NOT "That '70s Show"

Cetera® Investment Management LLC

When you think of the 1970s, you're likely to think of leisure suits, bell bottom jeans, disco music, mood rings, pet rocks, and green shaggy carpet. While some of those trends may be making a comeback, there is one thing we all wish was gone for good: high inflation. We would all gladly put on a pair of platform shoes and bell bottoms if that meant inflation remained as dead as a pet rock. Unfortunately, high inflation has returned and has a lot of people wondering if we are in a sequel of "That '70s Show." **We will explain why we don't think an exact parallel exists, but first, let's turn the dial back to the 1970s.**

The Montreal Canadiens experienced inflation during the 1970s in the form of a **rapid rise in Stanley Cups, winning six during the decade.**

Talk about inflation! **In the 1970s, a Big Mac cost just $0.65**. **However, the average hourly wage was only $4.61/hour in 1975.** Today, a Big Mac costs an average of $6.05 in the U.S. and the average hourly wage is $27.12/hour.

Home Box Office, better known as HBO, launched in 1972, kicking off a new era of television. You would think that wouldn't have been a good idea with inflation running rampant, but HBO's pay-for-TV service found a niche, and the rest is history. Its inaugural program was an NHL game between the New York Rangers and the Vancouver Canucks.

Salaries rose quickly in baseball during the 1970s. In 1974, Chicago White Sox infielder Dick Allen became the first player to make $250,000, and Philadelphia Phillies legend Mike Schmidt became the first player to have a contract exceed $500,000 in 1977. Nolan Ryan became the first athlete to sign a contract that paid more than $1 million per year when the Houston Astros signed him to a four-year, $4.5 million contract in 1979.[1]

Inflation wasn't the only force driving the 1970s. A long time ago in a galaxy far, far away... **the first "Star Wars" film hit theaters in 1977 and became the highest grossing film of the decade.** May the force be with you!

The 1970s - When Inflation Was Off the Hook

Nowadays, people aren't just talking about the 1970s because of the groovy disco music. The 1970s was also known as a time of high inflation, kicking off at the start of the decade at 6% year-over-year. A recession eased inflation to a decade low of 2.7% in August 1972 before quickly rising again to 12.3% by the end of 1974. However, that was not the peak. After falling back to 4.9% after the second recession of the decade, inflation started to rise again and did not stop until it reached 14.7% in April of 1980.

While we often hear about rising oil prices as the cause of inflation during this time, it was more complicated than that. Inflation in the 1970s could be attributed to many factors, some of which began to take shape in the decade prior.

Government Spending — Inflation really started to rise in the mid-1960s from a low point of under 1%, and can be blamed on a host of reasons, but an increase in government spending caused by the Vietnam War and policies of the Great Society are largely the root cause.

Expanding Money Supply — The U.S. money supply expanded after we completely exited the gold standard in the summer of 1971, adding to inflationary pressures. With the U.S. dollar no longer able to convert into gold, the United States no longer had to adjust the supply of dollars to maintain the relationship between the two. Countries could no longer redeem U.S. dollars for gold, so the money supply was allowed to expand, and the value of the dollar allowed to fall relative to the price of gold.

Rising Oil Prices — Rising oil prices caused by the Oil Embargo (1973-1974) and the Iranian revolution (1979) were a key cause of inflation. Both energy shocks were major contributors to inflation in the 1970s.

Gas shortages were so bad in the 1970s that gas stations had odd-even rationing. Drivers with a license plate that ended in an odd number could get gas one day, those with an even license plate on the next.

Monetary and Fiscal Policy Mistakes — The U.S. Federal Reserve's understanding of inflation and unemployment (an economic concept called the Phillips Curve) was also flawed, complicating matters even more. High economic growth and inflation are not always synonymous with low unemployment.

