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INSIDE STORY

How Did We Get Here?

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How Did We Get Here?

As our economy slows and inflation remains stubbornly high, one must wonder if we will ever learn our lessons. We have been here before and we know what causes this, yet here we are once more. We did not learn the lesson of the 1970s; but why?

I believe it is the all-too-human instinct to look for one explanation for complex problems, when in truth it is never just one thing. In the case of inflation, most want to look towards the Federal Reserve Bank (Fed). They want to give the Fed all the blame for inflation and all the credit for stopping inflation. While there is some truth in that, it is at best a grossly oversimplified view and at worst just plain wrong.

This is not to say that the Fed can't do any damage. They certainly share fault for the housing bubble of the 2000s, which led ultimately to the financial crisis of 2008. That too was a complex development with multiple contributors, but in that case the Fed escaped culpability as "bankers' greed" made for better headlines. However, in the case of inflation I believe the misdiagnosis comes from the two schools of economics.

"Those that fail to learn from history are doomed to repeat it."
~Winston Churchill

I have no idea how they teach economics today, but 30 years ago when I was a student one had to learn about "microeconomics" and "macroeconomics." Microeconomics dealt with consumer behavior, the backbone of which was the law of supply and demand. A product which is in high demand but of limited supply will sell at a high price.

There are other laws of microeconomics such as the law of marginal utility, which explains that the fourth piece of cheesecake is not as enjoyable as the first piece. In fact, it may very well leave one so sick that he never wants cheesecake again.

Macroeconomics is the study of the economy at large. When I was a student, it mostly revolved around the theories of John Maynard Keynes, and the primary focus is what they call "aggregate demand." This is the sum of all demand for all products in the economy. One would study the different factors that led to aggregate demand and how a government could manipulate those factors to keep the economy growing. Primarily at that time we would learn these complicated mathematic formulas that would predict the growth of the economy based on things like government spending.

In micro class we would study the various laws of economics and see real world examples of how these laws could be seen in action. These were laws, after all, and they worked then and still work today. If one is trained, then one can see them in action. One of my favorite examples would be foreign to young people today who have never seen an actual newspaper, but when I was a student, it fascinated me. Did you ever wonder why the soft drink vending machine would only dispense one soft drink at a time, while the newspaper vending machine allowed one to grab every paper inside if she so chose? This was the law of marginal utility in action. A second soft drink may have less value than the first to a thirsty consumer, but it still has significant value. A second newspaper is worthless unless you are using it for something other than reading. So vending machines allowed only one soft drink, but every remaining newspaper – knowing consumers would take only one newspaper, but would likely take more than one soft drink if given the chance. Occasionally some Robin Hood-type character would grab the whole stack of papers and place it on top of the machine for others to get a free paper, but that didn't happen enough to hurt the newspaper business.

In macro class we would learn mathematical formulas for predicting GDP. We learned the basic Keynesian formula. We practiced it and practiced it, and then we would be tested. After the test the professor would come in and say, "Well that is the basic formula, but it didn't actually work in real life." Then we would learn a more complicated formula. We practiced it and practiced it, and then would be tested. After the test the professor would come in and say, "Well that is the second iteration of the formula, but it didn't work any better." We would learn an even more complicated formula…well, you get the picture.

It should be obvious based on my description that I gravitated to microeconomics. It should also not be a surprise that we believe in bottom-up investing; in other words, the micro view of investing. Our top-down, macro view is simply the sum of all the

bottom-up micro views. What does this have to do with inflation? Everything.

The view that the Fed caused inflation and, more importantly, that the Fed can cure inflation, is a macroeconomic view. It makes for some wonderfully complex math that a professor can really enjoy teaching to young economic students, but after the test has been graded, she then has to explain to the class why it doesn't work in the real world.

Low interest rates theoretically would encourage more borrowing, which stimulates aggregate demand. How truly effective this is in stimulating the economy cannot be known. One problem with macroeconomics is that, unlike science, there is no control group. There is no way to know exactly what impact the Fed has on the economy. We know that during the recession brought on by the financial crisis, the Fed went to extraordinary measures to boost aggregate demand and thereby the economy. We know that the recession ended, although the recovery was anemic and most thought we were still in a recession. It seems logical that the Fed's actions were helpful in stimulating demand, but we can't know for certain. Congress was also taking action in the form of TARP, and of course recessions will simply end on their own, so how can we know?

Fast forward to the pandemic and the Fed acted once again, but having never fully undone the actions of a decade earlier they had fewer options. They encouraged Congress, who also acted, and acted again, and again. Both fiscal (spending through Congress) and monetary (Fed action) stimuli supposedly boost aggregate demand. In theory, the boost in demand will raise prices, suppliers will act to raise supply, and the economy will grow with low controlled inflation.

This does not seem to be working, and it didn't work in 1970 either. When supply doesn't react but demand gets stimulated, we don't get growth we get inflation. Back then, as now and always, there wasn't just one cause. We had runaway government spending from the Johnson administration that kept going under Nixon. We had an OPEC oil embargo. We had civil unrest surrounding Vietnam and we had a crisis in Watergate. In 1970 the Fed raised rates from 4 percent to 9 percent and we dove into a recession. Inflation persisted. Four years later the Fed raised again, this time from 3.5 percent to 13 percent, and once again we went into a recession. Once again, inflation persisted.

