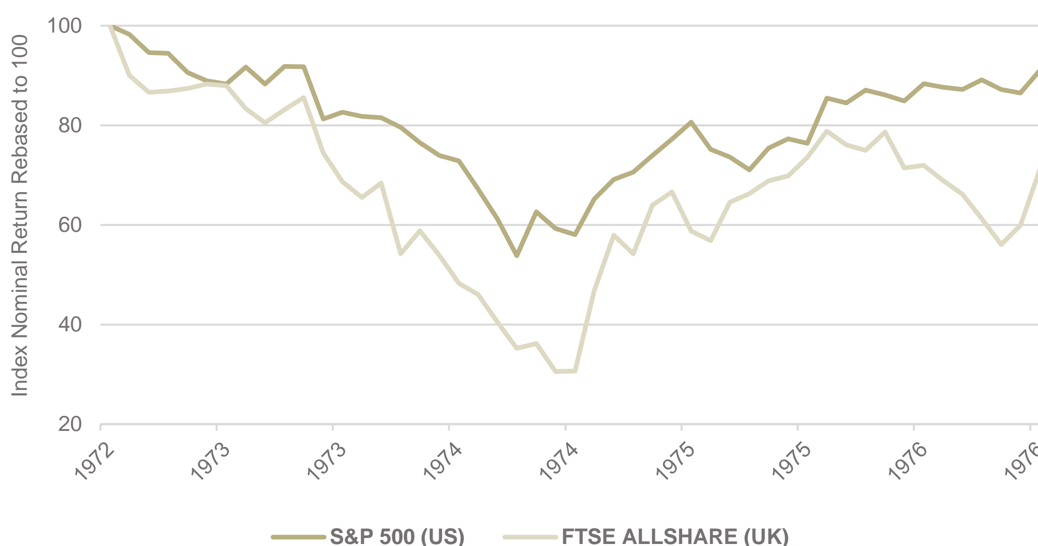
UK Macro | The 1975 Redux

By December 1974, in arguably the greatest crash of all time, the FTSE All Share index had fallen 70% from its 1972 high to its all-time low, trading on a dividend yield of 12.7% with a Price/Earnings ratio of 3.6x. *"This bear market is the financial equivalent of the Great War"*, read a 1974 year-end stockbroker report: "*Lamps going out, end of an era, casualties numbered in millions, will it ever end?"*[1]

By the end of February 1975, the FTSE All Share Index had risen an astonishing 90% and would end the year up 140% (See Fig 1. The same stockbroker which only two months earlier had compared the previous year's rout to the Great War noted that "*most investors were wrong-footed by the sudden change and remained imprisoned by the seemingly irrefutable logic of their gloom."*[2]

Fig.1 | UK and US Stockmarket Returns 1973-1975



Source: Bloomberg, Argonaut Capital Partners

January 2023 has been the 3rd best month for the highest-risk stocks in 35 years.[3] As in 1975, stock performance has so far been the exact opposite of the previous year, with most winners having at least halved in value during 2022. It is difficult to point to any single catalyst as the New Year dawned to turn the glass half-full. In 1975, stock market folklore suggested a boozy Christmas lunch at Prudential's High Holborn offices, attended by fund managers of all the UK leading insurance companies, after which they all apparently concurrently decided to ramp the market.[4] Today's fund management compliance departments would certainly prevent such concerted buying, and almost definitely prohibit any alcohol-fuelled lunch.

According to UK stock market historian John Littlewood, and in contrast to the Prudential lunch legend, most professional investors were caught unawares by the rally and were sitting on "*cash resources for sunnier days*", having sold out of the riskiest stocks, whilst the retail investor was "*disillusioned beyond repair*":

