

A Golden Era Marks Two Golden Anniversaries

Largely unnoticed, the third quarter of 2021 marked the 50th anniversary of two momentous decisions that changed the course of economic history and commenced a multi-generational era of unprecedented global growth. On August 15, 1971, President Richard Nixon removed the United States from the Gold Standard, saying that he wanted to create more and better jobs and to halt the rise in the cost of living.¹ This bold and politically risky move effectively ended the 1944 Bretton Woods Agreement, whereby U.S. dollars were convertible into gold at a fixed price and all other Western currencies were pegged to the greenback. Thus began the current system of “fiat” currencies, backed only by confidence in the issuing governments and their central banks. From that point forward, each nation’s currency was worth whatever the market said it was worth. Moreover, by scuttling the Agreement’s complex system of exchange, international trade no longer had to balance, ushering in a period of surpluses and deficits that can (and often do) have a meaningful impact on a given nation’s prosperity.²

Critics alleged that Nixon’s move would debase the dollar and result in massive inflation. They were correct, at least for a while. Over the following decade, the price of gold rose from \$42 per ounce to \$410,³ and the dollar lost more than a quarter of its value relative to the currencies of major trading partners Japan and Germany.⁴ Domestic inflation accelerated sharply, peaking at 14.8% in March 1980,⁵ even though economic growth sputtered, a corrosive combination known as stagflation.

But during that fateful summer of 1971, Nixon had another trick up his sleeve. In July, the President ordered National Security Council head Henry Kissinger to make a secret trip to China, the first step towards normalizing relations with the world’s most populous nation.⁶ Nixon could not have envisioned the far-reaching consequences of this extraordinary act of diplomacy. By opening China, allowing currencies to float and fostering trade agreements that brought billions of new participants to the global economy, a President most remembered for his misdeeds arguably gave rise to a five-decade era of growth and globalization that endures today.

“It ain’t what you don’t know that gets you into trouble. It’s what you know for sure that just ain’t so.” --Anonymous

It has become popular to predict rising inflation and to claim that we have entered a new period of stagflation. Such fears are not unfounded: in the twelve months through August, the U.S. inflation rate as measured by the Consumer Price Index (CPI) was 5.3%, more than twice the trailing thirty-year average of 2.3%.⁷ The Producer Price Index registered an 8.3% year/year increase, portending further upward pricing pressure in the months ahead.⁸

At the same time, economic activity has been somewhat slower than consensus forecasts. After contracting by 3.5% in 2020, U.S. gross domestic product grew at an annual rate of 6.7% in the second quarter of 2021,⁹ but is likely to decelerate as the year draws to a close. Help wanted signs have appeared nearly everywhere in the country as employers, particularly in retail services, have struggled to find employees even at elevated wages. The continuing COVID pandemic threatens a full reopening of the economy, and supply chain disruptions are distorting the growth of nearly every sector to some extent.

The Federal response to the pandemic has been unprecedented deficit spending. In 2020 the Federal budget deficit was \$3.7 trillion, and this year the deficit is projected to be \$3.4 trillion. At the same time, the Federal Reserve has pursued an aggressive monetary policy, creating \$4.5 trillion of new money supply through quantitative easing (QE), more than doubling its balance sheet since the beginning of the pandemic. For the moment, QE continues at a rate of \$120 billion of new money created each month.¹⁰



Taken together, it is easy to conclude that fiscal and monetary policies are inflationary, even as the economy is likely to slow—the very definition of stagflation. But is such an outcome inevitable?

“Nothing is more obstinate than a fashionable consensus.” --Margaret Thatcher

Bashing the Federal Reserve and attributing nefarious narratives to its motives have become fashionable in recent weeks. The jury is still out, but we agree with Fed Chairman Jay Powell, who believes that while inflation has recently exceeded expectations, the causes are likely transitory. As noted above, the pandemic disrupted supply chains and caused shortages of critical materials and components. For example, when the pandemic hit with fury in early 2020, automobile manufacturers fearing slumping demand abruptly cancelled semiconductor orders with chip manufacturers.¹¹ Their place in line was quickly taken by demand from the rest of the increasingly digital-hungry world, especially as many millions began working from home. As a result of their miscalculation, auto makers cannot secure enough chips to meet demand and have had to delay production. Long waits for new cars led to a 45% increase in used car and truck prices in the year ending June 2021, accounting for an astounding one third of the overall increase in consumer prices during that period.^{12, 13}

Commodity prices have been mixed, but the price of some key inputs such as lumber and soybeans have declined in recent weeks and months.^{14, 15} Although oil prices are up this year, they are still a third lower than they were for much of 2013 and 2014, a period of very low inflation. Oil is abundant but dependent on needed new pipeline infrastructure to reach the market. Longer term, we expect the electrification of transportation and other carbon-reduction initiatives will put permanent downward pressure on oil prices.

