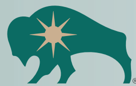
# THE CHAPTER 3 PROJECT

HEALTH WEALTH PURPOSE

## A Generational Macro-Economic Moment:

# Stagflation Is Coming



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# A Generational Macro-Economic Moment: Stagflation Is Coming

***"History doesn't repeat itself, but it rhymes."***

*- Mark Twain*

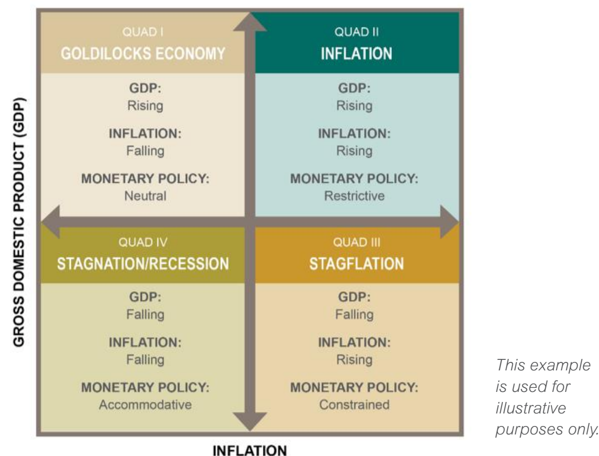
## Introduction

History rhymes, just like seasons rhyme. One spring or summer is not identical to the previous one, but they are similar. While one spring may be wetter than another, and one summer may be hotter than another, plants blossom in the spring, and days are longer and hotter in the summer. When we notice the signs of the season, certain things become predictable.

You might not know it, but the economy has seasons, too. They don't recur as regularly as the seasons of nature, yet they do come and go. While this essay is a bit lengthy, the topic is of critical importance for retirement income investors in the coming decade. The purpose of this essay is threefold:

1. To demonstrate that economic seasons exist and identify them.
2. To illustrate that we are in the midst of a significant economic shift. That is to say: The investment season is changing, and will have significant ramifications upon investment performance of popular asset classes.
3. To offer ideas for successfully navigating the coming investment season.

Nature's seasons show themselves in changing temperature and hours of daylight. The economy's seasons show themselves in changing rates of growth (GDP) and inflation. Using these two macroeconomic variables, the four economic seasons can be drawn like this:




*This example is used for illustrative purposes only.*

**Quad 1**

The best growing season for financial assets (stocks and bonds) is when the economy is growing and inflation is falling. This is represented by Quad 1 in the chart and referred to as a Goldilocks economy; everything is just right—especially for financial assets.[1]

**Quad 2**

Central bankers naturally want to keep an economy growing and as a result frequently keep monetary policy[2] loose. Cheap money greases the wheels for economic growth and therefore demand for the raw inputs of production (commodities and labor) grows. Increased demand for raw inputs leads to higher costs which producers must eventually pass on in the form of price increases for finished goods. This is a reasonable description of Quad 2 of the chart, both the economy and inflation are growing. Stocks of companies that grow faster than the rate of inflation can continue to do well in this environment, but they must overcome the weight of falling price/earnings multiples for the overall equity markets, as will be shown later in this essay.

**Quad 3**

Stagflation, Quad 3 of the chart, is an unusual economic season. It combines the inflation expected in a growing economy, but the growth is absent and instead weak employment is a characteristic. Stagflation is the result of conflicting economic policies, some expansionary and some contractionary. These conflicting policies can be triggered by an exogenous economic or geopolitical event. An example of this was the 1978 Iranian Revolution which led to the Iranian Hostage Crisis a year later. A result of this geopolitical volatility was a spike in oil prices, jumping from less than $9.00 a barrel in 1978 to over $34.00 a barrel in 1981. This was essentially a significant tax hike on the entire economy as the price of literally everything is influenced by the price of energy.

In the meantime, Paul Volker became chairman of The Federal Reserve. Much to President Jimmy Carter's chagrin, Volker changed monetary policy to quell double digit inflation.[3] His new policy drove interest rates much higher. The prime interest rate[4] was 12% when Volker took office in August of 1979; by April of 1980 it was 20%.[5] Mortgage rates doubled from 9% to 18% during this time,[6] locking millions of young families out of the home-buying market. The simultaneous skyrocketing price

increases for both energy (an exogenous factor) and money (an endogenous factor) created too much pressure for the economy to handle. The release valve to that pressure was a deep recession resulting in an almost doubling of the unemployment rate from 5.7% when Volker took office to 10.8% in 1981.[7] Volker eventually succeeded in quelling inflation, but that success came at a heavy price.

Stagflation places central banks in a difficult situation. Relaxing monetary policy to alleviate weak employment aggravates inflation, while tightening monetary policy to combat growing inflation exacerbates growing unemployment. The last experience of stagflation in the United States was in the 1970s, so many of today's investors are unfamiliar with it and consequently are unprepared for it.

**Quad 4**

Recessions represent Quad 4 of the graph, and they are characterized by falling growth rates and falling, if not negative, inflation (deflation). Recessions are difficult to experience but are an important contributor to long-term economic health. They are cathartic; they purge inefficiencies from the economy, including inefficient companies. Almost like a wildfire, they take away the old, decaying debris. It's a natural clearing away of the old for the new. However unpleasant recessions are for most voters, they are outright frightening for policy makers seeking reelection or reappointment. As such these policy makers often promote policies that might postpone the inevitable recession until after the next election cycle. Postponing recessions with bad economic policies[8] creates "zombie companies".[9] These zombie companies, rather than dying, linger on and wreak havoc by robbing healthier companies of pricing power. Without that pricing power, healthy companies will have less income to invest in new innovations. This can lead to delayed and/or weaker economic recoveries. The COVID-19 economic shutdown contributed to a large number of zombie companies operating throughout the US economy.

General Electric (GE-NYSE) is a notable example of a zombie company. As recently as 2007 GE was the number 1 most admired company in the world according to Fortune Magazine[10] and today is among the walking dead. To get its stock price up to the level of genuinely successful companies, GE recently completed a 1 for 8 reverse stock-split.[11] This desperate attempt at retaining a connection to the company's past prominence is simply GE feigning a false stature.

