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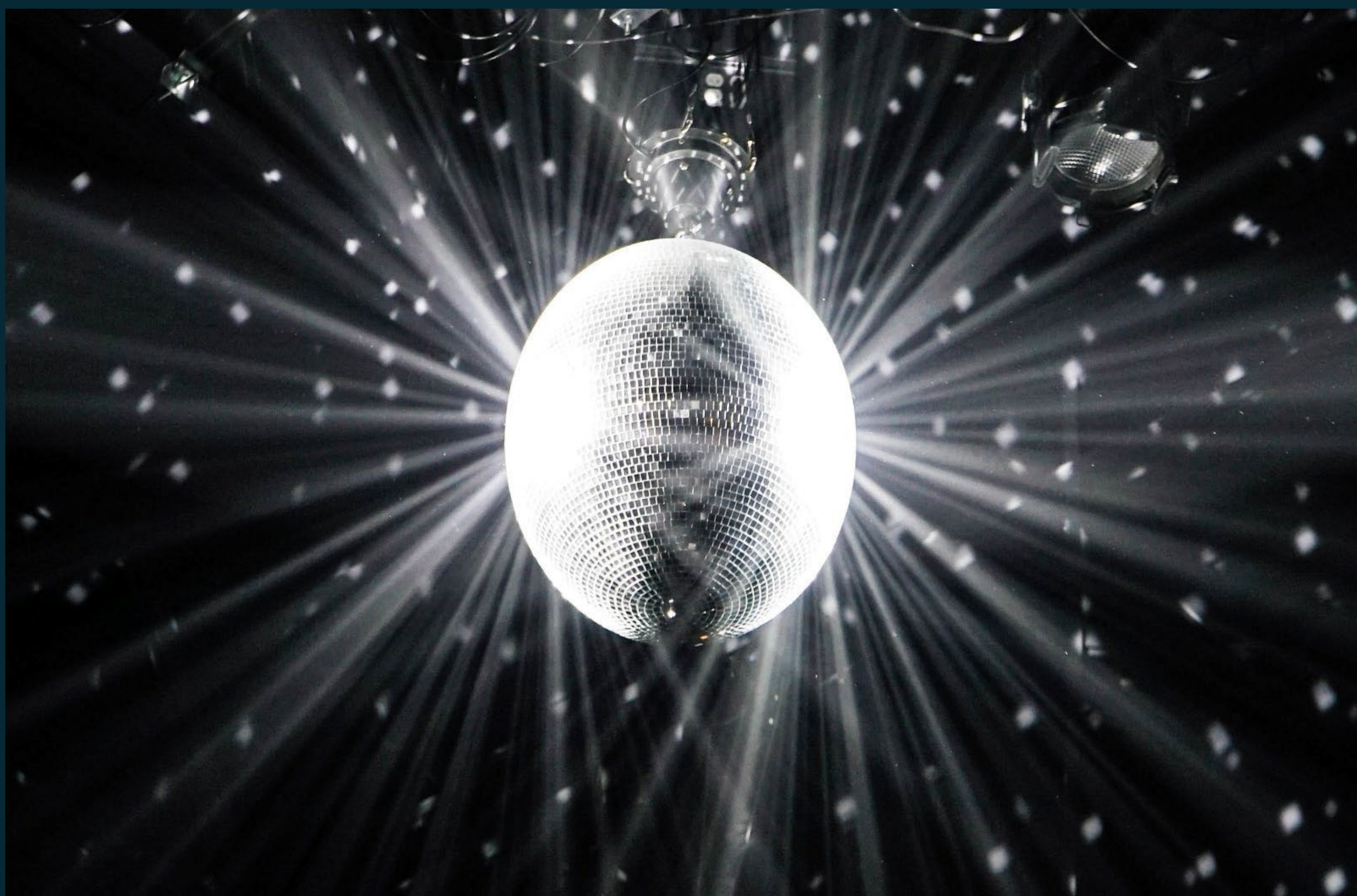

That 70's Show

The Eerie Similarities and Stark Differences Between Today's Investment Climate and That of Fifty Years ago