Compared to other input costs, labor is far more significant and exerts greater influence on the rate of inflation. According to the Federal Reserve’s nominal Wage Growth Tracker, the year/year median change in wages as of August 2018, 2019, 2020 and 2021 were 3.5%, 3.7%, 3.5% and 3.9%, respectively. While higher than the period 2009-2017, it is about 15% lower than average wage growth for the 11-year span from 1998 to 2008, a period marked by muted inflation.¹⁶

Looking into 2022, fiscal and monetary stimuli are likely to fall sharply. The Federal deficit is currently estimated to decline to \$1.2 trillion, and the Fed is signaling that tapering of its bond purchases will begin soon (if it doesn’t cut back, the Fed’s buying could outstrip new Treasury bond issuance within the next few months). Together with low interest rates, a mixed bag of commodity prices, relatively stable wages and a strengthening dollar, it is hard to make a case for runaway inflation. In fact, recent data shows a softening in consumer inflation during the third quarter. In July and August, the core CPI (excluding the volatile food and energy components) rose 0.3% and 0.1% respectively, consistent with the trailing twenty-year monthly average of 0.2%.

Beyond the next twelve months, we think the outlook for inflation is likely benign. With continuing cross border flows of capital and increasingly skilled labor (much of it online), the accelerating application of robotics, automation, artificial intelligence, fintech and other technological advances, we expect inflation to moderate as pandemic-induced supply shocks abate. If the fiscal deficit shrinks and monetary credit growth slows as expected, U.S. total demand will likely weaken at the same time that supply increases. Therefore, we may soon return to a pre-COVID world where plentiful global labor and industrial capacity lead to the persistently low inflation we have experienced for nearly 40 years.



“October: This is one of the peculiarly dangerous months to speculate in stocks. The others are July, January, September, April, November, May, March, June, December, August and February.”

--Mark Twain, Pudd'nhead Wilson

Although we make no forecast on the direction of the equity markets, we expect greater volatility in stock prices heading into 2022 as investors anticipate the impact of slower growth and potentially higher interest rates on earnings. In such an environment, picking the right companies in which to invest becomes more important, and the potential value of our disciplined five-filter research approach increases. We seek to identify businesses with sustainable competitive advantages, strong balance sheets, stable free cash flows and attractive valuations relative to our assessment of intrinsic value. We look for smart shareholder-oriented managers with ample opportunities to reinvest free cash flow for growth. Additionally, the Douglass Winthrop research team has recently begun to investigate and quantify another characteristic of truly exceptional companies: “operational agility.” The pandemic has provided a unique opportunity to evaluate companies on this measure. We think there are a number of companies in our portfolio that have been particularly agile, including **Nike** and **Starbucks**.

Fifty years ago, a global sports apparel company like Nike would have been inconceivable. Nike directly employs approximately 75,000 people worldwide. But this understates the case: Nike’s carefully managed contract manufacturing partners employ over 1,000,000 people around the globe, mostly in Asia. Some 40% of Nike’s footwear is made in Vietnam. The recent surge of COVID cases has forced the closure of most of its Vietnam production capacity. Nike is demonstrating its agility by shifting apparel production to other countries where viable. Even as Nike contends with this supply-shock challenge and the resulting impact on sales over the next few quarters, it is hard to imagine a company better positioned to thrive both during and after the pandemic.

Nike CEO John Donahoe is a digital native, having been the CEO of both eBay and Service Now, one of the most significant cloud based software companies. On a recent call with analysts he said: “So while the environment is dynamic, these supply chain issues we believe are temporary. And from what we can see today, we’re optimistic that available inventory supply will be improved as we head into fiscal year 2023.” Meanwhile, Nike’s business is transforming to increase automation of the supply chain, and focus on e-commerce and direct engagement with its customers. Nike’s membership program now has 300 million members who receive early access to new products, the ability to design their own apparel, and special offers. This engagement provides Nike with actionable data about its customers so it can rapidly adjust to new trends, increasing loyalty. Nike is investing in 3D printing and automated machinery. This innovation is expected to halve labor costs, use 30% less material, and get products from design to market in one-third the time. Management has also cut the number of its retail resellers from over 250 to 40 and invested in higher margin and faster growing direct-to-consumer channels. In our view, Nike is proving to be one of the most agile companies on the planet.

