MORNING BRIEFING
August 15, 2023

The 1970s All Over Again?

Check out the accompanying chart collection.

Executive Summary: The current alignment of economic forces—resulting in a growing economy with low unemployment, falling inflation, and stimulative fiscal policy balancing out restrictive monetary policy—seems too good to be sustainable. Is stagflation what comes next? … We doubt it. We don't see inflation turning back up and economic growth slowing down as the decade progresses. We continue to place greater odds on "The Roaring 2020s" scenario (65% odds), a reboot of productivity driven growth à la the 1920s, than we do on "The Great Inflation 2.0" scenario (35%), a replay of the 1970s/early 1980s stagflation story.

Weekly Webcast. If you missed Monday's live webcast, you can view a replay *here*.

Inflation: Twin Peaks? One of our many thought-provoking accounts sent us the following thought-provoking email message on Sunday: "Is it even possible to have an environment where the Fed is raising rates, fiscal policy is pedal to the metal, employment is totally full, and we get non-inflationary growth? Has it ever happened before? Isn't it always at best stagflation?"

Here was my short response: "It hasn't happened before, but it is what we have right now." The following is my long answer.

Since March 2022, monetary policy has been restrictive, while fiscal policy has been stimulative. As a result, the rapid increase in interest rates since early last year hasn't caused a recession so far. Indeed, the unemployment rate was 3.5% in July. Yet inflation has been moderating since last summer. The headline CPI peaked at 9.1% y/y last year during June (*Fig. 1*). The headline CPI with and without shelter were down to 3.2% and 2.0% last month. The core CPI with and without shelter peaked at 6.6% and 7.6% last year, falling to only 4.7% and 2.5% in July (*Fig. 2*). Meanwhile, the Atlanta Fed's *GDPNow* tracking model is currently estimating that real GDP is rising by 4.1% (saar during Q3).

My friend responded that this happy outcome can't be sustainable and inquired: "What's next?"

He might be right: This remarkably bright picture could still turn dark, resulting in stagflation. The analogy often proffered is the twin peaks in the inflation rate during the Great Inflation of the 1970s and the resulting stagflation during the decade. I first discussed this analogy in the September 27, 2021 *Morning Briefing*:

"In recent months, we've been discussing two alternative scenarios: The Roaring 2020s (TR-20) and The Great Inflation 2.0 (TGI-2.0). In the first scenario, the relevant paradigm is the decade of the 1920s; in the second, it's the 1970s. In recent Zoom calls, I've been asked by some of our accounts to assign subjective probabilities to these alternative scenarios. I am going with 65% odds for TR-20 versus 35% for TGI-2.0. I may be spending much of the rest of this decade tweaking these probabilities."

For now, I am sticking with those odds.

Today, reflationists undoubtedly would give higher odds to a rerun of the 1970s—probably well over 50%. After all, the price of oil is rising again. Labor unions are pushing for big pay increases and getting them. Some are even aiming to bring back cost-of-living-adjustment (COLA) clauses in their contracts. The federal deficit is ballooning as the federal government spends on infrastructure, green projects, and incentives to onshore manufacturing, particularly of semiconductors. The government is crowding out other borrowers in the capital markets and competing for workers in the labor market.

The reflationists have a point: It may be only a matter of time before these cost pressures show up as a second wave of inflation. That would force the Fed to keep raising interest rates until something breaks in the financial system, triggering an economy-wide credit crunch and a recession. It could all happen during the first half of the 2020s—like the 1970s on steroids.

But even in that case, I believe that the second half of the 2020s still could follow the 1920s script. In any event, Debbie and I remain disinflationists. We think that inflation peaked last summer and likely will fall to the Fed's 2.0% target by 2025.

Let's compare the 1970s to the 2020s so far:

(1) *Overview*. During the 1970s, two OPEC oil supply shocks triggered an inflationary wage-price spiral (*Fig. 3*). They also caused a couple of nasty recessions. The US budget deficit swelled as the government pursued a policy of both "guns and butter." Defense spending rose as the nation competed in the nuclear arms race with the Soviet Union and waged a

war in Vietnam. At the same time, spending on social welfare programs increased in response to widespread riots in the inner cities. The US trade deficit ballooned when Japan emerged as a significant threat to many American industries, especially the auto industry. There were growing concerns about "de-industrialization." Productivity growth collapsed during the decade.

