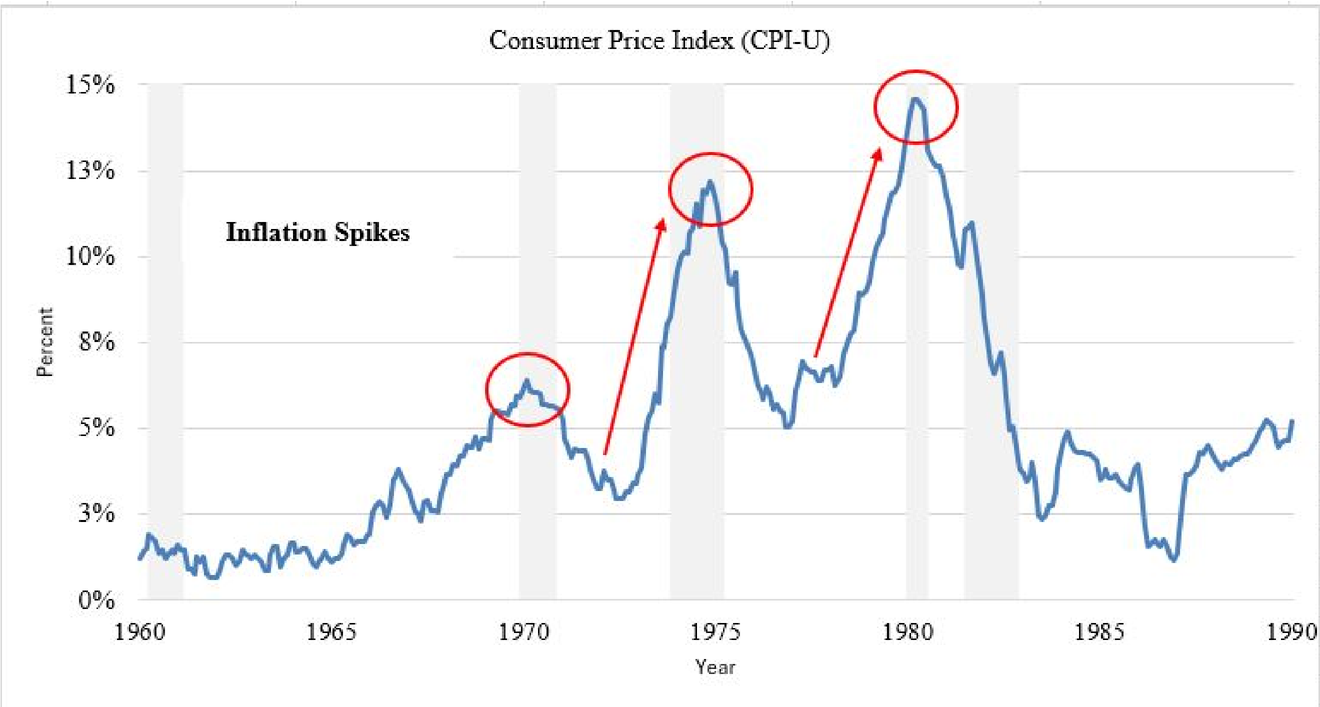
Echoes of 1974

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
Big Mac	0.65
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.[3] 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%

[4]

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.

