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Inflation and interest rates; a long range approach

by

SIDNEY HOMER

Voici un travail que M. Sidney Homer, associé de Solomon Brothers de New York, a présenté en janvier 1975 aux membres de l'Association des analystes financiers de Montréal. Nous le soumettons à nos lecteurs avec l'autorisation de son auteur, comme une contribution à l'étude d'un problème très sérieux. M. Homer nous paraît apporter une explication valable à un phénomène complexe devant lequel, trop souvent, on reste étonné, impuissant, peut-être parce que le comprenant mal, on se l'explique mal. A.

Over the years of my experience as a security analyst, I found the hardest chore has often been to distinguish between medium term market movements and long term market trends. Let us suppose in any market a convincing and vigorous trend is underway. We accept it but ask: is it a cyclical trend apt to be reversed sometime during the next year or two ? Or is it part of a long term trend which may not be wholly reversed for decades ? This pervasive and painfully difficult problem confronts the analyst of bonds, stocks, of the economy as a whole and many of its components, including my topics today: inflation and interest rates.

In analyzing interest rates, I have long found it useful to distinguish three types of trends — short term trends of a few weeks or months, cyclical trends usually of one to three years, and long term trends, often called secular trends, which last through two or more business cycles and often for several decades. While one brief glance at bond market history over the past thirty years will prove that the upward secular trend of interest rates was by far the most important, often shortening and cancelling out cyclical trends, nevertheless most bond market analysts still concentrate on cyclical trends. This is probably because cyclical trends lend themselves to factual analysis

and cover manageable time spans. One important first step in any trend analysis, however, is to be clear which of these trends we are talking about.

I remember once, when I was much younger, I found myself saying to a fortunately private audience, something like this:

> « Gentlemen, at present, while the near-term trend of prime corporate bond prices is down, their medium term (cyclical) trend is still up, though, of course, the secular trend continues to be down. »

I could see a bewildered look on many faces and concluded that one trend at a time is enough, if not more than enough, for a public speaker — certainly not three.

Cyclical Inflations and Secular Inflations

However, since this form of trend distinction and analysis has proved very useful in the area of interest rates, I will attempt to experiment with it today in the larger area of inflation which, of course, is intrinsically related to interest rates. With inflation, also, there are near term technical ups and downs in the inflation rate; there are also cyclical changes in the inflation rate lasting two years or so and alas there is the dominant long-term secular trend. It has been up for the past ten years at least and some would say longer.

In the United States, if we take the B.L.S. wholesale commodity price index as a guide, the postwar period up to 1965 was one of small cyclical fluctuations in the rate of inflation — a cyclical bulge in prices here and a cyclical bulge there during business peaks and then a retreat or a flat period for a year or two, usually during recessions. There was in fact in the postwar period up to 1965 a succession of small business cycles but no booms and no depressions. Since 1949, there have been fourteen years of no inflation or just half the total of twenty eight years. In other words, inflation was sporadic, not a continuous year in and year out phenomenon.

After 1965, however, all this changed. A continuous major inflation began which became a major inflationary spiral. At first, from 1965 to 1969 we treated this as just one more cyclical bulge, but we were sadly mistaken. Alas, we treated it with cyclical medicine, tools

which had always worked before at cyclical peaks and we were soon shocked and trapped by the failure of these conventional tools to work. We had made the mistake of not distinguishing between a cyclical inflation and a major sustained inflationary boom. Such a boom started ten years ago. In dealing with such a secular inflation, either from the point of view of the investor or of the government, conventional cyclical analysis is more apt to be misleading than useful.

Now let me come to my main point: this is not a traditional cyclical inflation, but rather a major secular inflation. Therefore, most of the traditional cures for a cyclical inflation are not appropriate today; they have not worked and they won't work. If we can keep this distinction always in mind, we will have taken a giant step forward in understanding our economic environment and coping with it, and we will better judge the outlook for interest rates.