Inflation trended higher despite a couple of severe recessions. That led to a widely held view that inflation had become a structural problem, raising the question of whether recessions could ever bring it down again. The oil shocks of 1973 and 1979 were transmitted to the wages of union workers by automatic COLAs in many of their contracts. As labor and fuel costs soared, companies raised prices. It was a classic wage–price spiral—which economists called "cost-push inflation"—caused by an exogenous inflation shock (*Fig. 4*).

In addition to a wage-price spiral during the 1970s, there was a rent-wage spiral. The CPI tenant rent inflation rate rose from 4.0% y/y at the beginning of the decade to peak at a record 11.0% during August 1981 (*Fig. 5*). That put lots of upward pressure on wage inflation (*Fig. 6*).

(2) *Commodities*. At the start of the 1970s, commodity prices soared when President Richard Nixon allowed the dollar to depreciate significantly (*Fig. 7*). Oil is priced in dollars, so OPEC cartel members, to offset the effects on their profits of the dollar's depreciation, succeeded in raising the price of oil by lowering their output. Both energy and food prices soared during the early 1970s and near the end of the decade, when oil prices jumped again, raising the cost of producing food (*Fig. 8*).

This time, the dollar remains relatively strong. Commodity prices remain weak. The price of oil has rebounded in recent weeks. However, global economic activity and demand for commodities remain lackluster as both China and Europe grapple with rapidly aging demographic profiles, depressing consumer spending. In addition, China is struggling with the deflationary consequences of the depression in its property market. In the US, the housing market remains in a recession.

(3) *Wages & rent.* In the US, union membership has dropped significantly since the 1970s. The available data show that 16.8% of private wage and salary employment was unionized in 1983 (*Fig. 9*). This percentage dropped to a record low of 6.0% during 2022. So we don't expect that the headline-grabbing news about recent union settlements will be as likely to boost overall wage inflation as it did in the 1970s.

Also, as noted above, there was a wage-rent spiral that spiraled out of control during the 1970s. We don't see that happening this time. Average hourly earnings for all workers peaked last year at 5.9% y/y during March. It was down to 4.4% this July. According to Zillow, rent inflation for new leases has dropped from last year's peak of 16.4% during March to 3.5% this July (*Fig. 10*). That augurs well for the CPI and PCED rent components in coming months since the Zillow rate leads them by about 10 months. It also augurs well for lower wage inflation.

(4) *Labor & productivity.* The Baby Boomers first entered the labor force during the 1970s, thus boosting its growth rate (*Fig. 11*). They were well educated but inexperienced. They contributed to the collapse in productivity growth mentioned above, as did rigid and costly work rules imposed on employers by their contracts with unions (*Fig. 12*). Meanwhile, hourly compensation soared during the 1970s, and so did unit labor costs (ULC) in the nonfarm business sector (*Fig. 13*).

This time, ULC peaked last year at 7.0% y/y during Q2, well below the double-digit twin peaks of the 1970s. ULC inflation tends to drive the CPI inflation rate. The former fell to 2.4% during Q2, confirming the drop in the CPI inflation rate to 3.2% y/y during July.

This time, the economy is experiencing structural shortages of labor. That could lead to higher wage inflation, we suppose. However, we are expecting a productivity boom over the remainder of the Roaring 2020s, which will keep a lid on price inflation while boosting real wages and profitability.

(5) *Inflation expectations.* By the end of the 1970s and the start of the 1980s, expected inflation over the next five years was in the high single digits. That's according to the same survey that is used to compile the Consumer Sentiment Index (CSI). In early August of this year, expected inflation was 2.9% y/y (*Fig. 14*). Fed officials have been saying that inflationary expectations are "well contained," and they've been right about that. Since mid-2021, when inflation started to take off, this measure of long-term inflationary expectations has remained close to 3.0%, up slightly from around 2.5% before the pandemic during 2018 and 2019.

