Are We Returning to 1970s-Style Inflation?

In 2004, *The Economist* ran a feature on global inflation, and on the cover of the magazine they posed the question: "Back to the 1970s?" Readers today know the U.S.[1] and developed world economy did not enter a period of 1970s-style inflation in the early 2000s, and in fact the U.S. was on the verge of a decade-plus run of below average inflation.

Fast forward to today, and many are again asking the question if we're heading for 1970s-style inflation, and at worst, a period of stagflation.

These gloomy comparisons happen a lot. I've been in the investment business for a long time, and I can assure readers that any time the U.S. economy has experienced above-consensus inflation for a period, the comparisons to the 1970s start coming out. Admittedly, 2021 has some interesting parallels to the 1970s – the U.S. just ended a long and troubling war (Afghanistan versus Vietnam), there is a semblance of a cold war (Soviet Union versus China and Russia), and labor shortages/supply chain issues have created some problems (some readers may remember the 1970s for its shortages).

A return to 1970s-style inflation does not necessarily make for great holiday reading. But not to worry – below I offer two key reasons 2021/22 should not encounter the same long-term inflation problems seen during the 1970s.

The first reason is oil. A key driver of inflation in the 70's was the wild surge of oil prices, from $2 a barrel to $32 a barrel over the course of the decade. That's a 16-fold increase, which in today's terms, would mean oil skyrocketing from the comfortable $40 to $60 range (for argument's sake) to at least $640 a barrel. This is unlikely.

Since the 1970s, there have been 'supply shock prevention measures' put in place that arguably would not allow such a massive increase over a short period of time. OPEC is one of them, and there has also been a shale boom here in the U.S. that has vaulted us to being the world's top producer. Oil prices remain volatile, of course, but compared to the 1970s prices should largely be viewed as stable.

Consumers are also in a better position today to weather slightly higher prices. Wages are on the rise, there are more available jobs than there are

people looking for work, and we spend less overall on energy – in the 1970s, for instance, gasoline made up 6% of spending, compared to 2% today.

The second key reason is the supply side of the equation. The 1970s was known for supply constraints, which gave rise to demand "chasing too few goods." A lot has changed since then. One of the biggest factors is a surge in global trade, particularly as China has become the biggest export economy in the world. Supply of goods has not been a problem since, except for in the current moment driven by the Covid-19 pandemic. The argument for a return to 1970s inflation implies that current supply issues are set to become permanent or semi-permanent, which I do not believe to be the case. Today's supply chain bottlenecks are not a result of a global economy unwinding, but rather a product of rolling economic closures and restrictions being met with a drastic shift in demand for goods (versus services). It's only a matter of time, in my view, before these issues are resolved and price pressures ease.

Finally, there is the question of stagflation. For readers who are not familiar, stagflation refers to the economic condition of high inflation and low or negative growth. When inflation runs higher than growth, the 'real' growth rate of the economy turns negative, which of course is a bad outcome. But I think these worries focus too much on a small data set (2021's summer months), and are not taking into account the possibility – or in my view, the likelihood – that the global economy will continue to press ahead with growth while inflation wanes over time.

Bottom Line for Investors

Any time economic conditions are flashing warnings signals – high inflation, low wage growth, weak jobs markets, etc. – the comparisons to darker economic times tend to emerge in full force. Higher- and longer-than-expected inflation today is drawing comparisons to the 1970s, when inflation was rampant and the Federal Reserve drastically engaged in a monetary tightening cycle that culminated in a 20% fed funds rate. Oil prices rose 16-fold, and supply constraints abound.

We're not seeing these types of outcomes today – the jobs market is very tight, wages are rising, prices are rising but largely in response to too much demand bumping up against temporary supply chain issues. The Federal Reserve may raise the fed funds rate in 2022, but basically off the zero bound (not up to 20%). Point is, comparisons to times like the 1970s tend to garner a lot of attention and media buzz, but the economic conditions and fundamentals simply don't line up.

