

April 2, 2024

1995 — Deja Vu

by Benjamin Tal benjamin.tal@cibc.com

"The fact that the unemployment rate and layoffs have remained low in the U.S. economy over the past year amid disinflation suggests that there is a path to restoring price stability without the kind of substantial increase in unemployment that has often accompanied significant tightening cycles."

Vice Fed Chair Philip N. Jefferson, Feb 22, 2024

The Fed is becoming more confident that a soft-landing scenario is nicely materializing. Escaping the tight hold of the Fed without entering a recession is not easy and is rare. In all likelihood, the economy could have landed softly in 2020, but then Covid happened. So we have to go back to the 1995 episode — the only soft landing in the post war era — to assess not only to what extent the conditions in the first half of the 1990s were similar to today's situation, but also to get a sense of what might await us at the end of the runway. Of course, no two cycles are the same, but the striking similarities between now and then make this exercise worthwhile.

The 1995 experience

A brief history: toward the end of 1993, the U.S. economy was recovering from the savings and loans crisis and the 1991

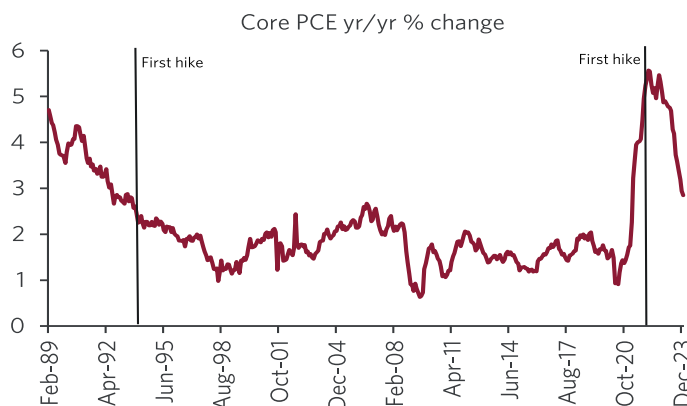
recession. The unemployment rate was falling rapidly to a level below its (perceived?) natural rate, and the capacity utilization rate was rising fast. Both indicators were approaching levels that, back then, were thought to trigger an acceleration in inflation. The Fed made its first move in January 1994 and had raised rates by 300 basis points to 6.05% by early 1995. There were some small rate adjustments in 1995, but in many ways, this was the first post-war experience of higher for longer. Importantly, in 1994, inflation was trending downward at the time of the first hike with Greenspan chasing phantom inflation out of a fear of being behind the curve. In the current situation, the first move by the Fed was triggered only after actual inflation was very evident (Chart 1).

Looks familiar...

Regardless of that difference, the sequence of events back then was very similar to what we have seen since 2021. The tightening cycle was preceded by a major sell-off in the long-end of the curve in 1993 with the 10-year rate rising by 260 basis points. In the current cycle, the bond market correction was of course more ferocious.

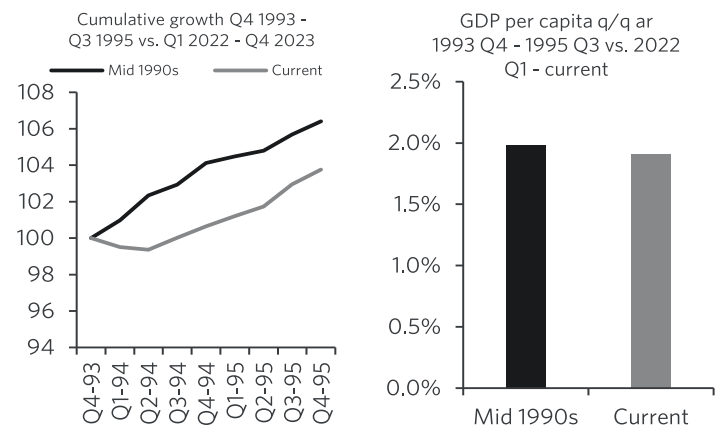
Back then, like now, the US economy did not succumb to the Fed's pressure in a way consistent with such a rapid

