Historical Inflation Parallels – Apples to Pineapples!

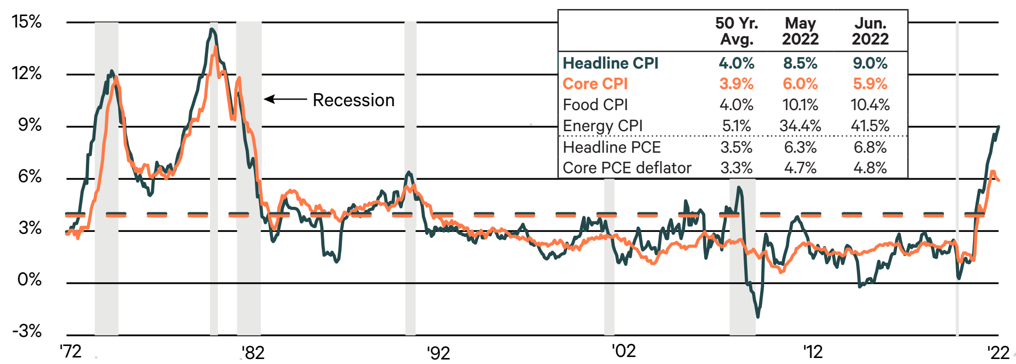
What Happens Next?

"History doesn't repeat itself, but it often rhymes."

Mark Twain
American Writer

Financial market observers study historical events and look for parallels that may portend similar outcomes to present day scenarios. Inflation is the current past-to-present market obsession that investors have not had to address for decades. This time, however, comparing inflation past-to-present may not be the most useful historical parallel to determine what comes next.

FIGURE 1: CPI AND CORE CPI
% Change vs. Prior Year, Seasonally Adjusted



Data presented is as of July 31, 2022 and is obtained from BLS, FactSet and J.P. Morgan Asset Management and is assumed to be reliable. CPI used is CPI-U and values shown are % change vs. one year ago. Core CPI is defined as CPI excluding food and energy prices. The Personal Consumption Expenditure (PCE) deflator employs an evolving chain- weighted basket of consumer expenditures instead of the fixed-weight basket used in CPI calculations. ***Past performance is no guarantee of future results.*** *Returns could be reduced, or losses incurred, due to currency fluctuations.*

Where We Are Now

Today's inflation emerged from the pandemic, which caused lockdowns, supply chain challenges, and large government stimulus flooding the economy. Once lockdowns subsided, people were ready to enjoy life again. Travel, shopping, visiting friends and family, and spending money accelerated quickly. The economy classically had too much money chasing too few goods, causing inflation to rise quickly. Just when things started looking better for the economy and the markets and there was hope that inflation could be contained, the war in Eastern Europe started and sanctions against the Russian Federation triggered shortages in oil, wheat, corn, and other

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raw materials. To make matters worse, China, to address its "zero COVID policy," locked down sizable portions of its population post-COVID. A massive drought in the western United States contributed to rising costs of food and energy.

These unforeseen events— impossible to forecast—once again whipsawed supply chains creating more shortages, which spiked inflation further. This soured investor sentiment. As a result, financial markets recorded one of the worst six-month starts in more than 50 years.

How does inflation in 2022 compare to the last time inflation was high?

Where We Were Then

There are more differences than similarities comparing the 1970s-1980s era of high inflation to today's inflation scenario. The two time periods share the political and economic challenge of inflation, and that is where comparisons end. We like to say any comparisons between the two are like comparing apples to pineapples.

The 1980s experienced double-digit unemployment (10.8% in 1982 vs. 3.6% today)[1]. The 10-year Treasury in 1981 was at 15.84% vs. 3.00% today[2]. FreddieMac mortgage rates in 1981 averaged 16.63%[3] compared to about 5.3% today[3], and trending lower at the time of this report. Inflation peaked at 14.8% in March 1980[4], compared to today's 9.0% for the 12 months ended June 2022[4]. Paul Volker, who served as chair of the Federal Reserve from 1979 to 1987, took drastic steps to end the high levels of inflation throughout the 1970s and early 1980s by raising interest rates to nearly as high as 20%[5], which stopped inflation but caused a recession. Today's federal funds rate is 1.50%-1.75%[6] and probably will approach 3.5% by year-end 2022 – low by historic standards. Today's Fed Chair, Jerome Powell, is taking much slower steps to restrain growth in money and credit, by steadily raising interest rates over time and broadly communicating future rate expectations.

