A Walk Down Memory Lane

by Ron Muhlenkamp, January 2023

In 1965 I was studying for a degree in Engineering. In order to broaden my horizons, I took a course in economics; the textbook was Paul Samuelson's "Economics." Samuelson was a proponent of Keynesian theories, many of which John Maynard Keynes developed during the Great Depression of the 1930s.

Keynes believed that much of the pain of recession/depression could be alleviated by the government and/or the Federal Reserve Bank putting more money in the hands of the public, thereby increasing spending, which would encourage more production and employment, resulting in lowering the high unemployment which was endemic to recession/depression. In summary, more money leads to more demand leads to more production and more employment. He also said that introducing more money into the economy at full employment would merely result in more inflation.

In fairness, Keynes recommended a balanced approach: when the economy is slower than optimal, he prescribed increasing money available to encourage growth in demand, production, and employment. When this has been accomplished (as evidenced by low unemployment) then reduce growth in the money supply. Samuelson's textbook was, and has been, widely used since my college days and has influenced economists, central bankers, and policymakers ever since. Unfortunately, they have adopted the first part of Keynes' prescription (print money to stave off recession) and ignored the second part (stop printing money when the recession has been averted or you will get inflation). That oversight has had profound consequences.

I entered the investment business in 1968 when everyone believed that a 4.5% yield on a quality corporate bond and a 17 price-to-earnings (P/E) ratio on stocks was normal. People did not talk about inflation because it had been consistently less than 3% since 1951. The major concern of economists at the time was the business cycle of 3-5 years and how to avoid the recession part of it. In the 1960s we had extended the growth part of the business cycle beyond the expected 3-5 years and avoided the recession part of the cycle; so naturally economists took credit for having licked the business cycle. By the time a friend of mine got his degree in economics in 1968, his school canceled their course on the business cycle because they believed it was obsolete. The cure for recession was to print more money (to encourage more demand, production, and employment). But printing more money did not end the business cycle, it merely overlaid inflation on each part of the cycle. Despite believing we had licked the business cycle, we had recessions in 1970, 1974, and 1980; and the difference between these and prior recessions was we also had to deal with inflation at the same time.

1968 was the first year since 1951 that inflation exceeded 3%. By 1970, inflation reached 5½%, driving interest rates up and bond and stock prices down. But the general perception was that it was "temporary." In early 1970, I took a job with an insurance company as an analyst, and I remember the VP of Finance saying, "It's a once in a lifetime chance to get 6½% on a corporate bond, everyone knows that 4½ % is the normal interest rate." And it appeared he was right; the U.S. had a recession in that year, inflation fell back to 3%, interest rates fell, our 6½% bonds appreciated in value only to be called away from us before we could make as much on them as we expected, and parts of the stock market (mostly the "Nifty Fifty") hit new highs. The S&P 500 representing the broader stock market did not.

By 1974, inflation exceeded 10% and interest rates exceeded 7%. This time the perception was "My God, inflation could be permanent!" and stock P/E ratios fell from 17 to 7 in less than two years. The remainder of the 1970s witnessed slow GDP growth accompanied by high inflation (stagflation) which according to the Keynesian economics I was taught, was not supposed to happen. But it did. (Note I distinguish between Keynesians/Keynesian economics and Keynes).

As stock prices and P/Es fell, Wall Street analysts kept telling us that stocks were cheap, on the assumption that a 17 P/E was normal. But prices kept falling.

In 1973, I started looking at companies and stocks through the lens of corporate finance and asking, "What is my cost of capital based on inflation and interest rates, and what prospective returns do I need to put up equity capital?" I concluded that if inflation stabilized at 7%, long-term interest rates should be 10% and that I would require a 13½% return on equity (ROE) to invest in stocks. Since corporate ROE averaged 13% at the time (and had been stable at 13 +/- 1% since World War II) this implied I should pay just under book value, or a 7 P/E for a stock. During 1973-74 prices on stocks fell from 17 times earnings to my price of 7 times earnings, and I have been using my valuation model ever since. My model says that the decline in stock prices in 2022 is appropriate for an increase in inflation from 2% to 4%.

