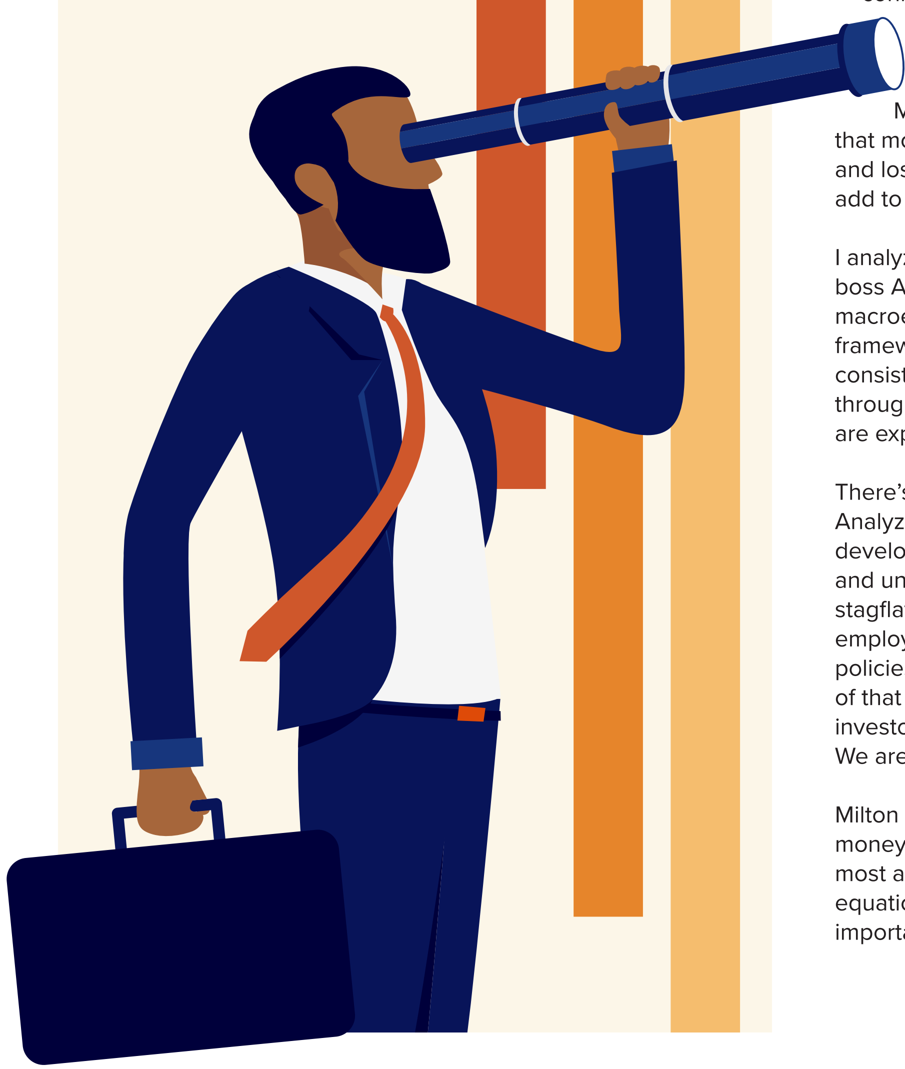


That '70s Show: *Economic Reruns Could Be on the Air for Another Decade*

By: Thomas F. Landstreet

A history in stagflation and other key elements driving the U.S. economy

Government is the 800-pound gorilla in the economy. Frustrating as that can be, investors who know how to connect the dots between policies and stock prices stand to make impressive returns. They can trade angst for alpha.

Macro investors seek to identify investment themes that move whole sectors of the economy, creating winners and losers. In the case of government policies, they never add to GDP, they just rearrange it.

I analyze policies through the scrim of what my former boss Arthur Laffer calls the "four grand kingdoms of macroeconomics." This is more than an economic framework--it's a way to make money. The Four Kingdoms consist of monetary, fiscal, regulatory and trade policies. It is through these grand kingdoms that all government policies are expressed.

There's been a lot of action in these kingdoms recently. Analyzing the effect they'll have on asset prices and developing an investment plan involves studying history, and unfortunately, in terms of policy, the best analog is the stagflationary 1970s. That's when a breathless Richard Nixon employed an ambitious mix of monetary and regulatory policies that created and prolonged the inflation/stagflation of that decade. It was a difficult period for the economy and investors' profits, if they had any, were eroded by inflation. We are facing a similar set of circumstances now.

