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EconomicReport

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FASTEN YOUR SEAT BELTS

Autumn 2006 finds the U.S. economy at several critical junctures. First, it's been almost five years since the last recession ended, back in November 2001. This means that the current expansion has now entered middle age in terms of longevity, thus making it more susceptible to any untoward event that may come down the pike. Speaking of which, it's been more than two years since the Federal Reserve changed its monetary policy from one of accommodation, to one of gradually withdrawing excess liquidity from the system with the intent of keeping inflation from flaring up. In the past, such tightening actions by the Fed have led to a recession, more often than not. Then there's the ongoing jump in energy prices, which is adding to inflation even as it depresses buying power, and thus spending. Finally, the bubble that developed in the residential real estate market as a result of the Fed's earlier largesse (*Economic Report* – July/August 2005) appears to have sprung a leak.

Not surprisingly, the rate of economic growth has slowed considerably from its earlier pace. From 3.9 percent in 2004, growth slowed to 3.2 percent last year, and was only 2.5 percent in the second quarter of 2006. Since the record shows that in order to whip inflation, growth has to slow even further, it is not surprising that the conversation among the chattering classes has turned to the possibility that we may be headed for another recession. However, instead of using the "r" word, which, as you might imagine, connotes many negative emotions – not to mention a degree of precision in forecasting that has eluded most economists in the past – the pundits, press and the politicians are hoping instead that the economy will come in for a soft landing. This occurs when the economy slows enough to dampen inflation, yet not so much that growth disappears entirely causing a jump in unemployment. However, given the Fed's track record, plus all the headwinds prevailing in the economy today, one might do better recalling the words uttered by the late great Bette Davis in *All About Eve*: "Fasten your seat belts; we're in for a bumpy ride."

Most economists are hoping that the economy will come in for a soft landing. However, given the Fed's track record, plus all the headwinds prevailing in the economy today, we're more likely to be in for a bumpy ride.

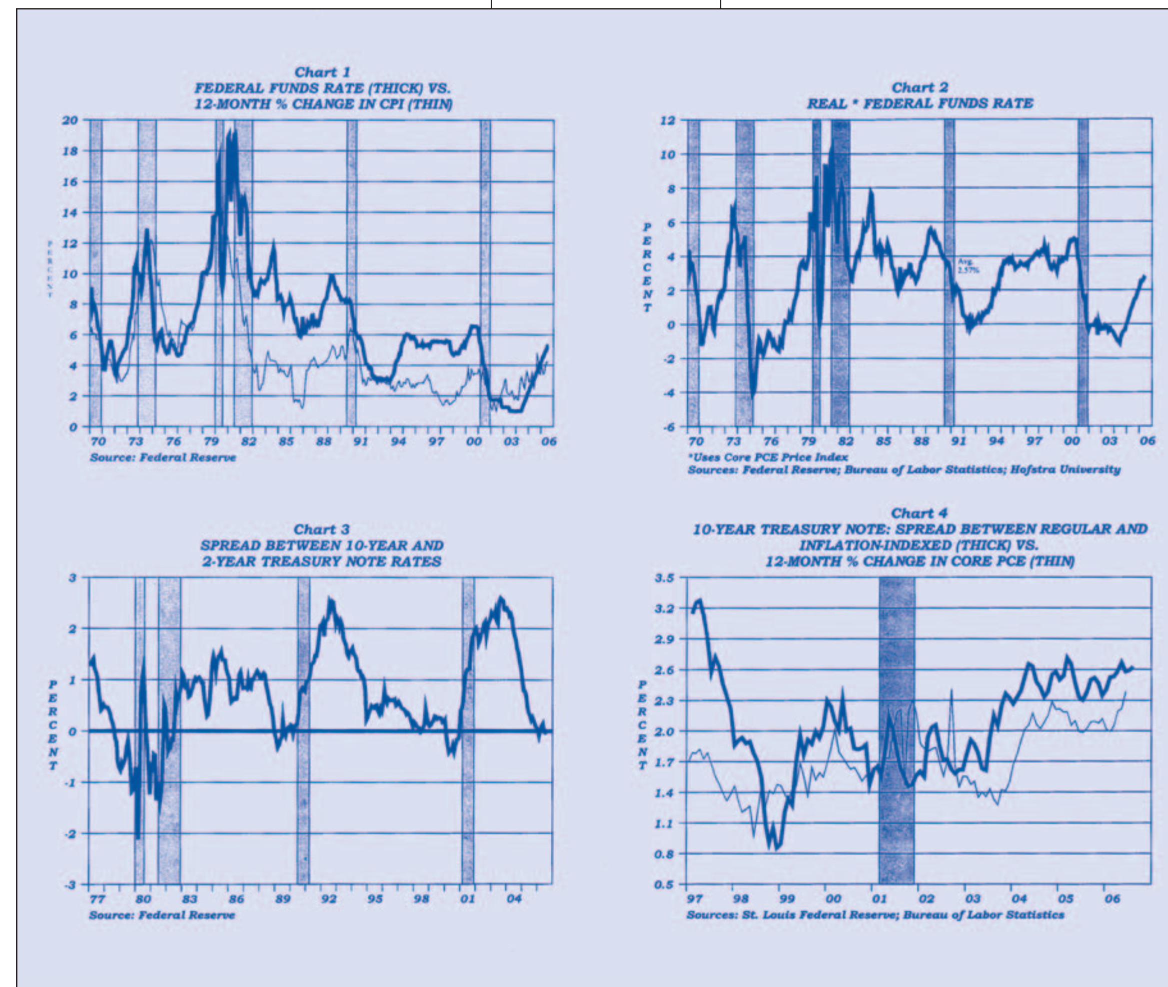
Keep in mind that when it begins its tightening cycle, the Federal Reserve does not deliberately set out to create a recession, or a hard landing, as it has come to be called. That said, such tightening invariably does lead to a recession for several reasons. First, monetary policy is an imprecise tool. The Fed is only one of four major players in the markets that can influence the supply of money and credit. The other three are consumers, business and government. In addition, the Fed usually acts cautiously when it comes to removing liquidity from the

