DAILY GLOBAL COMMENTARY

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Now vs. 1994/1995 – Part I

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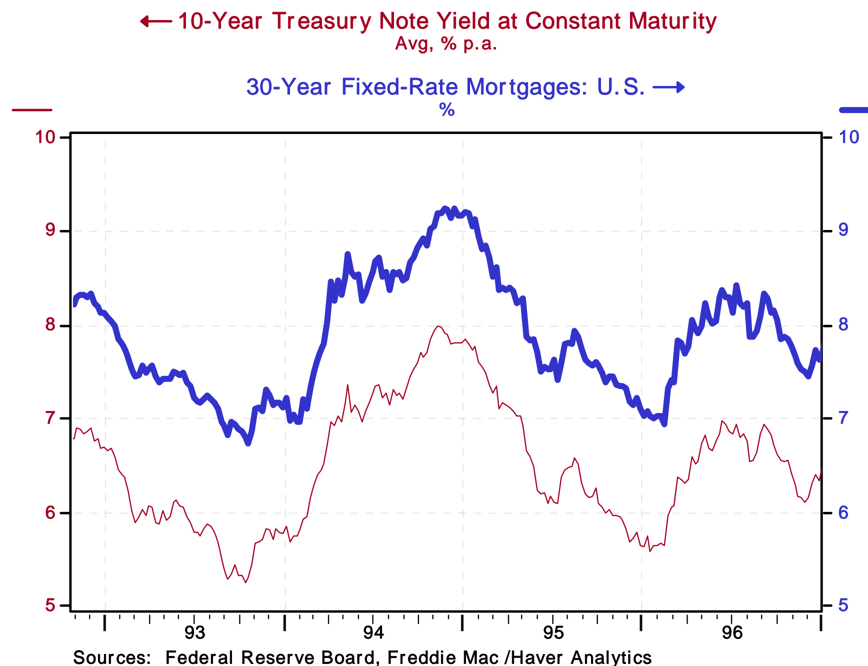
It is nearly certain the federal funds rate will be raised to 5.00% on May10, barring some downside surprises in economic reports. There is a growing cohort of market participants expecting a pause after the May hike. The relevant question now is if the Fed can repeat the soft landing scenario of 1995.

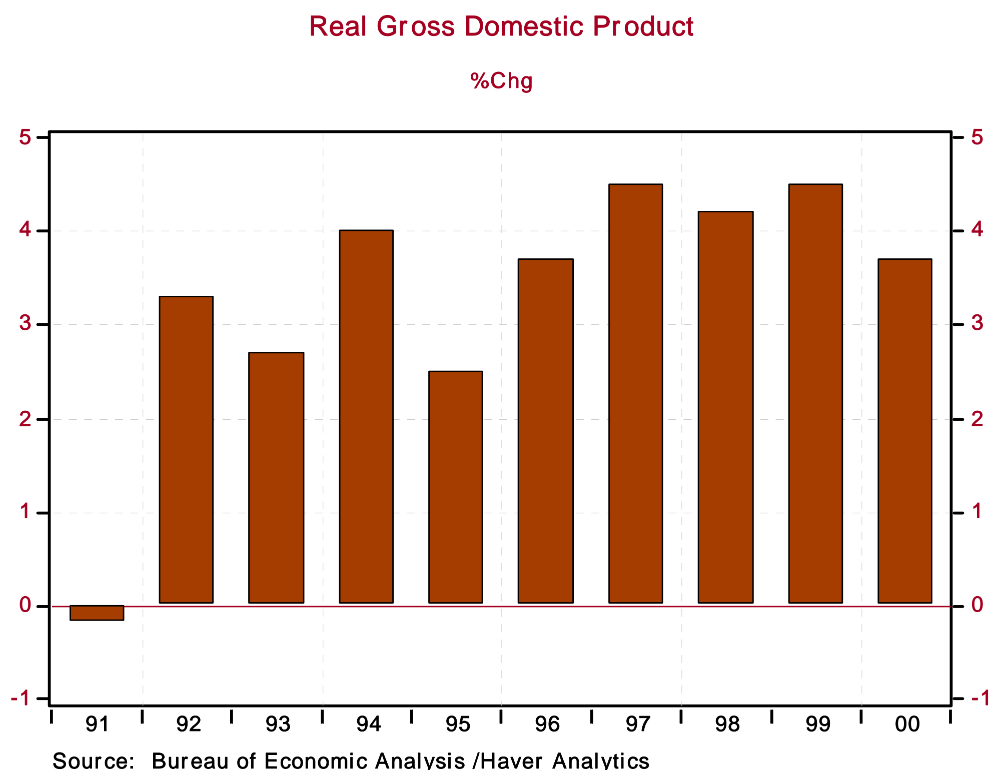
Tuning back to the 1994-1995 period, the FOMC started applying the monetary policy brake in February 1994 and followed it with aggressive policy moves that took the federal funds rate 300 bps higher in a span of twelve months to 6.00%. During this period, the 10-year U.S. Treasury note yield shot up to a high of 8.00% in November 1994 from 5.70% in January 1994. The 30-year fixed rate mortgage rose from 7.00% to a little over 9.00% in the same period.