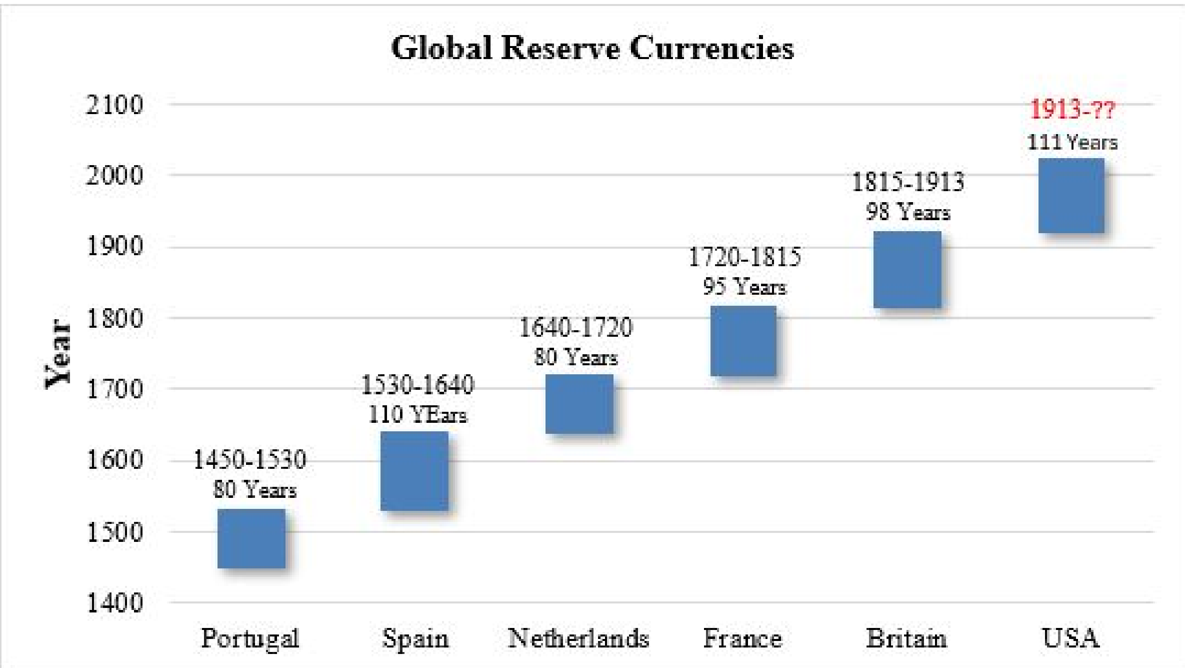
Lesson 4: War, Energy & the Middle East
The Yom Kippur War between Israel and several Arab nations in the fall of 1973 led to an oil embargo and spike in energy prices. Eerily, another conflict in the Middle East began last year one day removed from the 50th anniversary of this war, sparking many unknown, 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.[5]



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.

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Don’t Forget About the Trade War

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Before coronavirus and impeachment, the Sino- American trade war stubbornly remained on the mainstream news circuit while largely governing the direction of financial markets. With each rumor of concession or tweet of condemnation, stocks gyrated and bonds jittered. Each round of negotiation was been matched by salvos of tariffs, export controls, lawsuits, complaints, declarations, and threats. At its peak, the U.S. imposed tariffs on $550 billion of Chinese imports while China retaliated with tariffs on $185 billion of U.S. goods.[1]

With its early 2018 inception, many mainstream pundits and commentators agreed with President Trump that the trade war would be beneficial (or at least benign) and short (otherwise it would not be “easy to win”).2 But the trade war, albeit in fits and starts, continued, escalated, and now largely sits in stalemate – despite the “Phase One” agreement – with no clear visibility of resolution. Even with a recent reprieve, the trade war will likely continue for the foreseeable future with great risk to economies and financial markets.

Why Trump Will Likely Continue the Trade War

Some argue that President Trump is actually in favor of free trade but wishes to renegotiate various trade treaties. That is, by embracing protectionist policies, free trade can later be broadened on more "appropriate" terms. For example, some of the stated NAFTA renegotiation objectives included the elimination of "unfair subsidies, market-distorting practices by state owned enterprises, and burdensome restrictions on intellectual property." But this interpretation is contrary to significant evidence which indicts Trump as a devoted protectionist.

Trump's overall political philosophy is revealed by his pre-Presidential talk show confessions. The future President hit the talk show circuit extensively in the 1980's and 1990's by appearing on such shows as David Letterman, Oprah Winfrey, Phil Donahue, and Larry King. These interviews provide an insightful look into his core beliefs. Consistently, the most passionate commentary concerned foreign nations "taking advantage" of the U.S. – either by failing to contribute more to their own national defense or by running significant trade surpluses (U.S. trade deficits). In these interviews, the ire from the latter of these was usually directed (given the time) at Japan. Today it is China.

Trump clearly views trade in a zero-sum, mercantilist manner with the country possessing a deficit as "losing" and "down." In mid-2019, the President tweeted the following:

When a country . . . is losing many billions of dollars on trade with virtually every country it does business with, trade wars are good when we are down $100 billion with a certain country and they get cute, don't trade anymore-we win big. It's easy.[3]

Four other facts buttress Trump's position as an ardent protectionist. First, protectionism is theoretically consistent with President Trump's immigration position. If one believes immigrants take away American jobs, then logically one would also fear cheaper foreign goods which destroy the profitability of American companies – and by extension, cost U.S. workers their jobs.