Milton Friedman famously stated that inflation is "too much money chasing too few goods." But in looking for inflation, most analysts focus on the "too much money" part of the equation ignoring the "too few goods" part. The latter is an important variable both in the 1970s and today.

Neither party has a monopoly on bad ideas, but Richard Nixon takes the cake. In 1971, Nixon enacted a major monetary policy change when he ended the U.S. dollar's fixed-price convertibility into gold. It was set afloat as a "fiat" currency only to fall in value by 34% during the decade.

Nixon also famously pressured his Federal Reserve Chairman Arthur Burns to employ expansionist monetary policies to help him in his 1972 re-election campaign. Burns complied by lowering the discount rate (the minimum rate the Federal Reserve charges on loans and advances to commercial banks) and expanding the money supply. The monetary backdrop for inflation was set.

Ever the politician, as inflation persisted, Nixon panicked. He ventured into another of Laffer's kingdoms, regulatory policy, to impose price controls targeting oil prices in 1971. Oil remains an important input into every other aspect of the economy, but, as a percentage of GDP, oil consumption in 1971 was much higher than today.

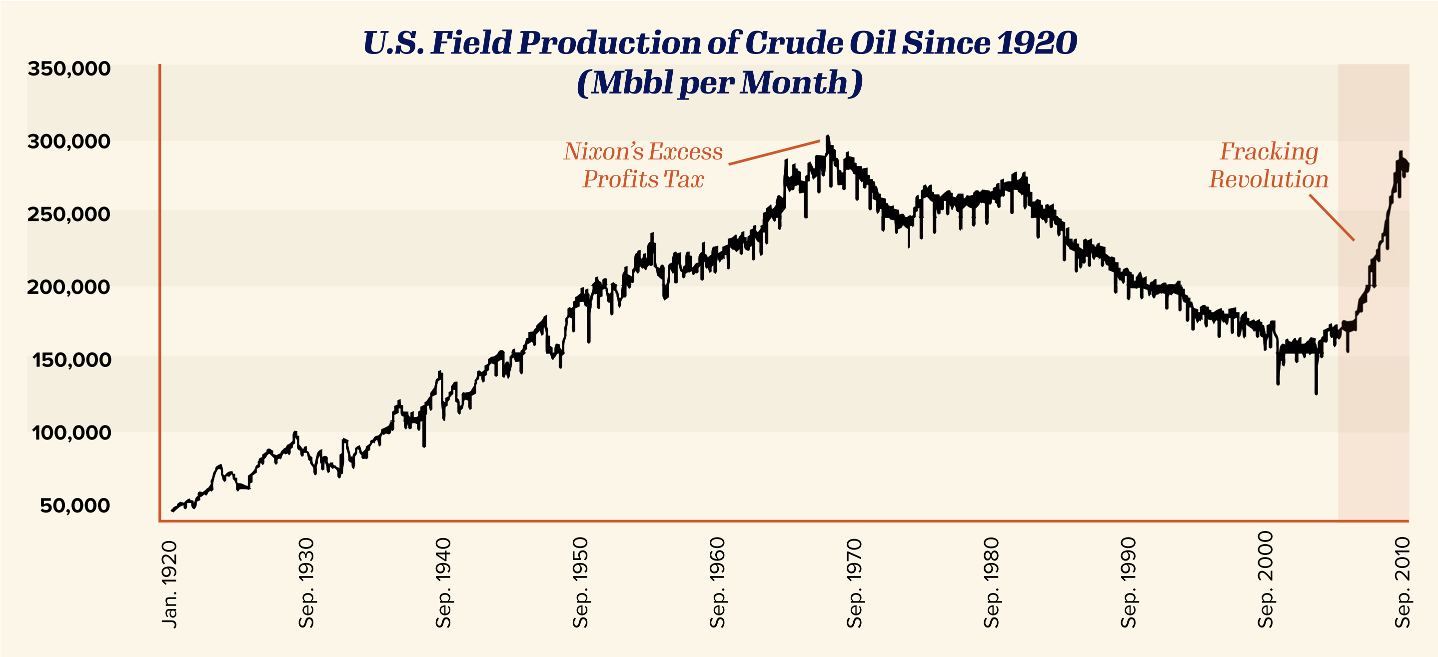
Fearing secular inflation, Nixon imposed oil price controls that capped what U.S. producers could charge per barrel - below the prevailing market price. As shown in the chart below, U.S. oil production, which had risen steadily since the 1920s, suddenly reversed and began a 40-year decline until hydraulic fracturing (fracking) was invented. Nixon's price controls penalized production and the supply response was immediate. Prices rocketed.

