Federal Reserve Tightening:
It Is Different This Time

Prior to the beginning of the current Federal Reserve tightening cycle in June 2004, we had a set of expectations about a typical rising rate period. Among these were the likely duration and distance to be covered by the process and what economic results we could expect from it. These were captured quite nicely by Merrill Lynch in a piece published as the Fed began their process over two years ago. It was entitled, “Everything You Wanted to Know About Fed Tightening Cycles but Were too Afraid to Ask.”

The key points from that analysis were as follows:

- A typical cycle lasts 13 months.
- The average increase in the Federal Funds rate is 250 basis points.
- Ten-year Treasury rates normally rise by 150 basis points over the cycle.
- Changes in interest rates impact the economy with about a one-year lag.
- Every 100 basis points of tightening squeezes GDP by .6% in the first year and 1.7% in the second year.

Other commentators have suggested similar insights and have further indicated that inflation responds to the tightening cycle with a bit longer than one-year lag (about 15 months).

<u>The Current Cycle</u>

This table shows how the current cycle has actually played out.

	Start (6/04)	**Expected End (8/05)**		**Now**
		Actual	**Projected**	
Federal Funds	1.00%	3.50%	3.50%	5.25%
Ten-year T-Note	4.70%	4.25%	6.20%	5.15%

For the first year, Federal Funds was on target, but now it has exceeded expectations in both time and distance. The ten-year Treasury has acted in a different but entirely atypical fashion.

Now let’s look at the changes in GDP on a quarterly basis. In 2004’s second quarter, real GDP increased at an annual rate of 3.5%. One year later it had a growth rate of 3.3% while the most recent statistic (Q1-06) registered 5.6%. Even if we average the first quarter this year with the hurricane-impacted fourth quarter of 2005, the average growth is still 3.7%. It appears that the Fed’s actions to this point have not had the desired impact on slowing the economy.

As a result, we have not seen an easing of inflationary pressures and, in fact, have witnessed an acceleration. Total consumer price inflation was running at annual rate of 2.9% in the twelve months ended May 2004 (last release before tightening began). The most recent figure is 4.1%. Now many will argue that energy is distorting the figures. However, excluding food and energy to get core consumer price inflation shows an acceleration from 1.7% to 2.4% over the time frame in question.

It’s pretty obvious that the current cycle has not followed script, and that at this juncture, the Fed can hardly claim success. This, of course, doesn’t mean that the increase in rates won’t eventually have the intended impact on the economy and inflation, only that it hasn’t so far. However, one place where the Fed has had an impact is on the profit levels of community banks.

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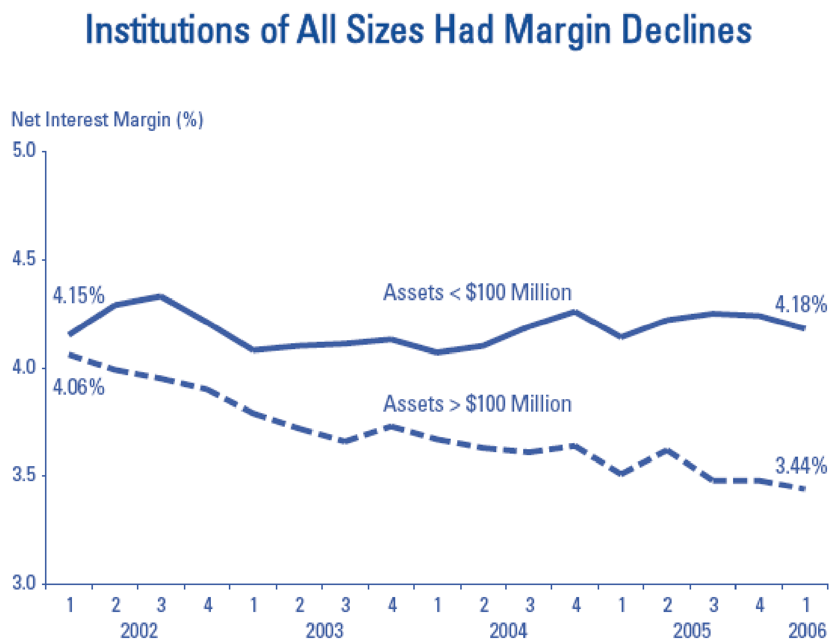
The Flat Yield Curve and the Long Duration of the Cycle

Even though the Federal Funds rate has increased by more than double the normal rise in a tightening cycle, the ten-year rate has risen by less than one-third its normal increase. This means that the typical profit from borrowing short and lending long is no longer available to community banks. There is another important result of the way the cycle has played out. We have generally focused on the size of the move and the resulting flat yield curve; however, I believe that the duration of the cycle has been just as important in the recent net interest margin squeeze. Look at this chart from the most recent FDIC Quarterly Banking Profile.



From the second quarter 2004 to late 2005, small banks had managed to hold margin levels while larger banks had done fine for the first year of the tightening. Note that this latter time frame matches up with the term of the typical cycle. It appears that if a tightening cycle lasts about one year, banks can get away with lagging deposit rates and thereby maintain margins long enough for the subsequent decline in rates to create breathing room. Not this time, however.

The general margin squeeze has also been impacted by a change in the mix of liabilities. As I commented in a late 2005 article in this newsletter, deposit growth has shifted from MMDA and other non-maturity deposits to certificates of deposit. Category change has added significantly to funding costs. The following table was extracted from a generic UBPR for banks between $100 million and $300 million in size.

	June 2004		March 2006	
	% of Assets	Cost	% of Assets	Cost
DDA	14.2%	-0-	14.3%	-0-
NOW	10.4%	.54%	9.2%	1.09%
MMDA/Savings	23.2%	.93%	21.7%	1.94%
Retail CDs	20.5%	2.36%	20.0%	3.56%
Wholesale CDs	12.4%	2.33%	14.8%	3.76%

The categories with the biggest relative declines are NOWs and MMDA/Savings. They have been replaced with wholesale CDs. Although the mix change does not look like much right now, momentum suggests that it will get worse before it gets better.

Outrunning A Tiger

Two hunters came upon a tiger in the forest. It saw them when they saw it. As they tried to run away, the trailing hunter said to the other, "You don't really expect to outrun the tiger do you?" The second hunter replied, "I don't have to outrun the tiger, I only have to outrun you."

The current and expected level of interest rates, the flat yield curve, and deposit shifting momentum all suggest that there will be downward pressure on net interest margins for the next few quarters. Although booking good quality loans can help, the real distinguishing factor for the near future will be managing deposit costs. There are a few things to keep in mind.

- Raise new dollars only if they are necessary to fund new loans. Don't build unnecessary liquidity.
- Defend market share only when the real core is threatened. Let the shoppers go.
- Substitute non-local sources if competitors become too aggressive.
- Focus marketing away from rate and toward account features and institutional benefits.

By and large, the suggestions I have offered mean slower growth or even balance sheet shrinkage. However, the size and the duration of the tightening cycle is such that the normal recovery in margins is likely to be much delayed. This calls for a different set of strategies. And remember, you don't have to outrun the tiger, just the hunter down the street.

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