and try to understand the causes and effects. It's a bit like trawling through the streaming libraries during COVID lockdowns to find an appropriate movie to watch. It is difficult to simply scroll through the movie titles that were produced forty years ago and identify something that is worth viewing today.

Unfortunately, I must admit that I have some experience with movies from the 1970's and '80's. As a kid, I vividly remember being dragged along to the local movie theatre by my older cousin to watch "Grizzly". It was released in May 1976 and had all the traits that were popular at the time; gut-crunching terror. I didn't judge the actors, I didn't rate the director, I just went along with the crowd. Imagine if I had of done a similar thing with investing? If I had of bought into the S&P500 in May 1976, I would have experienced a +3%pa total return over the next three years. Unfortunately, those meagre gains would have been more than chewed up by inflation which grew by +8%pa; the -5%pa real return would have been truly gut-crunching. Interestingly, my cousin did not coerce me into viewing "Raging Bull" when it was released in November 1980. It was directed by the up-and-coming Martin Scorcese and starred a youthful Robert De Niro. Some research at the time would have revealed that "Raging Bull" had all the traits required to be an enduring feature film. Likewise, an investment in the S&P500 in November 1980 would have yielded a +14%pa total return over the next three years which would have been partially offset by inflation of +6%pa; an attractive +8%pa real return would have been a far more palatable outcome.

Today, most market participants are grappling with a global inflation impost that was last seen in the 1970's and '80's. However, simply looking what happened forty years ago is no guarantee that a viable roadmap can be created for today's investment journey. But it can certainly help to frame a rough guide. The message that I am trying to deliver is that when investigating the past, it is often worth looking beyond the headlines. The devil is in the details, and the details are often owned by those that needed to make decisions during the period in question. Hence, when trying to understand what a high inflation environment is like, I found that trawling through sixty years of US central banker speeches and meeting minutes was quite instructive. I believe that it is important to appreciate what central bankers needed to contend with

during three phases; the Great Inflation phase between 1966 and 1982, the Great Moderation phase from 1982 to 2001, and the Great Intervention phase since 2001. Ultimately, these phases will provide the foundations needed for equity investors to avoid the "Grizzly" bear plots and instead pivot more towards the "Raging Bull" opportunities.

The Great Inflation phase: 1966-1982

During the decade leading up to 1966, the US inflation rate was remarkably stable averaging just 1.6%. World trade was expanding, exchange rates were steady and the standard of living throughout the developed world was improving. Unsurprisingly, the S&P500 doubled in price. However, things took a dramatic turn for the worse. The US government budget blew out following some sizable welfare spending programs, tax cuts and the funding of the Vietnam war. The devaluation of the dollar and the subsequent implementation of wage and prices controls did little to relieve the inflationary pressures. Droughts and unfavourable weather conditions in 1972 resulted in poor agricultural harvests and a world-wide food shortage. Food prices subsequently doubled. Then in 1973, the fourth of the Arab-Israeli wars broke out and oil prices skyrocketed. This cocktail of events led to a widespread expectation that inflation would continue to expand indefinitely. Arthur Burns was Chairman of the US Federal Reserve (FED) from 1970 until 1978. In 1979 Burns stated

> *If the United States and other industrial countries are to make real headway in the fight against inflation it will be necessary to rout inflationary psychology – that is, to make people feel that inflation can be, and probably will be, bought under control.*[1]

Unfortunately, under the leadership of Burns, the FED was at times hawkish, but the restrictive stance was arguably not maintained long enough to counter the inflationary undertows. The task of fighting inflation was ultimately embraced by Paul Volcker when he took over leadership of the FED in 1979. Volcker was vocal about the importance of productivity gains driving an improved standard of living. He was of the view that exogenous shocks that drove energy prices higher should not result in wage adjustments simply to maintain the level of real purchasing power; this had to be earned as opposed to "leap frogged". By 1980 Volcker confidently stated that

> *We're learning in economics, as well as other policies, about the need for a certain toughness, a certain persistence and realism in approach.*[2]

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[1] http://www.perjacobsson.org/lectures/1979.pdf

[2] https://fraser.stlouisfed.org/files/docs/historical/volcker/Volcker_19800115.pdf

During the sixteen year Great Inflation phase, the price of oil and food on average rose by 18% each year whereas the US CPI averaged 7%. The FED's target rate tended to average the same rate as CPI. The S&P 500 delivered a total return of +7%pa, but this was completely lost to inflation. The Great Inflation phase was a truly miserable investing climate.

