

# THE BUTTONWOOD



Second Quarter 2006



On May 17, 1792, twenty-four merchants gathered under a buttonwood tree at 68 Wall Street.

There they signed the *Buttonwood Agreement*, creating the first investment community, which later evolved into the New York Stock Exchange.

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## DO NOT INFLATE OVER 2.0% PER YEAR

By Henry Wildhack

In the 1970s, gold rose to over \$800 per ounce, OPEC initiated an oil embargo, there were wars in the Middle East. By mid-decade, the Dow Jones Industrials dropped by almost 50%, and the economy was a mess as inflation peaked at over 14%. Today, the price of gold has doubled to over \$500 per ounce, oil - supply, demand, refining and price per barrel - continues to make daily headlines, we are at war in the Middle East, the stock market has been through a correction not seen since the aforementioned 1973-1974 period and inflation has doubled since early 2000. I seem to hear people ask if history is repeating itself. Are we are in fact heading toward a trend of increasing commodity prices and high inflation?

In order to address this issue some perspective is in order. The seeds for the high secular inflation rates from 1970 to 1982 were sown in the mid 1960s. A December 1973 report by the Federal Reserve Bank of St. Louis stated that "the current inflation began in the mid 1960s in response to increased expenditures for the Viet Nam war, a rapid acceleration in the implementation of social programs, and the methods by which these activities were financed." Translated this means that the Johnson administration's policy of financing the Viet Nam war and the Great Society programs of the mid 1960s without raising taxes resulted in increased dollar outflows to pay for the war and hence inflation. At the start of the war in 1964 the inflation rate was 1.31%. By the war's end in 1974 the rate had climbed to 11.04%.

While there were a confluence of many factors that came together in the early 1970s that further fanned the inflation flames, the watershed event that brought this increase into our living rooms was the Arab oil embargo of October 1973. The effects of the embargo were immediate and hit American industry and the consumer hardest and where it hurts the most - the bottom line and the wallet. As the price of oil quadrupled to \$12/barrel by 1974, it quickly became apparent that no US business model had not anticipated this. The consumer was equally as

shocked when a gallon of gas jumped from the national average of 38.5 cents per gallon in May of '73 to 55.1 cents by June of '74. (Were those the good ole days?!)

Officially the embargo ended in March 1974 as a result of the Washington Oil Summit. But the genie was out of the bottle and further federal government missteps only made the situation worse. Included among them were price controls which limited the price of oil already discovered while newly discovered oil prices were allowed to match current market levels. The folly in this is obvious and the policy did nothing to remedy the underlying causes of inflation. The Ford administration issued "WIN" buttons (whip inflation now) which is akin to a pep rally on the eve of Armageddon. Late in his term as president, Jimmy Carter suggested that Americans were "suffering from a crisis of confidence" while the ravages of inflation and stagflation persisted.

On the surface no administration from Johnson through Carter placed a high enough priority on taming inflation. The politicians of the day were more interested in creating social programs to deal with every problem the nation faced, solving the energy crisis or making certain that current economic conditions didn't get worse. The irony here is that most of these programs were inefficient, didn't address the underlying causes of the problem and to some extent were inflationary in and of themselves.

It was not until late in the decade and early in the 1980s that politicians realized what inflation was doing to the underlying prosperity of the US economy. Washington finally realized that, if nothing was done, the nation could be looking at the prospect of permanent double-digit inflation. Finally a mandate emerged that said do what ever is necessary to break the back of inflation. The medicine came in the form of extremely high interest rates and resulted in a severe recession in the early 1980s. Federal Reserve chairman Paul Volker's policies set the stage for a secular decline in inflation, a gradual lowering of interest rates, and a period of stable economic growth from 1982 through 1999.

## DO NOT INFLATE OVER 2.0% PER YEAR - CONTINUED

If we fast forward to today we can't help but read the headlines that shout about a 3 cent stamp costing 39 cents today, gas at \$0.55 per gallon in 1974 vs. almost \$3.00 today, a new house in 1959 costing \$14,999 as compared to \$282,300 etc. There are other alarming parallels also. Recent upticks in inflation coincide with an increase in war spending and a tax cut, budget deficits are rising and oil prices are increasing. Admittedly consumer price increases seem mild today just as they were in the mid 1960s. But could they gradually spiral out of control just as they did in the late 1960s?

Despite these alarming similarities there is one significant difference that should be brought to light. Today the US economy is much more productive than it was back in the mid '60s and throughout the '70s. I can recall vividly the summers when I had a job in the General Motors/Chevrolet foundry in Tonawanda, NY. This facility poured the castings for Chevy engine blocks. How unproductive was the assembly process back then you ask? Shortly after I was hired as a summer employee I went home and told my father that the wonder was not that GM cars broke down, (remember the Vega) the wonder was that they ran at all! Typically a 19 to 20 year old has his mind on things other than productivity levels. But the lack of productivity was blatantly obvious to even the most casual observer.

Productivity growth, defined as the amount produced for a given amount of labor, slowed to less than 1% throughout the 1970s. In the last 15 years, productivity growth has averaged 3% to 4% per year. The key here is that faster productivity growth allows for faster wage growth without inflation. Another significant difference is the demand for higher wages. From 1971 to 1975 hourly wages climbed by 40%. During the same period labor productivity climbed by 6.5%. In 2005 wages rose by 3.7% and productivity rose by 3%.

Another variable we have to consider is prices on a relative basis. In 1980 the average monthly price for a barrel of oil was \$38. In today's dollars, a barrel of oil would have to average almost \$100 on an inflation adjusted basis to equal the 1980 price. Gold, which peaked at over \$800 per ounce, would have to climb to almost \$2000 today. Finally, during

Paul Volker's tenure as Fed Chairman from 1979 to 1987, prices rose less than 3% only once. Today Chairman Bernanke has identified a comfort zone in the 1 to 2% range.

Now that we have come "full circle" you might wonder what's the big deal? The answer is one of credibility and expectations. Stephen Axilrod, an advisor to the Fed under the Volker regime, stated that Bernanke is a relative unknown and untested Fed chairman who is following in the footsteps of 18 years of Greenspan. Mr. Axilrod has stated that "they are on the edge of losing their credibility...that gives them an immense dilemma." Indeed Mr. Bernanke seems to be going through somewhat of an initiation process as the markets seem to turn up or down on his every quote. There seems to be little question that Wall Street and the Fed chairman are going through somewhat of a feeling out process.

The expectation side of the equation is just as important. There is little doubt that the Fed wants to reduce inflation expectations, set very low tolerances for inflation growth and eliminate the inflation psychology that was rampant in the '70s. My sense is that the Fed is less worried about the runaway inflation of the '70s and is more worried about the early signs of inflation we see today that mirror the first increases in inflation in the mid '60s. Perhaps Charles Schultze of the Brookings Institute summed it up best when he said "you don't want inflation to be built into people's planning. Once that happens, then prices in one sector get passed to another, and then into wages then inflation starts to climb even faster."

While I for one do not think we are returning to the runaway inflation of 35 years ago, I do think that the Fed has a tough job at this particular juncture. There is little room to debate the notion that low inflation is necessary for stable economic growth. Today inflation pressures rear up on many fronts. These include energy, housing, commodities and to a lesser extent wages. In addition the Fed is setting policy in an international economic environment. How fine a line is the Fed treading on? Inflation at 2% will double prices every 36 years, 3% doubles prices every 21 years. If you're planning for retirement, that is a significant difference. There is no question Mr. Bernanke is following a legend in Mr. Greenspan. While it is only fair to give him a chance we must also hope he is up to the challenge.

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