Chart 1: In the 90s the fed hiked when inflation was still trending down



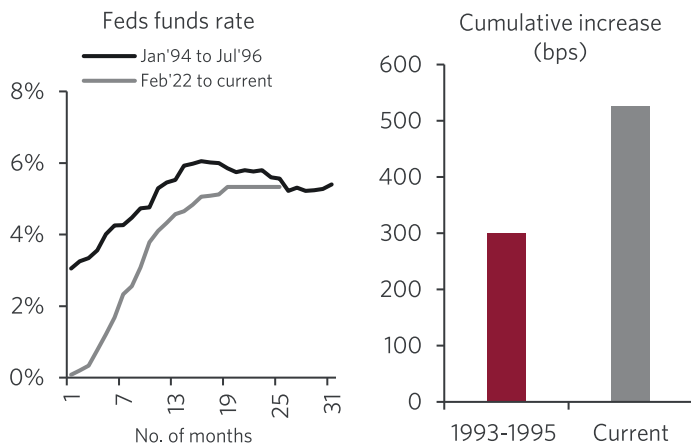
Source: Bureau of Economic Analysis, CIBC

Chart 2: Growth since first hike...then and now



Source: Bureau of Economic Analysis, CIBC

Chart 3: Hiking: Similar length different magnitude

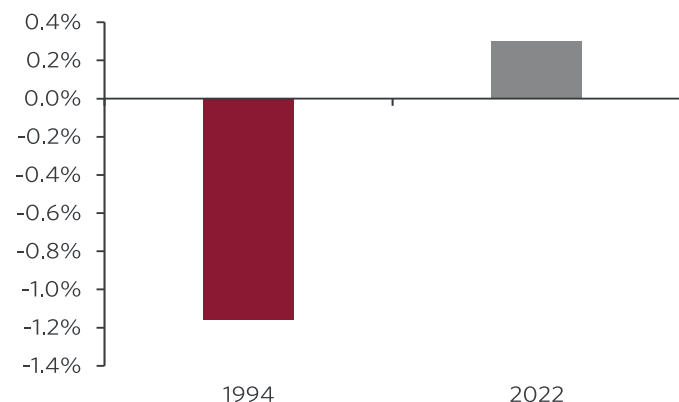


Source: Federal Reserve Board, CIBC

tightening trajectory. Yes, the economy of the mid-1990s slowed in response to the Fed's moves, but it stayed well clear of contraction, with real GDP growth bottoming out at a 2.2% year-over-year pace in the fourth quarter of 1995. As can be seen in Chart 2 left, the trajectory of the US economy in the current cycle is similar but more muted.

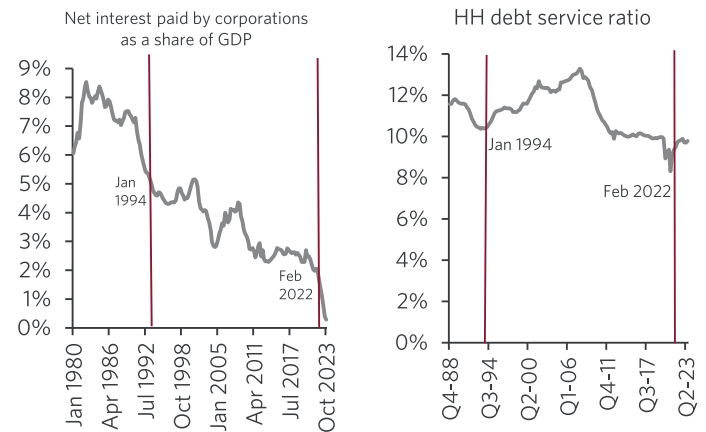
Now, it would be tempting to assume that the more aggressive Fed response during the current cycle is behind that underperformance (Chart 3). But that is not really the case. From chart 2 right we learn that the outperformance of the 1990s cycle was mostly due to stronger population growth and therefore higher potential GDP. Per capita, the GDP performance was basically identical. What's more, the first move in 1994 was in an environment of a substantial output gap, while in the current cycle, the Fed made its first move when the economy was operating very close to potential (Chart 4). So the different starting point might have played a role here. Now, in all likelihood this is not the data that Greenspan saw, since