While the Fed tried to kill inflation by lowering aggregate demand, other government programs were stimulating demand. Nixon implemented price-fixing, which caused shortages but was a boost to demand. Simultaneously there were restrictions on the production of supply. Our economy was over-regulated and the maximum income tax rate was 50 percent. This has an impact. In the late '70s my father took me to buy my first suit. He had known the salesman for several years and half-jokingly asked him why he wasn't the manager by now. The gentleman responded that he had been offered the job, but the raise would put him in a higher tax bracket and his take-home pay would actually go down. That was a disincentive to work harder and provide more supply. The Fed couldn't fix that.

It was not until Jimmy Carter began deregulating U.S. industry, then Ronald Reagan continued that trend and also reformed the tax code, that inflation was beaten. It should be no surprise that the official term for

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REVIEW *of* ECONOMY

The 1st quarter 2022 GDP growth came in down 1.6 percent and many are now calling for a recession. The underlying data is not as bad as it might seem, as consumers are doing better, but inventories remain a mess and government spending is down from the recent stimulus programs. Still there is no doubt that activity has slowed.

The official unemployment rate remains 3.6 percent through May. Jobs are being created and people are getting back to work. This is the key to avoiding a deep recession.

Inflation is 8.6 percent based on the latest consumer price index report. It continues to move upward. The producer price index, which tracks wholesale prices, is up 10.8 percent over the last 12 months. The Fed is acting but they will need help. +

REVIEW *of* MARKET

We entered a bear market during the quarter. For the quarter, the S&P 500 finished down 16.10 percent and small company stocks represented by the Russell 2000 index were down 17.20 percent. Value outperformed with the Russell 1000 Value index down 12.21 percent while the Growth index was down 20.92 percent. For small companies the value index was down 15.28 percent and the growth index down 19.25 percent.

Bonds crashed this quarter. The Barclays U.S. Aggregate Bond index ended down 4.69 percent. High yield bonds dropped 9.97 percent. There is no safety in bonds in an inflationary environment.

International stocks dropped as well. The EAFE index finished down 14.29 percent and the MSCI Emerging Markets index ended the quarter down 11.34 percent. +

MARKET *forecast*

Pessimism is very high right now, and we believe it is overdone. Stocks are the best long-term hedge against inflation which is the biggest economic concern. Recession fears seem overblown. We should start to climb the "wall of worry" as the market often does.

Value stocks and small company stocks still have more room to run in the long term. International stocks look more attractive than domestic and while still negative are holding up better.

Bonds are a problem. Even with large increases in yield that accompany drops in prices, bonds still deliver negative real rates. Until inflation is tamed bonds are worrisome. +

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"Reaganomics" was supply-side economics. By stimulating supply, inflation was tamed. It still took the Fed raising rates once again, and we will never know if that was necessary, but it happened and inflation was beaten.

We failed to learn that lesson and today we are repeating history. Inflation peaked in 1980 at 14.76 percent. The government has since changed how inflation is calculated. Larry Summers, National Economic Council Director for the Obama administration, has recalculated historic inflation rates using today's methodology. Based on his work that peak would be reported as 9 percent today, not far from the 8.6 percent we are experiencing.

We have an energy crisis today caused in part by overly optimistic "green" policies and the Russian invasion of Ukraine. We are coming off a historical reaction to a pandemic that shut down much of the productive capacity of the free world. We have members of Congress asking for price controls and a re-emergence of regulation through executive action. In other words, we are making very similar mistakes and getting a very similar experience.

The Fed can act aggressively and have an impact on aggregate demand, but that won't help supply. The Fed gets far too much credit and blame. It didn't get us into this mess by itself. Don't get me wrong: they made mistakes that have certainly contributed to this mess. They should have backed off on the emergency measures long before they did. However, they had a lot of help, starting with the shutdowns and then all the extraordinary measures taken right up the last trillion-dollar spending package, which went into effect in an economy already growing at more than 6 percent.

Macroeconomic tools – fiscal and monetary government policy – impact only aggregate demand. Supply-side economics was based on a faith in microeconomics; it understood that people react to incentives, and to disincentives. If a salesman in a men's store would end up taking less money home if he was promoted and got a raise, then he was not likely to accept that promotion and raise. That puts a cap on his productivity and therefore reduces aggregate supply. Governments can stimulate demand all they want, but if supply is simultaneously being held down, then all they get is inflation.

On the other hand, if supply is freed up, then the Fed can have an easy money policy for almost thirty years with little impact on inflation. I didn't understand that as a young economics student. All I knew was that macroeconomic professors were always making excuses for being wrong and the microeconomic professors were always describing things as they actually were in reality. Macro class had theories and formulas while micro class had laws.

The law of supply and demand determines prices. When supply and demand are in balance, prices are stable. When demand is stimulated while supply is simultaneously deterred, we get inflation. That is how we got here. Understanding that shows us clearly the only way to get out: we must stimulate supply, in a similar fashion to how supply was stimulated in the 1980s. The Fed may need to play a role, but they couldn't do it alone in the '70s and they won't be able to do it alone today.

We learned this lesson once already. While it is frustrating that we have to learn it again, at least this time we know what to do. Here's hoping policymakers have the wisdom to do it.

Warm Regards,

CHUCK OSBORNE, CFA *Managing Director*