Government spending remained on an upswing into the 70s and inflation got so bad that President Nixon issued an executive order in 1970 imposing a 90-day freeze on wage and price increases to help combat the issue. Unfortunately, after the freeze, companies played catch-up, and wages and prices spiked even more. In 1974, President Ford took a different approach, advocating a campaign to WIN, or Whip Inflation Now. People were encouraged to wear pins that said "WIN" to promote solidarity around voluntarily taming inflation without government price freezes. This campaign proved unsuccessful, but what it may have tried to address was yet another problem, psychology.

Psychology — When prices continue to climb, consumers naturally want to buy more before prices rise again. Inflation then becomes a self-fulling prophecy. We also see a similar phenomenon in deflationary periods when consumers hold off purchases, because prices are expected to fall.

The Painful Solution

Inflation finally met its match when Paul Volcker was appointed to chair the Federal Reserve in 1979. The tall, cigar-smoking Fed Chair raised interest rates, causing an economic downturn. He then lowered rates and the economy came back, yet he still was not able to shake inflation. Not accepting defeat, he tried again. This time, he raised interest rates as high as 20%, inducing a recession and eventually leading to unemployment over 10%. He stayed the course this time and inflation fell to around 4%, where it would stay for the next decade.

Paul Volcker may have towered over other economists at 6'7", but many of his ideas came from a famous Nobel Prize-winning economist, Milton Friedman, who was only five feet tall.

The 2020s – "It's Transitory"

Today, it is nearly impossible to miss comparisons between our current environment and the 1970s. There are similarities after all, and once again, high oil prices are being cited as the source of inflation. However, there are other factors to consider.

Government Spending — Massive trillion-dollar stimulus bills were passed to help those financially impacted by COVID-19. In the interest of time, much of the stimulus was broad-based and not targeted. Many Americans were able to work from home, refinance mortgages at lower interest rates, and thus benefit from the windfall of money. Savings rates hit all-time highs during the two-month recession in 2020. Money was spent on goods instead of services due to social distancing measures. Now consumers are shifting from goods to services. Last summer, airline tickets, rental cars, hotels and cars all saw huge price increases as demand far outpaced supply.

Expanding Money Supply — Just like in the 1970s, we have seen the money supply soar. A measure of the money supply, called M2, has gone from around $15 trillion to nearly $22 trillion since the pandemic (an increase of over 33%). In the 1970s, this figure more than doubled, going from around $600 billion to nearly $1.5 trillion.

Rising Oil Prices — The war in Ukraine has led to a surge in energy prices. Oil was as low as $66 a barrel in late November and rose above $120 a barrel as the war broke out.

Supply-Side Disruptions — There have been several supply-side disruptions since the start of the pandemic that have been inflationary. These disruptions range from multiple factory shutdowns because of the pandemic, supply disruptions caused by a ship stuck in the Suez Canal in the spring of 2021, and Hurricane Ida last fall. Moreover, increased goods demand strained our supply chain system, causing delays and higher costs. This is the factor that is perhaps the most transitory.

Yet another supply-side disruption has been brewing even before COVID-19. Prior to the pandemic, there were around one million more job openings than unemployed individuals. With local economies reopening, there are now over five million more jobs than people looking for work. These labor shortages are driving up wages and might be less temporary.

Monetary and Fiscal Policy Mistakes? — This leads us to perhaps the biggest question mark in comparing the 1970s to today: will there be monetary or fiscal policy mistakes? Last year, the Fed dismissed inflation as "transitory" as supply-side disruptions continued to bubble up. However, labor market inflation could be less transitory. Will Jerome Powell and the Fed sacrifice the economy and labor market to squash inflation the way Paul Volcker's Fed did? Will Congress spend even more money in the face of inflation?

Why is it *Not* "That '70s Show"?

