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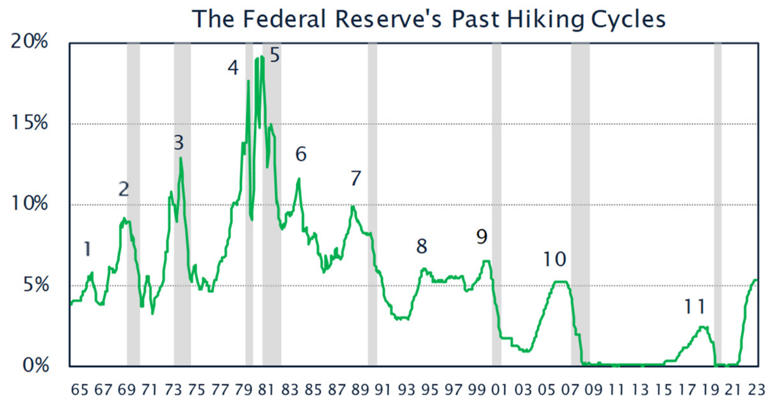
INVESTMENT UPDATE

If you pick up a business-related periodical at your local magazine stand these days, there's a good chance you'll find an article about the likelihood of a "soft landing" for the US economy. As its name implies, a soft landing happens when policymakers implement policies that restrain an overheating economy with such skill and precision that economic growth slows with little collateral damage, leading to either no recession or a very mild one. Soft landings are the unicorns of the economic world, and occupy the happiest dreams that a central banker can experience. The conventional thinking is that they almost never happen.

The reason why it seems so difficult to pull off a soft landing is well-documented: Raising short-term interest rates—the Federal Reserve's primary tool in braking economic growth—works with long lags, and is transmitted through the economy unevenly, impacting certain sectors (e.g., banking) far more severely than others. A 25 basis point hike in the overnight lending rate rarely has any measurable impact at all; a series of increases is needed, along with "forward guidance," which communicates the Fed's intentions for the next few quarters. And, remember, the Fed's goal isn't necessarily to slow the economy, it's to bring down inflation and that can only be achieved indirectly. Perhaps most importantly, the Fed doesn't operate in a vacuum; there are a multitude of exogenous factors beyond the Fed's control that can nullify or accelerate the impact of monetary policy. Certainly, this has been the case over the past few years, as inflation was supercharged by the impact of Covid relief payments and supply shortages on businesses and households. With all this in mind, it's easy to see how monetary policy can easily go wrong.



The Fed has often been accused of going too far in restraining growth, by either continuing to pursue restrictive policies beyond the optimal point, or failing to recognize outside variables. At other times, the Fed didn't appreciate that policies were working, but that those policies simply hadn't had the time to impact the economy to their full effect. As the venerable economist Milton Friedman stated in the early 1960s, the Fed's policies operate with "long and variable lags." It comes as no surprise that since he uttered that phrase, it seems like every Fed tightening cycle has resulted in a US recession.

Into this discussion comes former Federal Reserve Vice Chair Alan Blinder, who recently published a paper in the *Journal of Economic Perspectives* examining the history of recent Fed hiking cycles. As the chart on this page shows, Blinder identifies eleven separate tightening cycles going back to 1965, episodes where the Fed systematically pushed up the effective Fed funds rate. Keep in mind that prior to 1994, the Fed did not explicitly target the Fed funds rate like it does today; instead, the Fed (by turns) adjusted the discount rate, or targeted the growth in money supply, or (as it did in the late 80s and early 90s) targeted the level of reserves on the Fed's balance sheet, when making adjustments to monetary policy. He examines each in context and finds that the idea that the Fed has consistently "overcooked" monetary policy is not necessarily true.

With just a quick look at the chart, you can see what he's getting at. Not counting the current cycle, the eleven hiking cycles have resulted in just eight recessions (the gray shaded areas), using the NBER's standard definition of a recession. The 1965-66 cycle was a very modest one in terms of the increase in the Fed funds rate (up by only 175 basis points), and was spurred by a small increase in an already low inflation rate (from 1.3% in 1964 to 1.7% in 1965). US GDP slowed, and the dogs were called off, with the funds rate quickly falling back to its previous level. There was no recession, but this wasn't much of a hiking cycle, either, as inflation kept rising and the Fed was forced to begin a new tightening cycle the next year.

What followed from the late 1960s throughout the 1970s was a series of missteps by the Fed, combined with global events that only complicated the central bank's multiple attempts to bring down inflation. The first of these variables was the rapid increase in consumer spending in the late 60s, which led to an increase in CPI to 6% by 1970. Tighter monetary and fiscal policies (including an income tax increase) led to a mild recession

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in 1970—what Blinder identifies as a soft landing. But in 1972, a series of supply shocks began—the dreaded exogenous variables—first with food prices skyrocketing, and then in 1973 when OPEC restricted the supply of crude oil, quadrupling the price of oil in three months. Core inflation rose from 3.8% in September 1973 to 11.2% in just 14 months. GDP collapsed as inflation ate into households' and business' bottom line, and the Fed began backing off its tough policies while inflation was still accelerating, as puzzling as that now seems. The Fed reversed course again and the funds rate finally peaked out at 12.9% in July of '74 (#3 on the chart). That finally did the trick and a hard landing ensued.

