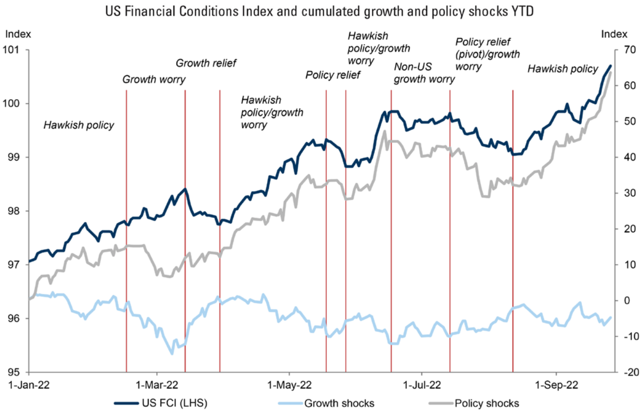
Volcker Revamped & Red October's Liquidity Hunt

Rate Divergence, Deleveraging & Dollar-Deflation



"*No, you're wrong Senator*", rebuked the 6'7" foot man, chuffing deeply on the *twenty-five-cent* cigar, when asked during the 1987 National Commission on the Public Service symposium whether the terminal definition of inflation, had in fact evolved from its original idea of simply being too much money chasing too few goods.

This moment, when Paul Volcker, Chairman of the US Federal Reserve Open Market Committee, or FOMC, retrohaled his cigar (the practice of blowing smoke through the nose) and illuminating the cigar's cherry ember came to be known as the "***quiet crisis***" eyewall, during the summer of '87 – two months before the forever fateful ***Black Monday*** capitulation.

[*Paul Volcker loved cheap cigars and his personal favourites were AC Grenadiers – known today as Antonio y Cleopatra Grenadiers – during Volcker's time, these sticks cost him a mere twenty-five-cents per cigar; Volcker liked them because they were "economical"*]

Nobel Laurette, Paul Samuelson said of relying too heavily upon economic doctrines, "*Funeral by funeral, theory advances*" and in 2022 we find ourselves once again facing a quiet crisis.

It was therefore a concern to hear US Federal Reserve Chairman Powell not only deliver a relatively hawkish speech at August's Jackson Hole caucus but moreover explicitly refer to the "*successful Volcker disinflation*", which did tame the 1965-1982 ***Great Inflation*** but also sent awry the *Plaza Accords*, the trigger point for October 1987's *Black Monday* Risk Asset implosion.

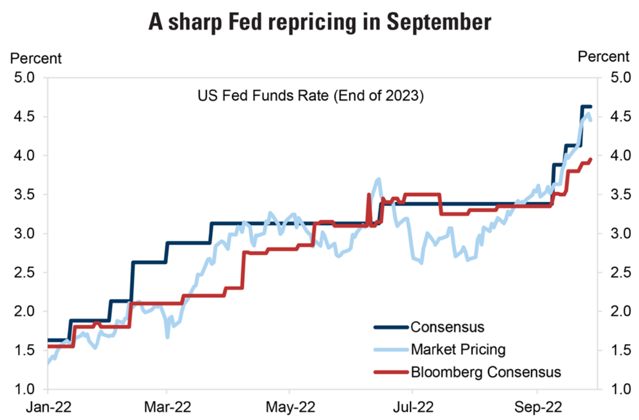
The last time the world faced the spectre of hyperinflation, the US Dollar, or Greenback, was pegged to gold, bracketing the inflationary spread possible across asset buckets, however, in 2022, the world faces a significantly different backdrop.

Following the recent market volatility, measures of market dislocation across assets have deteriorated significantly and the overall market impairment gauges have seen a ratchet higher over the past month; fueled by the weak market microstructure conditions in sovereign debt markets and an increase in funding stresses (evidently, for trans-Atlantic private banks as well).

While the liquidity in sovereign debt markets has been an ongoing issue for a while, the rise in funding stress appears to be a more recent development.

This is because of the year-end rolling into the three-month window in many funding metrics and reflects intermediation capacity constraints rather than a shortage of Greenback, notwithstanding, macro volatility emanating from Great Britain may have contributed to the velocity of funding demanded in late August and September.

Maintaining policy pressure towards tighter US



financial conditions until the American economy either enters a clear recession or shows sustained inflation progress appears to be the goal of this ***pseudo-Volcker revamp*** and equity market troughs in past monetary policy-driven corrections have always been quite closely preceded by a peak in ten-year yields, a threshold not yet reached and while the market has priced more risks of a hawkish and recessionary outcome, if the US Central Bank pushes the economy into recession, there could still be significant downside to both short-dated bonds and equities here.