The Pandemic Is Transitory

The COVID-19 pandemic that opened the 2020s placed unique pressures on the global economy; whereas the influx of government spending entering the 1970s happened over the course of several years, and fiscal stimulus due to the pandemic was isolated within a period of less than two years. About $4.6 trillion has been approved by Congress, according to Treasury Department data (usaspending.gov). Federal agencies have committed to using about $4 trillion of that and have made about $3.6 trillion in actual payments to date. The pandemic also created supply-chain issues due to widespread social distancing measures. One area hit hard by these shortages is the semiconductor chip industry. These chips are found in nearly everything with a plug or battery. Chip production, along with everything else, slowed during the height of the pandemic. When demand recovered faster than anticipated in the second half of 2020, the semiconductor industry struggled to keep up. The gradual economic reopening led to a surge in demand for vehicles, but auto manufacturers couldn't keep up with demand. This led to increased demand for used cars and to a 37% rise in prices in 2021, which has played an outsized role in driving the consumer price index (CPI) to a 40-year high. Positively, we are already seeing a slowdown in used car prices in recent months.

Different Views from the Fed

In the 70s, the Fed widely believed in the Phillips Curve, which states that inflation and unemployment have a stable and inverse relationship. They believed that increasing economic growth and inflation would cause unemployment to fall as more jobs were created. The 1970s challenged this theory with high unemployment and high inflation (stagflation). Both unemployment and inflation soared as this relationship fell apart. Today, the Fed is very aware of this phenomenon, having learned from past mistakes and currently is more cautious allowing interest rates to remain at low levels. Despite red-hot inflation data, several committee members reversed their push for a 0.50% increase in March due to the uncertainty around the war in Ukraine. However, the Fed implemented a 0.50% rate hike, the first in more than 20 years.

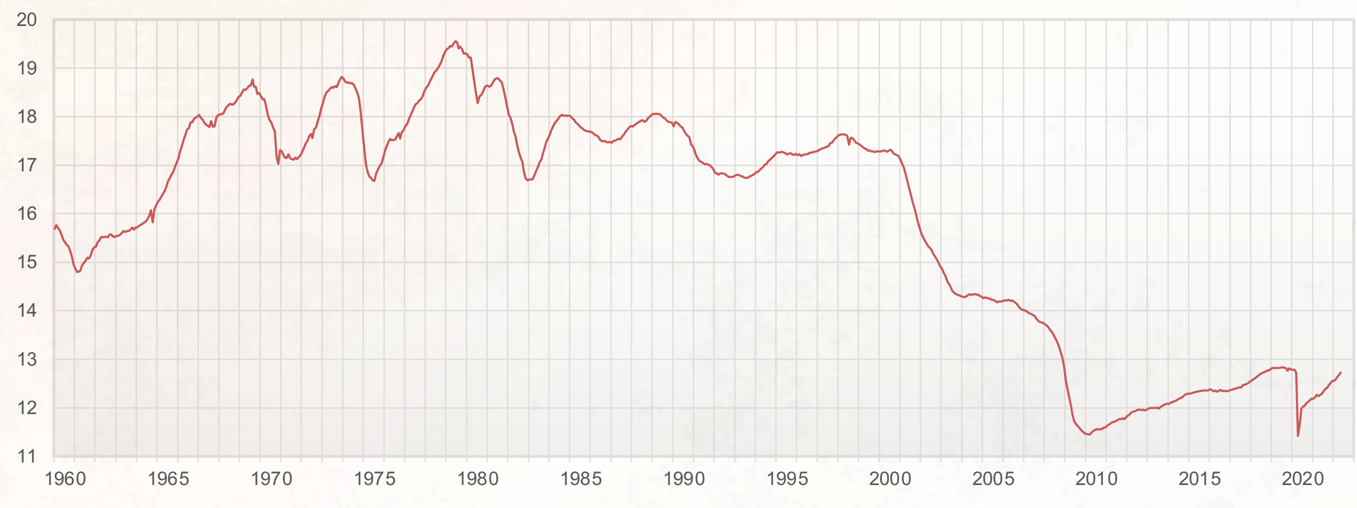
Though prices could continue to move higher month to month, the increases should be less dramatic. In fact, as an example of goods price deflation, the year-long surge in used car prices is already showing signs of reversing. The Manheim Used Vehicle Index is down around 7% this year. As the economy continues to reopen and spending trends back from goods toward services, supply issues should moderate. Going forward, the Fed will likely consider 0.50% rate hikes in future meetings.

