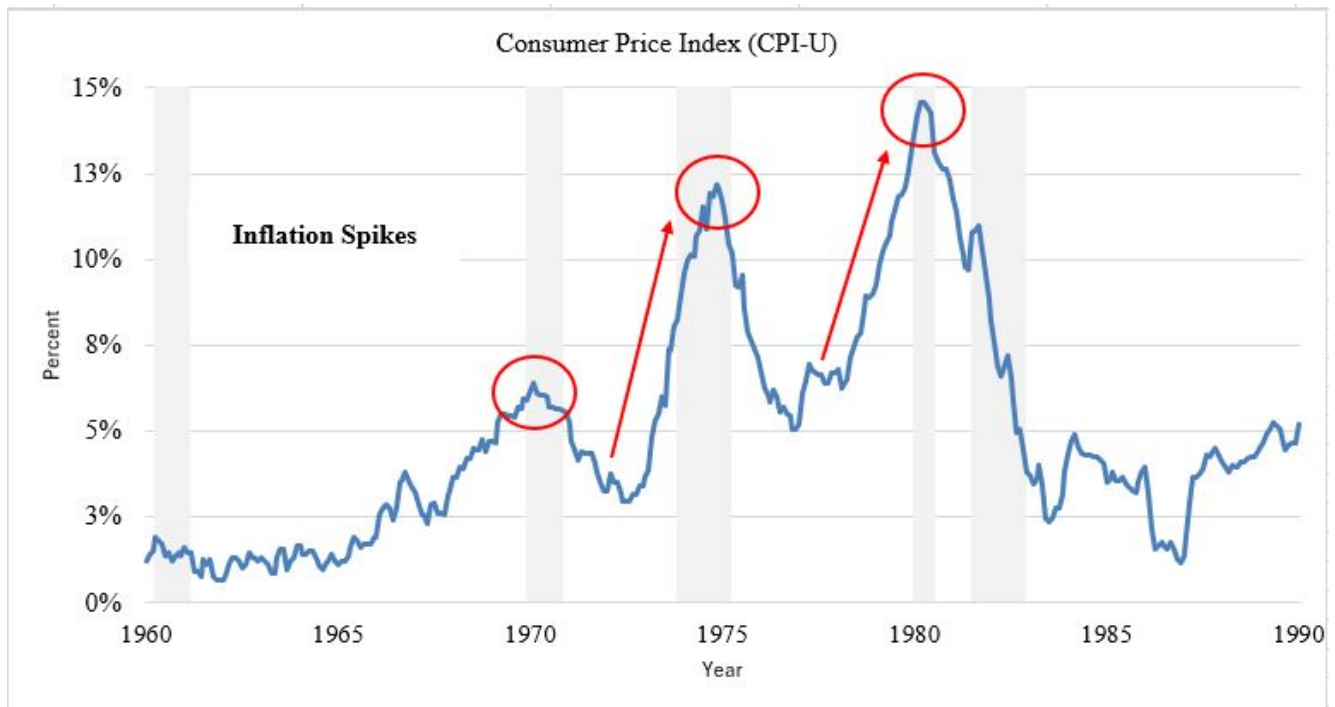


# Echoes of 1974

Each year brings investors a fresh list of hopes and fears. Often, mainstream financial firms provide guidance that extrapolates linear thinking into the future. We prefer to take a more cyclical view of the world to glean knowledge from patterns in past cycles that rhyme with today. With that in mind, we set our sights back 50 years ago to 1974, just long enough for most investors to have forgotten those events, and the lessons associated with them. There are five key lessons from that period that we believe are relevant to investors today.


## **Lesson 1: Inflation & Interest Rates – Volatile But Trending Upward**

After experiencing renewed inflation in the early 1970's, 1974 was an inflection point that marked a relative high in annual inflation of 11.1% and interest rates 10.5% (short-term T-bills) and 7.6% (10-year Treasuries). A significant recession hit in 1974 and inflation and interest rates fell. Like today, the consensus was that rising inflation and rising rates were a “blip on the radar” with the worst likely behind us. However, inflation and interest rates aggressively reasserted themselves several years later in a second major upcycle in the late 1970s. Inflation soared to 13.5% at its 1980 peak, pushing interest rates to 16.4% (short-term T-bills) and 13.9% (10-year Treasuries) by 1981.



1

Despite the inflation at the time, a Big Mac at McDonalds was only 65 cents, and it was actually called “Big” for a reason!

