

Why “Higher” Interest Rates Won’t Last “For Longer”:

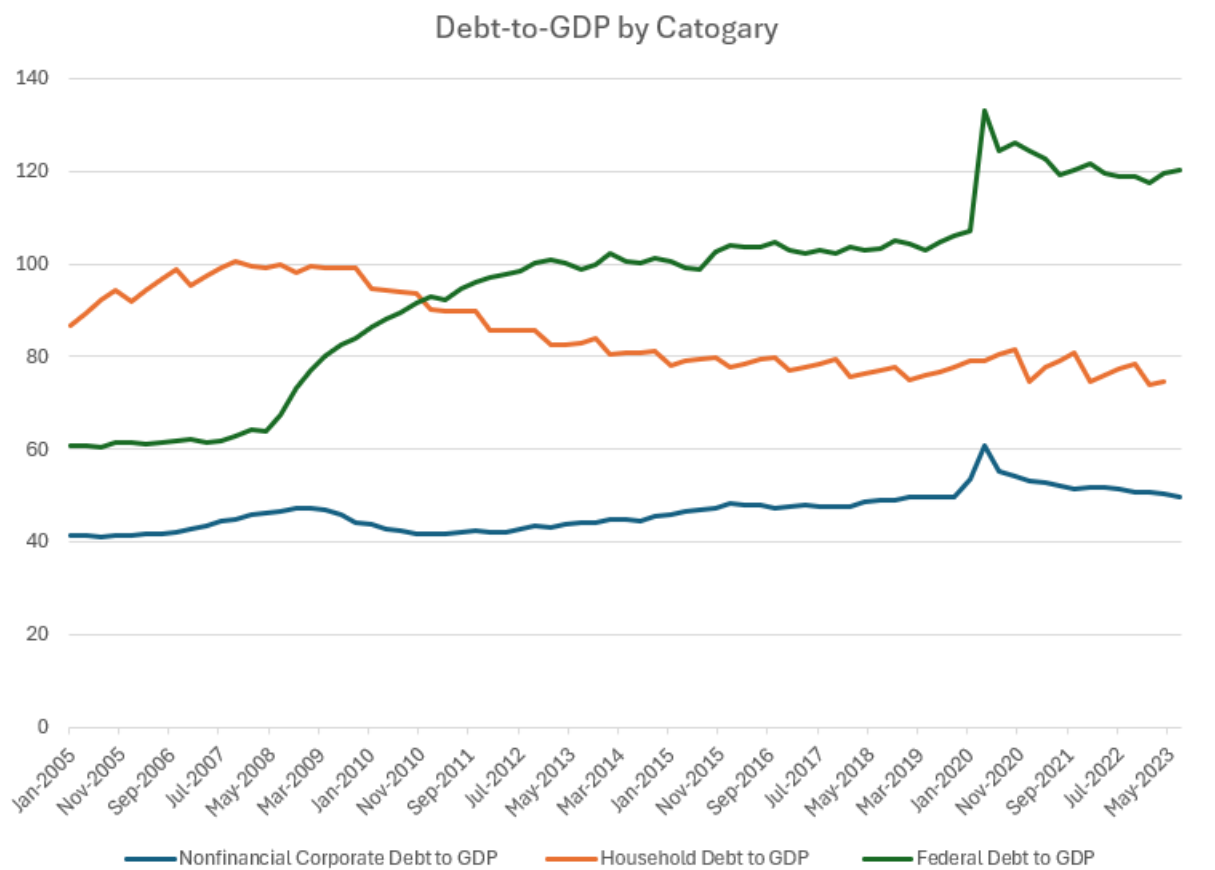
The Main Constraint for the Fed to Keep Rates Higher Despite Upward Inflation Trends

November 2023, Francie Chen

During 2020 – 2022, as COVID-19 and heightened geopolitical tensions caused supply chain disruptions, coupled with substantial increases in government support and central bank easing, US inflation climbed from 2% to 9%. In response to the elevated inflation, the Fed hiked rates from 0%-0.25% to today's 5.25%-5.5%.