The Federal Reserve Bank (The Fed) attempts to influence the macro variables of growth and inflation through its monetary policy decisions and therefore exercise some control over economic seasons. Through the decades they have had some success. Most of the period between 1982 and 2020 was dominated by the perception of a Quad 1 economy (with a small handful of visits to Quad 4). That perception was largely justified up until the Great Financial Crisis (2007-09). However, that perception was only maintained by extraordinary monetary policy post-GFC (from 2008 until the COVID-19 economic shutdown of 2020). That unconventional policy substantially increased our national debt as a percentage of Gross Domestic Product (GDP) to an unsustainable level. U.S. national debt as a percentage of GDP was 62% in 2007. By 2020 that ratio exceeded 130% (exceeding the 120% peak level of debt in WWII).[12]

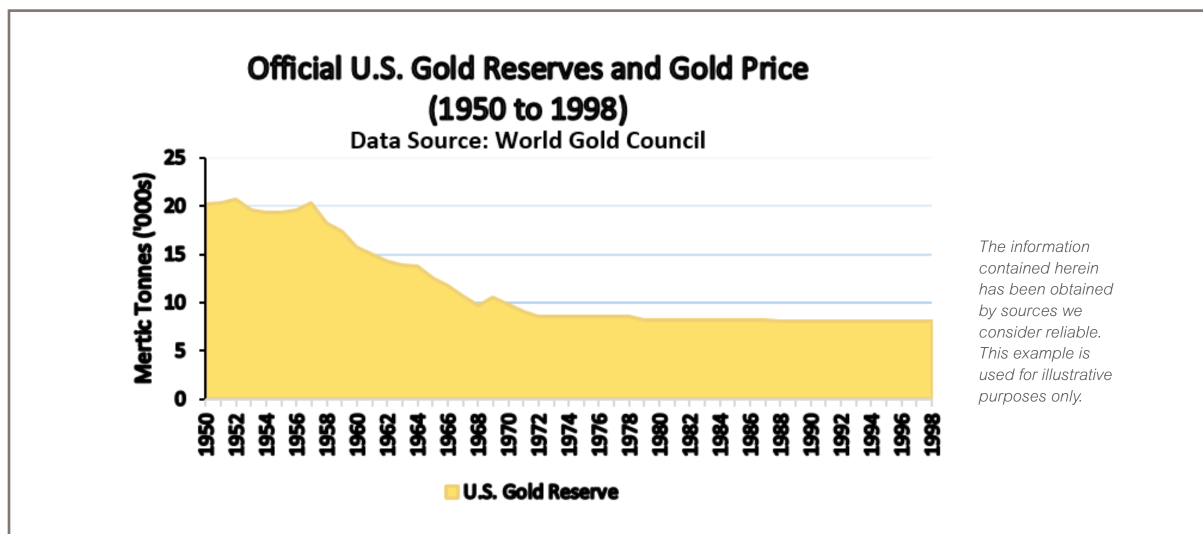
## How Did We Get Here?

When an economic trend can no longer continue along its current trajectory, the season changes to one that can digest the excesses produced by the previous season. These changes of season historically have lasted for decades. Because they occur so infrequently, the point of change is truly

a generational macro-economic moment. The current disinflationary season (Quads 1 & 4) began circa 1980 and lasted 40 years. The inflationary season preceding it (Quads 2 & 3) began with the election of FDR in 1932 and lasted almost five decades.

It appears stagflation will be the dominant economic season for at least the remainder of this decade, and possibly further. Recognizing and responding to this change of seasons is especially important to those who are retired or planning to retire within the next decade. Inflation will make fixed-income assets a liability; growing-income will be needed to protect purchasing power. Investment strategies that were successful in the last few decades will likely produce disappointing results in the next decade. To understand why that will be the case it is helpful to understand what created the current condition.

The post WWII system of international trade was established by the Bretton Woods Agreement of 1944[13] which made the dollar the world reserve currency.[14] The crux of that system was the U.S. dollar's convertibility into gold at an established price. The ability to convert dollars to gold gave foreign countries confidence to hold dollars acquired in trade as reserves.[15] However, during the 1960s the expenses of the Vietnam War and President Lyndon Johnson's War on Poverty led to significant deficit spending and a loss of international confidence in the value of the dollar. Foreign countries were increasingly exchanging their dollar reserves for the gold backing them, thus more than halving US gold reserves:

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To stem this depletion, on August 15, 1971 President Richard Nixon suspended the convertibility of U.S. dollars into gold, thus closing the gold window and allowing the dollar's value to float in the marketplace as a fiat currency.[16] Nixon in his speech announcing this suspension assured the world that this was a temporary action. It is now 50 years down the road and the gold window is still temporarily closed.

Arguably, the underlying cause of the current economic quagmire dates to that moment in time. Without the value of the dollar anchored to gold, government spending no longer had the value of national gold reserves as a constraint, which lead to substantially increased deficit spending. This increased deficit spending eventually became the primary underlying cause of the current crisis.

The condition one would expect from sustained deficit spending is growing national debt, which is exactly what happened in the United States. As previously mentioned, total public debt in 1980 was approximately 30% of GDP; at the end of 2020 it was over 130%.[17] As a frame of reference, imagine having outstanding credit card debt amounting to 130% of your annual income. Your ability to make any meaningful new purchases—such as a new car or a nice vacation—would be hindered by the amount of your income going to credit card bills. Again, this is exactly what happened in the United States. The annual, inflation-adjusted growth rate of our economy dropped from approximately 3.5% (1970-2000) to 1.75% (2000-2020).[18] As our public debt continues to grow, it is reasonable to expect future real GDP growth of 1% annually or less.[19] An unhealthy condition of over-indebtedness has developed.

Unhealthy conditions are vulnerable to unintended crises. When the care of forests is overlooked deadwood and dry grass build up, creating fuel for a potential wildfire — an unhealthy condition develops. If the catalyst of a fateful spark finally arrives, the devastation is immense.

