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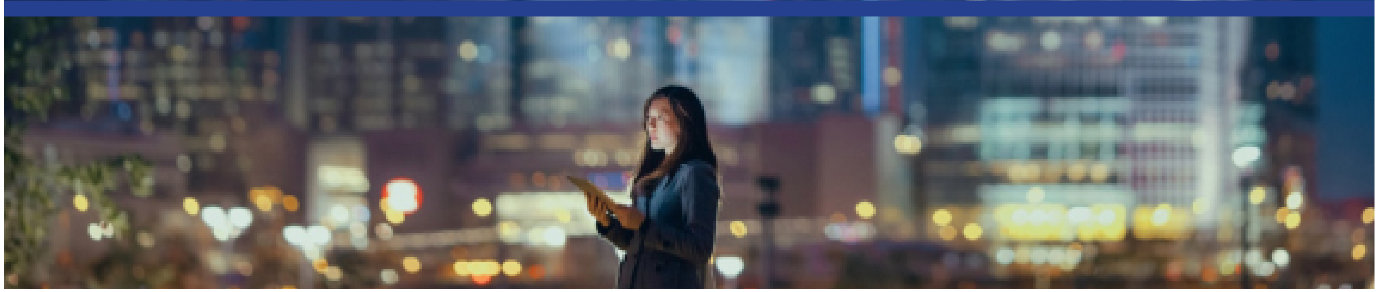

September 10, 2023

CIO Strategy Bulletin

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That 70s Feeling: Is Inflation Born to Run?

- Even as we still expect yields to moderate in the coming year, we would prefer to describe the 2022-2023 surge in interest rates a “normalization” rather than an “overshoot.” Both the double-digit yields of 1980 and zero yields of 2020 appear to be historical aberrations.
- In 2020, monetary and fiscal policy were pushing in the direction of a short burst in inflation, *larger than at any time in the 1970s*. US broad money growth was 25% that year. But unlike the 1970s, the burst of monetary stimulus is *not* being sustained.
- The 1970s was a decade of lasting monetary accommodation and negligence as inflation expectations accelerated (peaking near 10% in 1980). Today, long-term consumer inflation expectations hover near 3% even after supply shocks reminiscent of the 1974 OPEC embargo.
- Comparisons to the 1970s are not wholly “right or wrong.” US fiscal policy has retrenched only partially after the massive spending increases of the pandemic. Federal spending has switched emphasis to security, infrastructure and competitive issues that are more lasting. Securing redundancy in supply chains is unwinding some disinflationary benefits of globalization.
- Global demand for US bonds hasn’t kept up with US issuance in recent years. Yet global influences have not turned broadly inflationary. US import prices have fallen 4.4% over the past year with a likely further downward spur from China (offsetting new strength in petroleum).

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Is Inflation Born to Run?

Almost every rock and roll fan agrees that the 1970s was a fertile period. Punk rock, hard rock, heavy metal, and soft rock found their roots in the 1970's. The jazz band and the electric piano were of this time.

When it comes to economic history, many have sought to describe where we are now as a 70s throwback. Consider, is Russia's invasion of Ukraine comparable in size and broader in scope to the 1974 OPEC embargo?

The inflation of the 70s was mighty, mighty, but is the present déjà vu more than a feeling? Let's compare and contrast some data:

	Today*	1970s full year average**
Growth of US total wage payments	+5.6% (Year over Year)	+10.3%
Growth of US broad money	-3.7% (Year over Year)	+9.9%
US import share of GDP	15.5%	7.4%
Unionized share of US labor force	8.7%	23.1%

Source: Haver Analytics as of September 7, 2023. *Data reflects year over year change or point in time as indicated. **Data reflects full year 1970s average for the period January 1,1970 through December 31, 1979.

In 2021 and 2022 we have suffered inflation averaging nearly 7% in the US and higher in some regions. In the 1970s inflation ran at 8% for 10 years. So, are we entering a period like the 70s or are we exiting a period of unusual, non-systemic dislocations? With current bond yields roughly half of their upwardly-trending 1970s levels, should we be worried? (**Figure 1**).

What's Going On?

We do not see a return to sustained 1970's-style entrenched and accelerating inflation. Our reasons include large monetary policy differences, major shifts in global dynamics and the rise of information for consumers as a contributor to more competitive pricing. We see a notably different labor market with less-concentrated industry influence and union power. Just ahead of a potential US auto workers strike this week, it is striking that in the 1970s 11X more work hours were lost to strikes than in the US last year.[1]

We Won't Get Fooled Again: Wages are an Input to Inflation

US labor costs have indeed gone up recently. But the gap between higher wages and falling profits is most similar to 2015, not 1975. Wage payments are decelerating presently to a 5.6% year over year pace. This is about half the 10.3% *average pace* of the 1970s. This is **after** some recent, eye-popping collective bargaining settlements.[2]

[1] 'Analysis of Work Stoppages, 1970', Bureau of Labor Statistics.www.bls.gov, sourced September 8, 2023.