ABOUT MITCH ZACKS

Mitch is the CEO & Senior Portfolio Manager at Zacks Investment Management. Mitch has been featured in various business media including the Chicago Tribune and CNBC. He wrote a weekly column for the Chicago Sun-Times and has published two books on quantitative investment strategies. He has a B.A. in Economics from Yale University and an M.B.A in Analytic Finance from the University of Chicago.

[1] BlackRock, November 30, 2021. https://www.blackrock.com/us/individual/insights/comparing-todays-markets-with-the-1970s

Weekly Market Update

Important Market News We Think Worth Considering

IN FOCUS THIS WEEK

3 Economic and Market Events to Watch For in 2022

1. **Will the Federal Reserve raise interest rates?**
2. **Can corporate earnings continue outperforming expectations?**
3. **Will the jobs market strengthen and be a force for strong demand?**

1. Will the Federal Reserve Raise Interest Rates?

A big piece of the economic recovery story in 2021 was high and persistent inflation. Specifically, the highest rate of inflation the U.S. economy has experienced in 30+ years.

For the better part of the year, the Federal Reserve clung to the narrative that inflation was "transitory," signaling their view that pressures would eventually ease. Instead, the pressures remained. By late November, the Fed was engaging in a form of damage control, removing the word "transitory" from their inflation forecast and indicating a more rapid unwinding of QE. In the fall, the QE program was slated to end in June 2022. By the end of November, the date had shifted to March 2022.

In our view, the coming year should see prices stabilize, as consumers increasingly shift purchases to services and as supply chain kinks get ironed out. However, it is possible – perhaps even likely – that price pressures do not abate until the second half of next year, which may leave the Fed no choice but to move up their forecast for interest rate increases. To date, policymakers have been reluctant to raise rates during an ongoing pandemic – but inflation pressures and a strong labor market may force their hand.[1]

2. Can Corporate Earnings Continue Outperforming Expectations?

While coverage of inflation and supply chains has largely remained negative, U.S. corporations have continued to brush off the challenges and post record profits. Impressively, corporations have posted record earnings in the last two quarters (Q2 and Q3 2021) even without the help of the leisure, hospitality, and travel industries. Companies in this space are still earning significantly less than they did in the pre-Covid period, and in fact, many of these companies aren't expected to get back to pre-Covid profitability levels for another year at least. The key question in 2022 is whether spending will shift to services and boost other areas of the economy, and/or if inflationary pressures will finally start to crimp margins for the to-date well-performing parts of the earnings picture. The trend emerging from current consensus estimates (seen in the chart below) appears to show inflationary trends as indeed temporary with little effect on earnings in 2022. Time will tell.[2]

3. Will the Jobs Market Strengthen and Be a Force for Strong Demand?

Labor shortages in 2021 were a major headline. Something to watch in 2022 will be whether workers start to accept some of the 10 million unfilled job openings. As we write, some four million workers have yet to return to a job, for a variety of reasons – early retirement, lack of childcare, persistent fear of Covid-19. Will the tides shift a bit in the new year, in what could be one of the strongest jobs markets in U.S. history? Again, this will be a factor for investors to watch in the new year. If the jobs market strengthens further, it would arguably drive additional economic demand in 2022, particularly since wages have been rising at a rate close to inflation. Personal consumption has risen by 12% since 2020, and the ratio of disposable income to household net worth are close to a record high. Will consumer finances improve even further in the new year, driving another year of strong consumer demand? We think so.[3]

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[1] J.P. Morgan. December 7, 2021. https://www.jpmorgan.com/commercial-banking/insights/economic-trends

[2] Zacks. December 10, 2021. https://www.zacks.com/commentary/1838116/q4-earnings-season-gets-underway

[3] J.P. Morgan. December 7, 2021. https://www.jpmorgan.com/commercial-banking/insights/economic-trends

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