As of now, the term “Higher for longer” is being used frequently, with the Fed signaling its intention to keep interest rates elevated for a longer period. However, I believe a main constraint for the Fed is the current deficit level for the US government.

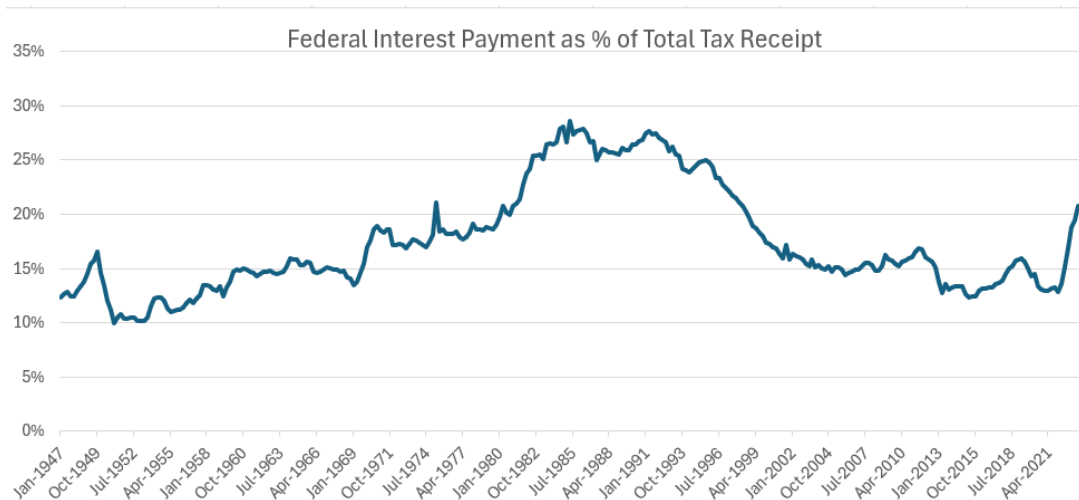
The 2008 financial crisis marked a turning point for the US debt structure and the Fed's response mechanism. The rapid accumulation of household debt from 2005 to 2007, coupled with rising interest rates, served as the primary trigger for the 2008 financial crisis. Subsequently, Fed's QE allowed the government to carry out fiscal stimulus, so household debt can decline in an orderly manner. At the same time, federal debt surged significantly from 60% to 100% of the country's GDP. Following the pandemic, such ratio further climbed to 120%.



Is the current level of federal debt sustainable? I think a more pertinent question is to what point the mass opinion would deem it unsustainable.

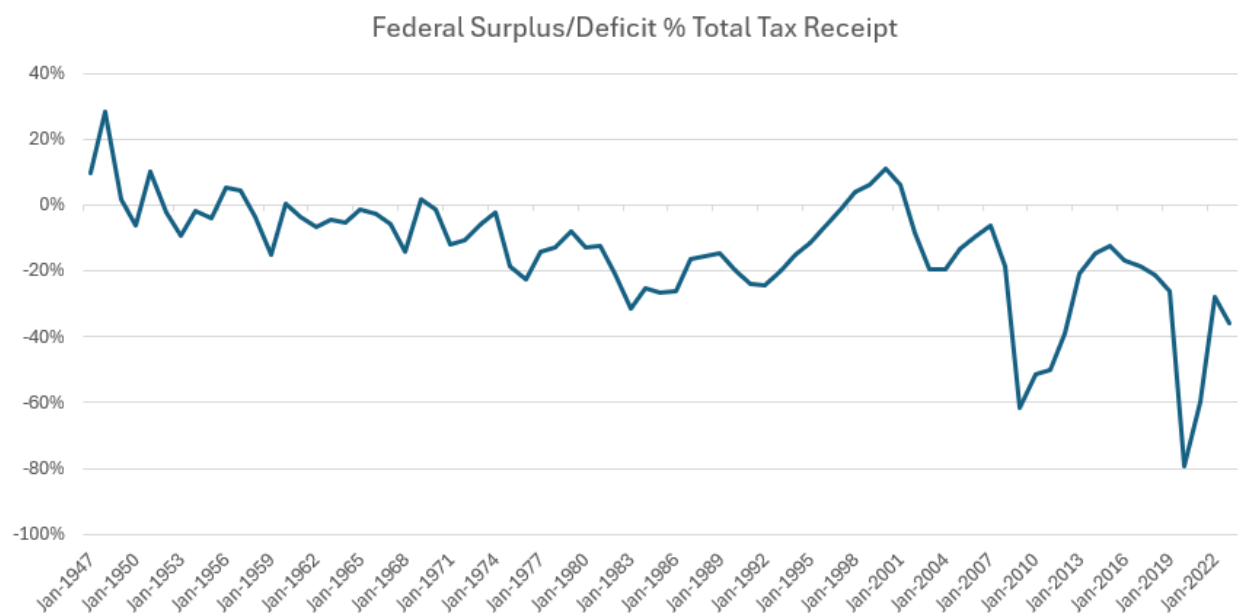
Here, I propose 2 indicators that might be helpful:

