Economics

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Anatomy of an easing cycle: Dissecting the past to predict the future

by **Avery Shenfeld** avery.shenfeld@cibc.com and **Ali Jaffery** ali.jaffery@cibc.com

It's not if, but when and by how much. An easing cycle seems highly likely to commence in both the US and Canada this year, with the Fed having seen two quarters in which core PCE prices ran at an annualized 2% pace, and the Bank of Canada seeing growing economic slack that should cool CPI inflation north of the border. But since markets have already priced-in a substantial dose of policy rate cuts over the next two years, fixed income investors need to fine tune their estimates for the pace of rate reductions ahead. And equity investors need to hone in on whether those cuts will enable the soft landing for growth that will be needed to support earnings projections.

There's no better place to start on those tasks than with a dissection of past easing cycles. If history is doomed to repeat itself, then equity investors might be in luck. Soft landings in Canada aren't as rare as many think. But its also the case that fixed income investors who are counting on a very aggressive pace of easing might be a bit disappointed, particularly in the US, given the history of easing in such soft landings.

Soft landings aren't impossible

Market participants often opine that central bankers never get things just right. But memories are fickle, and we typically recall the most dramatic economic turning points, and forget outcomes that generated less turmoil. As a result, there's a tendency to focus on major easing cycles that came amidst deep recessions, while failing to take note of smaller adjustments in rates that came in time to forestall such downturns.

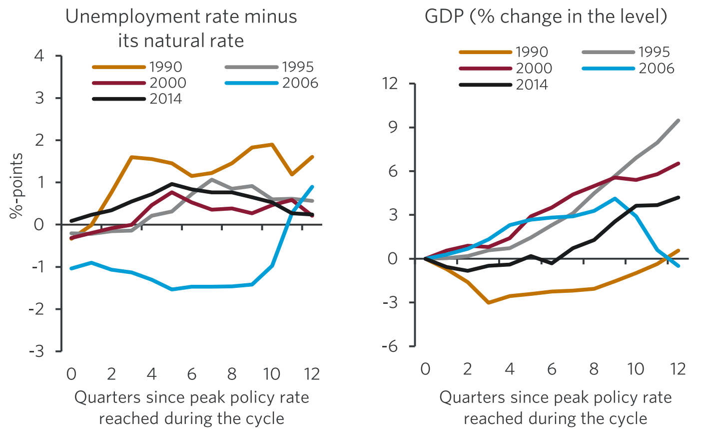
The full history since the 1980s shows that more than half of the Canadian easing cycles have been associated with soft or "softish" landings (Table 1). If we focus on the inflation-targeting era which was formalized in the early 1990s, the Bank's record of achieving soft landings is even better. And it seems hard to fault them on the few hard landings, given they were caused in large part by external shocks such as the First Gulf War in 1990 and Global Financial Crisis (GFC) of 2008-09.

Table 1: History of Canadian easing cycles

Date of Peak Rates	Landing	Context	Below neutral after two years?	Inflation after two years?	Output Gap after two years?*
1981Q3	Hard	Aftermath of OPEC II, Iran-Iraq War	No	Lower	-5%
1984Q3	Soft	Policy Recalibration	No	Higher	-2%
1990Q2	Hard	First Gulf War	No	Same	-3%
1995Q1	Soft-ish	Strong Domestic Demand	Possibly	Higher	-2%
2000Q4	Soft	Dot-Com Bubble	Yes	Higher	-1%
2006Q2	Hard	Strong domestic demand; then GFC	No	Lower	3%
2014Q4	Soft-ish	Oil Price Crash	Yes	Lower	-2%

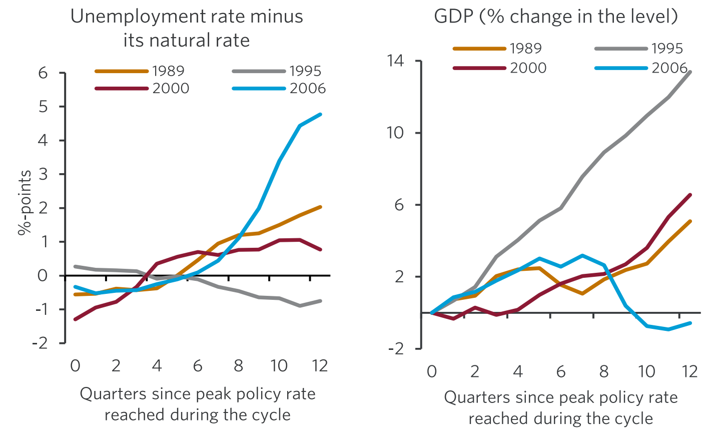
* Output gap is calculated using a standard's Okun's law using the Unemployment Rate Gap. An output gap of -2% is associated with an unemployment 1 percentage point above the natural rate of unemployment.

