Stagflation: Are We About to Repeat the '70s?

June 18, 2018

Stagflation: at first glance, this distressing description of 1970s economic difficulty seems ominously similar to conditions today. Headlines of rising oil prices, stimulative monetary policy, and weak economic growth are reminiscent of the causes and characteristics of the problematic situation of 40 years ago, and these warning signs demand analysis to determine if portfolios should be repositioned for a potential repeat of this past environment that ended in severe recession.

A 1970s Comparison: Inflation and Monetary Policy

Similarities between the 1970s and today's environment begin with rising inflation, largely driven by accommodative monetary policy. Extended accommodative monetary policy during the 1970s led to persistently high inflation: core Consumer Price Inflation (CPI) averaged 8 to 9 percent in 1974 and 1975 and, with the help of an oil spike, reached 12.4 percent in 1980! Headline inflation was even higher.

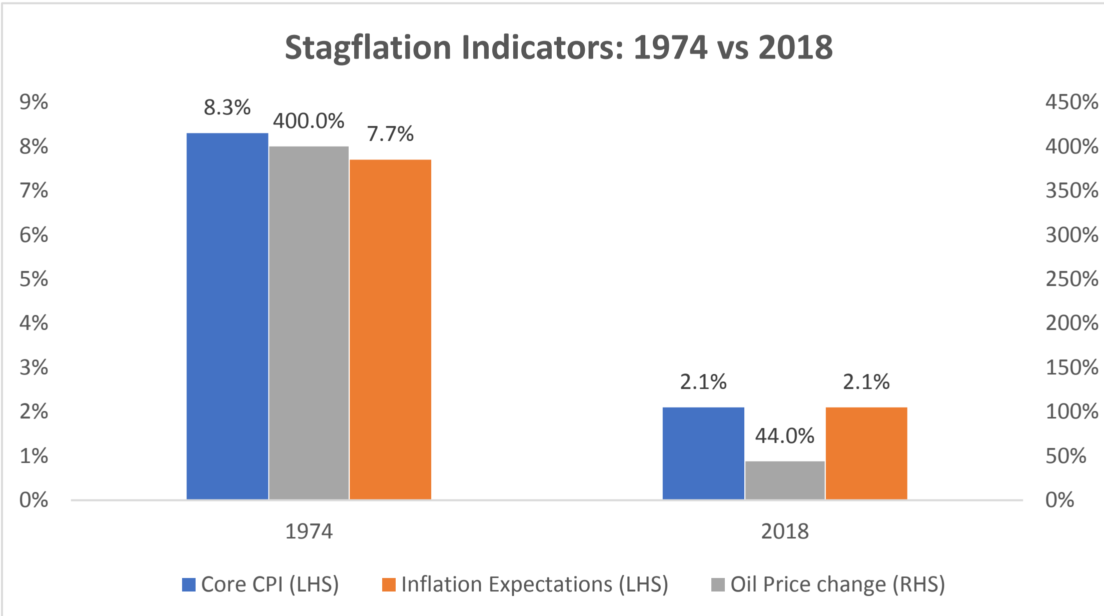
Over much of the past 10 years, the Fed has arguably been even more accommodative than in the 1970s. Fed funds (i.e., short-term interest rates) traded close to 0 percent for several years and have also been supplemented by quantitative easing. However, instead of this near-decade of accommodation resulting in persistent and rising inflation, we have yet to reach the Fed's (meager) inflation target of 2 percent. More specifically, the Fed's preferred measure of inflation, core Personal Consumption Expenditures (PCE), for April 2018, was 1.9 percent.

Consumer Behavior: Then vs. Now

More important than reported inflation may be inflation expectations. During the 1970s, the sporadic nature of monetary policy destroyed investor confidence in the Fed's ability to contain inflation. Inflation expectations increased to 8 percent during the 1970s, contributing to consumer willingness to pay higher prices and – with the help of strong labor unions – demand substantial wage increases. Arguably, then, high inflation expectations contributed to high inflation.

Inflation expectations and consumer behavior are far different today. Ten-year expected inflation is 2.09 percent, according to a May 10th report from the Federal Reserve Bank of Cleveland. The modern Fed has regained inflation-control credibility through policy based on consistency, gradualism, and transparency. Their recent rate hikes and quantitative tightening – well in advance of their 2% inflation target being reached – suggest continued inflation-fighting diligence. In addition, globalization and the internet have promoted consumer behavior that seeks lower prices, helping to manage price expectations in the process.

A brief synopsis of our analysis thus far: today's inflation and inflation expectations (as indicated in the chart below), consumer behavior, and monetary policy all differ greatly from the environment of the 1970s.