By David P. Harris, CFA

By any measure, Ambrose Burnside lived a full life with memorable accomplishments until his death in 1881 at age 57. He had been Governor of Rhode Island, Union General, United States Senator, and even President of a few railroad companies. Despite such a considerable resume, he may be best remembered for his unique facial hairstyle, as his name *Burnside* was reversed to *sideburns*, a popular men's hairstyle in the 1970's. While many important issues that helped shape the seventies are again reverberating through the economy, so far, we have at least been spared from some of the quirks such as sideburns, leisure suits, lava lamps, and pet rocks. In this issue of *Global Foresight*, I will focus on key similarities and differences in today's economic and investment climate from those of a memorable era that left a stark impression on those of us who lived through it.

Source: [1970's sideburns]

To summarize how difficult a period this was for investors, consider that the Dow Jones Industrials Average began the seventies at 800 and ended the decade at merely 848 - a scant 6% change over ten years. The slight gain over the period masked massive volatility, with the Dow reaching all-time highs in January 1973 and plummeting roughly 40% before bottoming in October 1974. Remarkably, the Dow did not fully recover for ten years when it finally set new highs in January 1983, a period of market futility that trails only the Great Depression in length.

In real terms, the returns for the Dow were in fact negative as U.S. consumer prices (as measured by the Consumer Price Index) compounded at a 7.4% annual clip, more than doubling for the decade, whereas the Dow, including dividend income, compounded at 5.2% resulting in a 2.2% annualized loss after inflation.

The seventies marked the first sustained bout of inflation in the U.S. going all the way back to 1917 when the U.S. Bureau of Labor Statistics (BLS) first collected data on expenditures aside from brief spikes during War World I and World War II. This is likely the reason inflation weighs more on the psyche of older investors -- anyone under age 50 is unlikely to have experienced it, since it has been reasonably well-contained the last 40 years.

The biggest reason the 1970's was such a poor decade for returns was because of inflation driving rates higher leading to price-to-earnings multiple compression. Ten-year U.S Treasuries entered the seventies yielding 7.9% and exited yielding 10.3%. As a result, the S&P 500 Index, a much broader gauge of the U.S. stock market, had multiples contract from 15.1x earnings at the start of the seventies to a paltry 7.5x earnings at the end of the decade. This multiple compression offset growth in corporate profits which more than doubled over the decade.

BusinessWeek magazine symbolized the frustration of investors with its infamous cover story from August 1979, "The Death of Equities – How inflation is destroying the stock market". Of course, in hindsight August 1979, with the Dow at only 875 and the S&P 500 at 107, would have been an incredible time for long-term investors to buy equities which shortly began a forty-year uptrend coinciding with a secular decline in inflation and interest rates.

Chronicle 1974 / Susan Ehmer

Source: [1970s gas lines - Bing images]

While every economic cycle is different, the 1970's and today have remarkable similarities. Both eras saw surges in prices that were stoked by accommodative central banks that chose to focus more on unemployment than inflation. Both also experienced supply shocks. In the seventies, the oil embargo that led to gasoline rationing contributed to a sense of panic that resulted in long gas lines - it was not uncommon to wait 45 minutes to fill up and many

service stations would routinely run out of fuel. Today we have experienced a string of supply shocks and shortages – some pandemic-related and more recently due to the severe dislocations in the energy and grain markets from the Russian invasion of Ukraine.

There are some notable differences. The seventies began with national debt-to-GDP at 35% and ended the decade at 31%, compared to roughly 125% today. Within the federal budget, we spent more on defense in the seventies and less on entitlements. The "peace-dividend" from the 1990's seems like a distant memory when defense expenditures were cut during that decade from roughly 5.5% of GDP to about 3% and have nudged higher to today's level of 3.5%. Despite far more national debt today, interest expense as a percentage of GDP is roughly the same now as it was in the seventies as low rates have mostly offset the impact of our national debt having grown four-fold.

Arguably the most notable difference between the periods is in population demographics, which materially impacts employment. We entered 1970 with the oldest of the baby boom generation aged 24 and the youngest aged 6. Half of all Americans were under 27 years of age (compared to 38 today). There was literally a generation of boomers to be absorbed into the work force. Those huge numbers of entrants into the labor pool each year contributed to exaggerated economic cycles as slowdowns led to massive surges in unemployment. The unemployment rate entered the seventies at 3.5%, peaked at 9.0% in 1975, and ended the decade at 6.0%.