Second, while the protectionist measures enacted so far have been focused on China, they have also, to a lesser extent, been levied against allies (e.g., Canada, Europe, etc.). This is why, when signing the new U.S.-Mexico- Canada Agreement in January, President Trump noted the agreement was "finally ending the NAFTA nightmare."[4]

Third, President Trump, almost immediately upon taking office, pulled out of the Trans-Pacific Partnership negotiations. While one could easily argue this agreement actually hindered free trade given its excessively burdensome and complex rules and regulations, the rationale given for withdrawing was a protectionist argument: the preservation of American manufacturing.[5]

Fourth, he has surrounded himself with advisors notorious for their protectionist policy advocacy. Most notable among them are economist Peter Navarro who authored the book Death by China and Commerce Secretary Wilbur Ross.

Today's political climate only serves to facilitate Trump's protectionist philosophy. In addition to this year's election and the likely need to secure Rust Belt electoral votes, anti-China rhetoric and positioning are popular with both political parties and the deep state.

Why China May Wait for the 2020 – or 2024

– Election

As any future trade agreement will decrease free trade (at least compared to the pre-trade war environment), any likely agreement will be, by definition and on the whole, deleterious to both countries to the advantage of certain industries, businesses, and/or occupations (including political offices). China singularly understands the benefits of free trade and stands to lose its prosperities as well as be burdened by any ancillary labor, intellectual property, or environmental provisions. It is in their interest to delay and forestall any agreement.

This strategy coincides nicely with two Chinese concepts: “saving face” and a “holistic” negotiating style. The concept of “face” refers, loosely, to the Sino- cultural understanding of respect, honor, and social standing. President Trump, with bombastic boasts and brash bargaining, only forces President Xi and Chinese leadership into steadfast positions.

It is culturally, and thus politically, difficult for the prospects of any agreement if it appears to be an American victory. This applies to both intra-regime circles (leadership struggles) and with the government vis-à-vis the populace. The former is exacerbated by the pageantry and intrigue of next year’s Communist party centenary. The latter of which is intensified by leadership’s keen sensitivity to Chinese society’s long- held belief in the “Mandate from Heaven” (the loss of which is frequently signaled by Heaven through such natural disasters as epidemics – especially untimely given both the onset of coronavirus and the perception of an inept government response).

Holistic negotiating style, or *zhengti guannian*, is a well-known and often frustrating exercise for any westerner having done business in China. As described in a Harvard Business Review article:

. . . the Chinese think in terms of the whole while Americans think sequentially and individualistically, breaking up complex negotiation tasks into a series of smaller issues: price, quantity, warranty, delivery, and so forth. Chinese negotiators tend to talk about those issues all at once, skipping among them, and, from the Americans' point of view, seemingly never settling anything.[6]

This concept has already manifested itself in the trade war; it is not uncommon for U.S. to believe an agreement has been reached only to be met by silence or denials from the Chinese.

Will the Trade War Cause a Recession?

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 (which is odd, especially since the Great Depression was well underway before it was enacted let alone took effect).

But tariffs may *indirectly* cause a recession. As recessions are caused by malinvestment (investments unjustified by the natural level of interest rates) created through artificially suppressed interest rates, then rising rates may serve to expose this malinvestment and force its liquidation (e.g., business closures, layoffs, bankruptcies, etc.) – also known as a recession.

Currently, U.S. Treasury debt held by China approximates $1.1 trillion.7 Curtailing future purchases and/or programmatically selling these holdings may increase interest rates dramatically (from where they would otherwise be, all things being equal). Many pundits cite the unlikelihood of this by noting such sales would decrease bond prices and thus the value of China's U.S. Treasury holdings. But the impact on U.S. interest rates need not result from a "liquidation" by China; rather, since all prices are determined at the margin, decreased demand or increased supply (sales) by China – evenly seemingly insignificant, may raise rates.

If the trade war turns to financial warfare tactics, both sides are more likely to receive recession than resolution.

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