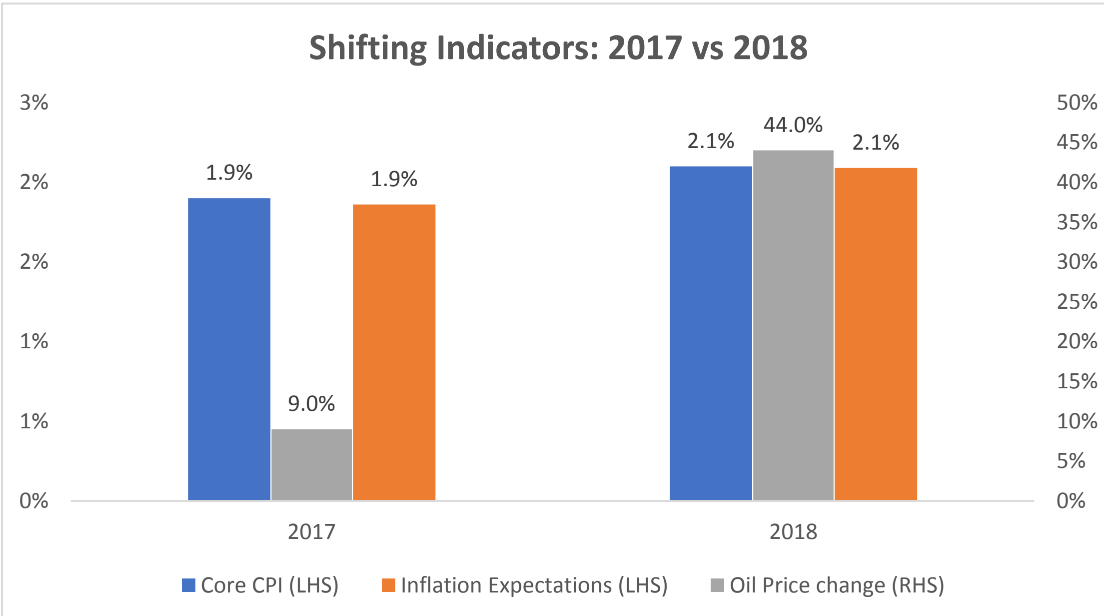
Sources & Data:
CPI: Bureau of Labor Statistics (1974=y/y, 2018=4/18)
Inflation: FRB Philadelphia 1yr expectations (1974=4Q '74, 2018=2Q'18)
Oil Price Change: FRB (1974=$2.90/b 10/73-$11.65/b 1/74, 2018=$50/b 5/17-$72/b 5/18)

Oil Shock, Again?
The above chart reveals that today's rise in oil prices is quantitatively different than the oil shock of 1973: the 44 percent rise in oil prices over the past year (from about $50 per barrel, in May 2017, to just over $70 per barrel, in May 2018) pales in comparison to the 400 percent (!) spike from just under $3 dollars per barrel in October 1973 to nearly $12 per barrel just three months later. Even if we were to encounter a more drastic spike in modern times, there are other differences in today's economy that should mitigate the impact of higher oil prices – especially from a supply perspective. For instance, we are nowhere near the seminal events of the mid-1970s that included violent trucker strikes, nationwide even/odd license-plate fuel rationing, and conservation efforts (such as a national maximum speed limit of 55 mph and the imposition of year-round daylight savings time) in response to limited fuel supplies.

A large component of diminished supply concerns is that U.S. dependence on oil and foreign oil has declined dramatically since the 1970s. In 2017, domestic energy production accounted for 90% of U.S. energy consumption; this production, substantially supported by shale oil, changes the economic impact of higher oil prices. Instead of the largely negative economic consequences in 1973, higher prices today also provide economic benefits of drilling, transportation, and refining jobs, as the U.S. becomes a key oil exporter.

It's *Still* About the Economy
Economic growth in 2018 also differs from the U.S. economy of the 1970s. The effects of tax cuts, reduced regulations, and improved capital spending plans seem likely to support economic growth over the next 12 to 24 months. Such an environment does not resemble the economic volatility of the 1970s that included wage/price controls and recessions in 1970, 1974-75, and 1980. There could be some compromise of the current pace of economic growth, especially if trade wars evolve, interest rates rise, or profits narrow; however, these developments – as with inflation, oil, and monetary policy – do not involve the magnitude or the volatility of events during the 1970s. Accordingly, 1970s-style stagflation and its devastating effect on the economy and investments does not seem imminent.

Portfolio Response
Even though 1970s stagflation is highly unlikely, the appropriate portfolio response is not, "do nothing." The issues that remind us of stagflation may not yet be powerful enough to create recession, but, as the below chart indicates, they do represent important shifts over the past year:



Sources & Data:
CPI: Bureau of Labor Statistics (2017=April y/y, 2018=April y/y/)
Inflation: FRB Cleveland 10 yr expectations (2017=April '17, 2018=April '18)
Oil Price Change: FRB (2017=$46/b 5/16-$50/b 5/17, 2018=$50/b 5/17-$72/b 5/18)

Inflation is creeping higher. Limited availability of labor, combined with constraints on immigration, suggests wage inflation will support this trend. Tariffs – to the extent they are implemented – will also result in higher prices, which, in turn, typically support higher long-term interest rates. Quantitative tightening is also expected to put upward pressure on rates. In addition to potentially rising long-term rates, higher prices may also justify an increase in the pace of Fed rate hikes, and, eventually, wage pressures and higher interest rates can diminish corporate profitability.

All of these effects are likely to be incremental; however, some changes that may prepare portfolios for an environment of higher interest rates, an increase in the pace of Fed rate hikes, and sustained oil prices above $65 per barrel, include the following:

Reduce portfolio duration to mitigate the negative impact of higher interest rates on bond prices. Selling longer-maturity high-quality debt to purchase short-term taxable or tax-free debt reduces the impact of higher inflation and rising long-term rates on the portfolio, and this move should be less painful given the recent rise in short-term rates.

Adjust high-yield holdings to reduce exposure to highly leveraged companies that may suffer most as interest rates rise. High-yield spreads are historically low, suggesting that investors may have captured most of the value in this sector. Reducing high-yield holdings in favor of short-term securities positions the portfolio to 1) avoid underperformance due to spread widening based on fears of higher debt-service costs, and 2) avoid the duration risk associated with longer-term debt. If yield is a priority for the portfolio, replacing high-yield debt with short-term floating-rate debt will reduce interest-rate risk and position the credit risk higher in the corporate structure, but with only a modest reduction in yield.

Favor shale oil equities, including transportation, pipelines, and drilling that may benefit from oil priced above $65 per barrel. Companies that were close to breakeven at $45 to $50 per barrel can be positioned to show dramatic earnings improvement at $65 to $70 per barrel and higher.

For more information or to discuss this commentary, please reach out to me or anyone on our team.

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