The U.S. experienced such a catalyst and ensuing crisis. It turned out to be of heretofore unimaginable magnitude with the COVID-19 virus becoming the catalyst to a government imposed economic shutdown. Some parts of the economy were brought to a complete halt. Others, those deemed essential businesses, were forced to operate with minimal staffing. Many millions of Americans lost jobs due to their businesses closing permanently. As a result, in the second quarter of 2020 the economy dropped by over 30%.

The government's response to this crisis has been unprecedented with increased and continued economic stimulus provided through deficit spending. The Congressional Budget Office now projects annual deficits well over $1 trillion well into the next decade,[20] resulting in more borrowing and increasing debt. The number 1 trillion is difficult to process. To put it in perspective, stacking 1 trillion pennies together would yield a cube of pennies 100 yards long, deep, and high. Just stop for a moment and visualize that (spoiler alert: there are only 150 billion pennies in existence). Another image to help grasp the magnitude of 1 trillion is that a trillion dollar bills laid end to end would measure over 96 million miles, which is more than the distance to the sun.

Massive stimulus may prompt the economy to produce a few quarters of above-average growth, due in part to pent-up demand from widespread business closures, but the longer-term consequence of extreme over-indebtedness is economic stagnation. The weight of the debt-service payments is too high for the economy to overcome.

Again, the United States is likely facing several years of economic stagnation. An economy running at chronically low levels is also prone to more frequent recessions. It doesn't take much of a shock to send a slow moving economy into decline.[21] Getting the economy back on a healthy growth trajectory requires reducing debt as a percentage of GDP.

## What Is the Path Forward?

Reducing national debt levels is a politically challenging task. There are only four ways in which a country can reduce debt levels: austerity, renegotiation, growth, and inflation with each presenting its own constraint(s). The trick to success for politicians is to find the option with the least painful constraint.

Austerity is belt tightening, getting by with less. This approach was tried by Greece during the Euro crisis immediately following the global financial crisis of 2008-2009. The Greeks quickly voiced their

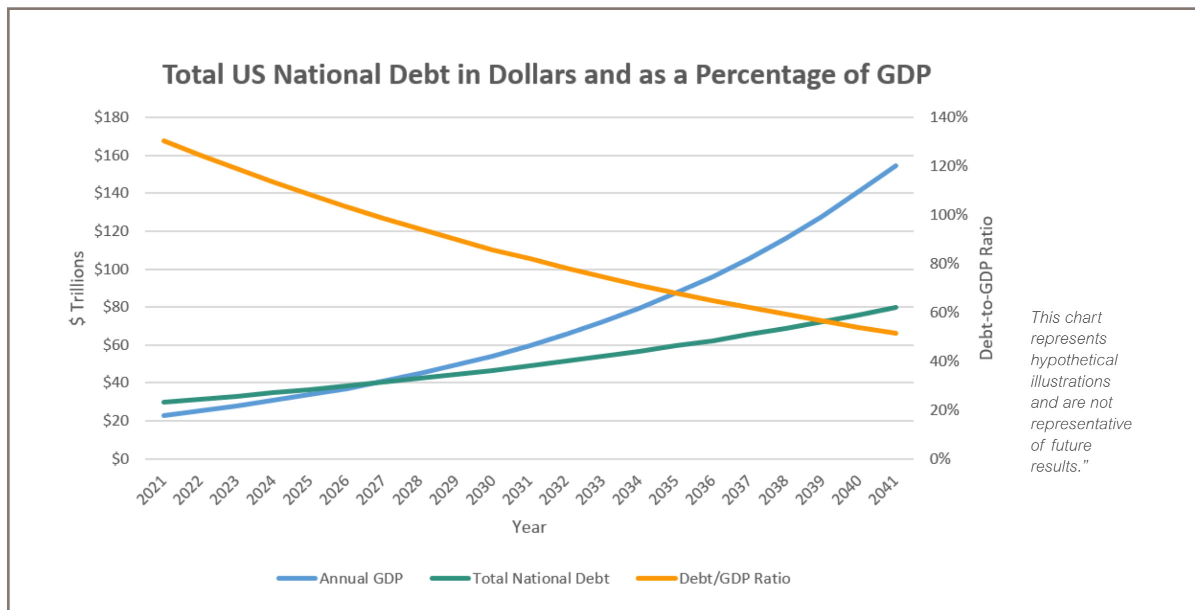
disapproval of this technique by literally lighting the country on fire. Their actions made it apparent that an immovable political constraint blocked this path from further consideration.

Renegotiation is simply a more polite way to say default, or to change the terms of debt repayment. This could include stretching the payments out longer, reducing the amount to be repaid, or some combination along that spectrum. Renegotiation is not uncommon in developing countries, but with over 80% of world trade consummated in the dollar it is not just another currency among many; it is the primary global reserve currency. A U.S. debt default would cause upheaval in the value of the dollar and severe disruption to global trade, potentially creating a global depression. In short, an economic constraint prevents renegotiation from being a tactic for the US to reduce debt.

Growth seems like an obvious solution to the situation and, in fact, played a key role in the reduction of debt after World War II. GIs returned home from the war, got married, started families, and went on a spending spree like the country had never seen before. The country's income (GDP) grew faster than its issuance of new debt and that helped bring things back into balance. A characteristic of a growing economy is a younger population, which the U.S. had from 1950-1980; but that is no longer the case for the U.S., or any of the leading countries of the developed world. Populations have grown, on average, older. Older populations tend to save more and spend less. Less spending is not a formula for generating economic growth. There is now a demographic constraint to growth as a debt reduction strategy.

That leaves inflation, which was a key strategic tool in reducing national debt in the United States during the 40s, 50s, 60s, and 70s. Since it's a playbook with which the government has already experienced "success",[22] there is good reason to expect them to try it again. It works like this: when a central bank holds interest rates below the rate of inflation, debt service expense as a percentage of national income drops. If the government can hold the growth rate of new debt issuance below the rate of inflation, then debt as a percentage of GDP will also drop. In such a scenario the absolute level of debt never goes down, but its size relative to GDP does.

