LAWSON KROEKER
INVESTMENT MANAGEMENT

As We See It

Stagflation Revisited

Back in the 1970s a new term was coined to describe the previously unprecedented combination of rising prices and stagnant economic growth—*Stagflation.* The term stagflation identified the simultaneous occurrence of recession and inflation—a phenomenon that Keynesian economic theory had suggested was impossible. In Keynesian theory, a recession (and the unemployment implied by it) is cured by inflating (or stimulating) the economy while inflation is cured by a recession. When both occur at once, the theory is seriously challenged and fiscal policymakers and money managers are at a loss concerning what to do next.

The only occurrence of stagflation began in 1973 following the Arab oil embargo. Prices of crude oil jumped four-fold and we experienced long lines at the gas stations in order to fill up our vehicles. This embargo dramatically increased inflation. The Consumer Price Index (CPI) nearly doubled in 1973 and practically doubled again in 1974. The shock to consumers' pocketbooks helped sink the economy into recession. Policymakers were in a quandary—if they relaxed monetary or fiscal policy, then inflation would take off even more to the upside, but if they tightened, bond yields would increase further, driving the economy into a deeper recession. As we now know, policymakers chose a relaxed monetary policy which resulted in higher inflation and a no-growth economy.

Stagflation is regarded as a *four-letter* word on Wall Street, simply because that once it begins it is very difficult to reverse. It becomes a *Catch-22* in that the government does not know whether to address a potential recession or tackle inflation. We recall the years of the mid to late 70s as a period with the three doubles—double-digit interest rates, double-digit inflation, and double-digit unemployment.

Talk of stagflation is likely to come up now and again at this point in the economic cycle because the basic ingredients can be identified for the event to reoccur even though the extremes are not present as they were in the 1970s. None of the three doubles are even close to occurring today. Economists currently point to an increasing rate of core inflation and higher commodity prices that will lead us to much higher inflation. Even though both trends deserve monitoring they are far from resulting in double-digit inflation.

As for weakness in the economy, the deflating of the housing bubble will extract a heavy toll on those left holding the bag, but we believe the main impact is likely to be regional. It will probably take an unexpected shock to the system to induce stagflation. Markets adjust to information as it becomes available and as far as oil and housing go, both trends are being monitored very closely. We wouldn't be surprised to see numerous articles on stagflation in the near-term and it will make some interesting media copy, but that's about it. Conditions today are far from what they were in the 1970s.

Long time clients and readers know well that we always have an eye on inflationary forces and continually analyze its potential impact on the portfolios we manage. We're not predicting anything like the stagflation of the 70s for the U.S. economy. As a matter of fact, we don't believe anyone can accurately predict the economy, but we think it is always prudent to be aware of forces in the marketplace that could affect investment prospects.

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