Remedies for Inflation

The distinction between cyclical bulges in the rate of inflation and a secular uptrend in the rate of inflation is all the more important because appropriate remedies for one are sometimes the reverse of appropriate remedies for the other. For example, one of the most obvious remedies for a secular inflationary trend is to increase productivity, to encourage plant and equipment expenditures for power or other essential products, so as to increase our productivity and thus permit our output to catch up with demand. After all, productivity is the source of all wealth. But on the contrary, when we are trying to cool off a transitory cyclical inflationary boom, the traditional method is to discourage plant and equipment expenditures by taxation, or by tight money, or other means. Here is a direct confrontation between dealing with a medium term cyclical inflation (which up to the last ten years most of our peacetime inflations were) and with a long term secular inflationary environment which we are now in.

We can find I believe a similar distinction in the use of fiscal policy to fight inflation. If we are dealing with a transitory cyclical inflation, a tax increase creating a budgetary surplus has often been effective because it cuts down total demand. But on the contrary if we are dealing with a long term secular inflation like the present one, a much more promising remedy would be restraint on government spending thus increasing the supply of goods and services and of credit available to the private economy.

Productivity

A program based primarily on increasing productivity — more goods and services to meet the demand — seems to me basic to bringing this secular inflation under control. It is, however, necessarily a long term program: new plants and pipelines and transportation facilities take years to build and in the meantime require that resources be diverted in periods of economic growth from consumption to production which necessarily holds down living standards and keeps up prices. In the United States, since the war, most of the efforts of our government have been directed to increasing consumption and as a result our productivity has suffered serious neglect. Scarce credit has most of the time been directed to finance consumption such as residential structures, automobiles, furniture and fixtures and ordinary day-to-day purchases, while at the same time our productive enterprises have found it increasingly difficult to obtain long term credit and high interest rates have increasingly discouraged productive investment.

Let me give you an example: in the boom year of 1973 residential mortgages in the United States absorbed $51 billion net of long term credit while electric and gas utilities obtained only $6 billion net of long term credit. This is a serious imbalance and calls into question our government's efforts to divert so much savings into housing. As a result, alas, a long list of needed power projects were abandoned in 1974. And yet our government has and is still exerting its power to divert new funds from the market for corporate bonds (a productive market) into the now depressed market for real estate mortgages. No doubt it is important to revive the depressed housing market but this should not be done at the expense of future productivity.

There are, of course, many other ways to improve productivity besides building new plants. All sorts of featherbedding legislation should be repealed and tariffs adjusted so as to bring in scarce needed supplies at good prices. In addition business economies dictated by the present recession will improve our productivity — but please keep in mind I am talking about long range productivity and not short range shifts in labor utilization.

One of the most discouraging and inflationary by-products of the recent oil embargo was to lead my country and many others into programs of self-sufficiency, not only in oil but in other essential pro-

ducts. This is understandable but could imply a gigantic drop in our productivity, as it is apt to divert scarce capital resources from other productive needs without making a net increase in goods and services available to consumers. One of our earliest lessons in economics stressed the obvious advantages of the division of labor in any community. With nations this means trading as freely as possible with each nation producing and selling those things in which it is most efficient and buying abroad those things which others produce more effectively. Alas, the embargo ended all that, at least for the time being, and the world as a result is moving towards a stockade economy dominated by expensive preparations for an era of economic warfare. This very threat makes it all the more important that we divert large resources away from consumption towards building up our productivity.

Some will say that the present recession is freeing abundant resources which will be available for both consumption and productivity. This is partly true, although the inflation is still using up scarce credit on a huge scale in spite of recession. However, my concern is how we will finance the next recovery which many believe will start late this year: will capital resources then be again directed to such consumption stimulants as housing and consumer goods and consumer credit, or will we take advantage of this cyclical period of oversupply in order to build up our productivity ?

Monetary Policy

One of the best illustrations of the contrast between remedies for cyclical inflation, and remedies for secular inflation, is to be found in the area of monetary policy. Monetary policy has in earlier decades been effectively used to fight cyclical inflations but attempts to use it also to fight this secular inflation have been disappointing. The reason is not hard to find. Tight money is used to discourage capital formation and this helps to cool off a cyclical boom. Now holding down plant and equipment expenditures was a sound method of cooling transitory booms but is quite undesirable when dealing with a serious capital deficiency. No doubt our present capital deficiency and hence inadequate productivity stemmed in part from the earlier monetary restraints which were necessary to arrest cyclical inflations. Thus if my distinction is correct our monetary authorities should, theoretically at

least, use very tight money to combat cyclical inflations and not rely on it to combat secular inflations.