Yesterday, the Federal Reserve Bank of New York released its monthly survey of one-year-ahead and three-year-ahead expected inflation rates. The former was down to 3.6% from a peak of 6.8% last year during June (*Fig. 15*). That's the lowest reading since April 2021. The latter was up 2.9%, confirming the low number in the CSI survey.

Calendars

US: Tues: Retail Sales 0.4%m/m/1.5%y/y; Business Inventories 0.1%; Import & Export Prices 0.1%m/m/-6.5%y/y & 0.2%m/m/-14.1%y/y; NY Empire State Manufacturing Index; NAHB Housing Market Index; API Weekly Crude Oil Inventories; Kashkari. **Wed:** Housing Starts & Building Permits 1.44mu/1.46mu; MBA Mortgage Applications; Headline & Manufacturing Industrial Production 0.3%& -0.1%; Crude Oil Inventories & Gasoline Production; FOMC Meeting Minutes. (Bloomberg estimates)

Global: Tues: Germany ZEW Economic Sentiment -16.0; UK Employment Change 3m/3m 50k; UK Claimant Count Change -7.3k; UK Unemployment Rate 4.0%; Japan Industrial Production & Capacity Utilization 2.0%m/m/-1.6%y/y; Canada CPI 2.7%y/y; European Economic Forecasts. **Wed:** Eurozone GDP 0.3%q/q/0.6%y/y; Eurozone Industrial Production -0.6%m/m/-4.2%y/y; Eurozone Employment Change 0.3%q/q/1.6%y/y; Spain Consumer Confidence 85.7; UK Headline & Core CPI -0.5%m/m/6.8%y/y & 0.3%m/m/7.4%y/y; UK PPI Input & Output -0.7%m/m/-51.%y/y & -0.4%m/m/1.2%y/y; Japan Core Machinery Orders -5.5%; Australia Employment Change 21.5k; Australia Unemployment & Participation Rates 3.5%/66.8%. (Bloomberg estimates)

Strategy Indicators

S&P 500/400/600 Forward Earnings (*link*): Forward earnings rose last week for LargeCap and fell for MidCap and SmallCap. While it's been 59 weeks since any of these indexes has hit a record high, all three are up from their lows during February and March. Through the week ending August 11, LargeCap's forward earnings is 4.2% above its 54-week low during the week of February 10; MidCap's is 2.8% above its 55-week low during the week of March 10; and SmallCap's is 0.8% above its 72-week low during the March 17 week. The forward earnings downtrend since mid-2022 for these three indexes has been relatively modest this time around compared to their deep double-digit percentage declines during the Great Virus Crisis and the Great Financial Crisis. LargeCap's is now 1.8% below its record high at the end of June 2022; MidCap's is 5.9% below its record high in early June 2022; and SmallCap's is 12.8% below its mid-June 2022 record. Forward earnings momentum remains near two-year lows. The yearly rate of change in LargeCap's forward earnings was negative for a 28th straight week, and up to -0.5% y/y from a 29-month low of -3.2% y/y during the June 23 week; that compares to a record-high 42.2% at the end of July 2021 and is up from -19.3% in May 2020, which was the lowest since October 2009. MidCap's rate of

-5.0% y/y is up from a 31-month low of -5.9% in early June, which compares to a record high of 78.8% in May 2021 and a record low of -32.7% in May 2020. SmallCap's -11.4% y/y rate is up from a 32-month low of -12.9% in mid-June and down from a record high of 124.2% in June 2021; it compares to a record low of -41.5% in June 2020. Analysts' consensus earnings forecasts for 2023 and 2024 had been heading steadily lower since last June, but 2023's estimates ticked higher during the Q1 and Q2 reporting seasons as analysts incorporated the strong earnings beats into their forecasts. Here are the latest consensus earnings growth rates for 2023 and 2024: LargeCap (0.6% and 11.9%), MidCap (-11.9, 13.5), and SmallCap (-12.1, 14.3).

