DECEMBER 2021

Focus —

US economy: Lessons from the 40s

While many economists have tried to compare the current macroeconomic landscape to that of the roaring 20s (optimistic scenario) or the 70s (pessimistic scenario), the context of the 40s is also rich in lessons.

PRIVATE BANKING

"We are at war…" This sentence pronounced by Emmanuel Macron during his health crisis speech in March 2020 is still in all our memories. His wording was criticised at the time because it was felt to be disproportionate by some. Armed conflict has often resulted in far more victims than the current pandemic, but also in enormous material damages that required a major reconstruction effort.

Yet some experts make comparisons between the current macroeconomic situation and that of the 40s.

Below we highlight the similarities and differences between these two periods and try to draw lessons from them for our macroeconomic forecasts and asset allocation decisions.

Similarities between the 40s and the Covid-19 pandemic

During these two periods, financial markets faced uncertainty and spikes in volatility. The source of this disturbance: the Second World War (and post-war) 80 years ago and the COVID-19 pandemic today. Although these two crises are structurally different, they have the following similarities:

The surge of government debt

The 40s is the only period in modern history when government officials increased spending in the same way as in the current health crisis, i.e. massively and on purpose. We cannot compare either the 20s or the 70s to this exceptional situation. In the 20s, the budget was at equilibrium, debt was under control and the Fed had raised interest rates. Governments around the world did not adopt Keynesian policies until the 1930s. During the crisis of the 70s, the budget deficit remained below 1% of GDP until 1974. It was only after 1983 that the latter exceeded the 4% threshold for a prolonged period.

Let's look back to the 40s. The Second World War proved to be very costly, leading to rising deficits and debt. In 1940, the US budget deficit was 3% of GDP before rising to -13.9% in 1942 and -29.3% in 1943. In that same period, the national debt had gone from 3 billion to 64 billion dollars.

The Covid-19 crisis has also led to substantial deficits and heavy debt. In 2020, the budget deficit reached about 3.1 trillion dollars (15% of GDP) compared to 984 billion dollars in 2019. The national debt rose from about 22 trillion dollars in 2019 to over 29 trillion dollars today.

Central bank intervention to ensure financial market stability

In both the periods that we are comparing, the US Federal Reserve pursued an aggressive monetary policy by lowering interest rates and using quantitative easing to stimulate the economic rebound and support financial markets. During World War II, the Fed did not hesitate to use unorthodox methods such as yield curve control by buying US Treasuries and implementing targets from April 1942: 3/8% for Treasury-bills (3 months) and a maximum of 2.5% for 10 year Treasuries. This policy aimed to reduce the interest burden the US government faced with an explosion of debt and budget deficits. It was not until 1951 that the Federal Reserve regained true independence.

During the 2020 pandemic, the Fed and other central banks also resorted to an asset purchase program consisting of purchases of Treasuries and mortgage-backed securities. It is therefore a strong similarity to that of the 40s: coordination of fiscal and monetary policies.

Demand and supply shock

Another similarity between the two periods is the sharp increase in demand for durable goods and the shortages observed at the end of the crisis. Similarly to the present, the restrictions in place during the Second World War resulted in high levels of excess household savings. The US household savings rate reached 27% of annual income, four times the pre-war level. After the armistice, households tapped into their savings, which led to a very sharp increase in demand. On the supply side, many assembly lines were severely disrupted because the US government had asked factories to focus on the production of military equipment (bombs, tanks, etc.). This resulted in shortages of durable goods, a situation exacerbated by the strong recovery in demand once the war ended. This dual shock - rising demand and supply bottlenecks - caused a series of inflationary spikes during the 40s.

A similar scenario appears to be unfolding in 2020-2021. The demand recovery is turning out to be much stronger than expected as the world faces shortages of goods and services, labour shortages, transportation delays, and supply-demand imbalances in the energy sector. Much like in the 40s, we are now facing a rise in inflation much higher than expected. Indeed, the inflation rate reached 6.8% (on a y/y basis) in November, the largest price increase in 32 years.

Negative real interest rates in the 40s

As discussed above, the fiscal stimulus has had a very positive impact on growth, while the double shock of rising demand and restricted supply led to a sharp rise in inflation. Under normal circumstances, such a surge in inflation would have put significant pressure on bond yields. However, under the pressure from the US Treasury, the Federal Reserve capped long-term government bond yields at 2.5% until spring 1951.

As a result, real (i.e., inflation-adjusted) interest rates became very negative in the 1940s, allowing the government to deleverage and the financial markets to stabilize.

These negative real rates also encouraged the purchase of risky assets such as equities and lower quality bonds as investors had no other choice if they wanted to earn a positive real return.

As shown in the table below (source: Strategas), despite a macroeconomic context far from being ideal (high inflation rate, large budget deficits, high debt level), stock market performance was relatively good (8 positive years out of 11), even if it was not until 1954 that the Dow Jones reached its all-time high of 1929.

