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The Dragon Slayers

Paul Volker defeated inflation in the 1980s and sparked an 18-year bull market in stocks. Jerome Powell has done the same with the latest bout of inflation. Yet, stocks may not react as enthusiastically today as they did 40 years ago.

For more than two years, investors have been wondering if Jerome Powell, the chairman of the Federal Reserve, would become central banking's equivalent of the semi-mythical St. George, the celebrated 3rd century knight who slew an evil dragon and saved an entire nation. In Powell's case the dragon was not of a spiritual nature but a more mundane one, namely inflation.

Not since the 1970s when inflation in the U.S. hit double digits, has a Fed chairman had to deal with the inflation dragon in any meaningful way as has Jerome Powell.

The latest bout of inflation started with the covid pandemic of 2020. Like a slithering dragon, inflation worked its way into the U.S. economy bit by bit through a convoluted path involving severe supply constraints, corporate profiteering, ultra-low interest rates, and government cash handouts to millions of Americans. All of these worked in unison to raise prices for every type of good and service and to heighten the country's sense of economic discomfort.

Through it all, pundits and the media characterized Powell not as a potential dragon slaying knight but as an out-of-touch and overly timid Fed chairman who made the faux pas of saying that inflation would be transitory after the pandemic of 2020.

No doubt, the definition of "transitory" is subjective. But Powell's characterization of inflation as a passing thing was not entirely illogical either.

He reasoned that since inflation in the U.S. came on the heels of the disrupted supply chains that plagued global trade during and immediately after the pandemic, inflation would abate once supply chains were restored to normal. He felt that was especially true where goods were involved, while inflation in the services sector would take longer to reduce. He was right. Services inflation has only recently come under control as the emergency conditions and labor shortages under which wages were increased during the pandemic have now subsided.

From start to finish the covid-related inflationary cycle lasted about four years from the middle of 2020 to the middle of 2024. At the consumer level, inflation reached a peak of 9% in June of 2022. It then consistently declined as the Fed raised interest rates. Inflation is now around 2%, which is the Fed's target range for sustainable economic activity and growth.

That said, for many who were hard hit by the post-covid bout of inflation, those four years may have seemed unending. Yet the situation could have been much worse, as history reveals.

Remembering the Inflation of the 1970s

Putting things into perspective, the epic inflation of the 1970s, seemed to go on and on without any end in sight. In fact, inflation reared its dragon's head in 1973 and stayed all the way to the start of the 1980s. That bout of inflation was anything but transitory.

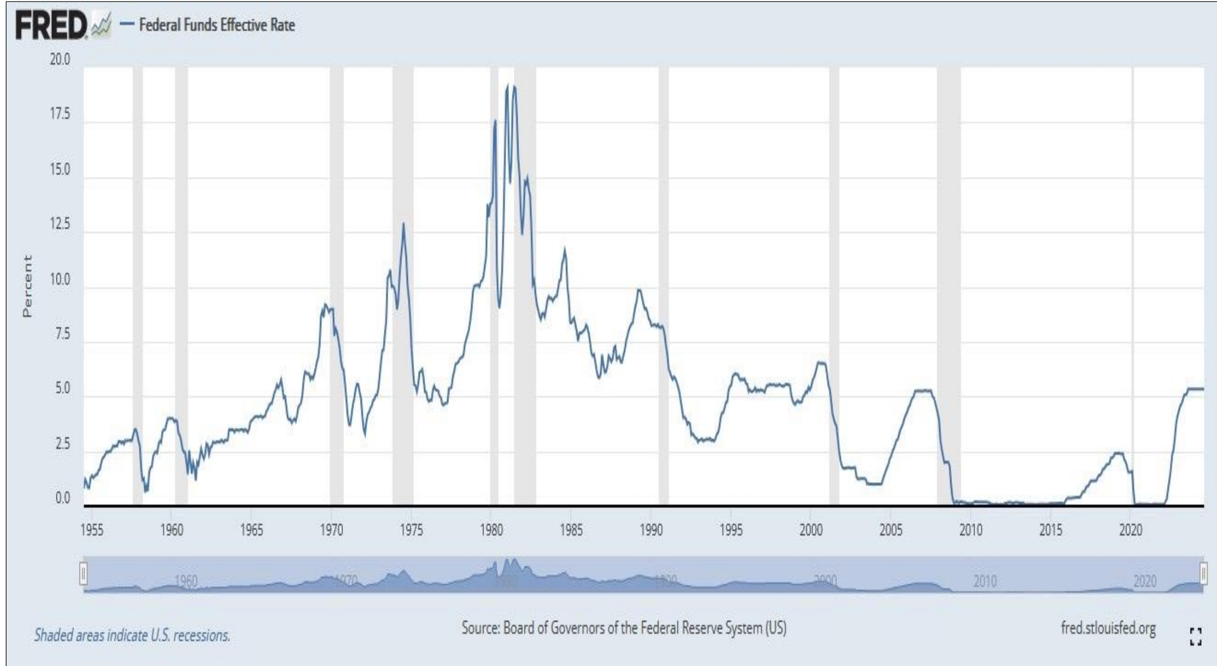
It started in the early '70s when the Fed's politically motivated interest rate cut in 1972 set inflation into motion. On pressure from President Richard Nixon to lower interest rates prior to the 1972 presidential election, Fed chairman Arthur Burns lowered the discount rate (the rate the Fed charges commercial banks and others for short-term loans) from the 6% level where it had been at the start of his chairmanship in 1970, to roughly 4% in 1972. The result was impressive. The economy grew stronger, and Mr. Nixon was re-elected in 1972 by a wide margin. The inflation rate that year was 3.3%.