[2] See the Teamsters collective bargaining agreement of July 25, 2023

Figure 1: US Nominal 10-Year Treasury Yield

Source: Haver Analytics through September 5, 2023. Grey areas indicate periods of recession. Past performance is not indicative of future results. Real returns may vary.

Wage growth – like the unemployment rate - serves as an indicator of overall demand in the economy. Since 2020, wages and spending in the US have only risen while unemployment has dropped. But while producers may have no choice but to pass their input costs along, it does nothing to ensure demand will remain high. Consumers focus on essentials and cut down on discretionary products when inflation spikes. Profits and sales can fall even as input costs rise.

Who'll Stop the Rain?

The central bank is the regulator of demand. In 2020, monetary and fiscal policy created a short, sharp burst in inflation, *larger than at any time in the 1970s*. US broad money growth was 25% that year. But unlike the 1970s, the burst of monetary stimulus is *not* being sustained. It is being reversed.

US broad money (M2) has contracted 3.7% over the past year, the first annual decline since the late 1940s (**Figure 2**). The Fed has swerved hard to convince the public that it is willing to risk a recession to contain inflation. As a consequence, long-term consumer inflation expectations and much consumer behavior suggests a marked difference from the 1970s. Present consumer long-term inflation expectations hover at 3%, not far above the pre-COVID period (**Figure 3**).

Figure 2: US M2 (leading 2 years) vs Consumer Price Index Year over Year%

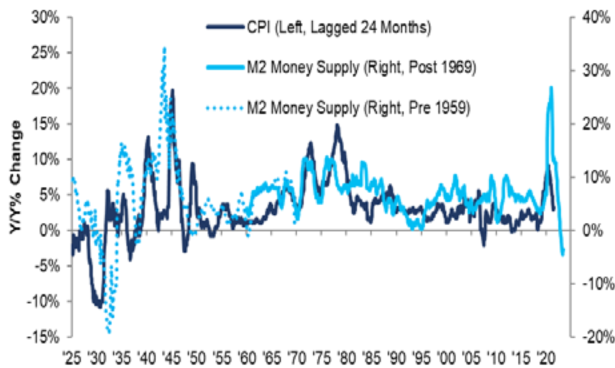
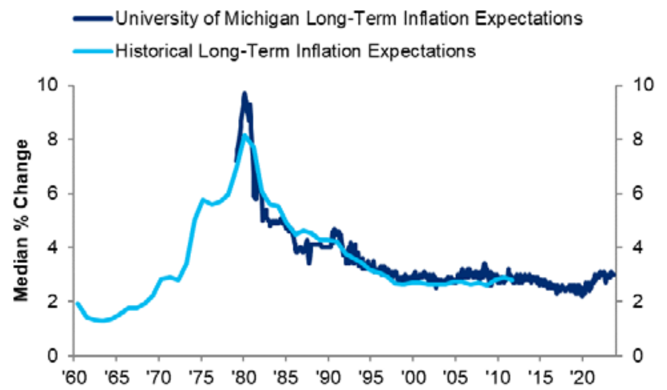


Figure 3: Long-term Consumer Inflation Expectations (Median)



Source: Haver Analytics, University of Michigan, Salomon Smith Barney, Citi Office of Chief Investment Strategist through Sep 7, 2023. The indexes are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance. Past performance is not indicative of future results. Real returns may vary.

Covid Policies: A Walk on the Wild Side

We have previously made the case that the COVID shock was akin to the swings of a war-time economy. Fortunately, signs point to a sharp diminution of these swings (**Figures 4-5**). In addition, as we discussed in our latest Quadrant, global demand slack may push consumer prices down. China's renewed export price declines have come after many had written off the competitive forces of globalization (**Figures 6**). While it is true that governments and firms will spend significantly to create redundant supply chains for sensitive inputs such as semiconductors, this does not mean that most consumer goods will be in short supply.

Figure 4: Global Supply Chain Pressure Index vs CPI Goods Year over Year%

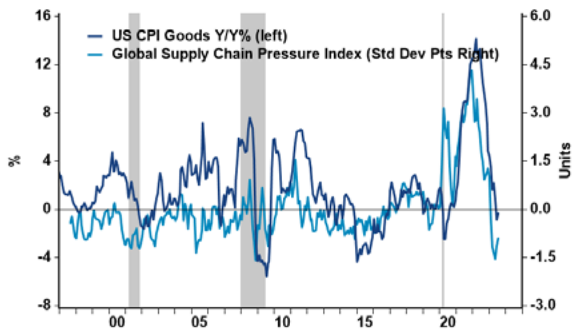
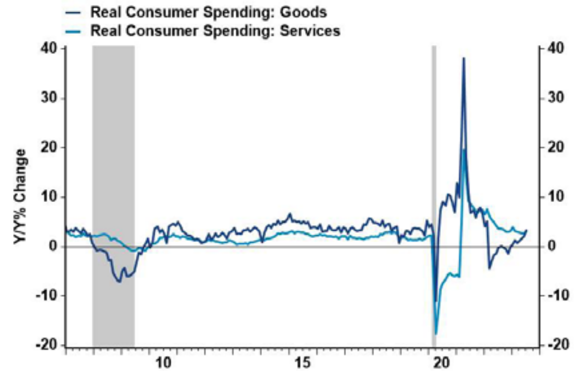


Figure 5: Real Consumer Spending: Goods vs Services Year over Year %



Source: Haver Analytics through September 5, 2023. Grey areas note periods of recession. The indexes are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance. Past performance is not indicative of future results. Real returns may vary.