But by 1978, food prices were soaring again, while "OPEC II" saw oil prices spike once more as a result of the Iran-Iraq war. Two Fed Chairs (Miller and Burns) came and went, before Paul Volcker was appointed to lead the Fed. By the time he came on board, inflation was back in the double digits; unlike his predecessors, Volcker wasted no time in doing what needed to be done to crush inflation (hint: there was no thought of a soft landing). Interestingly, the hard landing was double-barreled, as there was a period between hiking cycles 4 and 5 on the chart when inflation temporarily declined, and the Fed eased slightly. The result was two separate hiking cycles in quick succession and two recessions, with the second coming as a result of the most restrictive monetary policies in modern US history, with the effective Fed funds rate peaking at nearly 20% in the first half of 1981. Older readers will recall that US unemployment hit a post-WWII high of 10.8% in 1982.

What followed was a long period of falling inflation and relatively strong economic growth for most of the 1980s. There was a period of Fed tightening in 1983-84 (#6) which, like the 1965 episode, was more of a recalibration of policy than an attempt to smother inflation. But the Fed hiked by 300+ basis points, so it's a tightening cycle with a landing that was, according to Blinder, "about as soft as you can imagine." But by the late 80s, with Alan Greenspan as Chair, the Fed initiated another tightening cycle, as inflation had crept above 4%. In total, the Fed pushed up the funds rate by more than 300 basis points over a 13 month period (#7). The ensuing recession came late, and by Blinder's opinion had a hard landing only because of yet another oil price shock—this time as a result of Iraq's invasion of Kuwait. The landing was indeed hard, with GDP negative for three consecutive quarters and with the unemployment rate rising from 5.0% to 7.9% over the ensuing period.

The next tightening episode (#8) is often lauded as the quintessential example of a soft landing, and is also remembered for helping to burnish Alan Greenspan's reputation as Fed Chair. The catalyst for tightening was the belief that unemployment had fallen so far (down to 6.6%, hardly rock-bottom by today's standards!) that the Fed needed to preemptively suppress building inflationary pressures. A series of rate hikes throughout 1994, including a 75 basis point bump in November, boosted the funds rate by 300 basis points. The landing was soft—the unemployment rate remained essentially flat for all of 1995, before beginning a five-year decline. Greenspan let things ride in the second half of the decade—a long period of strong economic growth and moderate inflation. By the end of the 1990s, the Fed was forced to ratchet the funds rate up to combat "irrational exuberance" in the capital markets and an unemployment rate that had fallen into the low-4% range. The dot-com crash in 2000 helped to suppress economic activity, and a mild recession in 2001 followed. Not a soft landing, but certainly not much of a recession.

Which brings us to the last two cycles of Blinder's study. First, the global financial crisis, which needs little introduction or explanation for most of us. Blinder's take is that there was more of a regulatory failure than a monetary policy failure that caused the most severe economic recession since the Great Depression. This does little to take the heat off the Fed, though, since the Fed itself was one of the regulators that failed to identify (much less rectify) the dangerous degree of leverage tied to the booming US housing market of the mid-2000s. Still, the Fed's monetary policy leading up to the housing crash was pretty restrictive, if a bit late: it raised the Fed funds rate 17 times, from 1% to 5.25% in 2004-06 (#10). The housing bubble popped, and the landing was inevitably going to be hard. US GDP dropped at an annual rate of 8.9% in the fourth quarter of '08 and another 6.7% in the first quarter of '09. As we know, this was followed by a long and difficult recovery that resulted in the Fed having to buy billions in Treasury securities and agency-backed mortgage-backed securities (MBS) in order to stimulate economic activity after a 0% Fed funds rate was deemed insufficiently stimulative.

Which leaves the eleventh and last of the Fed tightening cycles in Blinder's paper. This, of course, is a strange one—and Blinder is correct to point out that a normal hiking cycle never played out, as the Covid pandemic upended a period of policy normalization after a prolonged period of zero interest rates. In any case, the US and global economies were crushed in the first half of 2020, with US GDP negative for the calendar year for the first time since 2008. An extremely hard landing, but not attributable to Fed policy.

To recap: Eleven hiking cycles, eight recessions. Of those eight, Blinder identifies six tightening cycles that led to hard landings—'72-'74, '77-'80, '80-'81, '88-'89, '04-'06, and '15-'19. To be fair, six hard landings out of eleven hiking cycles (over a sixty-year period) is probably a better result than most observers would have guessed, with more than a couple of those recessions largely beyond the control of the Fed.

It's too soon to know how the current cycle will play out—but a soft landing isn't out of the question. Powell & Co. have shown patience and consistency over the past two years. Yes, they were late recognizing the upward momentum in inflation in 2021, but since then, the Fed has navigated through some bumpy waters with a steady hand. After almost two years, the current hiking cycle may soon come to an end. The next few months will tell.

Until then, Happy Holidays—and may all your landings be soft!

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