To boot, last fortnight, the unprecedented British rates volatility spilled over to global bond markets and other assets after the announcement of the UK Government's mini-budget triggered a sharp sell-off of UK Gilts; in particular long-duration inflation-linked bonds which experienced an almost **10x standard deviation loss**.

The turmoil in the Gilt market has been further exacerbated by UK pension funds' LDI portfolios, whose collateral calls caused liquidity concerns, forcing asset sales and last Wednesday the Bank of England, or BoE, announced they would carry out temporary bond purchases to restore market functioning, which lowered real rates and risk premia on UK assets again.

However, despite the temporary BoE support, a weaker Sterling, persistent inflation and rising global yields present upside risk to Gilt yields in the medium term, also evidencing failed contemporary economic theorem during the seismic shifts of late 2022.

A calamitous amalgam of poorly executed policy decisions *across the pond*, conflating with a rudimentary misunderstanding of the terminal catalyst of both cost-push and demand-pull inflation.

In 1964, inflation measured a little more than one percent per annum and it had been in this vicinity over the preceding six years; inflation began ratcheting upward in the mid-1960s and reached more than fourteen percent in 1980, eventually declining to an average of 3.5 percent in the latter half of the 1980's.

While economists debate the relative importance of the factors that motivated and perpetuated inflation for more than a decade, there is little debate about its source, the origins of the Great Inflation were policies that allowed for an excessive growth in the supply of money – Federal Reserve policies.

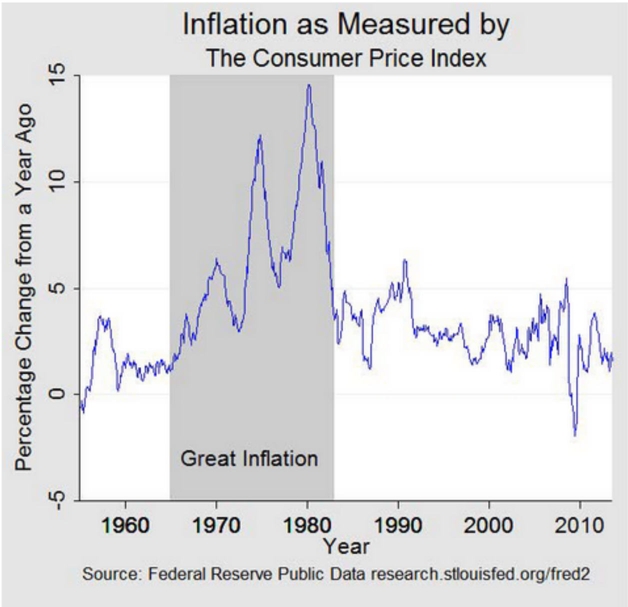
To understand this episode of especially bad policy and monetary policy in particular, it will be useful to tell the story in three distinct but related parts. This is a forensic investigation of sorts, examining the motive, means and opportunity for the *Great Inflation* which occurred (1965-1982), peaking in Australia during the ***Poseidon Bubble***.

The first part of the story, the motive underlying the Great Inflation, dates back to the immediate aftermath of the *Great Depression*, an earlier and equally transformative period for macroeconomic theory and policy.

At the conclusion of World War II, Congress turned its attention to policies it hoped would promote greater economic stability and most notable among the laws that emerged was the Employment Act of 1946.

Among other things, the act declared it a responsibility of the federal government, "*to promote maximum employment, production and purchasing power*", providing for greater coordination between fiscal and monetary policies.

This act is the seminal basis for the Federal Reserve's current dual mandate to, "*maintain long run* *growth of the monetary and credit aggregates… so as to promote effectively the goals of maximum employment, stable prices and moderate long-term interest rates"* (Steelman 2011).



Inflation as measured by the consumer price index. Data plotted as a curve. Units are percentage change from a year ago. The grey bar indicates a period of Great Inflation, which began in January 1965 and ended in December 1982. In January 1965, the percentage change from a year ago in the consumer price index began to rise until it peaked in March 1980 at close to 15 percent. In 1983, the percentage change from a year ago settled back to pre-Great Inflation levels of 0 to 5 percent. Source: Bureau of Labor Statistics via FRED; graph created by Sam Marshall, Federal Reserve Bank of Richmond)

The orthodoxy guiding policy in the post-WWII era was Keynesian stabilsation policy, motivated in large part by the painful memory of the unprecedented high unemployment in the United States and around the world during the 1930's.