The Great Moderation phase: 1982-2001

Back in 1979, one of Paul Volcker first initiatives was to rein in money and credit growth. Money growth was expanding more rapidly than the FED's targets and speculative pressures were becoming apparent in commodity markets. The FED decided to control the volume of reserves available to support deposits in the banking system. The FED was demonstrating an unwillingness to finance any activities that would inappropriately add to the inflation pulse.
By 1982 there were clear signs inflationary pressures were subsiding, but recessionary conditions were evident. The US unemployment rate had risen to over 10%, consumption had declined, inventories were building, and capital spending was being postponed. Despite this, the FED remained resolute in its commitment to monetary restraint; it stood behind its belief that price shocks like those experienced in commodity markets persist and spread only if they are accommodated by growth in money. Volcker succinctly stated

> *Too much of the energy of our citizens was directed towards seeking protection from future price increases and towards speculative activity, and too little towards production.*[3]

By the time Volcker handed to reigns of the FED to Alan Greenspan in 1987, the US unemployment rate had fallen by 4%, more than 11 million jobs had been created, the economy had expanded every year and the Federal Funds rate had declined 8%. A month after Greenspan's appointment, the FED lifted the Federal Funds rate. The following month the S&P500 suffered its worst ever one day move when it collapsed 22%. The FED immediately started exploring options to supply liquidity to major institutions if necessary and interest rates were eased. Greenspan appeared to be very attuned to the movement in asset market prices. During Greenspan's first decade years as head of the FED, the target rate was changed forty-nine times; twenty rate hikes and twenty-nine rate cuts. However, the FED's actions during the collapse of hedge fund LTCM in 1998 demonstrated that central bankers were determined to expand their reach beyond monetary policy.

During the nineteen year of the Great Moderation phase, the price of oil and food on average rose by 1% each year whereas the US CPI averaged 3%. The FED's target rate was typically twice the CPI rate. The S&P 500 delivered a total return of +15%pa or +12%pa in real terms. The Great Moderation phase was an exceptionally productive era

[3] https://fraser.stlouisfed.org/files/docs/historical/volcker/Volcker_19820126.pdf

for investors. It was especially productive during the Volcker years when the S&P500 delivered a +21%pa real total return.

The Great Intervention phase: 2001-today

The terrorist attacks on 11th September 2001 ushered in an era where the FED would utilise as many tools as required to stabilise asset markets. By October 2002 the FED had reduced the Federal Funds rate to just 1.25%. For the first time in decades, the FED was now grappling with the notion that disinflation was becoming an imminent threat. Interest rates were kept low for another two years which helped foster the largest housing boom that the US has ever seen. Subprime lending was dominating home mortgage originations and Alt-A mortgages were growing in popularity. Then in 2004, global food and oil prices started moving sharply higher. The FED subsequently enacted seventeen consecutive rate rises in just two years and, by June 2006, the Federal Funds rate stood at 5.25%. Unfortunately, many of the subprime loans were structured with low starting interest rates that graduated into variable rates. So, by the time that Greenspan had handed the responsibilities of the FED over to Ben Bernanke in 2006, more than 10% of subprime loans were already delinquent. In Alan Greenspan's book The Age of Turbulence, he stated that

> *I was aware that the loosening of mortgage credit terms for subprime borrowers increased financial risk; and that subsidized home ownership initiatives distort market outcomes. But I believed then, as now, that the benefits of broadened homeownership are worth the risk.*[4]

By 2008 the Global Financial Crisis (GFC) was in full swing and 25% of subprime loans were delinquent. Bernanke had deeply researched the Great Depression of the 1930's and was well equipped to construct a set of tools that the FED could utilise through the GFC. These included extensive policy communication, the provision of short-term liquidity to sound institutions, and the purchase of longer-term securities for the FED's portfolio. By 2014 the Federal Funds rate was 0.25%, the FED's balance-sheet has expanded fourfold to $4 trillion. In 2018 Jerome Powell was appointed as the Chairman of the FED and promptly began reducing its asset base. Throughout 2018 the FED lifted the Federal Funds Rate on four occasions. However, by early 2019 Powell famously pivoted away from his hawkish stance.