US economy: Lessons from the 40s

Exploring the similarities and differences between post-WWII and the current pandemic's economic environments

DECEMBER 2021

Macroeconomic and stock market indicators in the United States during the 40s

Year	3 month interest rate	10-year bond yields	Inflation rate (12 months rolling)	Budget deficit / surplus in % of GDP	Bond yield spreads (in basis points)	Performance of the S&P 500 (in %)
1940	0.04	2.20	0.7	-3.0%	64	-9.6
1941	0.13	1.99	5.1	-4.3%	78	-11.6
1942	0.34	2.11	10.9	-13.9%	72	20.1
1943	0.38	2.07	6.0	-29.6%	66	25.6
1944	0.38	2.09	1.6	-22.2%	63	19.5
1945	0.38	1.73	2.3	-21.0%	90	36.3
1946	0.38	1.74	8.5	-7.0%	79	-8.0
1947	0.60	1.85	14.4	1.7%	76	5.6
1948	1.05	2.15	7.7	4.5%	67	5.4
1949	1.12	1.93	-1.0	0.2%	73	23.6
1950	1.20	2.05	1.1	-1.1%	58	32.6

Source: Strategas

The come-back of the 40s?

'History doesn't repeat itself, but it often rhymes,' Mark Twain said.

As discussed earlier, the current macroeconomic scenario seems to have some similarities with that of the 1940s (high growth, high inflation, record debt, abnormally low interest rates, etc.). However, there are some notable differences. First, we believe that global economic growth should normalize in the coming years. The same is true for inflation. Firstly, the dual demand-supply shock should start to unwind next year. Secondly, there are now secular deflationary trends that we call the 3 Ds - demographics, digitalization and debt. Only the last factor (the D of debt) was relevant in the 1940s. Inflation could therefore be close to peaking, although it could remain above the Fed's target for a longer period than initially expected.

On the other hand, it is unlikely that the huge debt and large budget deficits in the United States can be eliminated in the coming years. As a result, interest rates and nominal bond yields may remain low for a few years to allow the U.S. Treasury to meet its borrowing obligations.

Inflation above the central bank's target and an expansionary monetary policy should de facto generate negative real rates, which is rather favorable for risky assets. Beware, however: this exceptional situation could lead to volatility in macroeconomic figures, with a corresponding increase in financial market volatility.

Conclusion

What are the main lessons of the 40s?

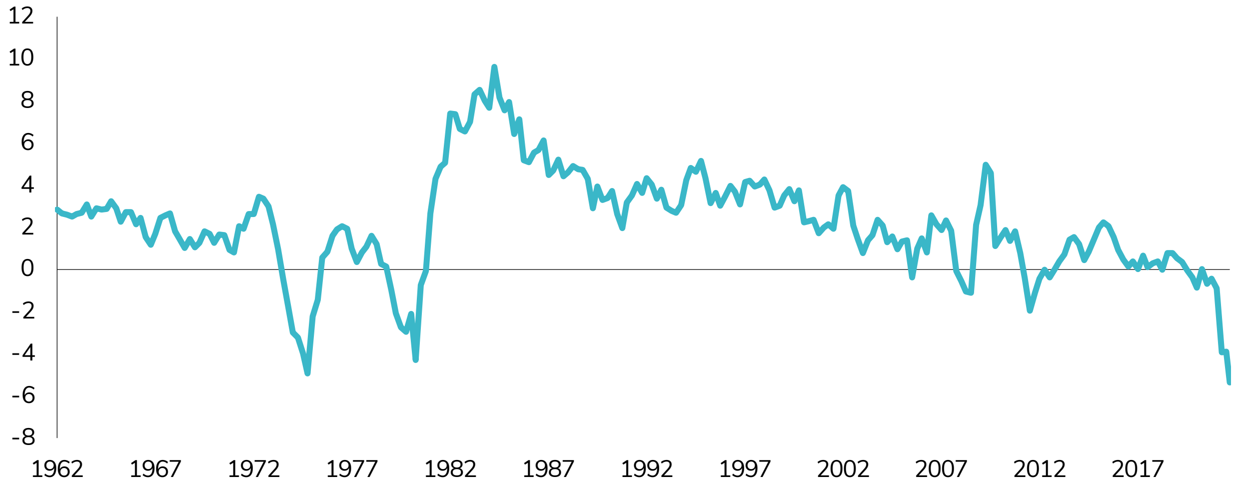
1. The use of fiscal stimulus has very positive short-term effects on growth. Between 1941 and 1945, real GDP in the United States grew by 12% on average. Note that the latest estimates from the Atlanta Fed NowCast indicate real GDP annualized growth close to 9% in Q4.
2. There is a high probability that a large expansion of the monetary base in a period of strong growth will lead to higher inflation (one exception: Japan, which continues to pay for its monetary policy mistakes).
3. High volatility in the rate of inflation is likely to generate significant volatility in the P/E multiples of the S&P 500. In the 1940s, the P/E fluctuated between 8x and 22x between 1941 and 1946 before falling back to 6x in 1949.
4. A fiscal stimulus policy must be supported by an expansionary monetary policy via financial repression, i.e. negative bond yields. It seems that we are indeed in this paradigm, since the real 10-year yields on US bonds are currently at -5.4%, the lowest level since .... the 40s (see chart below). Real rates are pushing investors into risky assets.

US economy: Lessons from the 40s

Exploring the similarities and differences between post-WWII and the current pandemic's economic environments

DECEMBER 2021

US 10-year real yield (in%)



Source: Bloomberg

For further information

Banque Syz SA
Quai des Bergues 1
CH-1201 Geneva
Tel +41 58 799 10 00
Fax +41 58 799 20 00
syzgroup.com

Charles-Henry Monchau, Chief Investment Officer
charles-henry.monchau@syzgroup.com