S&P 500/400/600 Valuation (*link*): Valuations mostly ticked lower for these three indexes through the August 11 week. LargeCap's forward P/E fell 0.1pt w/w to 19.0, and is down from an 18-month high of 19.6 during the July 28 week. It's up 3.9pts from its 30-month low of 15.1 at the end of September, which compares to an 11-year low of 11.1 during March 2020. MidCap's forward P/E was steady w/w at 14.1, down from a 21-week high of 14.4 the week before that and is just 0.6pt below its recent 10-month high of 14.7 in early February. It's now up 3.0pts from its 30-month low of 11.1 at the end of September, which compares to a record high of 22.9 in June 2020 and an 11-year low of 10.7 in March 2020. SmallCap's forward P/E fell 0.1pt to 13.9, which compares to a 19-week low of 12.5 during the May 12 week and is now just 0.4pt below its recent 12-month high of 14.3 in early February. It's 3.3 pts above its 14-year low of 10.6 at the end of September and compares to a record low of 10.2 in November 2009 during the Great Financial Crisis. That also compares to its record high of 26.7 in early June 2020 when forward earnings was depressed. The forward P/Es for the SMidCaps have been mostly below LargeCap's since August 2018. MidCap's 26% discount to LargeCap's P/E remains near its 24-year-low 30% discount during the June 23 week. It had been at a 21% discount during the March 17 week, which was near its best reading since November 2021. SmallCap's 27% discount to LargeCap's P/E last week is not much above its 21-year low of 32% in April 2022. That compares to a 22% discount during the March 10 week, which was near its lowest discount since August 2021. SmallCap's P/E had been mostly above LargeCap's since 2003. Looking at SmallCap's P/E relative to MidCap's, it was at a discount for a 113th straight week; the current 1% discount is near its lowest since July 2021 and an improvement from its 20-year-low 9% discount in December 2021.

S&P 500 Sectors Quarterly Earnings Outlook (*link*): Following the Q3-2020 earnings season, when the US economy emerged from the Covid shutdown, analysts began raising their consensus forecasts for future quarters instead of lowering them as is the historical norm. That six-quarter streak of positive revisions throughout the quarter ended during Q1-

2022, and the estimate declines accelerated considerably for the three quarters ending through Q4-2022 before easing for Q1-2023. Looking ahead to Q2-2023, analysts are forecasting that the S&P 500's y/y earnings growth rate will mark its cyclical bottom with an 6.7% decline, down from -2.8% y/y in Q1-2023. On a pro forma basis, they expect the y/y earnings decline to bottom at -3.8% in Q2, down from a 0.1% gain in Q1-2023. However, S&P 500 ex-Energy earnings are forecasted to be up 2.5% y/y in Q2-2023, an improvement from the 1.6% decline in Q1-2023 and the 7.4% drop in Q4-2022. Seven sectors are expected to record positive y/y percentage earnings growth in Q2-2023, up from five sectors that did so in Q1-2023 and up from only two in Q4-2022. Here are the S&P 500 sectors' expected earnings growth rates for Q2-2023 versus their final earnings growth rates for Q1-2023: Consumer Discretionary (52.3% in Q2-2023 versus 56.2% in Q1-2023), Communication Services (16.0, -8.9), Industrials (14.2, 27.1), Financials (9.9, 7.7), Consumer Staples (7.2, 0.4), S&P 500 ex-Energy (2.5, -1.6), Information Technology (1.9, -8.3), Utilities (0.6, -21.8), Real Estate (-2.2, -6.2), S&P 500 (-3.8, 0.1), Materials (-26.5, -22.2), Health Care (-26.7, -14.8), and Energy (-47.7, 21.0).

Contact us by *email* or call 480-664-1333.

Ed Yardeni, President & Chief Investment Strategist, 516-972-7683
Debbie Johnson, Chief Economist, 480-664-1333
Joe Abbott, Chief Quantitative Strategist, 732-497-5306
Melissa Tagg, Director of Research Projects & Operations, 516-782-9967
Mali Quintana, Senior Economist, 480-664-1333
Jackie Doherty, Contributing Editor, 917-328-6848
Valerie de la Rue, Director of Institutional Sales, 516-277-2432
Mary Fanslau, Manager of Client Services, 480-664-1333
Sandy Cohan, Senior Editor, 570-228-9102