The following year, 1973, the Middle East Oil Embargo caused energy supplies in the U.S. to drop to near-catastrophic levels. Gas was strictly rationed, and energy prices soared. Inflation spiked to more than 12% in 1974. The economy went into stagflation, a sluggish period characterized by inflation, combined with little-to-no growth.

By the end of the decade, rising inflation ultimately necessitated aggressive action by Fed chairman Paul Volker, who raised short-term interest rates to 19% in 1980/81. He aggressively lanced the inflation dragon, ending it soundly and freeing the economy to go on to new heights over the coming decades. If ever central banking had a St. George, it was Volker. His decision to resolutely

fight inflation precipitated a recession but also put interest rates on a multi-decade decline that helped to propel the stock market higher from 1982 to 2000.

The charts below show the direction of both interest rates and stock prices during that period.



Is 2024 the new 1982? Not Likely

The Powell Fed's 50 basis point interest rate cut last month has prompted some to speculate that stocks will enter a new multi-year bull market. While anything is possible, it is unlikely that the stock market will follow the same script that it followed from 1982 onward when it entered a secular bull cycle.

The difference is that today's stock market is very expensive, whereas it was very cheap in the early 1980s, as this annotated chart of the Shiller P/E shows.

The stock market's current lofty valuation is apparent in almost every broad measure of valuation that one can think of. One highly intuitive measure is the S&P 500-to-Gold ratio (chart below, source: macrotrends.com). This measure of valuation shows how many ounces of gold are required at any point in time to buy one unit of the S&P 500 Index. Since gold is universally accepted as a relatively stable long-term store of purchasing power, the S&P's secular cycles above and below the one-ounce mark, can provide us with clues about the stock market's potential future returns. This chart shows that it now takes about 2.25 ounces of gold to buy one S&P 500 Index unit.

At the stock market's peak in 2000, 5 ounces of gold were required to buy one unit of the S&P 500 Index. That was an historically high valuation level that ultimately led to a

50% contraction in the S&P 500 Index over the next two years. Today's S&P 500-to-Gold ratio is almost the same as the level in 1967 just before the stock market went into a 15 year bear market. And it is higher than the 1929 level just before the Great Depression, during which the market collapsed by approximately 89%, peak to trough.

While the elevated levels of today's valuation metrics are not perfectly predictive of future stock prices, they should nevertheless be seen as cautionary. Cheaper money by way of lower interest rates often fuels asset bubbles, including bubbles in the stock market.