For example, the chart below shows what happens to debt levels and the economy if the government allows inflation to run at 10% (as it did in the 1940s) while holding the growth of new debt issuance to 5%. Both grow, but the economy grows much faster than the outstanding debt. The gold line of the chart shows how, even while the national debt grows from roughly $30 trillion[23, 24] to $80 trillion, the ratio of debt to GDP falls over time.




*This chart represents hypothetical illustrations and are not representative of future results."*

A key point to note is that inflation as described here is not an accident brought about by an economic policy mistake; it's an intentional policy objective, one that will likely persist for years rather than months or quarters. Few, if any, policy makers will admit this in public interviews; intentionally devaluing the electorate's savings is not a good policy look at election time. Instead, policy makers will describe inflation in imprecise, ambiguous terms like transitory or temporary. In rate of change terms, inflation is transitory. The annual rate of inflation goes up and down from year to year, but it rarely goes negative in any given year, and price increases are rarely given back in the future. So the absolute level of prices keeps increasing as time goes on and consumers become something like the metaphoric frog in a pot of boiling water. According to the metaphor, if you put a frog in a pot of boiling water, it will instantly leap out... but if you put it in a pot filled with pleasantly tepid water and gradually heat it, the frog will remain in the water until it boils to death. Because it involves the least amount of immediate economic pain, using inflation to lower debt levels as a percentage of GDP is the least constrained path available to policy makers, and therefore the one they are likely to follow.

Since a consequence to the condition of extreme over-indebtedness is economic stagnation, and a likely policy objective to alleviate that condition is inflation, it appears the United States is headed for an extended season of stagflation. Because that condition has not been experienced in over 40 years, most investors today were not active during the last bout of stagflation and may not recall how that economic misadventure evolved.

Inflation is often triggered and/or exacerbated by supply shocks. In the early 1970s there were two significant supply shocks that fed into that decade's bout of stagflation: the 1973 Arab Oil Embargo and the 1972 Soviet Grain Robbery. Many people remember OPEC's response to U.S. support of Israel in the Yom Kippur War was to terminate shipments of Mid-East oil to the United States.[25] The result of the embargo was a tripling of oil prices (from $4 per barrel to $12). Energy is considered the "master-commodity" because it is a basic input to pretty much everything. When energy prices spike upward, economic calamity follows.

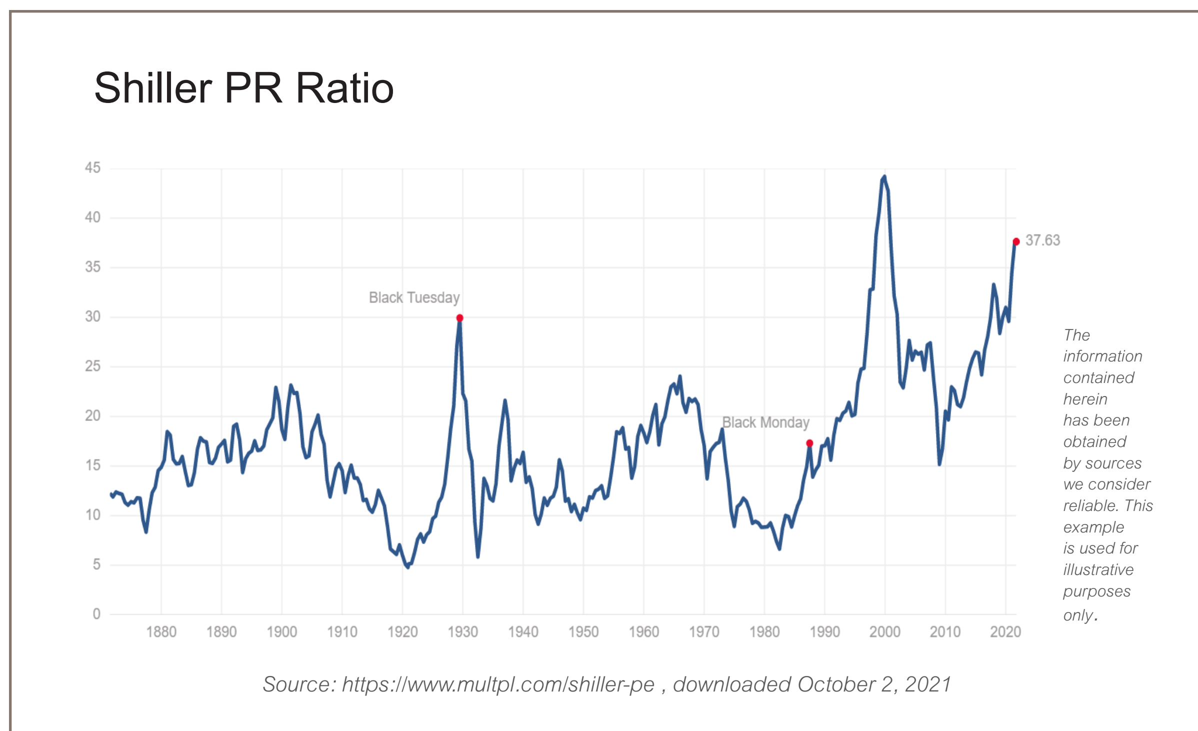
Less well remembered is the Soviet Grain Robbery of 1972, which proved to be a significant policy failure and embarrassment for then President Richard Nixon, his Secretary of State Henry Kissinger, and his Agriculture Secretary Earl Butz. The Soviet Union suffered severe crop shortfalls in 1971 and 1972.[26] This forced them to look abroad for grain to prevent famine in their country. The United States stepped-up and agreed to provide 10 million tons of grain at subsidized prices.[27, 28] The United States trade representatives failed to realize during their negotiations with the Soviets that the entire global grain market had suffered shortfalls, not just the Soviets. The deal, which amounted to a quarter of the entire U.S. wheat harvest for the year, resulted in the rest of the world scrambling to find grain, and prices skyrocketed. The increased price of grain also affected the market for meat and dairy as feed prices soared. By 1973 food prices increased over 20%.[29]

The combination of increased energy and food prices meant consumers had to reduce purchases of other goods and services which contributed to a significant recession and rising unemployment. Trade unions, which were very powerful at the time, demanded higher wages for their members in response to the rising cost of living which contributed to the inflationary spiral.