Menu Items - 1974		Price
Quarter Pounder w/ Cheese		0.70
Quarter Pounder		0.60
<b>Big Mac</b>		<b>0.65</b>
File-O-Fish		0.48
Cheeseburger		0.33
Hamburger		0.28
Large Fry		0.46
Regular Fry		0.26
Hot Apple Pie		0.26
Milk		0.20
Coffee		0.15

2

### ***The Lesson Today:***

While inflation fell leading into 2024 and 10-year Treasuries remain around 4%, inflation is not dead. It is wise to prepare for a second, bigger wave of rising inflation and interest rates in the coming decade. That said, 2024 may bring a

continued temporary lull in inflation and interest rates if global economies weaken. The big caveat for this “lull scenario” is the massive Federal debt levels relative to 1974. The official national debt has surpassed \$34 trillion and added a whopping \$1 trillion in the last 30 days alone! The question is not who will buy the debt, as there will always be takers at the right price. The question is what interest rate will be demanded by investors.

## Lesson 2: Extreme Stock Valuation Led to Pain

Today’s Magnificent 7 tech stocks have led the S&P500 with extremely narrow stock market leadership.<sup>3</sup> Their valuations continue to rival periods such as the 2000 Tech Bubble and the Nifty Fifty from 1974 (a basket of 50 stocks that people believed would lead to outsized returns with a single buy-and-hold proposition). These stocks were the leaders of that era until their ultimate crash into the recession of 1974 when most lost 50% to 80% of their value.

Stock	% Change	Stock	% Change
American Home Prodcuts	-78.1%	Johnson & Johnson	-57.6%
American Hospital Supply	-60.4%	Louisana Land & Exploration	-25.8%
Avon Products	-85.5%	Lubrizol	-45.2%
Baxter International	-54.1%	3M	-67.1%
Black & Decker	-80.7%	McDonald's	-46.4%
Bristol-Myers	-55.3%	Merck & Co	-88.0%
Burroughs Corporation	-72.1%	MGIC Investment	-65.1%
Chesebrough-Ponds	-69.6%	PepsiCo	-49.9%
The Coca-Cola Company	-69.1%	Pfizer	-71.5%
Amery Air Freight	-51.4%	Phillip Morris	-86.7%
Gillette	-65.4%	Polaroid	-39.2%
Halliburton	-30.6%	Procter & Gamble	-43.7%
Heublein	-97.0%	Schlumberger	-43.7%
IBM	-62.3%	Sears, Roebuck	-55.4%
International Flavors & Fragrances	-75.5%	Simplicity Pattern	-88.0%
International Telephone & Telegraph	-40.2%	Squibb	-79.2%

### ***The Lesson Today:***

When investors fall in love with a narrow group of expensive

stocks that have pushed up the stock indices, markets are at risk to greatly disappoint (or crash). Today, the S&P500 has been mainly driven by just seven stocks or approximately 1.4% of total stocks in the index. This suggests the near-term prospects for equities are challenged barring any surprise return to money printing. Although money printing will return, it will take significant pain in the stock markets first for the Fed to justify it.

### **Lesson 3: Political Instability Rising**

President Nixon was the first president to “voluntarily” resign in 1974 amidst the Watergate scandal. This led to an era of distrust and loss of confidence in the government and economy for nearly a decade. Today, the political environment is rife with instability as we enter an election year with a divided country, polarized views, and questions at every level of government.

#### ***The Lesson Today:***

Politics is a key factor in the confidence of a healthy, functioning capitalistic system. When markets feel at risk and do not trust the institutions or the rules, faith can be lost and not easily recovered.

### **Lesson 4: War, Energy & the Middle East**

The Yom Kippur War between Israel and several Arab nations in the fall of 1973 led to an oil embargo and spike in energy prices. Eerily, another conflict in the Middle East began last year one day removed from the 50th anniversary of this war, sparking many unknown, long-term consequences.

#### ***The Lesson Today:***

War in the Middle East has many geopolitical implications. It risks dividing countries and causing an unknown future impact on energy markets. Global war, if this were to expand, often goes hand in hand with difficult economic times in history. War has always been a great excuse to tear things up and rebuild them, but not always to benefit of the average

citizen.

### Lesson 5: Changing of the Guard in Currencies Every 100 Years

The early 1970s was a critical time for the U.S. dollar. What had been a pre-World War II system of currencies disciplined by the backing of physical gold or silver morphed into a dollar system under the Bretton Woods Agreement. However, holders of dollars became increasingly nervous in the early 1970s as U.S. spending was seemingly out of control (imagine if they could see things today!) due to social programs and the Vietnam War. The Bretton Woods system promised the dollar could be converted to gold – until it couldn't. France led the charge to redeem dollars for gold. This resulted in President Nixon's famous 1971 speech in which he was "temporarily suspending the convertibility of the dollar to gold". Of course, like most things from the government, temporary programs never go away. From that point forward, the dollar was simply printed out of thin air without constraints.

