The More Things Change, the More They Stay the Same

This essay was originally published in Muhlenkamp Memorandum *Issue 19, July 1991. At that time, most economists agreed that the recession of 1990–91 was over. However, they were concerned with the shape the recovery might take. Some economists feared that any strength in the Gross National Product (GNP) would result in higher inflation. Others feared that the recovery would be aborted by a combination of high inflation and modest growth in the money supply. The same economists had feared the same things in 1982, and they were wrong. Ron believed they were wrong again. There were no indications that we were headed toward inflation, and though he believed interest rates were still high (relative to inflation) and that might slow the recovery, he felt (contrary to most) that rates were likely to fall. Ron wrote this essay to explain why.*

One major function of recession is to dampen consumer enthusiasm, typically after years of growth. Another function is to make the public reevaluate and reappraise those areas where prices have gotten most out of line with economic reality. During the 1970s, for example, farmers who sold land for twice its "economic" price watched their neighbors bid it still higher. In Texas, the assumption that the price of oil could only increase drove other prices up as well, especially real estate. Oil and farmland were subsequently reappraised in the recession of 1980-82, but the rest of the country ignored the warnings. During the 1980s, the public's perception of ever-rising real estate prices was unshakeable. Eventually it became apparent that the economic realities of both commercial and residential real estate had changed dramatically from the 1970s. In 1987, we wrote an essay entitled "Wake Up, America— Houses Don't Make You Money!" attempting to point out these changes. We received many responses of "yes, but not in Boston; or yes, but not in Washington D.C., Philadelphia, etc." Real estate nationwide is now in the process of being reappraised.

Among homeowners we are seeing a shift in attitudes and actions from "trade up on equity" to "prepay the mortgage." Demographers have been saying for years that when the baby boomers turn 40-something, their focus would shift from borrowing for houses to saving for college tuition. We suspect that the traumatic events of 1990 (recession and the Gulf War) may have helped to accelerate this shift.

We don't yet know how large the shift will be, and we are not likely to know for some time. But any shift at all will have tremendous effects on the shape of our economy for at least the next decade.

While the 30-something baby boomers have been paying high interest rates without giving it critical thought, their retired parents have been receiving correspondingly high rates on their savings, and assuming it would continue indefinitely. These retirees were taught to "protect principal and spend income," a rule of thumb which works well in a low inflation (0%–1%) environment. But they continued to use this rule when inflation soared to over 10% in 1980–82 and then settled at 2%–5% for a number of years. Such inflation destroyed much of the purchasing power of their principal (see our essay, "The Inflation Time Bomb") without their knowledge. They only became aware of the destruction when interest rates (and thus their "income") subsequently fell.

During the first leg down in interest rates in the early 1980s, many bought "high-yield" bond funds or other securities which promised high incomes, only to discover that the promises were empty. Many lost sizable portions of their assets. We are now in the midst of a repeat of that experience. Many retirees have come to depend on "income" yields of 8%–9%. Yet, since last winter, short-term rates have dropped to 5%¬6%. Relying on their rule of thumb, many retirees are facing a spending cutback of up to 30%. Some are simply hoping for a return to higher rates (very unlikely, in our opinion). Others are moving money to various areas where they are promised (often only implicitly) rates of 8%–9%. Some of the things they are buying will not fulfill that promise.

As investors, our thoughts on solutions to this dilemma have been covered in earlier essays. Our point in this essay is that, in addition to a reappraisal and subsequent lower spending by baby boomers, we are also likely to see a reappraisal and a reduction in spending by retirees as well. Such a reappraisal would reinforce the decline in interest rates we've been warning about.

Editor's Note

When the economic climate changes, there is often a lag in public perception. Recessions and traumatic events often trigger a reassessment by the public, which then gets things "caught up" to reality. In the 1970s, prices of real estate and oil got out of line with reality.

The recession of 1980–82 brought back oil and farmland. The recession of 1990 brought back interest rates. In 1999, tech stock prices got out of line with reality. There was a recession in 2001, and the tech stocks gave it all back. Short-term emotions and lags in perception can make the stock market stray from reality. Eventually the perceptions catch up with reality, and the market returns to rational pricing.