As the introductory quote of Mark Twain suggests, history has a tendency to rhyme. Today's rising energy and food prices, along with an economy that is still struggling to recover all the jobs lost as a result of the COVID-19 lockdowns are certainly not a mirror of the early 1970s, but they do have a familiar ring to those who were around to experience them in real time.

Stagflation is a challenging environment for financial assets. Most bonds pay a fixed rate of interest over their lifetime. Inflation eats away at the purchasing power of these fixed interest payments, thereby making the maintenance of a standard of living challenging for investors placing a heavy reliance upon fixed income investments.

Stocks can also struggle during times of stagflation for a different but related reason. A common measure of stock valuations is the price to earnings ratio. What an investor is really buying with a stock is the future stream of earnings for that business. In times of low or falling inflation, the purchasing power of future earnings is greater than during inflationary times and therefore investors may be willing to pay a higher price for them. For instance, when inflation peaked in the early 1980s the price/earnings ratio for the Standard and Poor's 500 Index[30] was approximately 7 — investors were willing to pay roughly 7 times a company's annual earnings per share. Today, after 40 years of falling inflation, that same measure of valuation is over 38 times earnings per share. That level is the second highest on record, exceeded only by the Internet Stock Bubble in 2000.[31]

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*Source: https://www.multpl.com/shiller-pe , downloaded October 2, 2021*

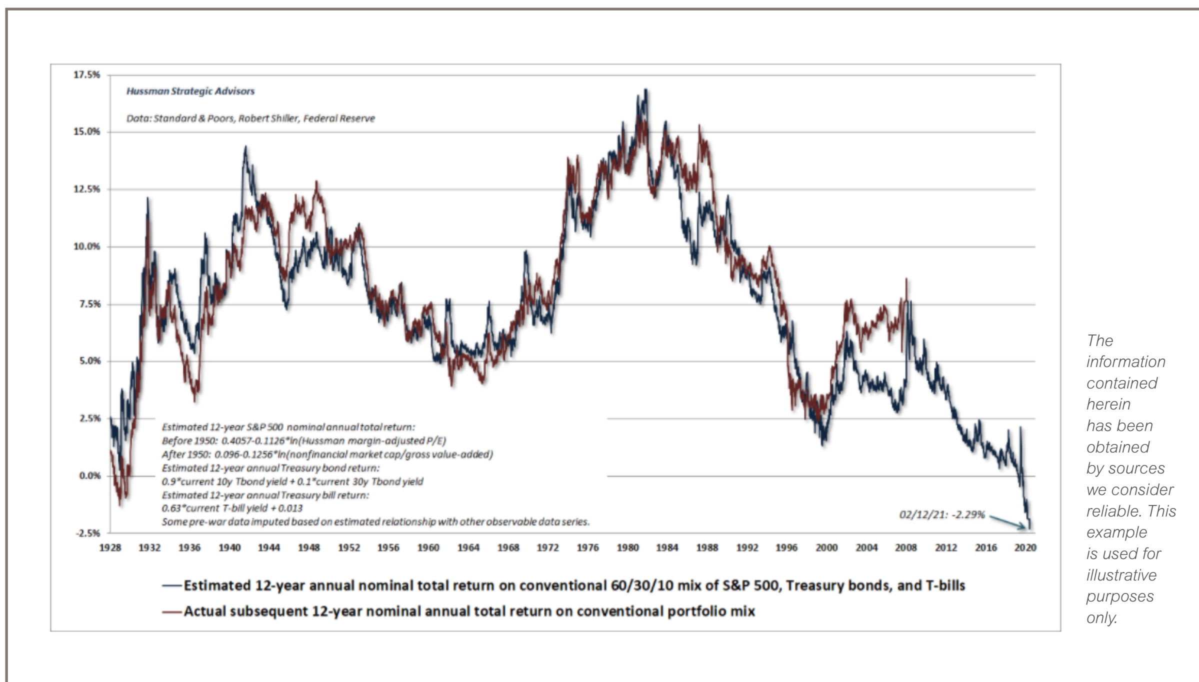
The relationship of inflation to price/earnings multiples works in the opposite direction as well; if inflation is expected in the near future it is unlikely investors remain willing to pay such lofty multiples for future earnings (note the 1940s and 1970s). Falling price/earnings multiples are a stiff headwind for stocks to overcome and can contribute to lackluster or even negative performance.[32]

## Investing for Stagflation

So how should investors consider adjusting portfolios for a changing macroeconomic environment? An option is to employ a process that takes these considerations into account. The three most important variables to consider are your specific objectives, your time frame, and the amount of risk you are willing to accept in pursuing them.

**Step 1**

Imagine taking a journey on a bus. The first thing to decide is the desired destination; this will determine which bus to board. Not all buses are headed for the same destination. If the destination is preserving principal while generating moderate inflation-adjusted returns, getting on the bus to maximum capital appreciation over the next 20 years will likely produce a much bumpier ride than the one to the intended destination. An important point is noting just how many different destinations — and, therefore, buses — are available. The most important work in building an appropriate portfolio is gaining crystal-clear clarity regarding the desired destination. Some investors will set their objective by targeting returns of widely recognized indices. This exercise is commonly referred to as benchmarking and can work well when market averages are performing well. However, given the discussion above regarding traditional stock and bond investments potentially struggling in a stagflationary environment, targeting the widely popular blend of 60% stocks and 40% bonds[33] could produce very disappointing, possibly even negative total returns over the next few years. The following chart created by Hussman Strategic Advisors suggests average nominal (not adjusted for inflation) returns for an allocation very similar to that for the next 12 years at -2.29%. Negative 2.29% on average, per year, for the next 12 years:

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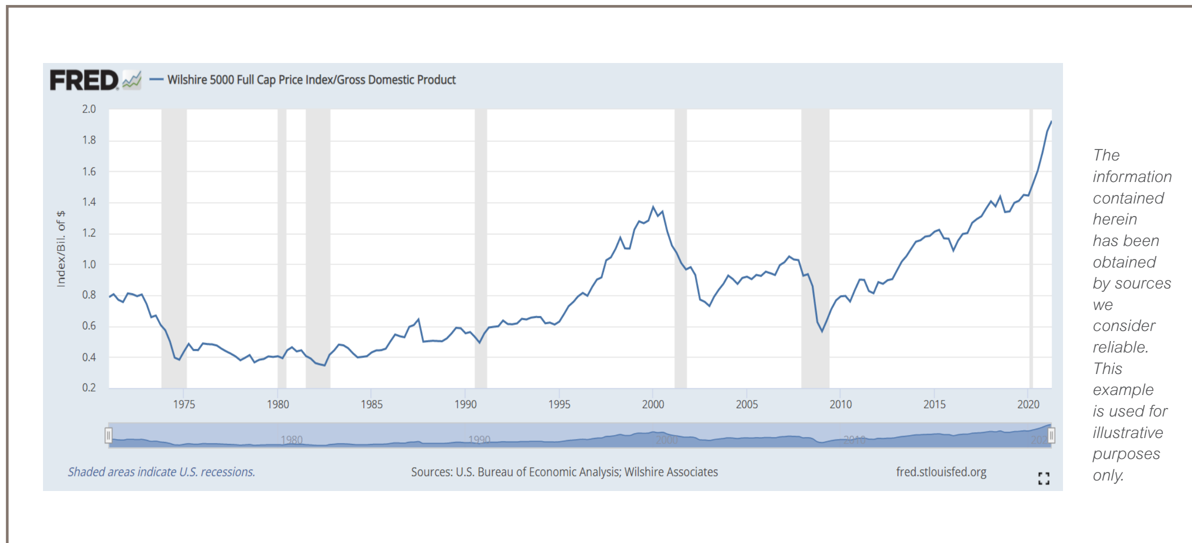
Another notable investor shares a negative outlook for general stock market returns over the next decade. Warren Buffet utilizes a particular measure of valuations that has become known as The Buffet Indicator. It is similar to a price to revenue ratio[34] in that it measures the amount of the country's business (GDP) relative to the price of the stock market.[35] Buffet credited this ratio as a significant factor in keeping him out of the dot-com market malaise of 2000. In the late 1990s the ratio was rocketing to an all-time high; Buffett saw that as a time to sit on the sidelines, which allowed him to avoid the ensuing crash. The chart on the next page demonstrates that same ratio now exceeds the levels of the dot-com era, indicating what could be a dismal picture for general market performance in the coming decade.



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The take-away here is that choosing a bus intended to mirror stock and bond index returns, as opposed to specific goals for you and your family, may prove to be a very disappointing experience. Putting the work into determining specifically what you are solving for, your desired destination and arrival time — and, therefore, the appropriate bus to board — is worth the effort.

### Step 2

Step 2 in the process is considering the season in which your journey will occur. For all the reasons previously mentioned, it appears the coming macro-economic season will be stagflation.

### Step 3

With the destination and the season established, Step 3 of the process determines the appropriate route for an on-time and safe arrival. If the weather is fair and the roads are clear, then taking the route over the mountain pass may be the most direct and quickest way to travel. However, if the weather is stormy and the roads are icy, that route presents too much risk. This step in the analogy turns to picking your allocation to particular asset classes; determining which specific mix of investments represents the appropriate route to your destination.

### Hard Assets

While stagflation is not a friendly environment for traditional financial assets, hard assets—and businesses related to them—tend to do well. Hard assets are those with a long supply response time to increased demand.[37, 38] These include precious metals, commodities, real estate investment trusts (REITs), and infrastructure (the tangible skeletal structures that allow the economy to operate). Other investment strategies that can provide positive investment performance during times of stagflation include dividend growth stocks, secular growth stocks (companies with practical applications of disruptive technologies), tactical managers, and liquid alternatives.

### Precious Metals

Precious metals include both gold and silver. Platinum and Palladium are also considered precious metals, but their investment markets are quite small relative to gold and silver. These metals have been treated as a form of money for millennia. They gained this status due to their ability to fulfill three primary functions:

1. Medium of exchange
2. Unit of account
3. Store of value

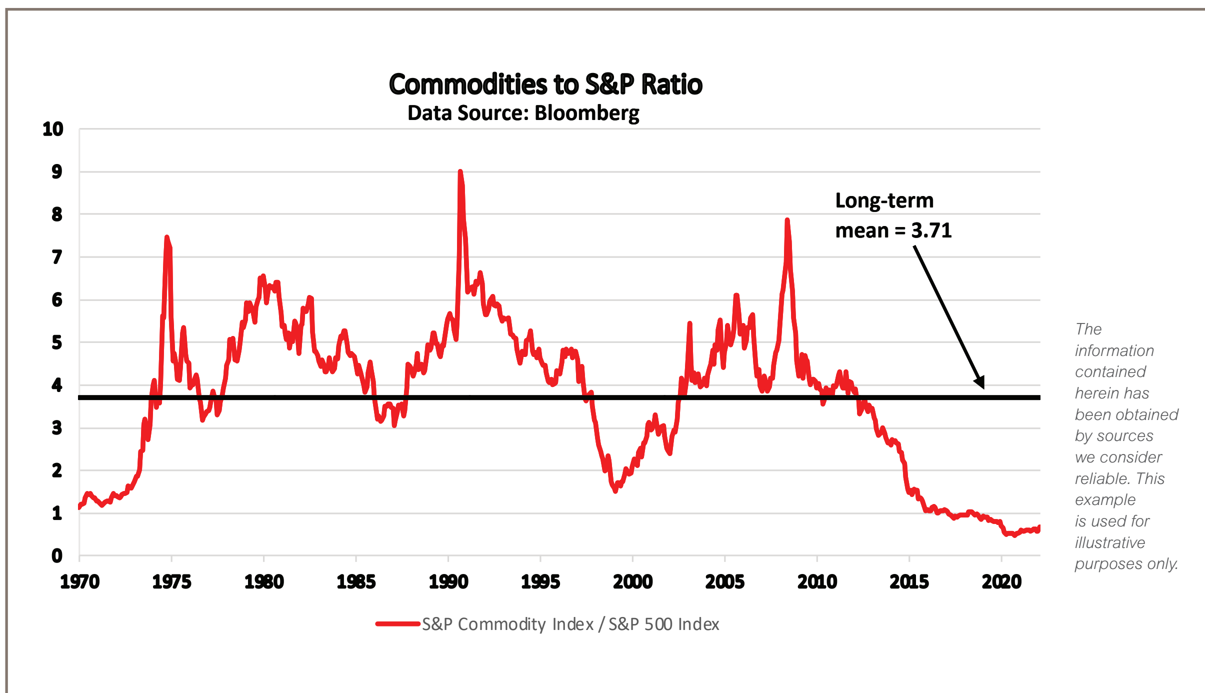
Gold performs well when the dollar loses its ability to act as a store of value. The dollar loses this ability in times of negative real interest rates, which occur when inflation outpaces nominal interest rates (like it does presently). In such circumstances dollars lose a portion of their purchasing power and cease to act as a store of value.

