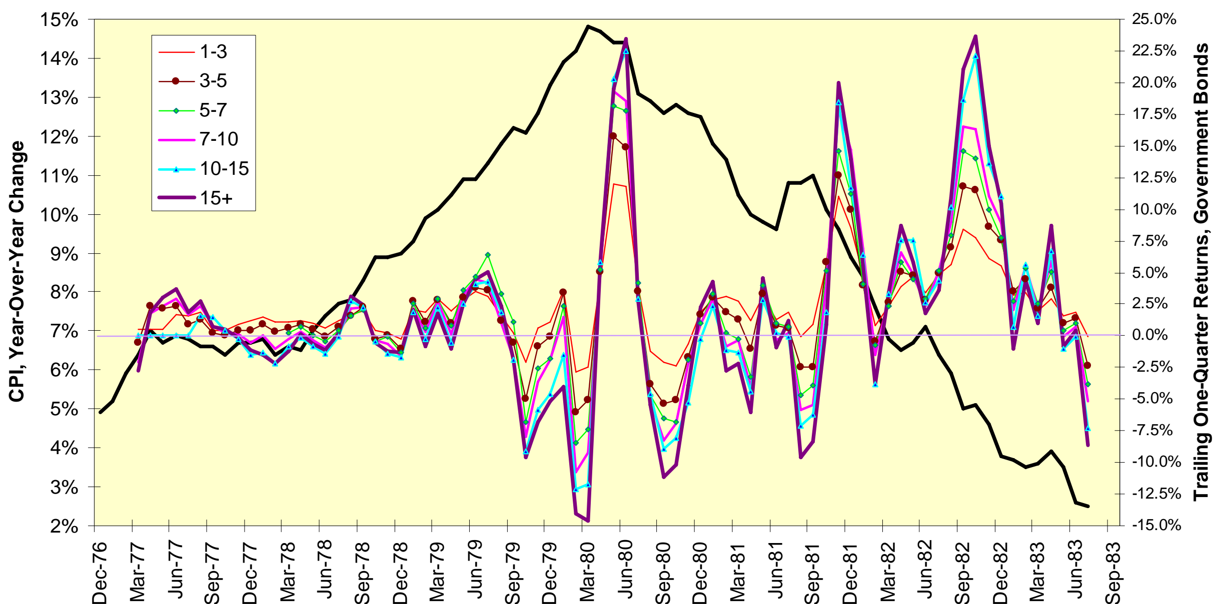
Bonds During The Last High-Inflation Era

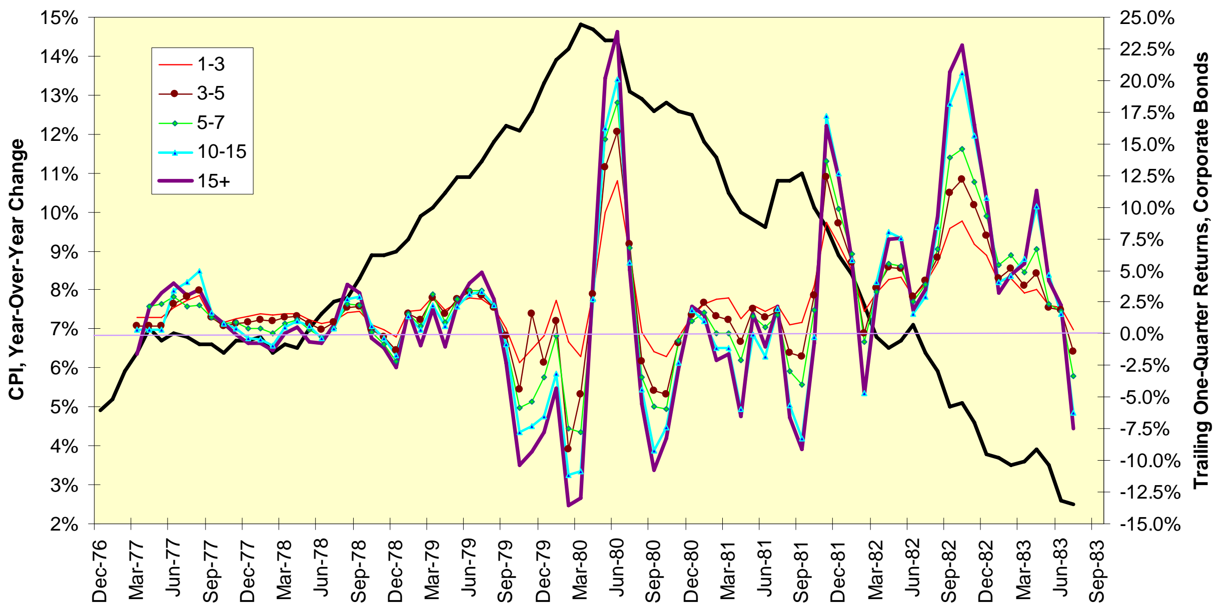
Unless you find yourself working for Uncle Sam, the best time to start thinking about something is before, not after, it becomes a crisis. Otherwise you might find yourself chasing reality with a set of rate cuts, emergency facilities and selective bailouts worthy of *An Evening at the Improv* but without the harmless laughter.