system, meaning that even as interest rates rise, there is still lots of money and credit remaining that can fuel continued spending – not to say inflation. This, of course, only makes the Fed's job more difficult, causing the central bank to overshoot to ensure that its campaign against inflation is successful. Indeed, this approach to monetary policy may be the key reason that growth slows long before inflation tops out, leading to a period of stagflation (the combination of stagnation and inflation first coined by the late British Chancellor of the Exchequer, Iain Macleod).

In the final analysis, a recession, or something close, is about the only thing (short of wage-price controls) that will deter business from raising prices and labor from demanding big wage increases. In the vernacular of those who exercise, it's called "no pain, no gain." Chart 1 shows that all recessions that have occurred since 1970 followed periods in which the Federal Reserve was actively tightening money by raising interest rates. Interestingly (and this is what has given rise to the hope that this time the economy will come in for a soft, rather than a hard, landing), all tightening cycles except two wound up producing a recession no later than two years after interest rates peaked. The two exceptions took place in 1983-84 and 1994-95. As you can see from this chart and several of the others, rates went up and inflation retreated, yet the economy as a whole did not lapse into a recession, as determined by the umpire of the business cycle, the National Bureau of Economic Research.

Chart 2 provides added fuel to those who think we might be in for another soft landing this time around. As you can see, the real, or inflation-adjusted federal funds rate, while well above its lows plumbed in the middle of 2004 (which, incidentally, was last seen in the mid-1970s, giving you an idea of just how accommodative Fed policy was before it embarked on its current tightening cycle), is still below levels reached prior to the six previous recessions. And since the Fed passed on the opportunity to raise rates at its August meeting, many think the central bank may turn that pause into a permanent halt for the current cycle, thereby limiting the possibility that the real funds rate might climb into the pre-recession zone.

Another good indicator of future economic trends comes from the term structure of interest rates, otherwise known as the yield curve. Typically, long-term interest rates are higher than short-term rates because of the need to compensate those who invest in such instruments for the uncertainty of how much inflation will erode the buying power of their returns over the life of the security. When long-term rates are equal to or go below short-term rates, it's usually a sign that the fixed-income markets expect a recession, which brings with it an easing of Fed policy, and thus a decline in interest rates going forward. Chart 3 depicts the yield curve over time, by plotting the spread, or difference, between rates on the 10-year Treasury note and the two-year note. In the past, recessions would develop when the yield on the two-year note was about half a point higher than the yield on the 10-year for at least six months. So far in the current tightening cycle, the spread has not been negative enough long enough to provide an unambiguous signal that a recession is nigh.



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However, while the financial markets may not be expecting a hard landing at the moment, they are expecting (and pricing in) a pickup in the rate of inflation. By comparing the yield on the regular 10-year Treasury note with the yield on its inflation-indexed counterpart (known as TIPS, for Treasury Inflation Protected Security), Chart 4 measures the bond market's expectations for future inflation. The implication of the rise in the thick line is that bond buyers do not appear to believe that the Fed has done enough to curb inflation. In the final analysis, these expectations may well be thwarted because they will encourage the Fed to tighten further until such attitudes change. As you might imagine, this would increase the odds that the soft landing many now anticipate could well turn out to be a hard landing.

Even in the unlikely event that another soft landing does occur, this does not necessarily mean that the U.S. economy is home free. As we have seen all too often in the past, the economy does not have to endure a hard landing for a crisis to develop somewhere in the business or financial sector. Indeed, since 1970 alone, there have been at least a dozen such episodes that arose in the wake of the various Fed tightening cycles. These include: the bankruptcies of Penn Central in 1970 and Franklin National Bank in 1974; the crises in Latin American debt and the Farm Belt in 1982; the collapses of Drysdale Securities, Penn Square Bank and Continental Illinois Bank in 1983-84; the stock market crashes of 1987 and 1989; the junk bond crisis and the real estate and savings and loan collapses of 1990; the Mexican peso crisis and the bankruptcy of Orange County, CA, in 1994; the Asian currency crisis, Russian debt default and problems with the Long Term Capital Management hedge fund in 1997; the implosion of many Internet and telecom companies in 2000; and, also in 2000, the collapse of stocks into the worst bear market since the Great Depression.

As far as the current tightening cycle is concerned, there are a number of sectors that could run into trouble. The real estate bubble is already leaking and could well burst before long. Other industries tied into real estate might encounter difficulties as well. The health of a number of firms in both the auto and airlines sectors has already been questioned. In the financial sector, there is the ongoing issue of the derivatives market and the status of a number of hedge funds. And, of course, something completely unexpected could arise – as it has many times before.

In sum, the protracted tightening of monetary policy since the middle of 2004 has slowed economic growth, but not inflation. And while the Fed did not raise rates further after its August meeting, the ongoing rise in inflation and the expectation of inflation suggests that the central bank may not be finished removing liquidity in the current cycle. It is too soon to say with certainty that we are headed for another recession, but there has been a lot of speculation about how much economic growth will slow over the next six to 12 months. Such commentary has taken the form of guessing what type of landing the economy will achieve. In my view, whether the economy experiences a soft landing or a hard landing will only be the tip of the iceberg. A crisis of some sort or another is probably brewing – just as it has in the wake of previous Fed tightening cycles. ■