Chart 4: Output gap at the time of the first hike



Source: Bureau of Economic Analysis, CIBC

Chart 5: Lower debt service burden this cycle



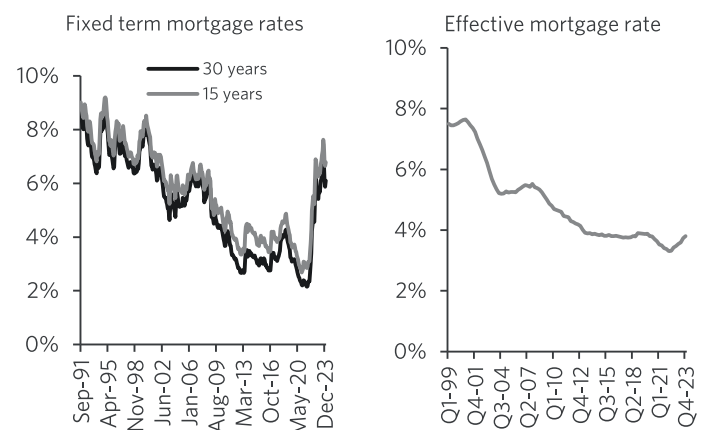
Note: Vertical lines indicate beginning of tightening cycle.

Source: Federal Reserve Board, CIBC

the minutes of the FOMC minutes noted that members thought the economy was operating at a level that would generate inflation pressures ahead.

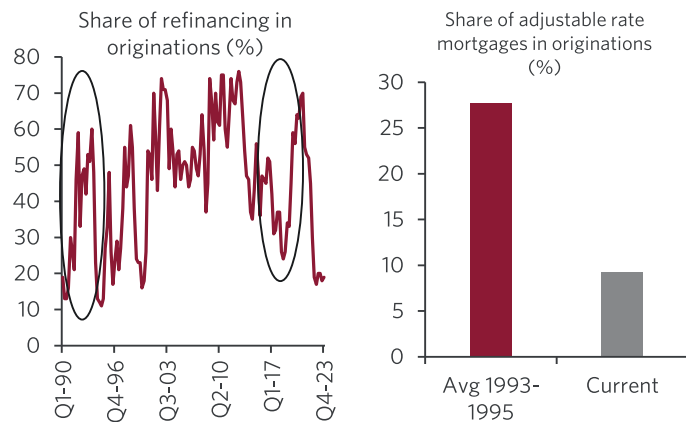
So the similar performances in per capita GDP growth despite different monetary responses suggest that a basis point now is very different than a basis point in the 1990s. There is very little debate that the effectiveness of monetary policy when it comes to real economic activity has been diminishing. The Phillips curve (the relationship between economic slack and price movements) is much flatter now than it was in the 1990s, while the increased reliance on the service sector and high-tech manufacturing reduces the need for leverage-based capex. No surprise then, that net interest payments by corporations as a share of GDP are now miles below the rates seen in the mid-1990s (Chart 5, left), suggesting reduced sensitivity to changes in interest rates. Ditto for households where low interest rates and the deleveraging during the financial crisis led to a situation

Chart 6: Effective mortgage rate much lower currently



Source: Federal Home Loan Mortgage Corporation, Bureau of Economic Analysis, CIBC

Chart 7: The mortgage market then and now

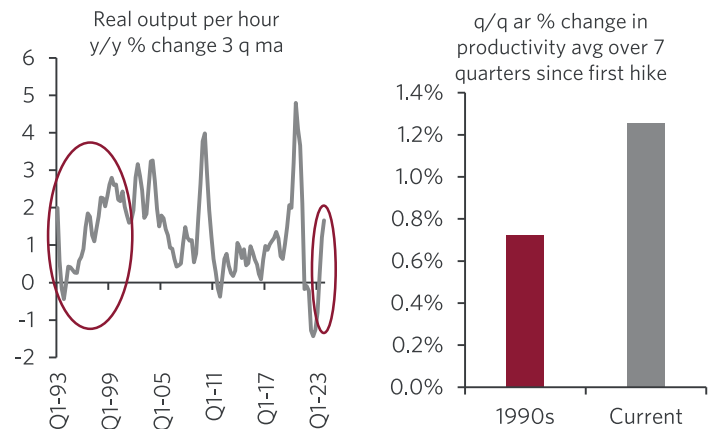


Source: Federal Home Loan Mortgage Corporation, CIBC

in which the current debt service ratio is below the one seen on the eve of the 1994 tightening (Chart 5, right).