The geopolitical stasis that followed remains today and now appears to be worsening. In 1975, Mideast countries began to nationalize their resources, kicking out western companies and establishing their own government-controlled companies to produce oil. These policy changes subverted the free market for energy and led to ever-higher prices.

Frustrated, Nixon was not done fighting persistent inflation. His administration concocted a scheme to impose a 90-day freeze on every price in the U.S. economy; they staffed and funded an entire bureaucracy to manage it. Assuming your brain is now reeling from this concept, I'll go through it for you.

As a product is manufactured and sold at retail, it moves through many hands. Iron ore is forged into steel and sold to a "value-added" distributor, who supplies a manufacturer, who sells to another distributor, who sells to a retailer, who sells to a consumer. Each seller in that supply chain was suddenly responsible for imposing Nixon's price freeze. The bureaucracy required precise recordkeeping with the threat of penalty. It was so disruptive, it gummed up the entire supply chain and - you guessed it - sent prices soaring. By the way, those price controls remained in place in various guises for over a decade.

And Nixon's administration was thought to be one of the most intelligent in history! Today's policy mix also involves incursions into monetary and regulatory policy.



Predictably, oil prices led to higher inflation. At the time, the U.S. was the largest oil producer in the world. OPEC, formed in the early 1960s, had not yet coalesced into a legitimate price-fixing cartel. The rising oil price emboldened Mideast governments to collude in 1973, raising prices and restricting sales to countries who supported Israel in the Yom Kippur War. The war fractured the Mideast and the West forever.

Milton Friedman would be appalled at the amount of money the Federal Reserve has created out of thin air since 2009. In response to the Great Financial Crisis and the subpar growth that followed, the Federal Reserve employed an ambitious series of policies that still prop up the U.S. economy. We've come to realize that without easy money, the U.S. economy might no longer function. Here is a chronology:

After the debt-infused housing bubble exploded, the Federal Reserve and Treasury spent $2 trillion bailing out charlatans like Fannie Mae, Bear Sterns and AIG. This only encouraged more risky behavior and corporate debt creation. They employed "yield curve control" to force interest rates lower. They even "invested" $1 trillion to - hang onto your hat - encourage more borrowing. Yet somehow this extreme level of intervention failed to move the needle. The economy never recovered from the Great Financial Crisis; the recovery was the weakest on record, also partly due to the Obama administration's heavy-handed regulatory regime.

So, in 2010, Federal Reserve Chairman Ben Bernanke initiated a monetary program called Quantitative Easing (QE 1, 2, 3) to boost economic growth. It was novel in every way. The Fed, through a series of QE (bond-buying) programs, has since increased its balance sheet by over $8 trillion. The Fed buys these bonds from money center banks. Thus, the newly printed money was injected directly into the main artery of the financial markets, resulting in the "everything bubble." Asset values skyrocketed.

Knowing history's greatest monetary intervention couldn't last, the Fed, starting in 2014, made several attempts to moderate their policies over the following years. Usually, it involved jawboning and little else. The Fed frequently warned markets that this time, they were serious. Normalization of policy was just around the corner.

In 2016, Donald Trump named a "hawk" to the Fed, Jerome Powell. He vowed to reduce the Fed's monetary incursions. Emboldened in December 2018, Powell announced that the Fed's tightening policy was on autopilot. But he quickly softened his rhetoric when the stock market responded by falling 20% that month. "Autopilot" was removed from the Fed's vernacular, and the market recovered.

Yet, Powell continued to reduce the size of the Fed's mammoth balance sheet (albeit at a slower pace) until the market reacted again. This time, the "repo" market seized up. This normally liquid market for overnight credit is a staple of the financial markets and the economy. Its malfunctioning was a bad sign.

That's when the Fed reversed for real, injecting hundreds of billions of dollars into the repo market. By the winter of 2019, encouraged by the Fed's numerous bailouts, 60% of Nasdaq companies had junk bond-rated debt. So, when the COVID crisis hit, the private sector was vulnerable, and the Fed was forced, once again, to bail out the economy. They commenced a $120 billion-a-month bond-buying program that lasted until May of 2022, when inflation became a real problem. This year, the Fed has raised rates at the fastest rate in history.

During the decade following the 2009 intervention, U.S. GDP growth averaged a subpar 1.5%, yet the stock market increased in value by over 400% thanks to the money printing. The everything bubble included residential and commercial real estate, public equity and bond markets, private equity and venture capital markets, profitless technology companies, "meme" stocks, hundreds of cryptocurrencies and "Non-Fungible Tokens" (NFTs).