As for the equity markets, in the late 1970s/early 1980s, the stock market was dominated by institutional investors and pension funds, which is no longer true with today's expansive global capital markets. Inflation had been trending higher since the mid 1960s and had contributed to slow economic growth and bear markets, which had created a sense of malaise among investors.

This culminated in an infamous BusinessWeek cover story in 1979 titled, "The Death of Equities"[7], which noted that inflation was destroying the stock market due to the distorting effect that inflation had on financial markets and its capital flows. Instead 1979 was the year that a multi-decade bull market began as investors anticipated the coming peak and ultimate decline in inflation and the removal of its corrosive impacts on the economy and stock markets.

1 https://www.thebalance.com/unemployment-rate-by-year-3305506
2 https://ycharts.com/indicators/10_year_treasury_rate#:~:text=Historically%2C%20the%2010%20Year%20treasury,an%20effort%20to%20contain%20inflation
3 https://www.freddiemac.com/pmms/pmms30
4 https://www.bls.gov/opub/ted/2022/consumer-prices-up-8-6-percent-over-year-ended-may-2022.htm#:~:text=From%20May%202021%20to%20May,the%20period%20ending%20December%201981
5 https://alfred.stlouisfed.org/graph/?g=SnyV
6 https://alfred.stlouisfed.org/graph/?g=SnyO. *As of July 31, 2022.*
7 https://ritholtz.com/1979/08/the-death-of-equities/

FIGURE 2: Inflation and the S&P 500® Index

Year		1970	1971	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984
Inflation		5.84%	4.29%	3.27%	6.18%	11.05%	9.14%	5.74%	6.50%	7.63%	11.25%	13.55%	10.33%	6.13%	3.21%	4.30%
S&P 500® Index	1 Year	4.01%	14.31%	18.98%	-14.66%	-26.47%	37.20%	23.84%	-7.18%	6.56%	18.44%	32.42%	-4.91%	21.55%	22.56%	6.27%
	3 Year			12.26%	5.09%	-9.28%	-4.87%	7.70%	16.40%	7.00%	5.42%	18.67%	14.25%	15.24%	12.31%	16.55%
	5 Year					-2.35%	3.21%	4.87%	-0.21%	4.32%	14.76%	13.95%	8.08%	14.07%	17.31%	14.79%

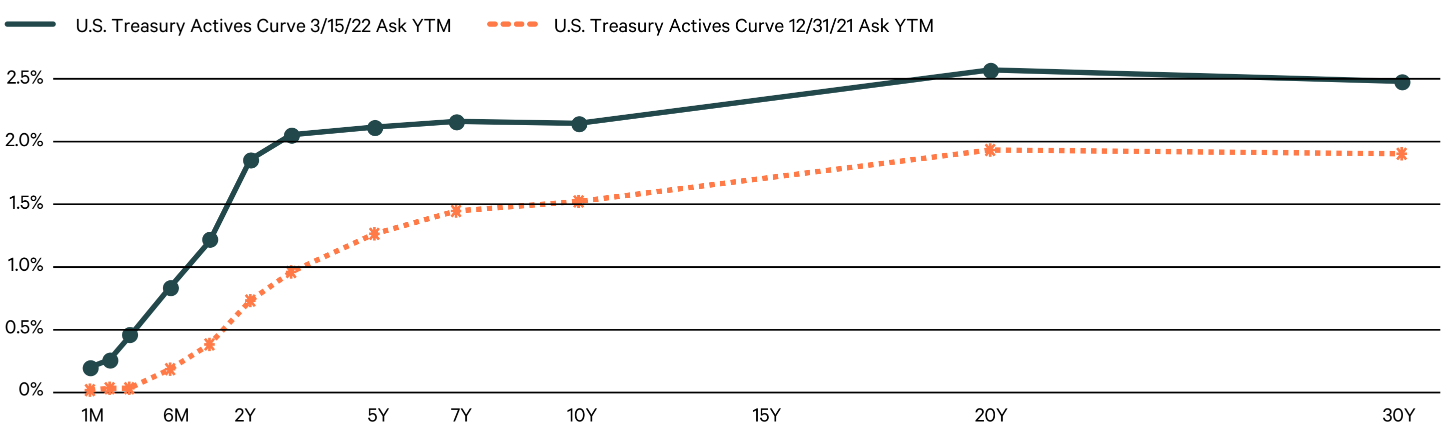
Source: FactSet Research Systems. Data is assumed to be reliable. This information is being provided by Kayne Anderson Rudnick Investment Management, LLC ("KAR") for illustrative purposes only. **Past performance is no guarantee of future results.** *Returns could be reduced, or losses incurred, due to currency fluctuations.*