Chart 1



The Fed's monetary policy strategy was effective in bringing down the growth of the economy to a 2.5% pace in 1995 vs. a 4.0% pace in 1994. After this soft landing, the economy continued to grow at a remarkable clip for the next five years.

Chart 2



Are there parallels between the 1995 soft landing scenario and the current period? In short, there are relatively more risks now than in 1995 and more stark differences than parallels.

We will examine the monetary policy path, the behavior of the 10-year U.S. Treasury note yield, and overall economic growth during the current cycle in comparison with the 1994-95 period in today's commentary and visit the household and business sectors and the international position of the U.S. economy in tomorrow's commentary.

The Fed has raised the federal funds rate from 1.00% to 4.75% in a measured manner from June 2004. The FOMC needed to first bring the federal funds rate from a historically low level and negative real funds rate readings to a neutral setting This operation differs from the Fed attempting to fight inflationary pressures in 1994.

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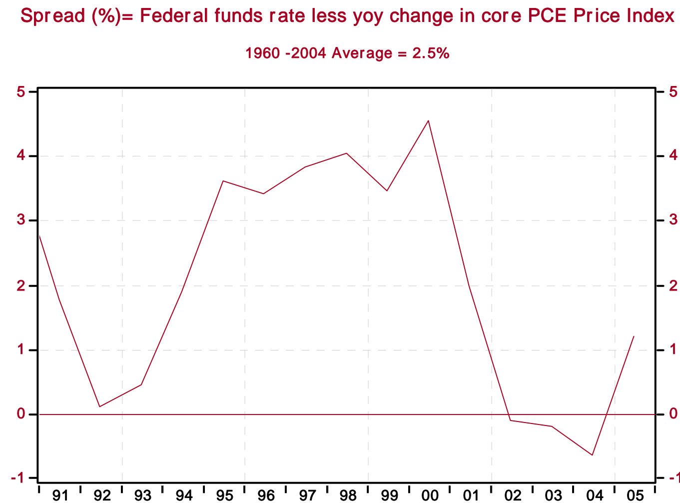
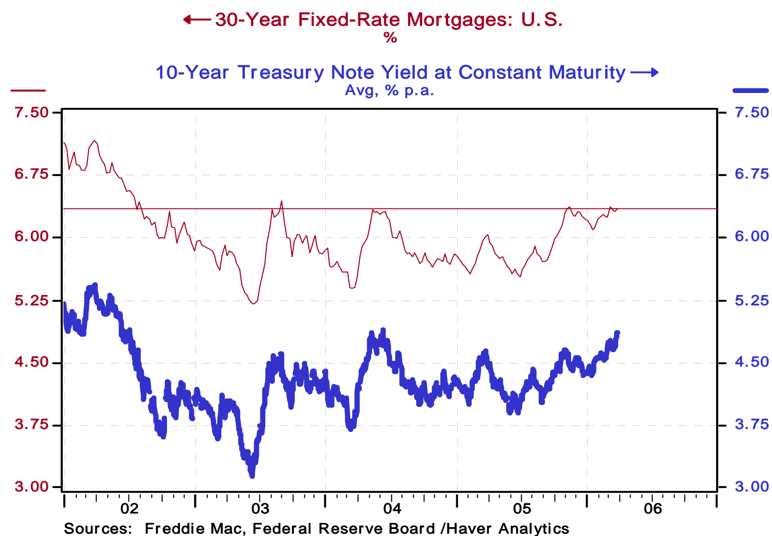
Chart 3



The U.S. Treasury note yield was hovering around 4.70% in June 2004. As the Fed continued on the measured path of tightening, the 10-year Treasury note yield has taken ride down to a low of 3.95% and is now trading at 4.86%. This is an atypical behavior of the 10-year U.S. Treasury note yield in a monetary policy tightening cycle. There are competing theories to understand this trend. The main implication from this atypical situation is that the Fed's attempt to restrain economic growth was partly stifled by the unexpected direction of long rates.

