FOUNTAINHEAD INSIGHTS

Market Commentary: '40s or '70s: What's the Better Comparison?
April 2022

It was late 1940, some of the darkest days of the war for Great Britain. The Luftwaffe[1] was indiscriminately bombing British cities, primarily London, on a nightly basis. Winston Churchill was privately working with President Franklin Delano Roosevelt to intervene in the war. President Roosevelt was sympathetic to Great Britain's plight and understood the bigger picture, but America was rabidly isolationist. That means Roosevelt was limited in his ability to assist Great Britain, especially given he was running a tough re-election battle. Once he won his next term, and recognizing not only the trouble Great Britain was in but also the risk this posed to America, Roosevelt had a brainstorm about how to help Great Britain and sell it to the American people:

Let's say your neighbor's barn catches fire and you have a water pump and hose. Do you go up to your neighbor and offer to sell him your water pump and hose and only then give him what he needs to put out the fire? No! You lend him what is needed immediately. If the hose gets destroyed in the act of putting out the fire, you ask your neighbor to pay you back – after the fact. If not, he just returns the hose.

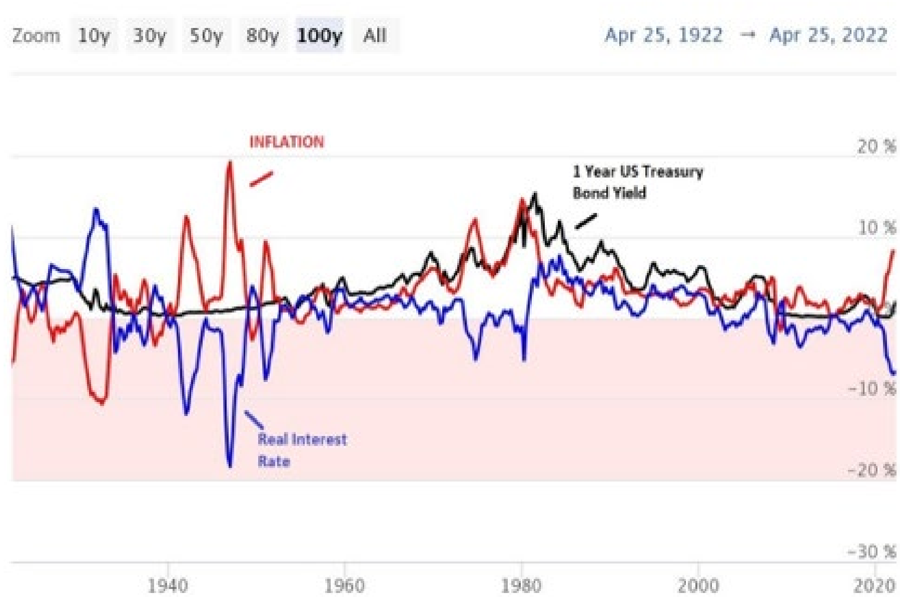
The Lend-Lease[2] Act was born, and America began significantly supporting Great Britain in their defense against Nazi Germany.

President Biden and a united Congress just invoked the Lend-Lease Act in supporting Ukraine's efforts against Russia – the first time since WWII this act was invoked to our knowledge.

What sticks in the national psyche? Certainly, the Great Depression, World War II, ***inflation of the 1970s***, ***double digit interest rates in the early 1980s***, and the Cold War with Russia, to name a few. It is reasonable to believe that Covid will last the test of time but perhaps, it will fade materially as did the 1918 flu (which may have had too much competition from WWI). How about our current bout with inflation?

Inflation is a primary culprit in pressuring markets downward. The Fed is aggressively forecasting over 2% of further rate hikes over the remainder of the year, as well as materially reducing the Fed balance sheet, which pundits translate as having the effect of another 1% of tightening on the economy. The Fed is simply following through on one of their primary mandates of keeping both inflation and deflation in check. This has contributed to negative returns in both fixed income and equity markets so far this year.

Nominal vs. Real Interest Rate vs. Inflation



[3]

It is worth analyzing the long arc of history to get some perspective on how long inflation may last as well as potential lasting consequences. The red line in the graph to the right reflects inflation. Everyone points to the 1970s as the point to

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[1] German Airforce
[2] Lend-Lease - Wikipedia
[3] Real Interest Rate - 151 Year Chart | Longtermtrends

compare to, but how about post World War II when inflation hit 20% in 1947? Inflation in the early 1940s seems like a logical comparison, since all manufacturing essentially went to the war, squeezing supply. It is interesting to review what was taking place two years after the war, when, despite the Fed maintaining interest rates at 1%, inflation came down. In contrast, today Fed Chief Powell is invoking the Volker Rule. What is different today from post-World War II, and why a different approach?

The truth may be that today's inflation is comparable to a *combination* of the late 1940s and 1970s. In the 1947 - 1948 period, there was pent up consumer demand as life returned to relative normalcy, and as rationing and US mandated price controls ran off. At the same time, factories and global supply chains were not quite ready to support this new consumer demand, resulting in an inflation spike. As both global supply chains normalized and factories refocused on new consumer trends, inflation declined. Sound familiar? The post-WWII period is most likely a better comparison to the aftermath of Covid-related stresses on production and global supply chains.

One of the reasons yields remained low in the late 1940s despite the jump in inflation was that Treasury controlled the curve (as opposed to the Fed) and, more concerned with deflationary elements of the recent war, they decided to keep a lid on short-term yields – they were more concerned about deflation. The Fed, however, did look to tighten, by introducing minimum down payments on credit, among other actions.[4]

Meanwhile, some of the commodity shocks felt in the 1970s from oil embargos are more similar to the reverberations currently affecting global energy supply due to the Russian invasion of Ukraine. We have covered this topic in our recent Explorations in April and Market Commentary in March to better understand similarities and differences between the 1970s and now.

As hard as it may be to process today, past inflationary periods were relatively brief, and markets recovered. Although periods of political and economic turmoil can be difficult to weather, they have also produced results like the Lend-Lease concept and energy innovations of the 1980s to date. And while past experiences are not guarantees of future performance, we believe that the ability of humans to expand on innovative ideas over generations does lead to real economic value, which ultimately leads to market growth as well.

[4] The Second World War and Its Aftermath | Federal Reserve History, Historical Parallels to Today's Inflationary Episode | The White House