During this time (the early '70s), I had conversations with analyst friends who had studied Wall Street finance and invested primarily in "growth stocks," which means they made calculations/assumptions about future growth and then discounted the future back to the present. They used a discount rate based on inflation and interest rates. In 1968-1972 they believed that the Nifty Fifty companies could each grow at 15% or more and they discounted back to the present at 9%. If you do the arithmetic, you can justify any price depending on how far into the future you are willing to look. So, these were "one decision" stocks, i.e., buy and hold forever. During the period '73 - '74, these analysts started moving their discount rates up based on higher inflation and interest rates. At a 15% discount rate the value of the future collapsed, and they got the same values that I did.

By 1975, inflation had declined to 6%, we were recovering from a serious recession in 1974 and stock prices had reached (roughly) a 7 P/E . NOW there were good prospective returns in the stock market, but bonds were still mispriced with interest rates well below inflation. From 1978-1980 inflation continued to climb, reaching 13% in 1980. As inflation climbed, so did interest rates, also reaching 13%. In fact, for a period of time, you could buy a corporate bond yielding 13% or you could buy the stock of a company earning 13% return on equity at book value. No company is going to intentionally borrow money at 13% to invest it at a 13% ROE . We concluded that either ROE had to increase or interest rates had to decrease or companies would not invest in capital spending. Over time, companies increased their ROE toward 15%, but in the interim interest rates continued to fall. As interest rates fell bond prices went up. From 1982-1993 we invested a third of our portfolio in bonds because we could get stock-like returns from the same bonds that had been cut in half from 1970 through 1980.

Inflation and interest rate changes had impacts beyond the stock and bond markets. For the period 1970-1980 interest rates were significantly below inflation. Our mothers and grandmothers, the savers of the world, were getting 5¼% on their passbook savings "the highest rate allowed by law" when inflation was near 10%. After nearly a decade of this, the pain of losing purchasing power overcame the fear of a Depression. So, when Merrill Lynch offered a money market fund yielding 13%, our mothers and grandmothers took their money out of passbook savings, put it into money market funds, and bankrupted the S&L (Savings and Loan) Industry.

Meanwhile the U.S. dollar was depreciating on the world markets to the extent that in August of 1979 President Carter named Paul Volcker to the chairmanship of the Federal Reserve and gave him the task of strengthening the dollar and controlling inflation. To my knowledge, it was the first time a U.S. President named a Chairman of the Fed based largely on international pressure on the dollar. Paul Volcker said he was going to grow the money supply at 4% and many economists went berserk. They said "Inflation is 7+% and is intractable. If you grow money at 4%, real GDP will fall to minus 3%, i.e., a serious recession." Volcker did it anyway and inflation fell from 13% to 3% in 3 years. When I saw this, I said "Sonuvagun, if you allow GDP to grow it will crowd out inflation." We also elected Ronald Reagan president, partly to get inflation under control but to also to generate real growth in the economy. Reagan accomplished this with tax cuts and scaling back regulations.

The effect of Reagan and Volcker changing policies was to give us a recession in 1980 and again in 1982, but to also set the stage for strong growth and low inflation for 20 years. According to Keynesian theory, high growth with low inflation was not supposed to happen. But it did. So, I witnessed the failure of Keynesian economics throughout the 1970s and 1980s.

The inflationary battle of 1968-1982 occurred in three waves. In the first wave, starting around 1970, the professional economists assured us it was temporary. In the second wave, around 1973-1974, the stock market reset prices to a new level, the bond market did not. In the third wave, the public demanded that our politicians fix the problem of inflation. And they did. In the 1973-1974 period, when it was apparent that Keynesian theories were not working, any number of people, including me, looked around for a better theory on how to control inflation and spur economic growth. Two other theories were available, Monetary Theory, of which Milton Friedman was the popular spokesman, and Austrian Theory, championed by Ludwig Von Mises. I read the works of both.