Chart 4



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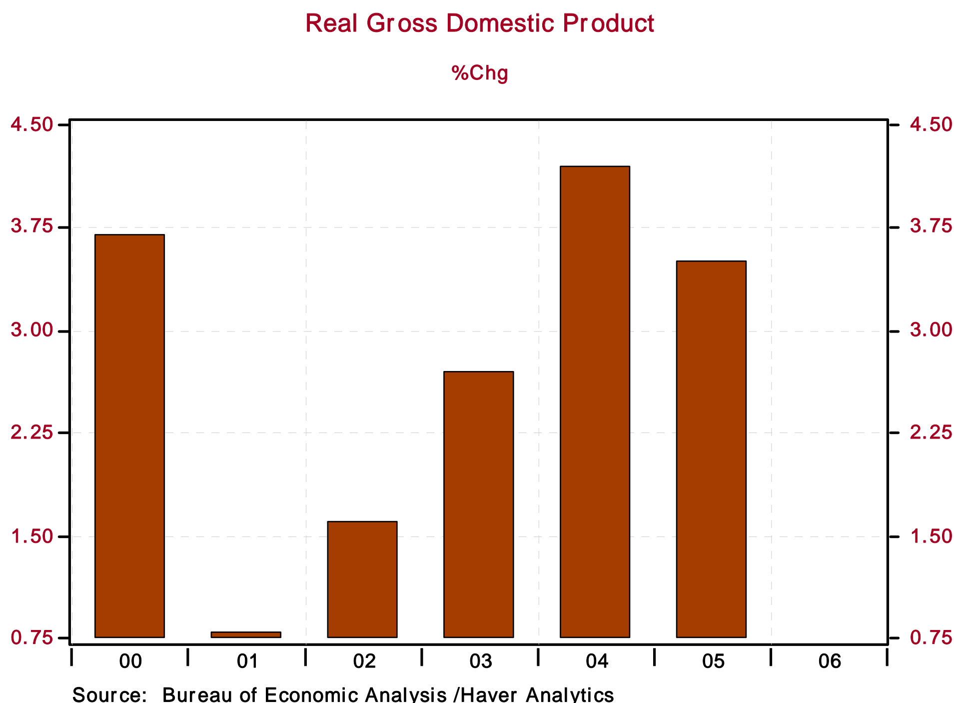
Favorable mortgage rates have supported the robust momentum of the housing market for the most part, with the moderation in home sales occurring only after August 2005. U.S. economic growth in 2005 slowed to a 3.5% pace following a 4.2% increase in real GDP in 2004. Historically, the current economic recover/expansion is the slowest on record in the post war period.

Chart 4



Several measures of economic activity -- real GDP, employment, factory output -- in current economic cycle send an unified message of below average performance after four years of economic growth. Payroll employment has grown between 1.2% and 1.6% on a year-to-year basis since the Fed started raising the federal funds rate in June 2004. This compares with payroll employment growing between 2.5% and 3.5% in the twelve months ended February 1995.

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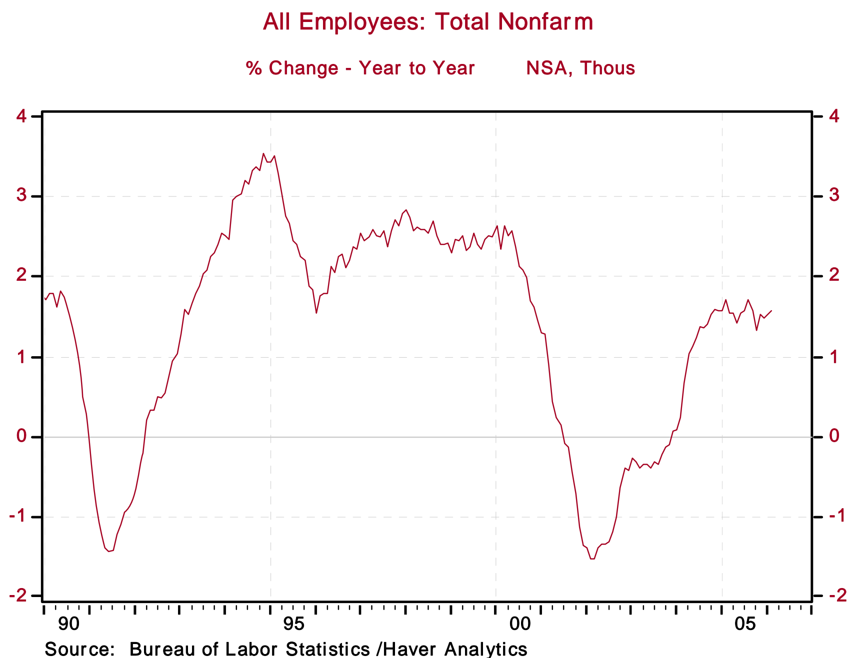
Chart 5



This background information will be followed by additional remarks about the U.S. economy focusing on households, business, and the international sector at the present time vs. the 1994-95 period in tomorrow's comments.

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