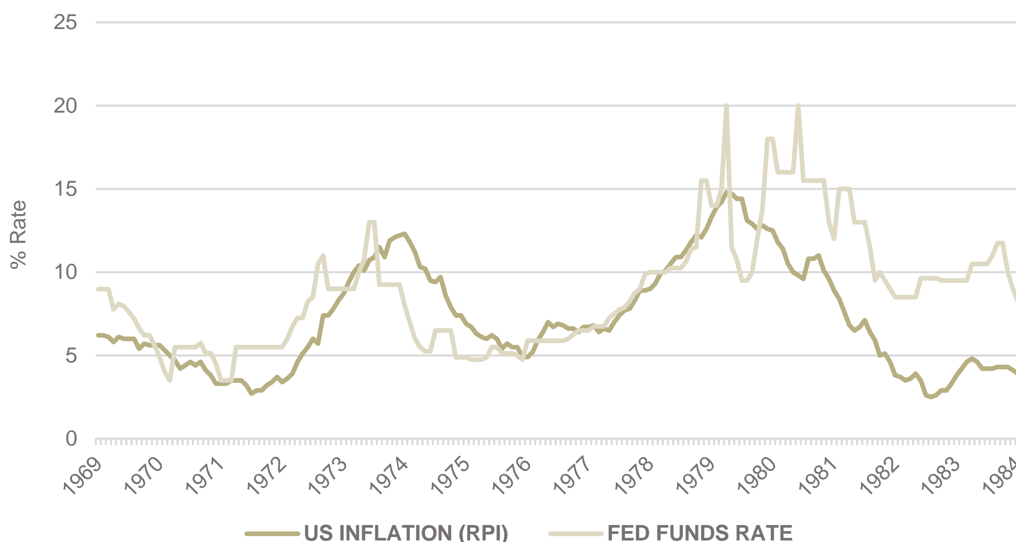
"These eight weeks amount to the most astonishing single period in the post war history of the stock market, although few investors would admit to having enjoyed thus frenzied feast while it was happening. Many simply looked on, paralysed like rabbits caught in the headlight. A small number of funds…had beaten their competitors into the ground

[1] James D'Albiac writing for stockbrokers Rowe & Pitman quoted in "The Stock Market" John Littlewood P214
[2] Attributed to Rowe & Pitman, "The Stock Market" John Littlewood P223
[3] BOAML Quant Strategy 6th Feb 2023
[4] See George G Blakey, A History of the London Stockmarket 1945-1997 P140

through the bear market by buying gold shares – the shining light of equity markets in 1973 and 1974 – but now found themselves stranded at the floor of the performance tables."[5]

Although the 1970's is now notorious for its high inflation, it is often forgotten that it also saw a prolonged period of disinflation in the US from 1974-1976 (See Fig 2) which allowed global financial conditions to ease and stock markets to rally. It is also a mistake to assume that contemporaries held the same binary views as most economic commentators today in comparing the performance of the Federal Reserve under Arthur Burns (1970-1978) and Paul Volcker (1979-1987).

Fig.2 | US 1970's Interest Rates & Inflation



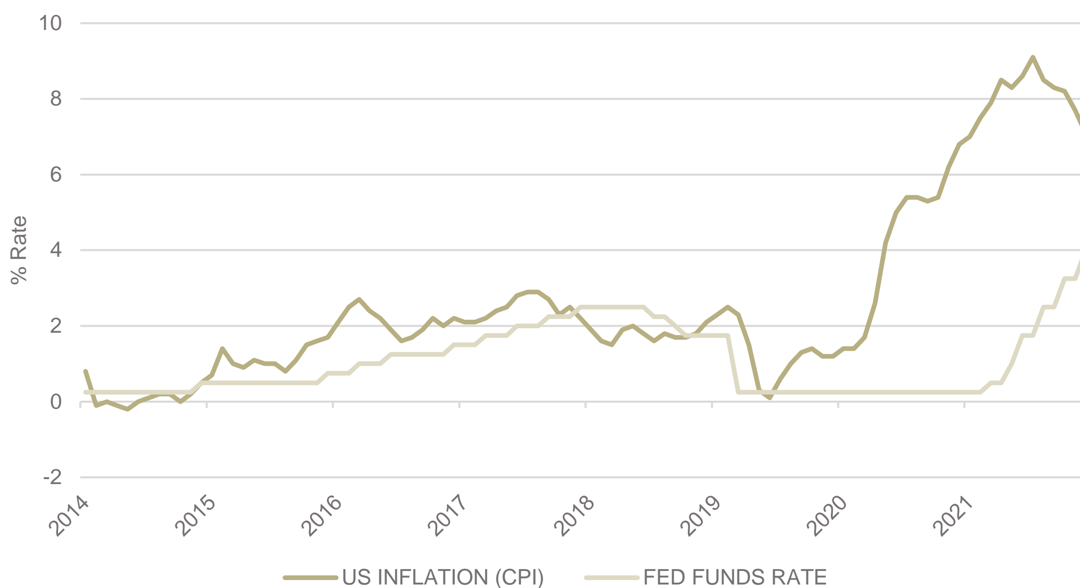
Source: Bloomberg, Argonaut Capital Partners