On the topic of inflation, Friedman had the greater appeal to me. Friedman maintained that "Inflation is always and everywhere a monetary phenomenon." That is, if you grow money in circulation faster than you grow the production of goods and services, the difference will be inflation. If you do not grow money in circulation faster than you grow the production of goods and services, you will not get inflation. So, if you want to contain inflation you can restrict the growth of money or increase the production of goods and services, or both. Volcker and Reagan did both.

So, how do the lessons I learned from 1968 through 2000 help us in 2023?

We have to start in 2008. In 2008 we had a serious recession and a near meltdown in international finance. And the U.S. elected Barack Obama president. Let's talk about the financial crisis first.

By 2008, we had nearly 30 years of economic expansion both in the U.S. and internationally, especially in China. As often happens in prosperous times, the underwriting of loans became loose and haphazard, especially in home mortgages. Both the lender and the buyers operated on the assumption that home prices never decline and made deals on that basis. Mortgages were packaged and repackaged to suit the desires of buyers including pension funds. But oversight by the lenders with their own money at risk was lost in the process. The problems thus engendered came to a head in 2008, resulting in a serious recession and the write-down in value of many financial contracts, especially mortgages.

We tend to forget the first priority of the U.S. Fed is to insure the viability of our banking system. The Fed upped the amount of cash reserves they required banks to hold and injected money into the system well in excess of the amounts required. The excess reserves exceeded $3 trillion. Many people, including me, expected these excess reserves to cause inflation, but I was wrong. It didn't happen.

I was wrong for three reasons:
1. The banks had just come through a recession where they had to write off numerous loans and were not eager to write new ones.
2. Companies had just come through a serious recession where making loan payments was difficult and they were not in a hurry to repeat.

These two effects are fairly normal when coming out of a recession. The difference from prior increases in the money supply was:

3. The Fed began paying interest on the excess reserves held by banks. This allowed banks to make a return on these funds without the effort of underwriting loans to the public, and thus neutralized the money printing and negated the inflationary effect (because the money never got into the hands of the public). Judy Shelton, among other economist, has done a good job of describing this policy and its effects.

At the same time the financial crisis was unfolding, Barack Obama was elected President. I had read his book "The Audacity of Hope" during his campaign and observed a few things. The book has roughly a dozen chapters, each on a different topic. After reading 2 or 3 chapters, I thought much of what he wrote was reasonable. After a few more chapters I realized he was setting up straw men and using them to make his arguments. The consistent underlying theme of his book was that the employer is the opponent. Nearly everything he did made it tougher on the employer. I have a small business, and I have watched my cost of providing health insurance for employees rise consistently, not only in absolute dollars but relative to everything else since I started the business in 1977.

So, on the heels of the 2008 Housing/Financial Crisis, President Obama promised that health insurance costs would go up, and my taxes would go up, with no mention of a limit. He also promised that the cost of regulation would go up, also with no mention of a limit. (To this day, half of the regulations promised by the Dodd-Frank Act have not been published.) I concluded that business owners would be slow to invest capital and hire people and that the recovery from the 2008 recession would be half speed and that productivity would slow. Productivity gains had averaged 2% per year since World War II. By the end of the Obama Administration, productivity growth was zero.* From 2016-2020 the economy improved; unemployment fell to 3 ½ %, productivity approached 2%, and the Fed began to shrink its' balance sheet.

Then COVID-19 hit. We immediately decided to shut down the economy and spend $2 trillion to offset the effects of the shutdown. After tanking in the first half of 2020, the economy worked its way back to near pre-pandemic levels. For a mix of reasons which economists are likely to study for years, inflation numbers did not balloon as the employment market tightened and unemployment again reached 3½%. (Note that economists believe 4% unemployment represents full employment.)

Between 2020 and 2022, we passed additional spending bills aggregating $3.3 trillion. In response to COVID-19 and the shutdown, $5.3 trillion was added to a GDP of roughly $25 trillion. That's 20% more money in the system. If production ALSO grows by 20%, there will be no inflation. So the questions are: where did/will that money go, and will it increase production by 20%?