Today, we are nearing another critical event in the life of the dollar – a rise in nations circumventing the dollar system as seen in the growing alliance of BRICS countries expanding non-dollar denominated trade.<sup>5</sup>



### ***The Lesson Today:***

No reserve currency has lasted more than approximately 100 years. Given this, the dollar is late in its life cycle as measured from the 1913 inception of the Federal Reserve system. While the dollar is not on its immediate way out, we envision world trade and capital markets becoming more multi-polar as reliance on the dollar fades. Eventually, the reality must be faced that the U.S. national debt cannot be serviced without creating a death spiral of more money printed just to service debt. Other world currencies face a similar predicament with no likely predecessor. Thus, the world will likely start a gradual, and then sudden path back to sound money (likely precious metals and perhaps cryptocurrencies) – not by choice, but by necessity.

### **Endnotes:**

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# What if This Time is Different?

What if This Time is Different? What if, before the world ever heard of coronavirus, every valuation multiple suggested the U.S. stock market was one of the most expensive in history? What if these valuations assumed – and required – continued economic growth, robust increases in company earnings, and sustained and substantial stock buybacks? What if those assumptions were completely wrong?

What if the current stock market rally assumes a “Vshaped” economic recovery with lockdowns ending soon, companies rehiring employees, pharmaceutical companies developing a vaccine, and a quick “return to normalcy”? What if those assumptions are wrong?

What if lockdowns drag out, companies enter bankruptcy en masse, unemployment remains high, and households stop buying? What if retail businesses only reopen with limited capacity? What if retail businesses cannot be profitable at such capacity levels? What if landlords stop receiving rents from tenants and start losing tenants? What if some industries like hospitality and airlines take years to recover? What if even hospitals lose money since elective surgeries are nonexistent? What if even universities bleed red ink as full-tuition paying foreign students don't return? What if other such industries

perceived to be immune from this crisis fail as their most lucrative revenue streams cease to exist?

What if banks refuse to grant forbearance to landlords and companies? What if defaults skyrocket? What if banks are incapable of even understanding the damage to their loan portfolio? What if banks raise lending standards so few qualify for loans? What if banks start charging higher interest rates as they perceive increased risk? What if banks have already increased rates on their variable loans? What if banks simply stop lending? What if banks fail?

What if public pension funds fail and states cannot bail them out? What if cities file for bankruptcy? What if states must sustain prolonged unemployment benefits? What if state governments' fiscal measures create debt levels which can never be repaid? What if these debt levels increase so much that their interest payments cannot be serviced? What if states go bankrupt?

What if the Federal Government's own estimates are right, and it borrows almost \$4 trillion this year? What if it's more? What if the U.S. government is already insolvent? What if the lender of last resort really is the last resort? What if printing more green pieces of paper doesn't solve these issues?

What if a recession actually started before coronavirus had infected anyone? What if an inverted yield curve, a deteriorating Cass Freight Index, and an unprecedented breakdown in the repo market suggest a recession started in late 2019 or was imminent in early 2020?

What if such a recession, rather than being a typical downturn, was one of monumental magnitude – even worse than that of the Great Recession? What if recessions are caused by increases in the money supply which artificially lower interest rates, thereby deceiving individuals and companies



into making poor investment decisions? What if the Federal Reserve's unprecedented (at the time) monetary expansion from the 2008 crisis sowed the seeds of an even greater recession today? What if all of this is happening in addition to the economic damage caused by coronavirus containment measures? What if such a recession was just getting started? What if it lasts for years?

What if a comparison of today's financial market valuations with deteriorating economic fundamentals suggests this is greatest stock market bubble in all of U.S. history? What if bonds are not safe when money is lent to bankrupt companies and insolvent governments? What if bonds don't protect an investment portfolio? What if stocks and bonds prove highly correlated – to the downside?

What if, after an initial bout of deflation, inflation kicks into overdrive? What if the 1970s suggest stocks and bonds can lose ground for a decade or more relative to inflation? What if most financial advisors only give lip service to inflation risk to their clients? What if their clients own no precious metals, farmland, rental real estate, or cryptocurrencies to protect them from inflation?

What if mainstream financial advisors were ultimately wrong when they said "This time is different" during the heady bull market years? What if they advise clients never to panic and never to sell? What if it is time to panic? What if it is time to sell?

What if equities crash and it takes years to recover like it has seven times over the last 100 years? What if the stock market collapses and it takes over 20 years to break even as it did after 1929? What if retirement-age workers can no longer afford to retire?

What if this time is not different?

What if most financial advisors are telling clients to buy the

dip? What if they are telling investors the markets always rebound and the economy always quickly recovers? What if investors are conditioned to believe them based upon their experience with the 2008 crisis?

What if this time is different?

## About WindRock

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## **When Euphoria Turns to Phoria**

Are the financial markets in a current state of euphoria with a commensurate risk of a market downturn? Various metrics strongly indicate as such.

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## **And the Election Winner is ... Inflation in a Landslide!**

Regardless as to which candidate secures the Presidency on November 3rd (or some subsequent date), the administration must cope with unprecedented federal debt.