Inflation Rate Forecast for 2022

The Federal Reserve started rising rates rapidly to slow the economy (initially by its transparent jawboning beginning in January). This had the effect of getting the bond market to start the heavy lifting of moving interest rates. On top of the 50-basis point moves in March and May, and the 75-basis point increases in June and July, the Fed has forecasted another half-percentage-point rise in September and quarter percentage point moves through November. Classic monetary policy works with a lag of typically 6-to-18 months from the first interest rate increase, which in this case began in January. Figure 3 shows the movement in the bond market prior to the Federal Reserve's first rate increase in March 2022.

FIGURE 3: YIELD CURVE SHIFT

From January 1, 2022 through March 15, 2022



Data presented is as of March 15, 2022. Data is obtained from Bloomberg and is assumed to be reliable. March 15, 2022 was the date of the first interest rate hike by the Federal Reserve. **Past performance is no guarantee of future results.** *Returns could be reduced, or losses incurred, due to currency fluctuations.*

There are signs of inflationary relief on the horizon starting with the consumer (70% of GDP). We have seen material retail sales shortfalls at large retailers and consumer confidence has hit 40-year lows. New orders for the Purchasing Managers' Index (PMI) have fallen below 50 which signals contraction. Raw materials, such as copper, aluminum, nickel, and zinc, have already experienced significant declines in price in the second quarter. Late in the quarter, even the strongest sectors (oil and semiconductors) started to show significant weakness. The Fed may be closer than investors realize to bringing inflation under control and slowing growth.

While a shallow recession is possible, this should not scare investors. Several strong tailwinds exist that could keep recession at bay:

- Unemployment is low—we have widespread employment and millions of job openings.
- Consumers are in good shape financially and have extra cash from government financial support and reduced spending during the pandemic. The same is true of many state and local government municipalities who benefitted from government stimulus along with real estate and sales tax boosts.
- Better supply-side metrics are taking shape with shipping bottlenecks slowly clearing.

These tailwinds should help blunt the worst effects should a recession arrive. We believe the biggest risk is the Fed overshooting rate increases and slowing the economy more than expected. There is also the possibility of more unknown risks, such as the unknowns that surfaced with the war in Ukraine and the China lockdowns that surprised global markets and caused unexpected disruptions and market volatility.

FIGURE 4: CIVILIAN UNEMPLOYMENT RATE AND YEAR-OVER-YEAR WAGE GROWTH
Private Production and Non-Supervisory Workers, Seasonally Adjusted, Percent