Chart 1: In most easing cycles, Canada's labour market has held up fairly well (L) and enjoyed solid GDP growth (R)



Source: Statistics Canada, CIBC calculations

Chart 2: Labour markets in the US crack about a year or so after policy rates peak (L) while GDP outside of the 1995 cycle has been less than stellar (R)



Source: Congressional Budget Office, Bureau of Economic Analysis, CIBC calculations

We characterize a soft-landing based on two criteria that are inspired by former Fed Vice-Chair Alan Blinder's recent work on hard and soft landings in the US (Blinder, 2022).Specifically, we look at whether the unemployment rate gap (the gap between the U-rate and an estimate of its level at full employment) exceeded 1 percentage point between one to two years after the policy rate peaked and whether GDP declined by 0.5-1% or more over a similar time period (Chart 1). We use our own estimate of the unemployment rate gap measure for Canada, but the results would not be very different if we used the Bank of Canada model-based estimates of the output gap. That measure would suggest Canada has achieved even softer landings.

As Blinder noted, the US experience hasn't been quite as successful, with true soft landings only achieved in the easing cycles that began in 1984 and 1995 (Table 2). A policy easing that began in 2006 managed to hold off the threat of quick economic downturn for the first two years, but that was followed by the global financial crisis recession. The CBO unemployment rate gap shows a materially widening of slack after a year from peak policy rates and anemic GDP growth in the 2000 and early 1990s cycles (Chart 2).

The 1995 cycle is the only soft landing for the US in what is practically-speaking the modern inflation-targeting era, in which central banks would act pre-emptively to keep inflation from deviating too far from target. But the good news is that the backdrop in that case bears close resemblance to what we see today in the US. Looking back, the CBO output gap was just closed in 1995 when the policy easing began, whereas in other cycles the economy was significantly more overheated. Perhaps more crucially, there was no bad luck in the form of a major external or financial shock. The Asian Financial Crisis occurred at the tail end of the cycle and had limited ramifications for a domestically-driven US economy. Today we are dealing with the aftermath of several shocks but at the moment, most of these shocks appear to have faded materially. And so far, no bad luck.

Table 2: History of US easing cycles

Date of Peak Rates	Landing	Context	Below neutral after two years?	Inflation after two years?	Output Gap after two years?*
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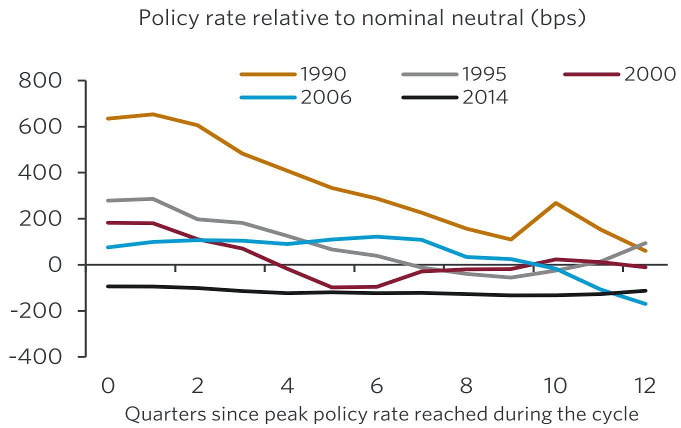
1995Q3	Soft	Strong Domestic Demand	No	Lower	1%
2000Q4	Hard	Dot-Com Bubble	Yes	Lower	-2%
2006Q3	Hard	Strong domestic demand; then GFC	Yes	Lower	-4%