The focal point of these policies was the management of aggregate spending (demand) by way of the spending and taxation policies of the fiscal authority and the monetary policies of the central bank; the idea that monetary policy can and should be used to manage aggregate spending and stabilise economic activity is still a generally accepted tenet that guides the policies of the Federal Reserve and other central banks today.

However, one critical and erroneous assumption to the implementation of stabilisation policy of the 1960's and 1970's was that there existed a stable, exploitable relationship between unemployment and inflation; specifically, it was generally believed that permanently lower rates of unemployment could be "*bought*" with modestly higher rates of inflation.

The idea that the "*Phillips Curve*" represented a longer-term trade-off between unemployment – which was very damaging to economic well-being, and inflation, which was sometimes thought of as more of an inconvenience – was an attractive assumption for policymakers who hoped to forcefully pursue the dictates of the Employment Act.

But the stability of the *Phillips Curve* was a fateful assumption, one that economists Edmund Phelps (1967) and Milton Friedman (1968) warned against; said Phelps, "*[I]f the statical 'optimum' is chosen, it is reasonable to suppose that the participants in product and labour markets will learn to expect inflation…and that, as a consequence of their rational, anticipatory behaviour, the Phillips Curve will gradually shift upward…*" (Phelps 1967; Friedman 1968).

In other words, the trade-off between lower unemployment and more inflation that policymakers may have wanted to pursue would likely be a false bargain, requiring ever higher inflation to maintain.

Chasing the *Phillips Curve* in pursuit of lower unemployment could not have occurred if the policies of the Federal Reserve were well-anchored and in the 1960's, the Greenback was anchored – albeit very tenuously – to gold through the ***Bretton Woods accord***; so, the story of the *Great Inflation* is in part also about the collapse of the Bretton Woods system and the separation of the US Dollar from its last link to gold.

During World War II, the world's industrial nations agreed to a global monetary system that they hoped would bring greater economic stability and peace by promoting global trade.

That system, hashed out by forty-four nations in Bretton Woods, New Hampshire, during July 1944, provided for a fixed rate of exchange between the currencies of the world and the Greenback, remembering that the US Dollar was linked to gold.

But the system had a number of flaws in its implementation, chief among them the attempt to maintain fixed parity between global currencies that was incompatible with their domestic economic goals; many nations, it turned out, were pursing monetary policies that promised to march up the *Phillips Curve* for a more favourable unemployment-inflation nexus.

As the world's reserve currency, the Greenback had an additional problem, as global trade grew, so too did the demand for US dollar reserves and for a time, the demand for US Dollars was satisfied by an increasing balance of payments shortfall and foreign central banks accumulated more and more Greenback reserves.

Eventually, the supply of Greenback reserves held abroad exceeded the US stock of gold, implying that the United States could not maintain complete convertibility at the existing price of gold—a fact that would not go unnoticed by foreign governments and currency speculators.

As inflation drifted higher during the latter half of the 1960s, Greenbacks were increasingly converted to gold, and in the summer of 1971, President Nixon halted the exchange of Dollars for gold by foreign central banks, which came to be known as the '***Nixon Shock***'.

Over the next two years, there was an attempt to salvage the global monetary system through the short-lived ***Smithsonian Agreement*** but the new arrangement fared no better than Bretton Woods and it quickly broke down; the postwar global monetary system was finished.

With the last link to gold severed, most of the world's currencies, including the Greenback, were now completely unanchored and except during periods of global crisis, this was the first time in history that most of the monies of the industrialised world were on an irredeemable paper money standard.

The late 1960's and the early 1970's were a turbulent time for the US economy – President Johnson's Great Society legislation brought about major spending programmes across a broad array of social initiatives at a time when the US fiscal situation was already being strained by the Vietnam War; these growing fiscal imbalances complicated monetary policy and in Australia, peaked with the ***Poseidon Bubble***, where nickel required for Australian, Canadian and American diggers' in Vietnam saw a bubble spike across martial metals.

In order to avoid monetary policy actions that might interfere with the funding plans of the US Treasury, the US Federal Reserve followed a practice of conducting "*even-keel*" policies.

In practical terms, this meant the central bank would not implement a change in policy and would hold interest rates steady during the period between the announcement of a Treasury issue and its sale to the market and under ordinary conditions, Treasury issues were infrequent and the FOMC's even-keel policies didn't significantly interfere with the implementation of monetary policy.

But as debt issues became more prevalent, the US Federal Reserve's adherence to the even-keel principle increasingly constrained the conduct of monetary policy.