What's more, despite the significant increase in 30 and 15-year fixed term mortgage rates over the past two years to levels seen in the 1990s, the effective mortgage rate is dramatically below the rate seen in the 1990s (Chart 6). Chart 7 helps to explain, in part, why. While the speed of increased refinancing in the period leading up to the first hike was similar in both cases (Chart 7, left), no less than 27% of mortgage originations back in the 1990s were Adjustable Rate Mortgages (ARMs), while this time around their share is under 10%, suggesting higher immunity to rising rates (Chart 7, right). The point here is that the de-facto impact of the 300 basis points of hikes in 1994/95 on the economy is not as different from the impact of today's 500 basis point tightening as might be suggested by the headline's numbers.

Chart 9: A productivity bet



Source: Bureau of Labor Statistics, CIBC

The US vs the rest of the world

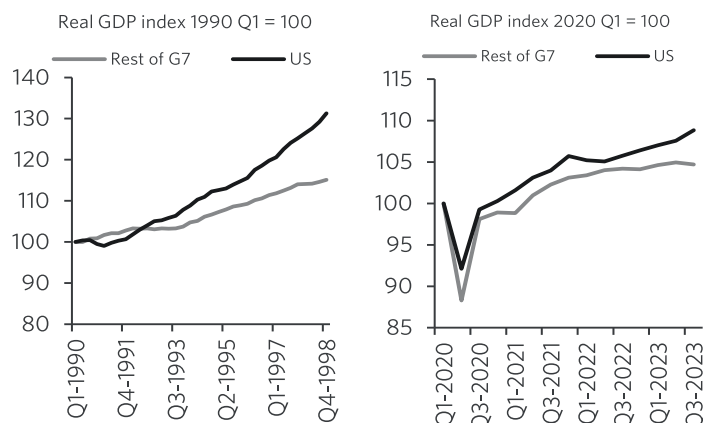
Another interesting similarity is illustrated in Chart 8. It's clear that the US economy is currently the only game in town. Canada is in a per-capita recession, the Eurozone is hardly growing, the UK is in recessionary territory, China is underperforming relative to expectations and despite a nice equity market showing, Japan is hovering around zero growth, hardly escaping a technical recession in the fourth quarter of last year (Chart 8, right). The situation in 1990s was very similar. The US economy was expanding swiftly while the rest of the world was much weaker. European growth was fragile, Japan was experiencing the adverse impact of debt deflation, while the Mexican peso crisis of 1995 had a negative impact on growth in many emerging markets (Chart 8, left). That divergence in growth trajectories led to a surge in the value of the US dollar in the second half of the 1990s, which in addition to slower global growth, worked to put downward pressure on commodity prices.

A productivity bet

The real story of the 1995 soft landing is that it led to a surge in productivity in the second half of the 1990s — led by the dot com revolution and resulted in strong disinflationary growth and surging equity market valuations. As illustrated in Chart 9, even here there are similarities. Productivity growth in the US during the current cycle has surprised on the upside. In fact, growth in output per worker during the eight quarters since the first move by the Fed has surpassed growth in productivity during the comparable period in the 1990s.

The big question is: to what extent is the current trend in productivity growth sustainable? We believe that the current environment might provide the right conditions for such persistence. Major forces including the current trend toward industrial reshoring, just-in-case inventories, a tight labour market, and green related costs, will work to put downward

Chart 8: US outperformed then and also now



Source: OECD, CIBC

pressure on profit margins and force firms to replace labour with capital. AI is well positioned to play a major role in that space.