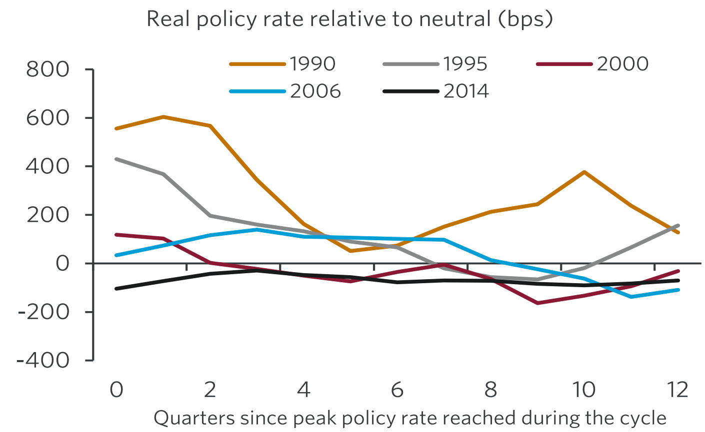
* Output gap is calculated using a standard's Okun's law using the Unemployment Rate Gap. An output gap of -2% is associated with an unemployment 1 percentage point above the natural rate of unemployment.

Chart 3: The Bank of Canada has eased policy rates closely back to measures of nominal neutral in most easing cycles



Source: Bank of Canada, Adrian, Crump and Moench (2013)

Chart 5: Canadian real policy rates generally move gradually toward neutral as well though the road can be bumpier



Source: Bank of Canada, Consensus Economics, Adrian, Crump and Moench (2013)

Soft landings mean a soft easing pace

All of these easing cycles started with monetary policy in a restrictive stance, with the policy rate above what we now know as neutral. In some cases such as the 1990 and 1995 cycle, monetary policy was far more restrictive than we are today, with rates much further above nominal neutral rate estimates.

To use an estimate of the neutral available at the time or a criteria that central bankers might have used, we look to the market's view of neutral. We assume the neutral rate is what markets estimate short-rates will be nine years ahead after removing the term premium. This is an approach also used by researchers at the Fed and BIS (Rungcharoenkitkul and Winkler, 2022). This view would also capture perceptions of future interest rates from current monetary policy and central bank communications.

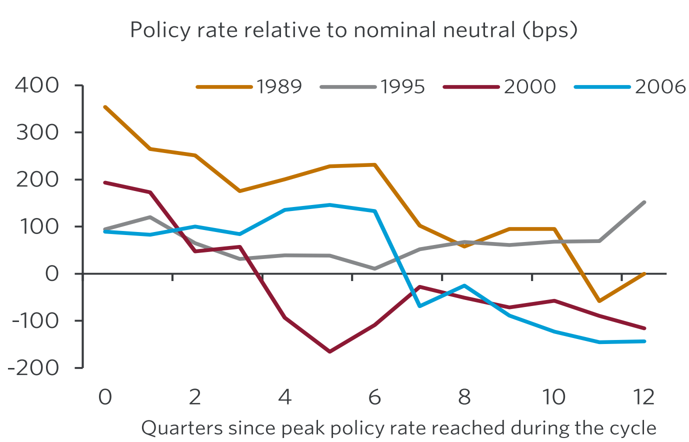
In Canada, the overnight rate gradually converges to match or sit a bit below the neutral rate in almost all easing cycles since 1990 (Chart 3). In general, the overnight rate was back to neutral in one to two years. The exception was the 2014 oil price shock where rates were already below neutral and stayed below throughout that period.

As we noted above, the US has had fewer true soft landings, and so rates more often ended up below neutral (Chart 4). But in 1995, really the last sustained soft landing, rates remained above neutral over a three year horizon.

We know central bankers like to think in terms of real rates and the story broadly still holds. Canadian real rates tend to gradually move towards or stay close to the neutral rate in soft landings (Chart 5), while in the US there are more abrupt adjustments due to hard landings (Chart 6).

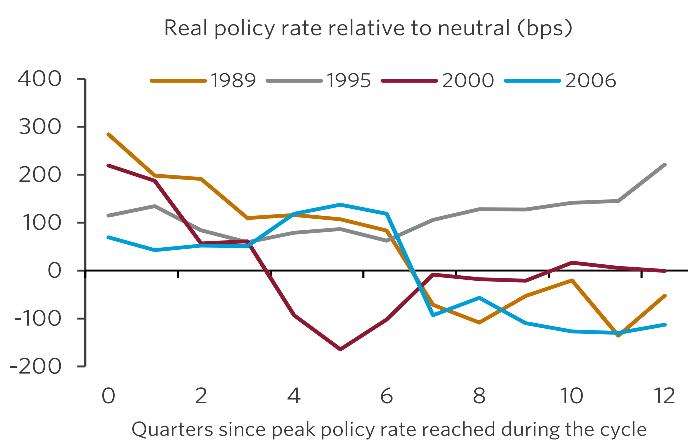
These differences might simply reflect the greater sensitivity of the Canadian economy to high rates, and thus the greater need to get rates back to neutral territory when the economy shows any meaningful slowing if a recession is to be averted.