A more disruptive force was the repeated energy crises that increased oil costs and sapped US growth; the first crisis was an Arab oil embargo that began in October 1973 and lasted about five months.

During this period, crude oil prices quadrupled to a plateau that held until the Iranian revolution brought a second energy crisis in 1979, the **second crisis tripled the cost of oil**.

In the 1970's, economists and policymakers began to commonly categorise the rise in aggregate prices as different inflation types: "*Demand-pull*" inflation was the direct influence of macroeconomic policy and monetary policy in particular.

It resulted from policies that produced a level of spending in excess of what the economy could produce without pushing the economy beyond its ordinary productive capacity and pulling more expensive resources into play but inflation could also be pushed higher from supply disruptions, notably originating in food and energy markets (Gordon 1975); this "*Cost-push*" inflation also got passed through the chain of production into higher retail prices, spurring the roaring 1980's.

From the perspective of the central bank, the inflation being caused by the rising price of oil was largely beyond the control of monetary policy, notwithstanding, the rise in unemployment that was occurring in response to the jump in oil prices was not.

Motivated by a mandate to create full employment with little or no anchor for the management of reserves, the US Federal Reserve accommodated large and rising fiscal imbalances and leaned against the headwinds produced by energy costs; these policies accelerated the expansion of the money supply and raised overall prices without reducing unemployment.

Bad data – or at least a bad understanding of the data – also handicapped policymakers and looking back at the information policymakers had in hand during the period leading up to and during the *Great Inflation*, economist Athanasios Orphanides has shown that the real-time estimate of potential output was significantly overstated and the estimate of the rate of unemployment consistent with full employment was significantly understated.

In other words, policymakers were also likely underestimating the inflationary effects of their policies and in fact, the policy path they were on simply was not feasible without accelerating inflation (Orphanides 1997; Orphanides 2002).

And to make matters worse yet, the *Phillips Curve* – the stability of which was an important guide to the policy decisions of the Federal Reserve – began to move.

Phelps and Friedman were right, the stable trade-off between inflation and unemployment proved unstable and the ability of policymakers to control any "*real*" variable was ephemeral; this truth included the rate of unemployment, which oscillated around its "*natural*" rate, the trade-off that policymakers hoped to exploit did not exist.

As businesses and households came to appreciate, indeed anticipate, rising prices, any trade-off between inflation and unemployment became a less favorable exchange until, in time, both inflation and unemployment became unacceptably high (*déjà vu* in 2022..).

This, then, became the era of "*Stagflation*" and in 1964, when this story began, inflation was one percent and unemployment was five percent >> Ten years later, inflation would be over twelve percent and unemployment was above seven percent; by the summer of 1980, inflation was near 14.5 percent and unemployment was over 7.5 percent.

American Federal Reserve officials were not blind to the inflation that was occurring and were well aware of the dual mandate that required monetary policy to be calibrated so that it delivered full employment and price stability.

Indeed, the Employment Act of 1946 was re-codified in 1978 by the Full Employment and Balanced Growth Act, more commonly known as the Humphrey-Hawkins Act after the bill's authors.

Humphrey-Hawkins explicitly charged the Federal Reserve to pursue full employment and price stability, required that the central bank establish targets for the growth of various monetary aggregates and provide a semi-annual Monetary Policy Report to Congress (motivation for the aforementioned, the 1987 National Commission on the Public Service symposium).

Nevertheless, the employment half of the mandate appears to have had the upper hand when full employment and inflation came into conflict, as FOMC Chairman Arthur Burns would later claim, full employment was the first priority in the minds of the public and the government, if not also at the Federal Reserve but there was also a clear sense that addressing the inflation problem head-on would have been too costly to the economy and jobs.

There had been a few earlier attempts to control inflation without the costly side effect of higher unemployment.

The Nixon administration introduced wage and price controls over three phases between 1971 and 1974, those controls only temporarily slowed the rise in prices while exacerbating shortages, particularly for food and energy.

The Ford administration fared no better in its efforts, after declaring inflation "*enemy number one*" the president in 1974 introduced the ***Whip Inflation Now (WIN) programme***, which consisted of voluntary measures to encourage more thrift: it was an abysmal failure.

By the late 1970's, the public had come to expect an inflationary bias to monetary policy and they were increasingly unhappy with inflation (redux in 2022…)

Survey after survey showed a deteriorating public confidence over the economy and government policy in the latter half of the 1970's and often, inflation was identified as a ***special evil***.