The COVID pandemic in 2020 prompted an immediate response from the FED. The Federal Funds rate was dropped to 0.25% and the FED's balance-sheet grew by a staggering $5 trillion. Unsurprisingly assets prices responded favourably. In fact, so much so, that inflationary pressures re-emerged. This partly reflected supply chain blockages that resulted from movement restrictions to curtail the spread of COVID. However, it also reflected an increase in speculative ventures. In particular, technology

[4] The Age of Turbulence-Adventures in a New World (2007) p233

companies were experiencing explosive increases in their valuation metrics. These valuation metrics were vulnerable to higher interest rates. So when oil and food prices surged in 2021 and persisted into 2022, the FED suddenly felt obliged to respond. Russia's invasion of Ukraine sealed the deal. The FED promptly hiked rates by 1.5% and equity valuation metrics have been subsequently crushed.
During the twenty-one year Great Intervention phase, the price of oil and food on average rose by 9% each year whereas the US CPI averaged 2%. The FED's target rate was on average half the CPI rate. The S&P 500 delivered a total return of +9%pa or +7%pa in real terms. The Great Intervention phase was eventful but was broadly beneficial for patient investors that stayed the journey.

Conclusion

So, what have I learnt? One stand-out observation is that sharp movements in food and oil prices should be treated with some scepticism. Paul Volcker was the only central banker to identify an intensification of speculative activity in commodity markets and that the danger was that momentum could lead to further surges in prices. It is not lost on me that severe market dislocations have tended to occur when the average oil and food prices shift by ±30%. It happened in 1987, 1990, 1999, 2002, 2008, 2011, 2015, 2018 and 2022. During each of these instances, risk indicators moved sharply higher and vulnerable assets were exposed. Importantly, equities tended to perform very well in between these times of elevated risk calibrations. The average total return from the S&P500 in between the eight perceived risky periods was +13%pa for four years and there was only one period of negative returns (from 1999 till 2002).

Another point worth mentioning is that the Reserve Bank of Australia's (RBA) archive of Governor statements on Monetary Policy only commenced in 1990. However, since then, the RBA's monetary policy cycles have generally moved in tandem with the FED's. That makes sense given the increased level of global interconnections. So, the big question that needs to be answered is "does today's FED travel down Burn's Great Inflation, Volcker's Great Moderation or Greenspan/Bernanke's Great Intervention trail?" Clearly the outcomes from the Great Moderation phase are enticing. Hence, these words from Paul Volcker should be etched in stone

> *Monetary, fiscal, and other public policies are constantly scrutinized – in financial markets and elsewhere – to detect any signs of weakening in the sense of commitment to deal with inflation. To speed the transition to lower interest rates and healthier capital markets, to reduce the costly elements of anticipated inflation built into wage and price contracts, to permit more confident planning for the future – to, in fact, lay the base for sustained recovery – credibility in dealing with inflation has to be earned by performance and persistence.*[5]

[5] https://fraser.stlouisfed.org/files/docs/historical/volcker/Volcker_19820211.pdf

Jerome Powell does not need to contend with a sixteen year precursor like the Great Inflation phase that Paul Volcker inherited in 1979. Powell simply needs to exhibit a persistence to address inflation with more vigour than people expect. The FED's guidance has already sufficiently tightened financial conditions, and this is paving the way for equity markets to return to a better performance period. Hence, I feel that it is important to avoid the pull of the crowd and pass on the "Grizzly" bear plot. The upside from embracing the "Raging Bull" storyline looks to be more enduring and sustainable.

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