Economic distance model

September 2022

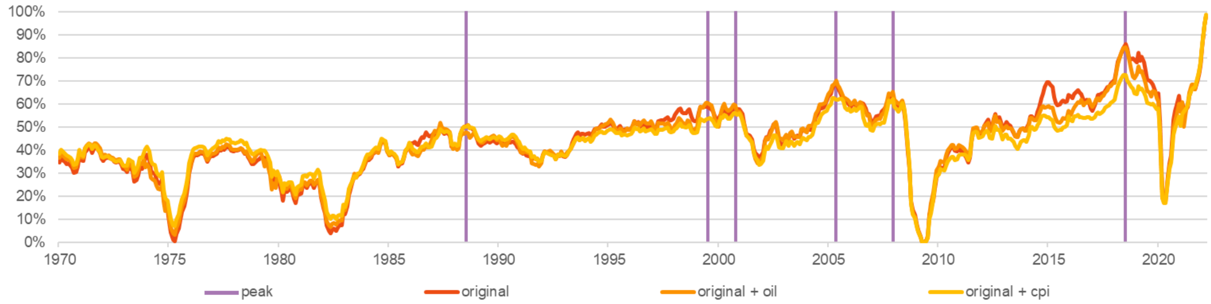
Inflation a major issue but not the same as the 1970s

The period of high and volatile inflation rates of the 1970s offers some valuable lessons for the current period. We have just completed a research paper, distributed exclusively to Frontier clients, where we gauge the main similarities and differences between the current economic conditions and historical periods dating back to 1970 by looking for the nearest neighbour in history using an 'economic distance model'. The model uses a selection of macroeconomic factors to measure the similarity of historic time periods (from an economic and market point of view) compared with today's conditions.

The key takeaway of the research is that today's environment is very different from the 1970s-style inflation spiral. While certain indicators (CPI, oil price) show some similarity, the overall low distance score in the 70s' to today, suggests fundamental changes in general market conditions over the past several decades. Further analysis shows the difference in today's environment is driven by multiple factors, including the paradigm shift in monetary policy framework, better anchored inflation expectations, strong labor market, relatively mild oil price surge magnitude and the rise of technology.

Economic distance score

Current environment looks quite different from history



Source: Refinitiv, Macrobond

*Economic distance score ranges from 0 – 100%, the higher the score, the more similar a historical period is to today. The latest period always has a score of 100% by definition, i.e,100% similarity to current economic environment.

Observations on the current economic distance (as of April 2022):

- The upward-sloping trend in score suggests higher similarity to the current economic environment in more recent periods.
- Within the 1970s, while the score is generally low around this time, there is higher similarity around '77/78 leading into the early 1980s' recession.
- While all three models align well in general, including oil as a factor increases the scores during the peak periods, indicating oil has historically been a key macroeconomic factor driving high inflation conditions.
- The current period scores most closely to 1988, 1999/00, 2005/07 and 2018, which were all periods of interest rate hiking (except for 2007).

The research paper provides Frontier clients with a further breakdown and analysis of specific factors and sectors and reveals the periods of most similarity to today's conditions. The paper also provides detail on the set up of the model which Frontier's Capital Markets and Asset Allocation Team has been utilising continuously for more than a year.

Our team has also produced an interactive website that allows real-time tracking of the market. We plan to make this tool, along with several other interactive quantitative models, available on our Partner's Platform in the future.

To discuss the full report please contact Frontier.

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