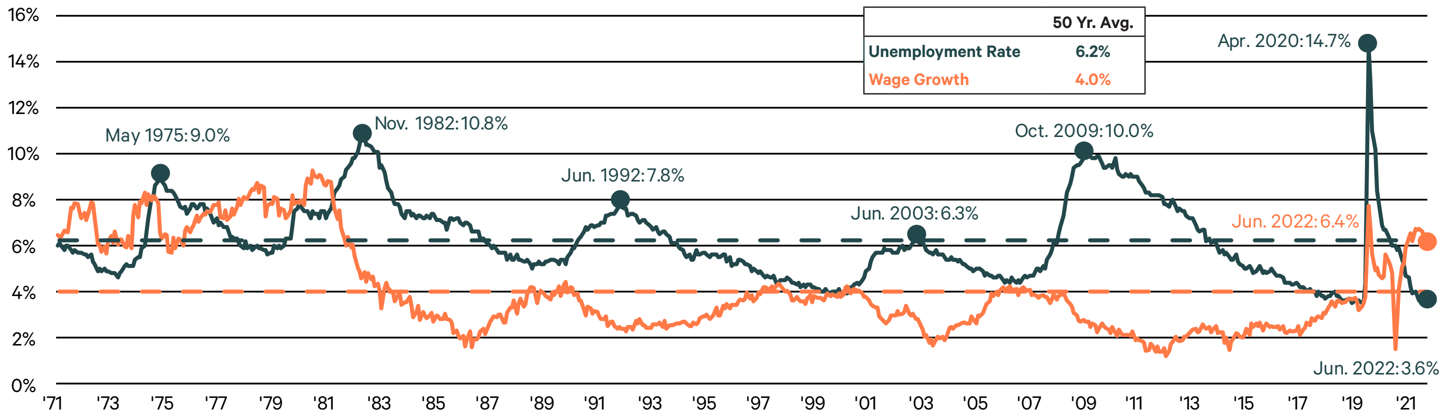


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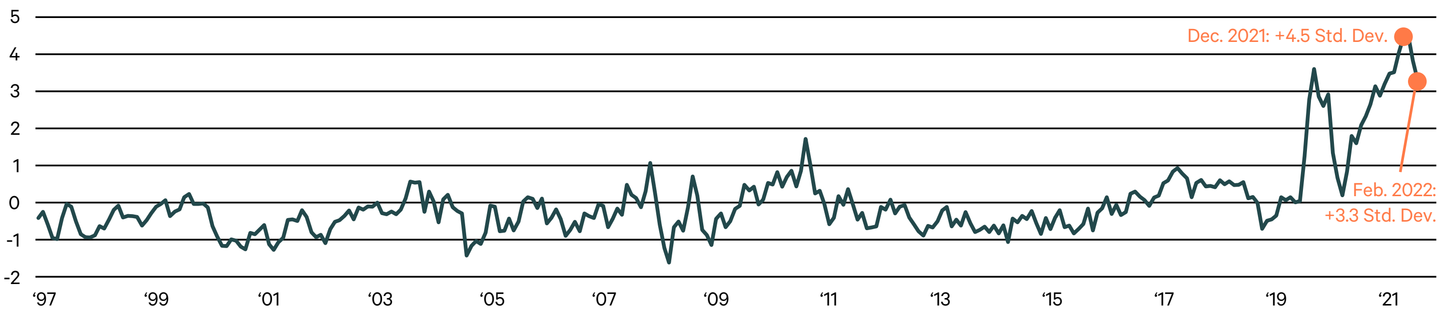
FIGURE 5: FED GLOBAL SUPPLY CHAIN PRESSURE INDEX*

Standard Deviation From Average Value



*Data presented is as of March 31, 2022. Data is obtained from Federal Reserve Bank of New York, IHS Markit and J.P. Morgan Asset Management and is assumed to be reliable. March 15, 2022 was the date of the first interest rate hike by the Federal Reserve. *The Federal Reserve Bank of New York bases its Global Supply Chain Pressure Index on the Baltic Dry Index (benchmark for the price of moving raw materials by sea), Harpex Index (benchmark for the rate liners pay to charter ships), BLS airfreight cost indices (benchmarks for measuring change in rates for air transpiration) and 3 PMI supply chain-related components: delivery times (the amount of time elapsed between the time an order is placed and the time it is shipped), backlogs (the volume of orders that a company has received, but not yet fulfilled) and purchased stocks (the level of inventory of materials purchased in the current month compared to the month prior) for manufacturing firms across seven interconnected economies: China, the euro area, Japan, South Korea, Taiwan, the United Kingdom and the United States.* ***Past performance is no guarantee of future results.*** *Returns could be reduced, or losses incurred, due to currency fluctuations.*

KAR's Focus

We believe that our continued focus on identifying high quality businesses that benefit from scale, protected markets, and sustainable pricing power means that we identify businesses that are likely to fare better than lower quality companies operating in more competitive markets. This is because we believe that high quality companies are more likely to grow earnings even in an inflation-to-recession economy.

We believe the longer-term market outlook is favorable, as valuations have become attractive with many stocks showing double-digit declines off their highs. The speculation that was rampant across IPOs, SPACs, and meme stocks is now essentially non-existent, which provides a more favorable long-term investing environment. In our view, quality companies have started to perform better on a relative basis, as we would expect given the slowing environment and flattening yield curve. On the fixed income side, we view the current environment as an opportunity to apply fundamental research and active management to source new high-quality tax-exempt bonds at more attractive prices and higher yields to build annual portfolio income.

While we cannot predict a soft-landing, if inflation show signs of slowing, the Fed may not have to be as aggressive in raising rates. For long-term investors, one important takeaway from past historical parallels indicates that patience has been rewarded.

Kayne Insights

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