The first indicator is the federal government's interest expense as a percentage of its total tax revenue.



Currently, the US government's interest expense accounts for 21% of its total revenue, with the average interest rate on the outstanding debt around 3%. If the average interest rate were to increase to 4%, it would push the interest-to-tax revenue ratio to the historically high level of 29% seen in the 1980s. It's worth noting that compared to the 1980s, the US government faces a series of challenges, including an aging population, a growing lower-income population, and a declining middle-income population.

Another indicator is the federal deficit as a share of its total tax revenue



Prior to the 2008 crisis, the largest US federal deficit as a share of its total tax revenue was 31% in 1983, during the worst economic crisis since the Great Depression. Following that, there were only three periods with a deficit-to-tax revenue ratio higher than this level:

- 1) 2009 – 2012: deficit ranged from 39% to 62% of total tax revenue
- 2) 2020- 2021: deficit was 79% and 60% of total tax revenue, respectively
- 3) 2023: deficit is expected to be 36% of total tax revenue

Note that for 1) and 2), these were crisis years, and we were in 0-interest rate environment. However, with the trend of deglobalization, I anticipate we return to an interest rate environment similar to the 1990s, with interest rates ranging from 3% to 6% (regarding this perspective, I have conducted an in-depth analysis in 2019: *Turning Point for the Long-term US Inflation Trend and Its Implications on Asset Prices*). Currently, with an average interest rate of 3% on federal debt, the deficit is 36% of total tax revenue. If interest rates remain at the current level of 5.25%, it's only a matter of time before the average interest rate on federal debt reaches 4%. At that point, the government deficit would be about 43% of its tax revenue. Running such a deficit level when the economy is not in crisis would challenge market confidence in the US government's solvency.

As of now, some of these concerns have already been partially priced into the market. This is evident in the disrupted relationship between gold and real rates since 2022.

Gold vs. (inverted) Real 10-Year Treasury Yield



If more people realize the risk, it might precipitate a confidence crisis for US treasuries and the dollar, leading to disorderly sell-off in US treasuries and triggering a global financial crisis. To maintain confidence in US government solvency, the government must convince the market of two key points:

- 1) It would be able to increase tax revenue in the long term. This means it will likely continue the path of deglobalization to revitalize the middle class - its largest tax income source. But the process requires a long time, and we won't see material changes in the next 1-2 years.
- 2) The deterioration in the deficit level won't accelerate.

If interest rates remain at current levels, the surge in interest expense would rapidly worsen the government's deficit level. This is why I think as long as inflation is not out of control, the Fed would be less hawkish than it sounds and keep interest rates lower than actual inflation. This means the 'higher' rates won't persist 'for longer,' and the average interest rate will probably be lower than 4% in the coming years.