We think Nike’s Seattle-based neighbor Starbucks is just as innovative and agile. Though the company is well-known for its loyal US consumer base, its international opportunity is under-appreciated, in our opinion. There are twice as many Starbucks stores in Shanghai than in New York City, and the company plans to add 600 stores in China annually for the next ten years. Incredibly, during the year of COVID, Starbucks delivered comparatively strong same-store sales by providing customers with mobile apps, employing increased automation, quickly relocating stores from office dominated locales to be closer to their customer’s homes, and adding drive-through capabilities (drive-through now represents 50% of sales, while fast-growing mobile contributes 26%). Starbucks’ future success depends on its ability to effectively manage its international growth and deliver a premium customer experience abroad. In 2019, under competitive threat in China, Starbucks rolled out delivery to 90% of its 5000 stores in just



seven months. Chinese consumers annually drink 1/600th the amount of coffee per capita as Americans. As tastes change, Starbucks is well-positioned to capture this brewing market.

President Nixon could not have imagined the impact the radical changes he wrought in 1971 would have on a company like Nike. Surely he had no clue that a single storefront coffee company founded that same year could eventually sell a commodity at premium prices in 80 countries. Fifty years later we can look back and thank this controversial and troubled man for the vast opportunities that resulted from his difficult calculations, including the opportunity to own shares of great businesses like Nike and Starbucks.

***“Games are won by players who focus on the playing field – not by those whose eyes are glued to the scoreboard.”
Warren Buffett***

The third quarter brought two new members to the Douglass Winthrop family. Nicole DeVivo joins our top notch customer service team as an Assistant Client Relations Manager, and Evelina Khorenko is our newest Associate, with primary responsibilities in Compliance and Operations. We also wish to acknowledge the retirement of our colleague and friend Grant Winthrop. We are grateful for his years of dedicated service to our clients.

Speaking of our clients, we thank them for the privilege of pursuing this rewarding profession on their behalf. All of us at Douglass Winthrop have a passion for the investment process. We derive satisfaction from trying to make sense of a complex world, while hopefully leaving it a better place. We are truly inspired by your trust and confidence. We welcome your questions and comments.

Sincerely,

Douglass Winthrop Advisors LLC

Note: All market data is from Bloomberg.

¹ <https://blogs.cfainstitute.org/investor/2013/03/13/president-nixon-the-man-who-sold-the-world-fiat-money/>

² Before Nixon's abandonment of Bretton Woods and turn to globalization, national economies were bound by labor and capacity constraints and trade between nations had to balance. The mechanism for balancing trade could be harsh, including recessions and monetary instability (inflation or deflation). In the post-Nixon economic era, however, production capacity and low cost labor could be sourced globally and trade no longer had to be paid for in gold. The U.S. Dollar became a universally accepted payment for goods and services. The globe was soon awash in Petrodollars and Eurodollars. Defying the expectation that abandoning the Gold Standard and flooding the world with dollars would result in runaway inflation, in the thirty years since 1991 and including 2020, the CPI measure of inflation has averaged a manageable 2.3%.

³ <https://www.macrotrends.net/1333/historical-gold-prices-100-year-chart>

⁴ <https://fred.stlouisfed.org/series/EXGEUS> and <https://fred.stlouisfed.org/series/DEXJPUS>

⁵ https://en.wikipedia.org/wiki/Paul_Volcker

⁶ <https://china.usc.edu/revisiting-kissingers-secret-trip-beijing>



⁷ <https://www.minneapolisfed.org/about-us/monetary-policy/inflation-calculator/consumer-price-index-1913->

⁸ <https://www.usinflationcalculator.com/inflation/current-inflation-rates/>

⁹ <https://www.bea.gov/news/2021/gross-domestic-product-third-estimate-gdp-industry-and-corporate-profits-revised-2nd>

¹⁰ <https://www.reuters.com/article/us-usa-fed-powell/powell-qe-taper-likely-well-before-interest-rate-increase-idUSKBN2C12HZ>

¹¹ <https://www.mckinsey.com/industries/automotive-and-assembly/our-insights/coping-with-the-auto-semiconductor-shortage-strategies-for-success>

¹² <https://fred.stlouisfed.org/series/CUSR0000SETA02> and <https://www.reuters.com/business/finance/us-consumer-prices-surge-june-2021-07-13/>

¹³ <https://fred.stlouisfed.org/series/CUSR0000SETA02>; https://ycharts.com/indicators/us_inflation_rate and <https://www.reuters.com/business/finance/us-consumer-prices-surge-june-2021-07-13/>

¹⁴ <https://tradingeconomics.com/commodity/lumber>

¹⁵ <https://tradingeconomics.com/commodity/soybeans>

¹⁶ <https://www.atlantafed.org/chcs/wage-growth-tracker>

¹⁷ <https://www.bls.gov/news.release/cpi.nr0.htm> and <https://www.bls.gov/news.release/pdf/cpi.pdf>

¹⁸ <https://www.officialdata.org/2000-dollars-in-2019?amount=100>

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