Chart 4: The Fed has brought rates below nominal neutral more often but in the 1995 cycle, rates remained well above nominal neutral



Source: Federal Reserve Board, Adrian, Crump and Moench (2013)

Chart 6: US real policy rate adjustments have been more abrupt given hard landings



Source: Federal Reserve Board, Cleveland Federal Reserve, Adrian, Crump and Moench (2013)

Lessons for today

Equity investors would, of course, welcome the milder earnings hit associated with a soft landing. In fact, the 1995 cycle, in which a soft landing was achieved, was the exception in that other cycles did not show a great history of sustained equity rallies (Chart 7).

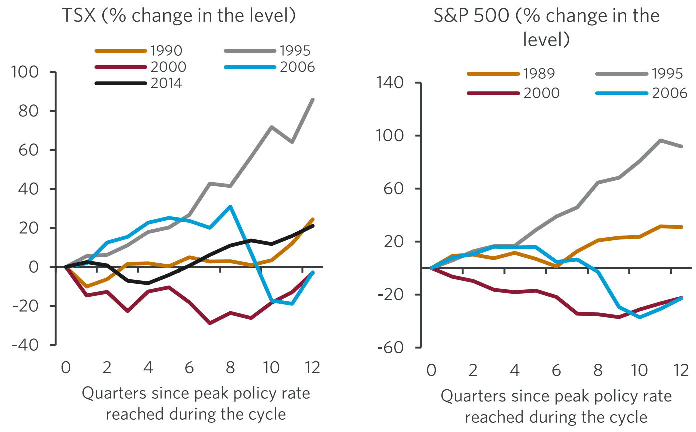
In the fixed income space, a soft landing tends to be associated with a softer pace and smaller dose of rate cuts, thereby leaving less room for a bond market rally. Typically, the easing takes place over roughly six quarters, and brings rates to rest somewhere in the vicinity of neutral. In the current circumstances, that would have the Bank of Canada take rates to somewhere in the 2.5% to 3% range by late 2025, assuming the first easing is in mid-2024.

Of course, yesterday is not today, and in all of the recent easing cycles inflation hadn't experienced anything like the recent above-target run for the CPI, which might suggest that policy makers will be slower in trimming rates. Fears that inflation gets stuck above target, because inflation expectations become a bit dislodged from 2% are still a concern on Ottawa's Wellington Street or in Washington's Eccles Building.

However, there is also an important difference between today and yesterday that might cause central banks to actually move more quickly. The will to crash to economy to bring inflation down rapidly is simply not there anymore. The lengthy recovery during the post-GFC period and the initial slow response to the inflation surge in the post-COVID era were indicative of a change in philosophy to ensure sufficient support to demand. Healing weak demand is no easy task, and these aren't the days when Paul Volker was dealing with a decades-long buildup in inflation, and had a free hand to induce substantial economic pain to reverse that trend.

With inflation sitting near the 2%, PCE target over the past half year, the Fed certainly has an easier job. It will have no reason to delay providing rate relief if economic data actually starts to show the economy needs it (Table 4), which we expect will start in second half of this year (Table 6). It's more complicated in Canada with inflation tracking stubbornly above target despite a weak economy (Table 3), but the Governor of the Bank of Canada doesn't need a dual mandate to behave in the same fashion, and we expect the overnight to start on a downward path in June (Table 5). Macklem has repeatedly stated that a recession won't be necessary to get inflation back to target, and since the Bank targets inflation a year or so ahead, he has room to provide rate relief well before seeing a 2% CPI pace.