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## **Winter is Coming**

Fans of HBO's hit series, Game of Thrones, know well the motto of House Stark: "Winter is Coming."

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# What Stops the Stock Market Rally?

In terms of magnitude and shortness of time, the stock market rally since its March lows has been unparalleled.

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## The Kitchen Sink

*April, 2020*

By late January, the die was cast: the virus had a name, it had reached our shores, travel screenings and restrictions were in place, and while not yet declared a pandemic, the World Health Organization declared COVID-19 a “Public Health Emergency of International Concern.”

Yet complacency reigned within financial markets. The stock market continued its march to new highs (reached on February 19th). The Federal Reserve, in its January 29th press release, failed to mention coronavirus in the list of variables it “will continue to monitor” save for a generic nod to “global developments.”<sup>[i]</sup> It began the missive by mentioning recent data “indicates that the labor market remains strong and that economic activity has been rising at a moderate rate.” Famous last words.

It was not until a full month later, and only after the U.S. stock market suffered its worst week since the Great Recession, did the Federal Reserve act. It was rather weak

work. On February 29th they issued a statement describing how they were “closely monitoring . . . the evolving risks of the coronavirus to economic activity.”<sup>[ii]</sup> On March 3rd, they cut interest rates by a not uncommon 50 basis points.

But on March 15th, the Federal Reserve completed its year-to-date journey from satisfaction to concern to sheer panic. That Sunday’s emergency announcement marked the first of several major measures meant to stop the bleeding on Wall Street and stem the tide of anticipated economic hardship.

**The Federal Reserve’s actions are unprecedented in both magnitude and breadth and will generate serious repercussions for investors down the road.**

While the financial media widely reported how the March 15th actions lowered the federal funds target rate to 0.00-0.25%, it missed the far more drastic action of eliminating bank reserve requirements. Previously, banks had to retain 10% of demand deposits which meant they could theoretically increase the money supply by ten times. Now no limit exists to their monetary expansion.

March 23rd brought more unprecedented action when the Federal Reserve announced it was buying \$375 billion in Treasuries and \$250 billion in mortgage backed securities *that week*. For comparison, 2008’s QE1 was \$700 billion (comparable in size) and it took months to deploy. It also announced it would continue buying assets “in the amounts needed” to support the economy. It started buying, for the first time ever, corporate and short-term municipal bonds.

Then, on April 9th, the Federal Reserve announced \$2.3 trillion in loans to “support the economy.” Not content with corporate and municipal, it started buying junk bonds. It could have saved itself the trouble of buying various bond sectors by simply writing a check for most of the office real estate (\$2.5 trillion), farmland (\$2.7 trillion), or multi-

family housing property (\$2.9 trillion) in the U.S.

The Federal Reserve's substantial and sustained efforts to pull the economy out of the 2008 Great Recession increased its balance sheet by \$3.6 trillion in just over six years. It just added \$2.3 trillion to its balance sheet *in a month*.<sup>[iii]</sup> This isn't throwing the kitchen sink at a problem – it's lobbing in the entire kitchen.

Even if the Federal Reserve stopped further actions and ceased its announced programs, its balance sheet will continue to swell as it finances proliferate spending by the U.S. Treasury. Given such actions as the CARES Act and its Paycheck Protection Program, the Congressional Budget Office estimates the 2020 deficit will reach \$3.7 trillion – a multiple of anything seen in the wake of the 2008 Great Recession.<sup>[iv]</sup> This estimate will only increase with any additional spending initiatives by Congress.

**Money supply has already exploded and is at the fastest rate in 92 months.<sup>[v]</sup> It is just getting started.**

In response to 2008, the Federal Reserve increased the money supply dramatically, but much of that was held by commercial banks in excess reserves at the Federal Reserve where they earned some small, yet risk-free, interest. This time is different. Not just in magnitude, but in breadth, which is to say by recipient. No longer will money be injected into banks and primary dealers, but to companies and individuals who make up the economy as whole.

Inflation will ensue. Not right away, for the deflationary forces of loan repayments and defaults will counteract and potentially overwhelm inflationary forces. But that will be somewhat temporary.

Until then, it is an opportune time to build up inflation protections for an investment portfolio: certain types of real

estate (e.g., farmland and some residential rental property), precious metals, and cryptocurrencies.

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# The Tariffing Prospect of a Trade War

If the trade war escalates, can it directly cause a U.S economic recession? Many mainstream pundits, citing the infamous Smoot-Hawley Act of 1930, warn as such.

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# **Irrational Complacency**

complacency (noun): a feeling of quiet pleasure or security, often while unaware of some potential danger, defect, or the like.

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## **Defense Wins Games**

Football fans always get excited about offensive prowess, but they also know that when it counts, it is the defense that wins games.