### Commodities

Commodities are the raw inputs that producers need to create value-added products for end users: industrial metals (steel, aluminum, copper, zinc, and tin), energy (oil and natural gas), agricultural products (corn, wheat, rice, etc.), livestock, and what are referenced as soft commodities (sugar, cotton, cocoa).

Commodities have long been considered an effective hedge against inflation. When the supply of dollars in the financial system increases faster than the supply of a given commodity, as it is right now, the commodity's value is maintained by its price in dollars increasing.

In addition, commodities are currently inexpensive relative to stocks. The following chart shows commodities are currently trading at their cheapest prices relative to stocks in over 50 years.



## Real Estate

Many individual investors have experienced real estate's ability to maintain its value during inflationary times. Given the limited supply of real estate this will likely continue. However, the COVID crisis has shown us that certain types of real estate may underperform going forward. For instance, people are becoming much more comfortable with e-commerce which may give traditional brick-and-mortar retailers, and the real estate that houses them, a real business challenge.

## Infrastructure

Infrastructure, the tangible, physical skeleton upon which an economy depends to function optimally includes railways, toll bridges and roads, seaports, airports, and the electrical grid. You may notice these types of assets are capital intensive (they take a lot of money to build). Because they are capital intensive, these infrastructure projects are typically offered competitive protection from the government. Absent this type of protection these projects would be harder to fund and build. However, because of their monopolistic status, infrastructure assets tend to have pricing power—they can pass cost increases on to end-users in the form of price increases. This makes them attractive assets for stagflationary times.

A particularly compelling form of infrastructure currently is domestic energy pipelines. The United States, over a short period of time, has experienced an energy revolution. As a country we have gone from being the largest importer of oil on the planet to a position of being energy independent if needed. A challenge in the production process is the transportation of oil and gas from the wells to the refiners and end-users. Pipelines are the safest and least expensive method of transportation for these products. Storage facilities are another critical component. Collectively, pipelines and storage facilities make up what is referred to as the midstream space of the domestic energy business. For reference, upstream is the exploration and production of raw oil and gas, and downstream is distribution to end users.

## Dividend Growth Stocks

Dividend growth stocks have a track record of increasing their dividends on at least an annual basis, often by as much as 10% or more annually. Even if that growth rate falls to 7% going forward, these companies' dividends would double over the next decade. If a company doubles its dividend over that time, it is likely something positive will happen to the price of the underlying shares. It may not be a corresponding double in value, but it should be a meaningfully positive increase.

## Secular Growth Stocks

The stock market may be more volatile going forward, but that doesn't mean it should be totally ignored. Secular growth, (as opposed to cyclical) will continue to be profitable. Secular growth typically comes from practical applications of disruptive technologies. A disruptive technology is one companies are essentially required to incorporate in their business models to remain competitive. Today, some examples of secular growth are biotechnology, artificial intelligence and robotics, cyber-security, and 5G networks.

## Tactical Equity Managers

Tactical equity strategies are managed portfolios designed to take advantage of market volatility. This is an especially timely strategy for an environment in which increased volatility is anticipated—like the current environment. Tactical managers employ a variety of differing techniques and work best when combined together in an allocation sleeve of a portfolio.

### Liquid Alternatives

The intent of liquid alternatives is to generate positive returns regardless of the general direction of the markets; they are also referred to as absolute return strategies. They are "alternatives" because they derive their returns from alternative sources of risk, outside of traditional investment asset classes (stocks and bonds), including managed futures and market-neutral trading strategies.

## Summarizing

While it's a paradox, it's an inescapable one for investors to remember: the only real constant is change. Time goes on and the seasons change. And this applies to economic seasons as well, although economic seasons change far less frequently. We have not seen a change of economic seasons in 40 years, but are experiencing one now — this is a generational macro-economic moment. It appears the economy is heading into a new season of stagflation, a season not seen since the 1970s. This change will have consequences for investors, especially for retirement income investors. Strategies that were successful in the last economic season will likely prove disappointing in the next. While traditional stock and bond investments have histories of disappointing results during periods of stagflation, hard assets have performed well during those times. Income-oriented investors should re-examine their investment strategies and confirm they match up to their specific objectives, timeframe, and risk tolerance.

Like generations that preceded us, we live in challenging times. Our current challenges, and the economic threats they pose, create a fertile environment for negative emotions. However, focusing solely on changing those to positive emotions will not provide protection from the reality of those current threats, action is required.

