



Over the last two years, I shared a bold prediction in two articles in this journal.^{1,2} I warned about a growing threat of “stagflation,” which is the combination of slow economic growth and inflation occurring at the same time. It was bold because the preponderance of economists and investors are conditioned to believe that growth is inflationary, and recessions are deflationary. But that is not the case currently nor was it the case during the 1970s “stagflation,” which is the topic I continue to explore here.

Let me start by reminding the reader that because I will address government economic policy, it obviously involves politics, but there is nothing partisan about this discussion. Neither party has a monopoly on bad ideas, and trade wars are a bad idea.

The assumption that recessions are deflationary stems from the focus on the “demand side” of the economy, whereby if demand falls, so do prices. But I worked five glorious years for the greatest living “supply-side” economist Dr. Arthur Laffer, and our studies concluded that inflation can be the unfortunate result of a supply-side shock as easily as from a demand-side shock. This was the case during the grinding 13 years of the stagflationary 1970s, and this is the case now.

I harken back to Milton Friedman’s quote about inflation as “too much money chasing too few goods.” That toxic mix is only more pronounced now, exacerbated by the latest offensive in the escalating trade war. We are witnessing a massive contraction in trade flows, consisting of a 90% collapse in container shipments from China to the United States. Combine this with China’s largest contract manufacturer Foxconn’s factory shutdowns across several Chinese provinces, and we’re likely seeing a deliberate Chinese state-led decoupling from the U.S. in response to the trade war. This negative supply shock might rival Nixon’s destructive price controls, which I outlined in my first article referenced above. America’s economy is 70% consumption-led.

Recall that Nixon imposed price controls across the U.S. economy, which led to a sharp decline in production and – a negative supply shock. Coupled with the expansionary monetary policy of the time, inflation soared while economic growth faltered. Laffer would say, “When you regulate something, you get less of it, and when you tax something, you get less of it.” This is a reminder that a tariff is a tax, and it will lead to fewer goods being available to purchase.

Now the stock market is taking notice of it.

The recent outsized market swings have made history in terms of their speed and magnitude. This volatility comes at a time when the macroeconomic backdrop is as shaky as it’s been in many decades. I’m referring to the government’s rapidly escalating debt and deficits. The Treasury Department recently issued its March report, indicating that the government’s budget deficit hit \$1.3 trillion in just the first six months of the fiscal year. That \$2.6 trillion annual run rate set another record. Deficit spending contributes to the “too much money” part of Friedman’s famous equation.

I’ll remind the reader that the U.S. deficit is currently greater than during World War II, when the U.S. was fighting two wars on two continents. The Trump administration inherited this burden, and his idea of the Department of Government Efficiency (DOGE) is a clever way to address it. DOGE has discovered the obvious: Government spending is out of control. The fiscal deficit is the primary issue facing the economy and markets in the coming years. Not just because it is a burden on the economy but because the economy depends on it. Cutting spending most assuredly will lead to a recession.

Of Laffer’s “four grand kingdoms” of macroeconomics, (monetary, regulatory, fiscal and trade policy) the latter two are where we find the most activity currently, but I expect monetary policy to come back into the picture soon. As a reminder, it is through these four kingdoms that all economic policies are expressed. I have dwelt on all of these “kingdoms” in prior missives. Now is a good time to review the policy mix within the kingdoms and consider what might happen going forward.

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Though these times are difficult for equity investors, we have a front-row seat to history in the making. We are about to see the debunking of the ‘recessions are deflationary’ myth, and we’re about to learn a lesson about the value of free trade.

Two years ago, I reviewed the history of the “stagflationary” 1970s, suggesting that we are facing similar economic policy conditions today. Clearly, we’re seeing that unfold. I focused on the Nixon administration’s foibles and missteps regarding monetary, regulatory and trade policies. Then, last year, I focused on trade and the stagflationary effect of tariffs and other trade restrictions, which both the Trump and the Biden administrations promoted.

I also elaborated on the budget deficit, which overrides trade imbalances as an issue of national importance. Here, we venture into fiscal policy.

The U.S. has amassed over \$36 trillion in outstanding Treasury debt. Most of it matures in less than five years, much of it this year. (Meanwhile, households and corporations wisely refinanced their debt while interest rates were nearly zero.) Private-sector balance sheets are healthier than that of the U.S. government.

