



As We See It

It gets harder and harder to support the government
in the manner to which it has become accustomed.

- Anonymous

Our investment approach is not greatly influenced by short-term or cyclical economic forecasting. Rather, our approach reflects a serious attempt to identify long-term or secular trends which are important to the investment process. One such trend we continue to foresee, is the secular decline in the rate of inflation.

Although inflation has cyclical characteristics—rising and falling with the business cycle—the prevailing trend of inflation tends to be long term in nature. While there are a wide variety of forces that can be cited as contributing to inflation, A. Gary Shilling and Kiril Sokoloff identify government activity as the central cause in *Is Inflation Ending? Are You Ready?*. In their book, published in 1983, they point out that in 1929, federal spending as a percentage of the gross national product (GNP) was a mere 3%. By 1982, when they were completing the book, the federal government was absorbing nearly a quarter of the GNP. The measure was closer to 36% when state and local government spending were included.

In the opinion of Shilling and Sokoloff, this rise in government spending was associated with a change in the attitude of the electorate. Following the devastating Great Depression of the 1930s when unemployment reached 25%, it was only natural for the public to fear economic weakness and elect representatives who espoused government programs designed to mitigate the effects of economic downturns. The New Deal of the 1930s, the Full Employment Act of 1946 and the war on poverty of the 1960s are examples of programs and legislation designed to protect people from economic hardship. Each program promoted low unemployment and encouraged bigger government. At the time, this was acceptable to the electorate. Past rates of inflation gave little reason for concern about the inflationary tendency of these actions.

Gradually, the national attitude about government and its ability to solve problems began to change. Most likely, the impetus for this change started with frustration over Vietnam and the disappointment with the many programs of the Great Society that failed to live up to expectations. These events were soon followed by the 1973-1975 recession—the most severe economic downturn this country had experienced since the 1930s. As the decade progressed, an ever-higher inflation ensued. As those fearful of another depression became a smaller percentage of the population, an increasing proportion of the electorate began to experience the uncertainty caused by the frightening rate of inflation and, *it*, not unemployment, became the top-rated national economic concern.

A shift in voter attitudes away from big government which began in the 1970s continues to gain adherents. Now, politicians seem to realize how important it is to the public to bring government spending under control. While there is disagreement as to the specifics of balancing the federal budget, there seems to be a growing consensus that it must, in fact, be balanced. The unwillingness of the American people to tolerate fiscal irresponsibility is beginning to have an increasing influence on politicians.

While Shilling and Sokoloff found government spending and related monetary policies to be the root cause of inflation, they also identified five additional factors which, when coupled with a return to fiscal responsibility would bring an end to inflation. Those factors were, ". . . financial shifts discouraging speculation, higher savings rates, improved productivity growth, more competition (because of worldwide commodity and manufacturing surpluses, a strong dollar and reduced regulation), and a reversal of inflationary expectations and other social attitudes that promote inflation." Although each of these factors deserve and will receive elaboration at a later date, suffice it to say that these other factors are either firmly in place or have stabilized. When these factors are combined with the downsizing of government, at the margin, they build a strong argument for continued low inflation.

The moderation in the rate of inflation during the past few years is evidence of a secular as opposed to a cyclical decline in inflation. Factors that will perpetuate this trend further seem to be endorsed by the general electorate. Such an environment has been favorable for financial assets and has produced a secular bull market in stocks and bonds. As history suggests, there will be a time when the pendulum will swing back the other way, but, for now, the secular outlook for inflation remains favorable. This, in turn, continues to present a favorable backdrop for financial assets.

Year End 1995