The US economy is showing promising signs of achieving the second soft landing in peacetime history. The similarities to the 1995 situation are very clear and shouldn't be ignored. At the margins, those similarities are consistent with a moderate easing trajectory by the Fed and potentially strong productivity-led non-inflationary growth.

Contacts:

Avery Shenfeld
avery.shenfeld@cibc.com

Benjamin Tal
benjamin.tal@cibc.com

Andrew Grantham
andrew.grantham@cibc.com

Ali Jaffery
ali.jaffery@cibc.com

Katherine Judge
katherine.judge@cibc.com

CIBC Capital Markets
PO Box 500
161 Bay Street, Brookfield Place
Toronto, Canada, M5J 2S8
[Bloomberg @ CIBC](#)

economics.cibccm.com

CIBC World Markets Inc., CIBC World Markets Corp., CIBC World Markets Plc., CIBC Australia Limited and certain other corporate banking and capital markets activities of Canadian Imperial Bank of Commerce operate under the brand name CIBC Capital Markets.

This report is issued and approved for distribution by (a) in Canada, CIBC World Markets Inc., a member of the Investment Industry Regulatory Organization of Canada, the Toronto Stock Exchange, the TSX Venture Exchange and a Member of the Canadian Investor Protection Fund, (b) in the United Kingdom, CIBC World Markets plc, which is regulated by the Financial Services Authority, and (c) in Australia, CIBC Australia Limited, a member of the Australian Stock Exchange and regulated by the ASIC (collectively, "CIBC") and (d) in the United States either by (i) CIBC World Markets Inc. for distribution only to U.S. Major Institutional Investors ("MII") (as such term is defined in SEC Rule 15a-6) or (ii) CIBC World Markets Corp., a member of the Financial Industry Regulatory Authority. U.S. MIIs receiving this report from CIBC World Markets Inc. (the Canadian broker-dealer) are required to effect transactions (other than negotiating their terms) in securities discussed in the report through CIBC World Markets Corp. (the U.S. broker-dealer).

This report is provided, for informational purposes only, to institutional investor and retail clients of CIBC World Markets Inc. in Canada, and does not constitute an offer or solicitation to buy or sell any securities discussed herein in any jurisdiction where such offer or solicitation would be prohibited. This document and any of the products and information contained herein are not intended for the use of private investors in the United Kingdom. Such investors will not be able to enter into agreements or purchase products mentioned herein from CIBC World Markets plc. The comments and views expressed in this document are meant for the general interests of wholesale clients of CIBC Australia Limited.

This report does not take into account the investment objectives, financial situation or specific needs of any particular client of CIBC. Before making an investment decision on the basis of any information contained in this report, the recipient should consider whether such information is appropriate given the recipient's particular investment needs, objectives and financial circumstances. CIBC suggests that, prior to acting on any information contained herein, you contact one of our client advisers in your jurisdiction to discuss your particular circumstances. Since the levels and bases of taxation can change, any reference in this report to the impact of taxation should not be construed as offering tax advice; as with any transaction having potential tax implications, clients should consult with their own tax advisors. Past performance is not a guarantee of future results.

The information and any statistical data contained herein were obtained from sources that we believe to be reliable, but we do not represent that they are accurate or complete, and they should not be relied upon as such. All estimates and opinions expressed herein constitute judgments as of the date of this report and are subject to change without notice. This report may provide addresses of, or contain hyperlinks to, Internet web sites. CIBC has not reviewed the linked Internet web site of any third party and takes no responsibility for the contents thereof. Each such address or hyperlink is provided solely for the recipient's convenience and information, and the content of linked third-party web sites is not in any way incorporated into this document. Recipients who choose to access such third-party web sites or follow such hyperlinks do so at their own risk.

© 2024 CIBC World Markets Inc. All rights reserved. Unauthorized use, distribution, duplication or disclosure without the prior written permission of CIBC World Markets Inc. is prohibited by law and may result in prosecution.

The CIBC logo and "CIBC Capital Markets" are trademarks of CIBC, used under license.