Recently I played a round of golf in Bandon Dunes, Oregon, at the Sheep Ranch course. For those not familiar, Bandon Dunes is a destination golf resort on the Oregon coast which many believe rivals Scotland in terms of links style golf. The Sheep Ranch course hugs the coastal cliffs and therefore catches the brunt of the ocean winds. When the season changes from summer to autumn the wind can get quite strong. The day I played was especially stormy; the wind was blowing the rain sideways. It blew so hard that at points in the day a golf ball would not stay on a tee. On one green I putted the ball at least a full foot past the cup. I chose to wait a moment to see what might happen; the wind blew it back into the hole! On another hole a guy in my group laid down his bag to play his shot and the wind began to blow his bag and clubs down the fairway! The point is, it was an exceptionally windy day. No amount of positive thinking was going to cause the wind to die down. The only way to get around the course that day was to change my approach and try to keep my shots lower than I normally hit them. I had to put the ball further back in my stance, slow down my swing and, most importantly, lower my expectations for scoring well. Because the season had changed the environment, expecting to score as well as I might have on a more pleasant day was unrealistic. The changing investment season brings similar requirements. To be successful, our approach to investing has to change to accommodate the changing season. No amount of positive thinking is going to overcome the challenges. Action is required. Perhaps the most important change to make is expectations for investment returns in the coming decade. We just experienced a multi-decade long run of historically high financial-market returns. Reversion to the mean in these markets is a realistic expectation. To outperform those mean-reverting returns will require changing strategies. When it comes to securing your financial future, it's not enough to be an optimist, to simply hope the winds will change. You need to be a realist, and that means changing with the season.

1. A component of interest rates is an inflation premium; when inflation falls, so does the inflation premium. This leads to falling interest rates, which is bullish for bonds because their fixed interest payments buy more goods when inflation falls. Falling inflation is also bullish for stocks because they are valued by the present value of their future earnings. That present value increases as inflation falls. The flip side is also true: when inflation rises, bonds and stocks struggle to produce gains.
2. interest rates
3. Volker's policy pegged the amount of money supply growth and let the price (interest rates) float. This was the opposite of previous policy which pegged the price of money (interest rates) and let the quantity of money float. Volker believed a floating supply of money was a significant contributor to inflation.
4. The prime rate is the interest rate that commercial banks charge their most creditworthy corporate customers.
5. https://fred.stlouisfed.org/series/PRIME
6. https://fred.stlouisfed.org/series/MORTGAGE30US
7. https://fred.stlouisfed.org/series/UNRATE
8. Perhaps artificially low interest rates, or other extraordinarily loose lending policies.
9. Those which do not earn enough to cover the interest expense on their debt, and therefore borrow more money to stay alive.
10. https://archive.fortune.com/magazines/fortune/mostadmired/2007/index.html
11. https://www.wsj.com/articles/why-ge-is-doing-a-reverse-stock-split-and-what-it-means-for-you-11615391261
12. https://www.thebalance.com/national-debt-by-year-compared-to-gdp-and-major-events-3306287
13. Representatives of The United States and 44 allied countries met for three weeks at the Mount Washington Hotel in Bretton Woods, New Hampshire to deliberate the structure of international trade in the post WWII global economy. The agreement took on the name of the conference's location.
14. The reserve currency is that in which most international trade takes place. Therefore, countries outside the United States needed to acquire and hold US dollar reserves in order to trade in this new world order. This eventually created resentment among trading partners as the US merely needed to print a $100 bill in order to spend it. Other countries needed to come up with products of value to trade for that same $100 bill.
15. Dollars were essentially, "as good as gold".
16. Nixon, Richard. "Address to the Nation Outlining a New Economic Policy: "The Challenge of Peace"". The American Presidency Project. https://www.presidency.ucsb.edu/documents/address-the-nation-outlining-new-economic-policy-the-challenge-peace
17. https://fred.stlouisfed.org/series/GFDEGDQ188S
18. https://fred.stlouisfed.org/series/GDPC1
19. See Reinhart and Rogoff, This Time is Different: Eight Centuries of Financial Folly (Princeton University Press, 2009)
20. https://www.cbo.gov/system/files/2021-02/56970-Outlook.pdf
21. Whether via an economic policy mistake or geopolitical surprise.
22. In the United States, national debt levels dropped from approximately 125% at the end of World War II to approximately 30% of GDP by 1980.
23. https://fred.stlouisfed.org/series/GFDEBTN
24. https://fred.stlouisfed.org/series/GDP
25. Shipments were terminated to a number of countries perceived to have supported Israel in the Yom Kippur War. In addition to the United States these countries included Canada, Japan, the Netherlands, and the United Kingdom. Portugal, Rhodesia, and South Africa were eventually added to the list of embargoed nations.
26. For a variety of reasons crop failures were common in the Soviet Union.
27. This period was the height of The Cold War and the US looked at the agriculture deal as a tactic for calming tensions.
28. The subsidized prices earned the deal The Great Grain Robbery moniker as the deal was consummated shortly before global grain prices shot up. The Soviets has successfully "played" the Americans.
29. Hathaway, Dale E., Hendrik S. Houthakker, and John A. Schnittker. "Food Prices and Inflation." Brookings Papers on Economic Activity 1974, no. 1 (1974): 63–116. https://doi.org/10.2307/2534073.
30. Measured by the Shiller P/E, a rolling average intended to smooth the variability of earnings over a market cycle.
31. For reference, the average level for the Shiller P/E over the last 150 years is 17.
32. As they did from 1968 to 1982.
33. Measured by the Standard and Poor's 500 Stock Index and the Bloomberg-Barclay's Aggregate Bond Index
34. A price/revenue ratio is similar to a price earnings ratio. Revenue is substituted for earnings in the denominator because it tends to be less volatile over time.
35. Buffet uses the Wilshire 5000 Index, one of the broadest measures of stock prices available.
36. Wilshire Associates, Wilshire 5000 Full Cap Price Index [WILL5000PRFC], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/WILL5000PRFC, October 2, 2021.
37. For example, permitting for a new copper mine might take up to a decade. Developing that mine to productive capability could be another decade. Even if everything proceeded perfectly and those time frames could be reduced by 75%, there would still be a five year time lag in responding to increased demand with a new mine. During this long response time the limited supply of copper would be allocated by price.
38. 38 https://superfund.arizona.edu/resources/modules/copper-mining-and-processing/life-cycle-mine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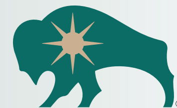

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