The Economy

Today's economy is a lot different than it was in the 1970s. Fifty years ago, the economy and labor market were more industrial and manufacturing focused. An industrial economy is more sensitive to rapidly changing energy prices. A quarter of the U.S. labor force worked in manufacturing at the start of the 1970s, compared to just 8.4% today. In fact, total manufacturing employment peaked at 19.5 million in 1979 during the second energy crisis of the decade. The U.S. population has grown by 107 million since, but 7 million fewer people work in manufacturing today. The decline in manufacturing employment is one of the reasons why fewer private-sector workers are members of a labor union. The private sector union membership rate was 24% in 1973, or four times the current rate (6%). A wage price spiral added to inflationary woes in the 1970s, and some view that the higher union presence in the workforce put more upward pressure on wages at that time.

Figure 1

Total Manufacturing Employment (Millions)



Source: Cetera Investment Management, FactSet, U.S. Bureau of Labor Statistics. Data as of 4/30/2022.

The labor market and economy have diversified away from manufacturing to a service focus. More than 40% of the labor force works in education and health services, professional and business services, and leisure and hospitality sectors. Only 20% of the labor force worked in those sectors in 1970. A more diversified economy may be less sensitive to energy shocks, but today's technology and service sectors are not completely immune to a rise in inflationary pressures. The good news is energy efficiency isn't stuck in the 70s as we'll discuss in the next section.

Energy Efficiency and Production

Energy prices surged globally this year, propelling gas prices in the U.S. to the highest level on record at more than $4 per gallon. In California, the average price of a gallon of gas is over $6. Consumers are feeling the impact at the pump but there are some key differences when compared to prior oil shocks. Though gas prices are up, wages have also risen. Gas prices relative to wages are only moderately above the historical average and cars are more gas-efficient than ever. Since 1976, a gallon of gas has averaged 12.6% of the average hourly wage of non-managerial workers. At present, a gallon of gas is 15.3% of the average hourly wage. Wage-adjusted gas prices are above average, but not as extreme as the last energy shock in 2008 when oil approached $150 per barrel. A gallon of gas was a record 22.6% of the average hourly wage when gas prices peaked that year.

Figure 2

Consumer Spending: Energy Goods & Services as a % of Total Expenditures

Source: Cetera Investment Management, FactSet, U.S. Bureau of Economic Analysis. Data as of 3/31/2022.

While spending on energy has risen since the start of the pandemic, it pales in comparison to the 1970s when consumers spent an average of 7% of their total expenditures on energy costs. The peak was 9.6% in March 1980, while consumer expenditures spent on energy goods and services was 4.7% in March 2022.

Energy costs are taking up a much smaller percentage of consumer expenditures largely because energy efficiency is much higher today. As an example, the average combined city and highway fuel economy for a new car is 26 miles per gallon, or twice the efficiency of a new car in 1975.[2] The fastest growing segment of the auto industry is electric cars and elevated gas prices add an extra incentive for more consumers to consume less oil. Sales of electric cars may exceed 50% of new U.S. auto sales by 2030, according to a 2021 survey of 1,100 auto executives.[3]

Domestic energy production has increased substantially since the 1970s and we are less reliant on foreign oil and gas today. Though energy markets are global in nature, the U.S. has the capacity to increase production. We didn't have this luxury in the 1970s when the U.S. was reliant on foreign oil during two major oil shocks. Without the ability to materially increase production, the government instead implemented consumption limits, resulting in long gas lines and economic disruption. We are in a better position today compared to the 1970s. Energy efficiency and domestic production are higher, while overall spending on energy is lower. Additionally, technological innovation and the move toward zero-carbon energy sources may further reduce the economy's sensitivity to energy price spikes as the decade progresses.

