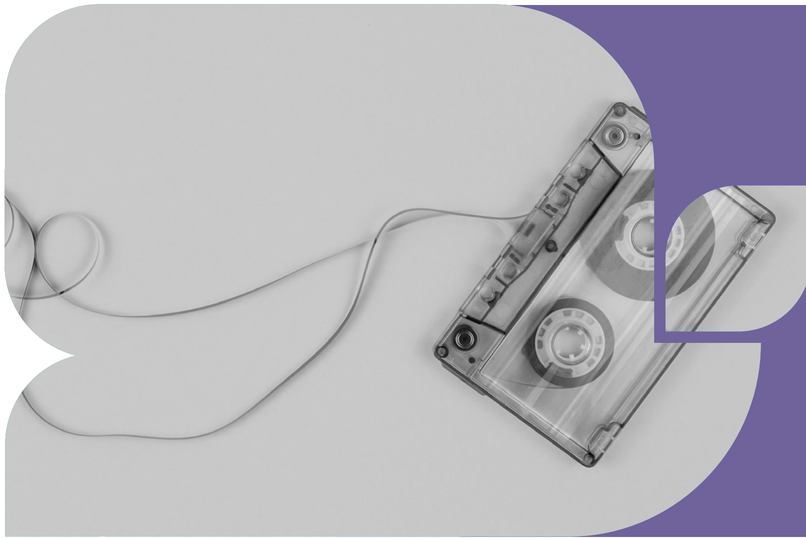

Rathbones
Look forward

Review of the week

28 March 2022

An economic rerun of the 1970s?

The 1970s suddenly seem relevant again given soaring oil prices, high inflation and rising interest rates. But we're not expecting a rerun of 1970s-style spiralling prices, sputtering economic growth and weak equity market returns.

There are undeniable similarities between some of the challenges emerging today and things that happened in the early 1970s: soaring oil prices, rising interest rates, inflation and slowing economic growth. It's understandable why this raises the spectre of a rerun of 1970s-style stagflation (the toxic blend of soaring prices and stagnant economic growth) and fears of a prolonged period of equity market weakness.

But despite some striking echoes of things that happened 50 years' ago, the world today is very different. We see five clear reasons why history isn't likely to be repeated.

1. Inflation was already endemic in the early 1970s when it got hit by an oil price shock in the form of the 1973-4 Yom Kippur War and the ensuing Arab/OPEC oil embargo. Today, the oil price has almost doubled in just a few months. Back then, it tripled in a similar span of time. But inflation had been running at more than 4% for several years before the Yom Kippur war broke out. In other words, high inflation had got entrenched long before the oil shock. Today, high inflation has been around for just 10 months or so - it hasn't already become the norm.
2. The energy intensity of Western economies is about 60% lower today than it was back then. And the amount consumers spend on energy as a percentage of their total expenditure is about 40% less. The tripling of the oil price in the early 1970s, therefore, had a much more profound economic impact than the doubling of the price over the last 12 months will inflict.
3. The spike in inflation in the 1970s was fuelled by a combination of bad data, bad economics and bad policy. Back then, the data available very significantly over-estimated the amount of spare capacity in the economy. Spare capacity tends to exert downward pressure on inflation so by overestimating it, the authorities underestimated the inflationary effects of their policies. Bad data combined with bad theories about how economies should work meant that both fiscal and monetary authorities delivered woefully inappropriate policy responses in the 1970s. Today, we don't see comparable institutional failings and policy mistakes occurring again, not least because the world's big central banks are independent now.
4. Medium-term inflation expectations today are much, much lower than they were in the 1970s. And consumers are exercising restraint as inflation heats up. This is a stark contrast with the 1970s when they kept on spending because they felt prices would only keep on rising ever higher. Today, consumers are saying it's a bad time to buy big ticket items because they don't expect current heady price rises to continue too long. In other words, inflation today is likely to curb demand and, as a result, become self-limiting and not self-perpetuating.
5. Finally, wage inflation today is much more contained than it was in the early 1970s. In the late 1960s and early 1970s, wage inflation ran ahead of price inflation. A recent examination of inflation spirals by Oxford Economics found that wage growth almost invariably tends to run ahead of price growth when runaway inflation occurs. That's not happening today and we don't expect it to start. Not least because labour market institutions are different - there are few inflation-indexed wage contracts, labour movements are weaker and so is bargaining power.

The bottom line

There are many other structural factors that militate against runaway inflation - demographics, wealth inequality, technological change - too many to go into in the space we have here.

The bottom line is that the 1970s was a period of extraordinary peace-time inflation: it was an historical anomaly. Even if our base case that inflation is going to begin to fade turns out to be wrong - and the risks are of course rising - the 1970s were really quite unlike today and are unlikely to be repeated.

Bond market sell-off resumes

Financial markets have remained volatile against the uneasy backdrop of the war in Ukraine. Over the weekend, Russia's Defence Ministry suggested it was focusing its invasion on the east of the country, signalling a possible shift in strategy. Meanwhile, at the conclusion of a speech in Warsaw on Saturday, President Joe Biden's comments that "Putin cannot stay in power" saw US officials rush to provide reassurance that the US is not seeking regime change in Russia.

Against this backdrop, many global equity markets moved tentatively higher while government bond markets continued to sell off, pushing yields - which move inversely to prices - higher in anticipation of a continuing policy tightening cycle among major central banks.

The 10-year US Treasury yield hit 2.5% on Friday, its highest level since May 2019, and the German 10-year bund yield, the benchmark for Europe, rose to 0.57%. Shorter-dated bonds - which are highly sensitive to the path of short-term interest rates - came under the most intense selling pressure. Longer-term bond yields have also risen, albeit less sharply, given uncertainty about how long inflation will remain persistently higher, which is chipping away at the allure of holding securities that provide a fixed stream of income long into the future.

If you have any questions or comments, or if there's anything you would like to see covered, please get in touch by emailing review@rathbones.com. We'd love to hear from you.

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