Much of this money was sent directly to people, unlike Fed money which goes through the banks. Some went to people who were still working and producing. Much of these funds went into people's savings accounts. Normally this would lower interest rates, but rates were already near zero, So, these funds had little effect on the economy or inflation.

Some funds went to people who were no longer working (30% of restaurants were closed). These funds were spent on goods and services but had little effect on increasing production, thereby inflating prices in what I call the real economy (goods and services). Some funds went to people who were not in the workforce, like my teenage grandchildren. Some of these funds were spent (see above) and some were used to invest/speculate in the financial economy (meme stocks, SPACs, Crypto, etc.) thereby creating inflation in the financial economy. Some of this money has now been lost.

Specifically the American Rescue Plan Act of 2021 "helicoptered" $1.9 trillion directly into the hands of the public with very little effect on increasing production. $1.9 trillion of money into a GDP of $25 trillion is just under 8%. (Is 7% inflation a coincidence?) One result of the reported inflation of 2022 is an 8% increase in Social Security benefits in 2023, which go to something over 15% of our population. 15% of the population receiving an 8% boost equals a 1.2% net effect on the above with little or no boost on production. It remains to be seen how much of the current inflation will be reflected in wage rates in the next few years.

In August 2022, the government passed the "Inflation Reduction Act" for an additional $1.7 trillion, but most of the spending will be spent over many years. So, the effects on inflation will be spread over time. Some of this spending may result in increased value of production, but most of it will not.

So far, the effect of increased inflation has been three-fold. An increase in interest rates, which are still negative in real (after inflation) terms, an increase in spending, much of which looks inflationary, and an increase in rhetoric (the 2022 spending bill should be titled "Inflation *Protection* Act"). If we are to subdue inflation this time, I do not believe it is necessary to follow the patterns of 1968-1982, but I do believe we must achieve most of the results of that period. Last time the sequence was denial/disbelief in 1970; economic realization in 1973-1974, and political change in 1980-1982. So far, it looks and feels more like 1970 than 1974 or 1980.

One problem with inflation is the difference in cause versus result. Inflation is caused by producing money faster than we produce goods and services. But we measure it by adding up prices. Last year's inflation is calculated by adding up prices that rose last year. Many of those prices have adjusted and are likely to come down. This year's inflation will be determined by price changes in a different set of goods and services, likely including wages.

Remember, inflation results when the government and/or the Fed print money at a faster rate than the economy produces goods and services. It can be controlled/reduced by slowing the money printing and/or by accelerating the production of valued goods and services.

The actions/reactions I've seen in response look much like I saw in the late 1960s and early 1970s. This is true among economists, politicians, the media, Wall Street, and the public. It's as if we learned nothing from the prior experience. The inflationary period of 1968-1982 forced me to rethink most of what I had been taught about economics and investing, but it doesn't seem to have had a similar impact on the economists and policy makers of today. In recent years, the focus has been solely on the Fed and Monetary Theory. I've learned that fiscal policy is important and that the inflation of the 1970s was not tamed until we changed both monetary and fiscal policies. In the 1968-1982 period it took us nearly a decade to apply both tools. This time, so far, we have only started to use the monetary tools of raising interest rates and shrinking the money supply. There is ZERO talk about using fiscal tools (tax cuts, spending cuts, regulatory cuts) to spur economic growth. Without economic growth, all that "stimulus money" does nothing but push up prices, increase inflation, and shrink the purchasing power of our dollars.

We've been here before. We actually know how to avoid a decade of pain, but we appear to lack the political will to make the necessary changes. We are still in denial…

**Source: Bureau of Labor and Statistics*

Book Value *(BV) or "Book" equals total assets minus total liabilities. It is the owner's equity in the business, often quoted as Book Value/Share.*

Price-to-Earnings (P/E) *is the current price of a stock divided by the (trailing) 12 months earnings per share.*

Return on Equity (ROE) *is a company's net income (earnings) divided by the owner's equity in the business (Book Value); ROE = Earnings/Book Value. This percentage indicates company profitability or how efficiently a company is using its equity capital.*

Stagflation *is a combination of low growth (stagnation) and high inflation, as seen in the American economy during the 1970s.*

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