Demographic Shift

There is a demographic bridge connecting the 1970s with our current decade. Baby Boomers, who entered the labor force in the 1970s, are currently trickling out of the labor force for retirement. As Baby Boomers reached their working age, the size of the labor force surged 30% during the 1970s. No decade in the post-war era had a larger increase in the size of the labor force. In comparison, the labor force today is only 6% larger than it was 10 years ago. The prime age work force, which is represented by workers between the ages of 25 to 54, has only increased by five million since 2000. In comparison, the prime age work force increased by nearly 25 million in the 1970s, or five times the increase over the last 22 years. Added inflationary pressure resulted from the massive rise in young adults during the 1970s. New household formations grew, consumption needs increased and the sharp rise in the number of employed individuals increased the amount of spending in the economy.

Population growth was much faster in the 1970s and the U.S. was a lot younger. As Baby Boomers are currently reaching retirement age, the percentage of the population over 65 is growing dramatically. In 1970, only 10% of the population was over 65. At present, 17% of the population is above 65 and that figure is expected to grow because of low birth rates and reduced immigration levels. The Census Bureau projects that 20% of the population will be above 65 by 2030.[4] Consumption habits change as we age and countries with older populations, like Japan, have weaker inflation.

On the other hand, labor supply is stagnating yet demand for labor is growing. There is a record 5.6 million more job openings than unemployed individuals seeking work as of March. Wage pressures have risen because employers are competing for a smaller pool of unemployed labor. There are supply and demand dynamics that could alter this mismatch, like an increase in immigration to boost labor supply or an economic slowdown, which would reduce the demand for labor. Yet the longer-term outlook indicates weak labor supply growth, and a boost in productivity growth could be what's in store. Business investment is already booming. Capital expenditure spending growth accelerated in the post-pandemic environment. Employers are looking for technological and process improvement solutions to boost overall productivity, offsetting the issues with low labor supply growth. If the labor supply-and-demand dynamic is normalized because of improved productivity, wage growth pressures will likely ease.

Conclusion

Inflation has risen sharply over the last year, surging to a 40-year high. After a few decades of subdued inflation some are wondering whether a repeat of the 1970s is upon us. While inflation might settle above pre-pandemic levels, we don't expect runaway inflation as our base case. Supply constraints will eventually ease, and inflationary pressures will likely subside. The impact from the pandemic was unique and our economy going forward will not mirror the past, in our view. We certainly aren't out of the woods yet, but we don't see this as a repeat of the 1970s. A lot of factors are different today. The demographic setup has moved from a youth movement to an aging population, the U.S. economy is less dependent on foreign energy, energy efficiency is much improved, the economy is a lot more diversified across industries, and technological innovation is increasing the potential for further productivity improvements.

The pandemic has been difficult in many ways, and the onset of inflation offset some of the important economic gains made during the recovery. The Fed is now fully focused on tackling inflation, though economic growth is likely to suffer as a result. We continue to recommend a diversified allocation as a hedge against inflation. Please consult with your Cetera financial professional for further guidance. From all of us at Cetera Investment Management, we hope you have a groovy summer.

[1] https://baseballhall.org/discover-more/stories/inside-pitch/nolan-ryan-million-dollar-man

[2] https://www.energy.gov/eere/vehicles/articles/fotw-1177-march-15-2021-preliminary-data-show-average-fuel-economy-new-light

[3] https://www.cnbc.com/2021/11/30/auto-executives-say-more-than-half-of-us-car-sales-will-be-evs-by-2030-kpmg-survey-shows.html

[4] https://www.aarp.org/home-family/friends-family/info-2018/census-baby-boomers-fd.html

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