Source: 1970's Lava Lamp

Contrast that with today's labor market which is the tightest on record based on the number of job openings compared to the number of persons unemployed. This suggests a couple of things: 1) wage pressure is unlikely to abate as firms are having a hard time retaining workers – we see this from the percentage of workers quitting jobs each month which is near record highs and 2) even in an economic slowdown we are unlikely to see massive surges in unemployment as we have in past cycles, and as we saw in the seventies. Those baby boomers that spanned from the ages of 6 to 24 in 1970 are now 58 to 76 years old. Many retired before the age of 65 during the pandemic and never returned to the workforce, explaining some of the current labor shortages.

Several industries have workforces that skew older and are scrambling for younger replacements. Airlines have been battling a pilot shortage as they gear up for a surge in travel. The trucking shortage has been well-documented, and the largest U.S. retailer recently announced that starting pay for its truckers would be boosted to $95,000 - $110,000. Competition to recruit for younger workers is fierce as salaries for recent graduates seem to be rising faster than inflation, although income for that specific demographic is not reported separately by the BLS.

The implications for markets suggest a big difference from the 1970s when rising inflation was met in lockstep with even higher rates. Back then, the 7.4% average inflation rate was matched with rates on 10-year U.S. Treasuries that averaged around 8%. Contrast that environment to today, as rates massively trail current inflation despite the recent surge in 10-year Treasury yields.

Just recently, real 10-year rates have approached zero - about where they were in January 2020, before the coronavirus spread into a pandemic - having been negative for over two years. For demographic reasons, we may not see real rates approach the 2% level where they were before the global financial crisis. Since real interest rates should reflect real economic growth rates over time, the bond market is signaling lower secular growth ahead, consistent with an aging workforce. The positive news is that unlike the seventies, we are less likely to see a price-to-earnings, multiple crushing rise in rates. I expect inflation to remain higher than economists' consensus forecasts which are absurdly low at 3.0% for 2023 and 2.3% for 2024 – by contrast the Treasury Inflation-Protected Securities (TIPS) market's implied inflation forecast is 3.5% annualized for the next five

years. This is far from the 1970's-style inflation despite its recent spike to those levels.

This is not to diminish the real risks to the equity markets. The longer the Ukraine War lasts, the more inflationary pressure consumers will feel. China's pursuit of zero-COVID creates more risk to the supply chain as we saw in the recent lockdown of Shanghai. Even a resolution of the Ukraine War is unlikely to fully restore global trade. Too many atrocities have been committed to return to "business as usual" once the fighting stops. Russia may have plenty of willing buyers for its oil in Asia that Europe may refuse to buy, but natural gas that is pipelined to Europe cannot be shipped to other geographies.

Source: 1970's Volkswagen Bus

The outlook for equities is more difficult than it has been for a while with earnings expectations running high after two years of tremendous earnings growth. In the face of rising cost pressure, earnings may disappoint in 2022. With economic uncertainties and rising recession risk, it is also difficult to expect price-to-earnings multiple expansion.

However, a slowdown would unlikely trigger massive unemployment and a prolonged credit cycle as we would enter a contraction with much tighter labor dynamics than in past cycles.

Consensus earnings for the S&P 500 are currently at $227 for 2022 and $247 for 2023. If we haircut those numbers to $215 and $230 respectively and shave the multiple to 17.5x 2023 EPS, this leaves an S&P 500 target of 4025 - less than a 10% correction from here. This does not feel like the 1970s in terms of downside risk. If rates top out in the 3% to 4% range, that multiple is not stretched. Should earnings hold up better than feared, markets can certainly do better than that downside scenario.

After a year of raising the alarm on higher rates and inflation risk in prior *Foresight* publications, it is important to highlight I do not think this is a repeat of the 1970s market environment. We are most likely to see some back-and-forth in equities in a trading range until rates stabilize and inflation begins to abate. It may not be the most exciting or rewarding market environment, but it sure beats the seventies, except for pop culture, fashion, and possibly even sideburns.

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