If we follow the suggestion made last week the recent and present course of monetary creation will lead to inflation at some indeterminate point in the future, it might be instructive to look at corporate and Treasury bond markets during the 1970s-early 1980s double-digit inflation era. For those of you who did not live through that era, congratulations are offered. It was ugly. One of the Carter-era proposals was to cap wages and prices at 7% growth rates; my employer thought the 7% wage cap was a great idea but the 7% price cap was something that had leaked out of Lenin's Tomb.

First, a little factoid: The double-digit inflation period as measured by year-over-year change in the Consumer Price index, marked with the heavy black line in the charts below, could be limited fairly to March 1979 – October 1981. But inflation is a state of mind as much as it is a state of economics. The chronology is telling: Inflation had been considered such a problem by the late 1960s that Lyndon Johnson closed the gold window to the French and Richard Nixon imposed wage and price controls in August 1971. Commodity-linked events such as the 1972 Great Grain Robbery and, of course, the 1973 oil price spike came afterwards. That higher oil prices are alleged as a cause of an already-extant problem tells us something about the state of economic literacy during the Leisure Suit era.

It is more interesting to extend the analysis backwards and forwards in time from the double-digit era to the takeoff point in December 1976 and the low of the first disinflation cycle in July 1983. We can overlay the trailing one-quarter returns for both Treasuries and corporate bond indices over a range of maturity segments.





Lessons

One thing we can see here is just how long it took fixed-income investors to grasp the damage produced by rising inflation during the 1970s and, in reverse, just how long it took them to embrace falling inflation during the 1980s. Markets are supposed to look forward; failing that, they are supposed to arbitrage existing events. Fixed-income investors had a hard time reacting to the past. To be fair, many investors felt burned by jumping on the bond bandwagon too soon in 1980 only to have Paul Volcker, in his pre-Volcker Rule days, pull the rug out from under them by raising rates.

This policy uncertainty went a long ways toward maintaining a higher cost of capital than would have existed otherwise. One of the largest determinants of the liquidity premium, or spread between long- and short-term interest rates, is interest rate volatility. Currency volatility is critical as well; foreign investors facing wide fluctuations in the dollar demand higher yield in recompense.

The net result of all of this was the U.S. did not escape the true costs of high inflation until the very end of the era. The great bull market did not begin until August 1982, nearly a year after ten-year Treasury yields peaked in September 1981.

The herky-jerky Volcker was replaced by the gradualist Greenspan who both raised and lowered short-term rates slowly until he started to believe his Maestro propaganda and left us with a string of disastrous bubbles. The next inflation may be greeted with a gradualist response at first. This will give you time to exit. Then whoever is in charge will channel his or her inner Genghis Khan and start slamming rates higher. Past performance is more useful in predicting future results than the literature suggests.