Interest rates appeared to be on a secular rise since 1965 and spiked sharply higher still as the 1970's came to a close.

During this time, business investment slowed, productivity faltered and the US's trade balance with the rest of the world worsened and inflation was widely viewed as either a significant contributing factor to the economic malaise or its primary basis.

Nevertheless, once in the position of having unacceptably high inflation and high unemployment, policymakers faced an unhappy dilemma → fighting high unemployment would almost certainly drive inflation higher still, while fighting inflation would just as certainly cause unemployment to spike even higher.

In 1979, Paul Volcker, formerly the president of the Federal Reserve Bank of New York, became chairman of the Federal Reserve Board and when he took office in August, *year-over-year* inflation was running above eleven percent and national joblessness was just a shade under six percent.

By this time, it was generally accepted that reducing inflation required greater control over the growth rate of reserves specifically and broad money more generally.

The FOMC had already begun establishing targets for the monetary aggregates as required by the Humphrey-Hawkins Act but it was clear that sentiment was shifting with the new Chairman and that stronger measures to control the growth of the money supply were required; In October 1979, the FOMC announced its intention to target reserve growth rather than the fed funds rate as its policy instrument.

Fighting inflation was now seen as necessary to achieve both objectives of the dual mandate, even if it temporarily caused a disruption to economic activity and, for a time, a higher rate of joblessness.

In early 1980, Volcker said, "*My basic philosophy is over time we have no choice but to deal with the* *inflationary situation because over time inflation and the unemployment rate go together.... Isn't that the lesson of the 1970's?*".

Over time, greater control of reserve and money growth, while less than perfect, produced a desired slowing in inflation.

This tighter reserve management was augmented by the introduction of credit controls in early 1980 and with the Monetary Control Act – over the course of 1980, interest rates spiked, fell briefly and then spiked again.

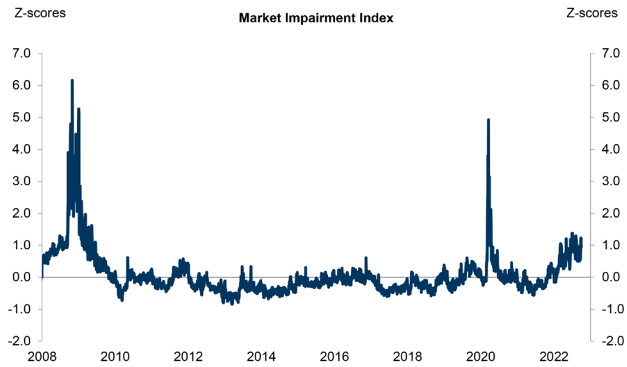
Lending activity fell, unemployment rose and the economy entered a brief recession between January and July; inflation fell but was still high even as the economy recovered in the second half of 1980.

Irrespectively, the Volcker-led central bank continued to press the fight against high inflation with a combination of higher interest rates and even slower reserve growth and the economy entered recession again in July 1981, and this proved to be more severe and protracted, lasting until November 1982, sometimes dubbed, '***Regan's Recession***'.

Unemployment peaked at nearly eleven percent, however, inflation continued to move lower and by recession's end, *year-over-year* inflation was back under five percent; in time, as the FOMC's commitment to low inflation gained credibility, unemployment retreated and the economy entered a period of sustained growth and stability: the Great Inflation was over.

By this time, macroeconomic theory had undergone a transformation, in large part informed by the economic lessons of that era and the important role public expectations play in the interplay between economic policy and economic performance became *de rigueur* in macroeconomic models.

The importance of time-consistent policy choices – policies that do not sacrifice longer-term prosperity for short-term gains – and policy credibility became widely appreciated as necessary for good macroeconomic results.



In late 2022, there is still money to be made in markets during the current tumult but that cannot be achieved via lazy long trading, bear market returns are all about positioning: the sharp rise in real rates, valuation, inflation and recession risks, all continue to be a prime focus and opportunity for those adept at capturing opportunistic *alpha* during two upcoming quarters of benign *beta*.

Volcker's inaugural 1979 remarks carry purpose to this day, "*Wall Street, like the US itself, is suffering most from uncertainty about the future, a fearful sense of drift that, for all its efforts, the new Administration has so far failed to arrest. Now that could, well change, though slowly. The President's new program represents a first step on what will be a long and punishing journey back to prosperity. The key question is whether the President can rally the nation to make the many sacrifices, large and small, that are absolutely necessary for winning the critical war against inflation*".

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Stirling Larkin, CIO,
Australian Standfirst Asset Management

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