The monetary backdrop for secular inflation has again been set.

Too Few Goods

Once again, energy is at the center of the current inflation drama. In recent years, western governments' urgent efforts to reduce carbon emissions have created a scarcity of investment in energy production. In its first act after the election, the Biden Administration clamped down on the production and transportation of oil by canceling the Keystone XL pipeline. Numerous announcements followed that were designed to restrict oil production. Environmental, Social and Governance (ESG) investing mandates denied capital to the hydrocarbon production industry. Recently HSBC, the global banking giant, announced that they will refuse credit to the oil industry. Meanwhile, hit with a wave of cold weather, Europeans are stealing firewood from each other.

For years, western governments forced closure of coal and nuclear plants to move to renewables. Wind, solar and natural gas filled the void, growing as a percentage of power generation. Meanwhile, governments have pressured natural gas production and transportation while promoting the use of expensive biofuels diverting corn and soybeans away from the food supply. The distortions in the energy markets will go down in history and will remain at the center of the coming decade-long inflationary period.

Europe's energy regulatory policies are almost suicidal. Forty percent of their energy comes from wind and solar, so when the wind stopped blowing and the sun stopped shining in the Fall of 2021, coal and natural gas prices rocketed higher. The realities of Europe's industrial economy demand a steady flow of power - so-called base load power - which is constant. Base load power comes from nuclear, coal and natural gas - not wind and solar. Europeans are currently paying 10 times the price for natural gas as Americans. Of course, higher energy prices bleed through to all manufactured products, so the cost of production is rising. It is wildly inflationary.

Ironically, their carbon emissions have skyrocketed as they burn more coal in desperation. They are in such a bind that Europe is importing American wood chips and burning them in coal plants. Their policies have backfired as emissions billow into the heavens. Unfortunately, the U.S. energy policy regime seeks to emulate Europe's.

Much like the Yom Kippur War in 1973, the Ukraine war is disrupting the flow of cheap energy to Europe and fracturing global alliances. China and former U.S. ally Saudi Arabia are cozying up to each other. The G7 (western) nations are now in conflict with the BRIC nations (Brazil, Russia, India, China), an alliance which is now expanding. This fracturing will be a story that lasts for years, not unlike the period following the Yom Kippur War.

The COVID crisis is the elephant in the room, of course. The effect of which is not dissimilar to Nixon's broad price controls that froze the entire economy. The Trump administration provoked a trade war prior to the world's (and especially China's extreme) COVID lockdowns, so global supply chains were already under stress. As a result, the imperative to diversify away from China has increased. Diversifying the supply chain will take years and reverses decades of downward pressure on import prices.

Which leads me to another “grand” kingdom - trade. The free flow of goods and services across national boundaries is necessary for global economic growth and stable prices. The glorious free trade relationship between China and the West is permanently impaired. That trade relationship will go down in history as one of the greatest - accretive to both parties. Announcements of new barriers to China/U.S. trade emerge daily now. The latest is the moratorium against the exportation of American semiconductor technology to China. All of this will lead to higher prices.

Europe just announced a plan to tax the carbon content of imported goods. The idea is to quantify the greenhouse gases emitted during a product’s creation and impose a tax based on that assumption. The bureaucratic apparatus necessary to carry out this program will frustrate producers. Once again, this is very Nixonian and very inflationary.

Like they did in the 1970s, commodities prices are likely to outperform all other sectors. The broad market was volatile but went essentially nowhere during that period. But, if an investor owned stocks worth $10,000 in the late 1960s, that amount was worth under $3,000 a decade later, adjusted for inflation. Commodities tend to do well in an inflationary or stagflationary environment. I predict we are in for a decade of stagflation unless policies miraculously reverse.

Oil and natural gas will remain in scarce supply as the industry lacks investment. The same goes for industrial metals. Oil and gas prices bleed into other commodity prices such as agriculture and manufactured goods. Oil company stocks were the best performers in the 1970s as oil prices rose tenfold during the decade followed by gold and silver miners. As the 70s stagflation persisted, the price of gold increased by nearly 800%.

This is the world we live in. The only things missing are bell bottoms and muscle cars. As for the investment opportunity, take a moment to review what investments worked during the 1970s and build a portfolio accordingly.

About the Author

Thomas F. Landstreet is the founder of N3L Capital Partners and the Portfolio Manager of the N3L Fund, a global macro hedge fund. He is also Co-founder and President of Trusco Investment Management, a Nashville-based wealth management company where Landstreet is responsible for the firms “big-picture” economic and thematic research and outlook. He can be reached at *tlandstreet@n3l.us*.