Of course, this dictum is difficult to implement for two reasons: 1) at the early stages of an inflation it may be impossible to label the inflation as cyclical or as secular, and 2) any sizable inflation will eat up all the money supply that is fed to it, however large the amount, so that even if an inflation is clearly secular, there must be a limit to the creation of new credit. Furthermore, regardless of monetary policy, in any inflation there is sure to be high interest rates. Perhaps the more new money created, the higher the rates of interest.

Nevertheless, my distinction is vital. Cyclical inflationary peaks can be contained effectively by tight money (more efficiently, of course, if this is supplemented by a restrictive fiscal policy), but on the other hand tight money simply does not control a secular inflation. Indeed by freezing productivity it tends to perpetuate the inflation and make it worse.

Since 1965 when the present secular inflation began, there have been at least two conventional business cycles, maybe three, and monetary policy has shifted from ease to stringency, to ease, to stringency, in keeping with conventional cyclical theory. Alas, the net result has been anything but happy because these monetary policy shifts did not take account of the deep underlying causes of the inflation which, therefore, went on spiraling. A long range fundamental cure was needed but the need was not recognized in time. Indeed, even today we are treating this inflation with the same cyclical remedies which we used in 1959. I do not mean to imply that we could have had easy money in 1970 and in 1973 and 1974, but that we should not have relied on monetary policy to stabilize our economy.

Demand

In these comments thus far, I have not touched on the other side of the equation — demand. Excess demand all over the world was, in the absence of adequate productivity, the immediate cause of this inflationary spiral. This was true only because the demand, created by social and political imperatives, was not met by any effective efforts to promote productivity. For example, pumping billions of government money into housing stimulated demand, but did little to produce the

future goods and services needed to meet the demand. We in the United States, since the war, have gone all out to stimulate consumption demand, but much less to stimulate the supply of goods and service to meet this demand. Credit has been directed massively by our government and by our institutional structure into consumption (housing, for example) and much less into production (factories, for example).

And now once again in 1975 we are apt to be diverted from striving for a fundamental cure for inflation by the arrival of one more recession, this time a severe one. Attention is being directed towards curing the recession and if the recession is as serious as I expect, the need to fight inflation is sure to take second priority. And, of course, the recession should be cushioned.

It is I believe erroneously thought that these two economic objectives are antithetic, that fighting inflation means deepening the recession or fighting recession means stimulating the inflation. This antithesis is valid only if this were a cyclical inflation which it certainly is not. Methods appropriate to fight this secular inflation are long range and would, by stimulating productivity, actually help cure the recession. If I am right about the nature of our inflation, there is no dilemma at all. A massive long range effort to build up our productive capacity would encourage demand and reverse the recession. However, credit should not then be force-fed all into consumption, but rather in part into productivity. I am not primarily concerned about our method of financing this recession which, of course, needs some demand stimulation — I am concerned about how we finance the next recovery. We should not then return to a period of overconsumption and underproduction.

Some of my economist friends are forecasting a sharp cyclical decline in the rate of inflation in the United States in 1975. I hope so. But the obvious danger here is that we may jump to the conclusion that our battle against inflation has been won and, therefore, relax our guard. Again, the real question is what happens next — what does the rate of inflation do in the next recovery. If we can enjoy stability only in recessions, we are very badly off indeed. There is nothing now visible that would prevent the next business upswing from restimulating inflation, indeed to new high levels. Hence, my emphasis

on a long range program to keep our productivity ahead of demand even when the latter is restimulated and rising.

Indeed I am probably suggesting something like a privately managed five year plan. This plan would aim at rebuilding our obsolete capital equipment, enlarging our sources of energy, strengthing our currency, ending scarcities and providing our people in future years with the possibility at least of higher living standards in real terms — not just paper escalations. Such a program would require many, many facets and innovations, but I am sure it could be accomplished within the framework of our free enterprise system. Indeed something of the sort may be required to maintain our free enterprise system and the personal liberties which go with it.