Chart 7: Equity market performance after peak rates has not been stellar outside of the 1995 cycle



Source: Toronto Stock Exchange, Standard & Poor's, CIBC calculations

Table 3: Canada forecast detail (real % change, SAAR, unless otherwise noted)

Variable	23Q3A	23Q4F	24Q1F	24Q2F	24Q3F	24Q4F	2023F	2024F	2025F
Real GDP Growth (AR)	-1.1	0.8	1.2	0.0	1.1	1.7	1.1	0.6	1.8
Real Final Domestic Demand (AR)	1.3	0.4	0.8	0.5	1.7	1.8	1.0	0.9	2.0
Household Consumption (AR)	0.1	1.3	0.8	-0.2	0.5	1.3	2.1	0.6	1.5
All Items CPI Inflation (Y/Y)	3.7	3.2	3.2	2.7	2.1	2.1	3.9	2.5	1.9
Unemployment Rate (%)	5.5	5.8	5.8	6.1	6.2	6.1	5.4	6.1	5.8

Table 4: US forecast detail (real % change, SAAR, unless otherwise noted)

Variable	23Q3A	23Q4A	24Q1F	24Q2F	24Q3F	24Q4F	2023A	2024F	2025F
Real GDP Growth (AR)	4.9	3.3	2.3	1.5	0.6	1.2	2.5	2.3	1.9
Real Final Sales (AR)	3.6	3.2	2.5	1.6	1.4	1.1	2.9	2.3	1.9
All Items CPI Inflation (Y/Y)	3.5	3.2	2.9	2.4	2.1	2.3	4.1	2.4	2.6
Core CPI Inflation (Y/Y)	4.4	4.0	3.6	3.1	2.9	2.6	4.8	3.0	2.5
Unemployment Rate (%)	3.7	3.7	3.8	4.0	4.1	4.1	3.6	4.0	3.9

Table 5: Canadian interest rates (end of period)

Variable	2024 Feb 13	2024 Mar	2024 Jun	2024 Sep	2024 Dec	2025 Jun	2025 Dec
Overnight target rate	5.00	5.00	4.75	4.25	3.75	3.25	2.75
98-Day Treasury Bills	5.01	5.05	4.50	4.00	3.60	3.00	2.60
2-Year Government Bond	4.34	4.30	3.90	3.60	3.10	2.85	2.70
10-Year Government Bond	3.65	3.50	3.25	3.20	3.15	2.90	2.95
30-Year Government Bond	3.47	3.40	3.40	3.30	3.25	3.10	3.05
Canada - US T-Bill Spread	-0.37	-0.25	-0.80	-0.80	-0.70	-0.85	-0.75
Canada - US 10-Year Bond Spread	-0.64	-0.75	-0.85	-0.70	-0.60	-0.70	-0.35
Canada Yield Curve (10-year — 2-year)	-0.69	-0.80	-0.65	-0.40	0.05	0.05	0.25

Table 6: US Interest rates (end of period)

Variable	2024 Feb 13	2024 Mar	2024 Jun	2024 Sep	2024 Dec	2025 Jun	2025 Dec
Federal funds rate (midpoint)	5.375	5.375	5.375	4.875	4.375	3.875	3.375
91-Day Treasury Bills	5.38	5.30	5.30	4.80	4.30	3.85	3.35
2-Year Government Note	4.62	4.60	4.35	3.75	3.35	3.00	2.65
10-Year Government Note	4.28	4.25	4.10	3.90	3.75	3.60	3.30
30-Year Government Bond	4.44	4.35	4.30	4.25	4.20	3.90	3.65
US Yield curve (10-year — 2-year)	-0.34	-0.35	-0.25	0.15	0.40	0.60	0.65

Table 7: Foreign exchange rates

Exchange rate	2024 Feb 13	2024 Mar	2024 Jun	2024 Sep	2024 Dec	2025 Jun	2025 Dec
CAD-USD	0.74	0.72	0.73	0.74	0.74	0.77	0.78
USD-CAD	1.36	1.38	1.37	1.35	1.35	1.30	1.29
USD-JPY	151	147	144	140	135	130	130
EUR-USD	1.07	1.07	1.10	1.11	1.12	1.14	1.16
GBP-USD	1.26	1.25	1.27	1.28	1.29	1.31	1.35
AUD-USD	0.65	0.66	0.67	0.67	0.68	0.69	0.70
USD-CNY	7.19	7.20	7.25	7.20	7.15	7.10	7.10
USD-BRL	4.95	5.00	5.20	5.20	5.00	5.20	5.20
USD-MXN	17.22	18.00	18.20	18.50	18.00	18.00	17.50

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

FICC Strategy
Ian Pollick
416 594-7057
ian.pollick@cibc.com

CIBC Capital Markets
PO Box 500
161 Bay Street, Brookfield Place
Toronto, Canada, M5J 2S8
Bloomberg @ CIBC

economics.cibccm.com