Between December 1974 and November 1976, US inflation (CPI) fell from 12.3% to 4.9%, whilst Fed Funds were eased from a peak of 13% in June 1974 to 4.75% in January 1976, conferring a begrudging if temporary prestige on Burns (See Fig 2). As his biographer has noted, "b*y 1976, Arthur Burns enjoyed perhaps greater prestige and notoriety than any previous Federal Chairman. The press seemed to consider him synonymous with the financial system: a coin decorated with Burn's profile graced the cover of Forbes magazine's annual issues on banking, and a New York Times caricature showed him wrapped in a toga that looked suspiciously like a dollar bill… Fed policy yielded results. In 1975, despite warnings that the central bank's caution would forestall recovery, the economy had rebounded well from recession while inflation had declined significantly. As one prominent business columnist wrote, "Burns and the Fed were right, and almost everybody else was wrong*".[6]

US inflation (CPI) peaked at 9.1% in June 2022, is currently 6.5%, and will almost certainly fall further over the coming months, owing to year-on-year deflation in manufactured goods and energy (See Fig 3. With the Federal Reserve indicating another two 25bps hikes in March and May, by June it is likely that US CPI and Fed Funds will – like ships in the night – have crossed paths and for there to be a positive real rate of interest on US dollar cash deposits. At this point, the Federal Reserve is likely to announce a pause in the hiking cycle (which the market is likely to confuse with an end).

[5] "The Stock Market" John Littlewood P223
[6] P178-179 "Monetary Caesar. Economist in an Uncertain World. Arthur F. Burns and the Federal Reserve", 1970-1978. Wyatt c. Wells

Fig.3 | Recent US Interest Rates & Inflation



Source: Bloomberg, Argonaut Capital Partners

Like Burns in 1976, Powell will be feted as a "Monetary Caesar", and inflation pronounced "transitory" after all. There may be an exuberant mood – particularly amongst those who easily forgot the lessons of 2022. There will likely be speculation that the Fed may now embark on a rate cutting cycle, which Powell might find difficult to push back on. This would loosen financial conditions further, achieving the same stimulatory outcome.

At this point, it is probable that inflation will prove stickier and may start to accelerate again. Wage inflation is unlikely to be tamed without a period of higher unemployment, especially in an era of reshoring manufacturing jobs and deglobalisation. Commodity prices will have reaccelerated on China's reopening (though we have doubts about how China funds a prolonged property boom renaissance unless it enjoys the "exorbitant privileges" of the renminbi becoming an international reserve currency, which may well be its plan). It is also our view that the West's "Energy Transition" is incompatible with cheap and reliable energy and therefore will fail, though not before it is responsible for a decade of energy inflation and falling living standards.[7] In short, by the summer, the positive catalysts behind the 2023 market rally may be behind us. As witnessed on the movie "Jaws", just when the Mayor of Amity Island pronounces the sea safe for swimmers again, it will be time to be fearful of sharks.

We now know that Burns' Fed did not defeat inflation, which began reaccelerating again in 1977, peaking at 14.8% in 1980 (See Fig 2). It required a prolonged period of high real interest rates under Paul Volcker in the early 1980's, two deep economic recessions, and the ramping up of oil production in Alaska and the North Sea before inflation fell to 2% in 1983. Similarly, we think it likely that this Fed hiking cycle will be unable to defeat inflation and that it is the prospect of economic "Goldilocks" – rather than inflation – which will prove transitory. This is, however, likely a fight for a sunnier day.

Barry Norris
February 2023

[7] See our Stockumentary "What have fossil fuels ever done for us?" https://youtu.be/qR5cNyehO88

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