Today I have not attempted to mention all of the ways in which our secular inflation could be attacked. I have emphasized productivity, especially through directing credit to plant and equipment expenditures rather than to consumption. Of course, fiscal policy could make a gigantic contribution if during the next recovery period it absorbs less credit and thus redirects vast sums for rebuilding our productive plant. There are many other devices by which our long run inflation could be controlled once we recognize the long range nature of the problem and stop dealing with it as a quarter-by-quarter cyclical evil.

Interest Rates

What does this analysis suggest for the future of interest rates in the United States ? Here again we will benefit if we recognize the dual nature of our problem: a powerful cyclical trend superimposed on an even more powerful secular trend. If we direct our attention solely to just one of these, we are sure to be misled sooner or later. The existence of these two simultaneous market forces means that when both coincide we will see enormously rapid market fluctuations and when they are moving in opposite directions we will see surprisingly moderate fluctuations.

For example in the first three quarters of 1973 both trends favored higher interest rates and the rise was spectacular especially in short term rates. Thereafter with the onset of a then mild recession the cyclical trend gradually shifted in the direction of firm or lower rates, while the inflation worsened. As a result we had, in 1974, wide

rate fluctuations in both directions, frequent vigorous reversals which constantly surprised the market participants. So vigorous was the inflation that at one time in the recession year of 1974 yields reached new highs, but most of them soon came down again. Nevertheless, throughout 1974 inflation was the dominant force and all rates remained very high in spite of a deteriorating business picture.

Right now, with accelerating recession, the cyclical trend towards lower yields should become more forceful. However, with a continuing disastrous rate of inflation the secular trend towards higher rates is still powerful. Thus we have recently had big zigzags in long yields and it is just this that we should expect for the rest of this year.

Recently in another area there have developed conflicting market trends. The serious nature of this recession and the many political and economic uncertainties around the world have led to a sudden preference for prime quality investments. Thus, we have lately seen prime bonds advance in price while good medium grade issues have declined. Ratings have been reduced and some erstwhile market favorites, for example the electric utilities, are under a cloud. Indeed a low level of liquidity throughout our economy has been created by the inflation. Inflation builds up liabilities much faster than capital funds can be accumulated. Thus, there is a fear of insolvencies. It looks as though a preference for prime credits, especially governments, will be a feature of our bond market for some time to come.

I might now mention other technical forces within our market which should affect medium term price movements and to some extent temporarily offset the continued overriding power of the inflation. With the worsening of the recession, which will probably continue through most of this year, business demands for short term credit should decline sharply in 1975 both in the banking system and in the open market. Therefore, given a more accommodating monetary policy, the banking system should be able to help finance a large government deficit and also assist the depressed market for municipal bonds. Again, while the mortgage market may recover later in the year, its requisitions for the year as a whole should be far below the huge 1973 volume. On the other hand, low liquidity assures a very heavy volume of corporate bond financing, especially during the first half year and concentrated in prime credits, and also probably a large volume of

stock financing. Government agencies should be smaller borrowers and lenders. Consumer credit demands should continue depressed.

On the other side of the equation, the flow of non-bank institutional funds to the market should increase moderately and the expansion of bank credit should rise substantially. There is also a good chance of increased foreign investment in our market. Thus, on balance, an easier statistical picture presents itself for prime credits which suggests the obvious — that in a recession cyclical trends are in the direction of lower prime yields.

However, my main point today is that it is not enough to watch the business cycle. The great inflation is still with us and its disastrous consequences around the world have not yet been fully exposed and our credit markets are still overextended.

Until the secular inflation is controlled it is hard to see any sustained trend to lower long term yields. But the analyst must be alert to events which will spell the end of the inflationary boom. It may end itself, as most booms have done, by a financial breakdown. Alternatively, it may end by the not impossible development of effective long range government policy. In either event, cyclical and secular trends would then coincide in favor of substantially lower interest rates. This is a hope — not a forecast.