The U.S. Treasury must refinance nearly \$7.5 trillion of maturing debt by this September, the government's fiscal year-end. On top of that, the Treasury must issue new debt to finance the current \$2.6 trillion annual deficit PLUS another \$1.3 trillion to pay the interest on the \$36 trillion in old debt. They're issuing trillions of dollars of new debt just to pay interest on the old debt. Meanwhile, foreigners historically represented 50% of the demand for U.S. debt. I doubt the trade war is going to encourage them to buy more, so who will step up as the marginal buyer? (Dare I say it will be the Federal Reserve?) Meanwhile, this Treasury report indicates that DOGE, as clever as it is, has yet to move the needle on spending.

Since the economy and the markets were propped up by massive deficit spending over the last two years, I would expect the austerity that DOGE requires to have the opposite effect. Without the \$5 trillion in helicopter money, the economy would have been in a recession, and the stock market would have floundered. It's worth noting that government spending comprises a full 37% of Gross Domestic Product (GDP) as it's defined.

As sick as it sounds, the stock market loves deficit spending and so do politicians. That's why the markets rocketed 40% higher over the last two years. Of course, this provides a twisted incentive for politicians. The fastest way for a president to boost GDP and his election odds is to spend more money. This isn't new – and that's the problem. If it succeeds, the DOGE “austerity” does not bode well for the economy and the market.

As foreign buyers step away from the Treasury market, the Fed might be forced to become the “buyer of last resort” again. That would be wildly inflationary, supercharging the money supply. Now, we enter the monetary “grand kingdom.”

Federal Reserve Chairman Jerome Powell has been eager to “normalize” monetary policy after years of unprecedented expansion. Beginning with the housing crisis in 2008 and culminating during the COVID crisis, the Federal Reserve has expanded its balance sheet in an unprecedented manner to \$9 trillion.

Here's the mechanism for that process: The Fed creates money, digital dollars, (in this case, four trillion digital dollars) and buys Treasury securities directly from the world's largest banks – so-called money center banks. All banks are required to hold Treasuries as risk-free reserves against their loans. Keep in mind that these Federal Reserve purchases must be sufficiently large to push interest rates down in one of the largest, most liquid markets on earth. Since interest rates move opposite a bond's price, the Fed – unlike any other buyer – seeks to pay MORE for a bond than it is worth. Every other buyer is looking for a

bargain. Ponder that for a moment.

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credit, venture capital, etc., whose values have skyrocketed as a result. The Fed hoped that this massive liquidity injected, as I said, into the main aorta of the capital markets would filter out into the veins and capillaries of the economy, lifting all economic

activity. Each crisis, which seems to escalate in severity, has been met with greater monetary injections. This has put the U.S. economy on monetary life support.

Poor Powell. Appointed in Trump's first term, he came into office hoping to reverse the trend. He began to reduce the rate of Fed Treasury bond purchases in 2018 and announced to the world that this time, nothing would stop the Fed from tapering its purchases. It worked just fine until the so-called “taper tantrum” of October of that year. The stock market collapsed by nearly 30%, forcing him to reverse course by December of 2018. The market turned on a dime and rallied strongly. Like having the first drink after rehab, the addict felt much better.

Recently, President Trump posted an aggressive tweet criticizing Powell for not cutting rates like the European Central Bank (ECB) has “for the 7th time.” This won't make it easy for Powell to cut rates, as you can imagine, as the Fed seeks to protect its independence. Keep in mind that President Nixon famously browbeat his Fed Chairman Arthur Burns, who in 1973 cut rates prematurely and exacerbated the inflation of the day.

The Federal Reserve is on a razor's edge, damned if they do and damned if they don't cut rates. As markets shudder, the economy enters a recession, and the Treasury Department struggles to find buyers for the massive pile of debt that requires refinancing, the Fed might be called upon to step back in with massive bond buying. That is the last leg of my stagflation narrative. And like the 1970s, it might culminate in double-digit interest rates early in the next decade.

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References

¹<https://bit.ly/landstreet23>

²<https://bit.ly/landstreet24>