Low or declining interest rates during the current interest rate cycle could keep the market moving higher, potentially contributing to the market's elevated valuations.

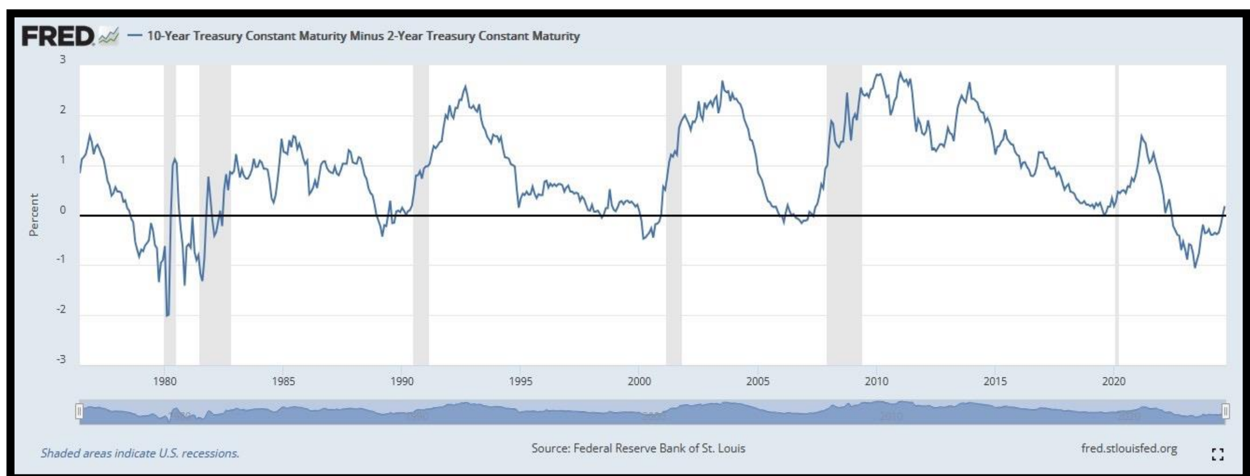
S&P 500 Earnings Growth is a Positive Short-term Backdrop for Stocks

For the moment, the earnings growth figures of the S&P 500's constituent companies continue to be positive, and therefore supportive of a bullish stock market in the near-term. Per the September 20, 2024, edition of FactSet Earnings Insights, Wall Street analysts on average expect 2024 year-end earnings to rise by 10%. At the end of 2023 their expectation was that 2024 earnings would grow in the 11.5% range.

This lowered Street expectation can also be seen in the S&P's sales growth figures. At the end of 2023 the estimate for the S&P's year-end 2024 sales growth was 5.5%, whereas now Wall Street anticipates that 2024 sales growth will be 5%, a market slowdown.

The Street's consensus growth projections for 2025, however, are much higher, at +15.2% for earnings, and +5.9% for sales. These figures suggest that Wall Street is expecting the economy to be strong in 2025, with no recession in sight.

That view may turn out to be correct, but with the Treasury yield curve now fully un-inverted, as the chart below from the Federal Reserve Bank of St. Louis shows, we should not ignore the possibility that a recession may materialize in the coming months.



Remain Selective and Focused on Risk Management

Despite the title of my investment letter this quarter and my slightly tongue-in-cheek description of two inflation-fighting chairmen of the Federal Reserve as “dragon slayers”, I am not an apologist for the Fed.

On the contrary, I acknowledge that over the years, the Fed has made its share of mistakes and has missed the mark on a number of occasions. Inflation can have complex causes, some in the hands of the Fed itself, as when the Fed kept interest rates too low for too long over the past decade, and others out of the Fed’s control, as when energy supplies were disrupted from far off lands in the 1970s.

Powell has been successful in lancing the latest inflation dragon. By doing so he has initiated a new interest rate easing cycle which should help to boost corporate profits and stock market returns in the near-term. Still, it makes good sense for investors to remain selective and focused on risks and risk management in their portfolios.

Whether Powell will turn out to be central banking’s new equivalent of St. George remains to be seen. It will depend mostly on the trajectory of inflation and the economy in coming months and years.

V. Henry Astarjian

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