Figure 6: US Import Prices: Renewed Downward Pressure from China but Waning from Peak

Source: Haver Analytics through September 7, 2023. Grey areas note periods of recession.

Don't Fear the Reaper

Among the strongest drivers of "70s deja-vu" has been the increase in labor union activity, political emphasis on unions by the US administration and high-profile labor actions. This coming week, the United Auto Workers threatens a strike at one or more of the "big-3" auto producers. According to the *Wall Street Journal*[3], Ford Motor company has offered workers a 9% wage increase over 4 years. The UAW asked for a 46% increase.

The US auto industry has been in a period of recovery from critical parts shortages this year and is only now beginning to satisfy unmet demand from 2021-2022 (see this week's Data Watch for more details). Labor friction amidst technology revolutions (like electric vehicles) are just one reason why we don't emphasize investments in industries that are capital-intensive, cyclical and undergoing structural realignments.

While far from unimportant, the US autos industry has been diminishing as a share of economic activity. A potential strike would have an impact on regional growth measures, but is very unlikely to be decisive for the economy as a whole (**Figure 7**).

The larger story of union power and strikes has mostly followed the same course. The perception of severe labor action might seem high, yet the number and scale of labor disputes and strikes has stayed dramatically lower than the 1970s, as has union participation (**Figure 8**).

Figure 7: US Motor Vehicle Output as % of GDP

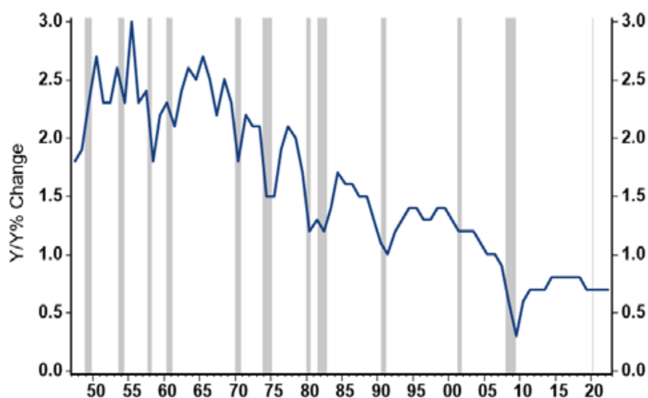
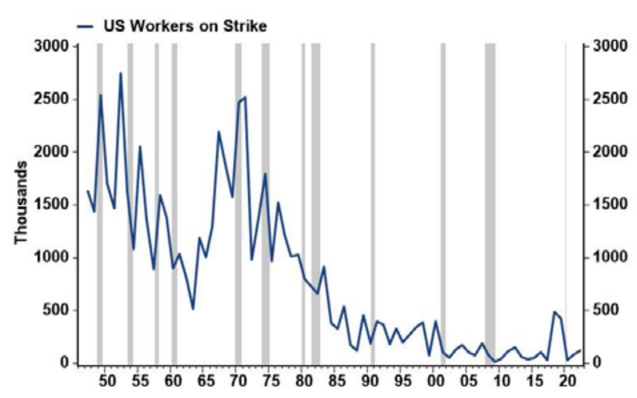


Figure 8: Thousands of US Workers on Strike



Source: Haver Analytics and Google through September 6, 2023. Grey areas note periods of recession.

Bridge Over Troubled Waters

We believe the widespread fear that we are in the midst of is a repeat of the 1970s period of rising inflation and eroding asset prices is misplaced. Notably, such fear is not priced into markets. US Treasury Inflation Protected Securities embed a 10-year average 2.3% gain for the Consumer Price Index. Meanwhile, the S&P 500 trades at 20X this year's likely profit.

The Fed is not following its 1970s course of neglect and the belief that higher inflation "greases the wheels of commerce." As the world public has certainly experienced the ugly side of inflation over the past two years, policy has tightened. The Fed has been convincing markets that it intends to see inflation curtailed to normal levels by 2024-25. Only recently, markets have come to the view that a recession might not be needed to achieve this.

Even as we still expect yields to moderate in the coming year, we would prefer to describe the 2022 surge in interest rates a "normalization" rather than an overshoot. Both the double-digit yields of 1980 and zero yields of 2020 appear to be historical aberrations.

3 'Labor Could Be Detroit's Next Big Disruption', Wall Street Journal www.wsj.com, September 4, 2023

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High quality (very strong)	Aa	AA	AA
Upper medium grade (Strong)	A	A	A
Medium grade	Baa	BBB	BBB
Not Investment Grade			
Lower medium grade (somewhat speculative)	Ba	BB	BB
Low grade (speculative)	B	B	B
Poor quality (may default)	Caa	CCC	CCC
Most speculative	Ca	CC	CC
No interest being paid or bankruptcy petition filed	C	D	C
In default	C	D	D

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