MV CAPITAL MANAGEMENT

Weekly Market Flash

The Fork in the Road

March 16, 2018

Readers of a certain age might remember a perennial favorite among the many outstanding skits performed by late-night TV host Johnny Carson (hi, kids! – ask your parents or their parents). Playing a manic movie review host named Art Fern, Carson would suddenly display a spaghetti-like road map and start giving inane directions to somewhere, leading to the gag: “And then you come to – a fork in the road” at which moment he points to a space on the map where an actual, eating utensil-style fork is crudely taped over the incoherent network of roads. Ah, kinder, simpler, Twitter-less times, those were.

The fork in the road was a key theme of our annual outlook a couple months ago (no match for Art Fern in wit or delivery, but still…). Are we heading down one path towards above-trend growth powered by an inflationary catalyst, or another one characterized by the kind of below-trend, muted growth to which we have become accustomed in this recovery cycle thus far? For now, the data continue to point to the latter.

No Seventies Show, This

Carson’s heyday as host of the Tonight Show was in the 1970s, that era of cringe-worthy hairstyles, mirror balls and chronic stagflation. When the Bretton Woods framework of fixed currencies and a gold exchange standard fell apart in the early years of the decade it freed countries from their exchange rate constraints and encouraged massive monetary stimulation. The money supply in Britain, to cite one example, grew by 70 percent in 1972-73 alone. More money chasing the same amount of goods is the classic recipe for inflation, which is exactly what happened. OPEC poured flames on the fire when, as a geopolitical show of strength, it raised crude oil prices by a magnitude of five times in late 1973. A crushing global recession soon followed as industrial output and then employment went sharply into reverse, with countries unable to stimulate their way out of the mess caused by inflation.

A popular delusion in the immediate wake of the 2016 US presidential election was that some modern day variation of that early-70s stimulus bonanza was about to flood the economy with hyper-stimulated growth. Interest rates and consumer prices would soar as the new administration tossed out regulations, slashed taxes, lit a fire under massive public infrastructure and induced companies to kick their production facilities into high gear. The “reflation-infrastructure trade” flamed out a couple months into 2017 (though CNBC news hosts never got tired of hopefully invoking the shopworn “Trump trade is back!” mantra for months afterwards, every time financial or materials shares had a good day).

Herd-like investor tendencies aside, though, there was – and to an extent there continues to be – a case to make for the return of higher levels of inflation. Economies around the world are growing more or less in sync, which should push both output and prices higher. Taxes were indeed slashed – the one piece of the reflation trade puzzle that actually transpired – and as a result the consensus estimates for US corporate earnings have moved sharply higher. And yet, the numbers keep telling us something different.

Secular Stagnation Then, and Now

When we say "numbers" we refer generally to the flow of macroeconomic data about growth, production, consumption, labor, prices *et al*, but we've been paying particular attention to inflation. The core (excluding food and energy) Personal Consumption Expenditure (PCE) index, which is how the Fed gauges inflation, has been stuck around 1.5 percent for seemingly forever. This past Tuesday gave us a fresh reading on the core Consumer Price Index (CPI), the one more familiar to households, holding steady at 1.8 percent. We also got another lackluster reading on retail sales this week, suggesting that consumption (the largest driver of GDP growth) is not proceeding at red-hot levels. And last week's jobs report showed only a modest pace of hourly wage gains despite a much larger than expected increase in payrolls. These numbers all seem to point, at least for now, towards the path of below-trend growth. Perhaps the bond market agrees with this assessment: the yield on the 10-year Treasury has been cooling its heels in a tight range between 2.8 – 2.9 percent for the past several weeks.

The economist Alvin Hansen coined the phrase "secular stagnation" back in the late 1930s, at a time when it seemed that long term growth lacked any catalyst to kick it in to a higher gear. We know what happened next. The war came along and rekindled productive output, followed by the three decades of Pax Americana when we ruled the roost while the rest of the world rebuilt itself from the ashes of destruction. Former Treasury Secretary Lawrence Summers brought the term "secular stagnation" back into popular use earlier in this recovery cycle. The numbers seem to tell us that this remains the default hypothesis.

But the story of the late 1930s reminds us that all a hypothesis needs to knock it off the "most likely" perch is the introduction of new variables and resulting new data. Foremost among those variables would be productivity (hopefully productivity from benign sources, and not from hot geopolitical conflict). It may well be that we have not yet arrived at that "fork in the road" but are still somewhere else on Art Fern's indecipherable road map – and that a new productivity wave will pull us off the path of secular stagnation. The data, though, aren't helping much in signaling when, where, and how that might happen.

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