



WITH CONSUMERS FEELING THE PAIN AT THE PUMP AND THE FEDERAL RESERVE
SCRAMBLING TO TAMPER RECORD INFLATION FIGURES INVESTORS ARE RIGHT TO ASK

ARE RISING RATES A CERTAINTY?

CREWCIAL
INSIGHTS
Fixed Income | August 2022

ARE RISING RATES¹ A CERTAINTY?



MOST RESEARCH SUPPORTS THE ARGUMENT THAT, FOR DEVELOPED AND OPEN ECONOMIES, ACTUAL AND EXPECTED RATES OF INFLATION PRIMARILY DETERMINE THE LEVEL AND CHANGE IN INTEREST RATES. THIS ARGUMENT INTUITIVELY MAKES SENSE, AS THE REAL GROWTH RATE, WHICH IS INEXTRICABLY TIED TO THE REAL INTEREST RATE², IS TYPICALLY VERY STABLE OVER THE INVESTABLE TIME HORIZON. HOWEVER, INFLATION, WHICH IS THE LINK BETWEEN REAL AND NOMINAL GROWTH AND INTEREST RATES, CAN BE VOLATILE AND QUITE DIFFICULT TO PREDICT OVER SHORT AND INTERMEDIATE TIME PERIODS.

80%
Q1 2020

98%
Q1 2022

SINCE THE ONSET OF COVID-19, THE UNITED STATES' FEDERAL DEBT PROFILE HAS INCREASED FROM 80% TO 98% OF GDP AS OF Q1 2022.

¹ In this essay, the term "rates" or "interest rates" refers to the general level of risk-free interest rates.

² <https://fred.stlouisfed.org/graph/?g=ShLc>

Ample evidence exists suggesting rising interest rates are anything but a certainty and that interest rates are just as likely to fall to the zero-bound as they are to rise or remain at their current range. Evidence in support of falling rates emphasizes aging demographics, weakening productivity, over-indebtedness, and burdensome banking regulations, while evidence in support of rising rates emphasizes deglobalization, falling real capital expenditures, and decelerating money-supply growth.

THE CASE FOR FALLING RATES

The aging demographic profile of the United States favors a relatively modest level of GDP growth for the foreseeable future. This is because potential GDP growth—i.e., the sum of population and productivity

Over-indebtedness presents a more ambiguous situation, not only because it is somewhat nebulously defined (i.e., it is a relative exercise), but also because it has been difficult to support the logical argument that a positive relationship exists between debt outstanding and interest rates. Said another way, an increase in debt should shift the demand curve to the right and provide a tailwind for inflation. But when a monetary sovereign is not budget-constrained, the empirical record shows that interest rates fall with increasing levels of debt. This has been the case in the Eurozone and United States from the Global Financial Crisis (“GFC”) until the onset of COVID-19, and in the case of Japan, since the early 1990s⁵; since the onset of COVID-19, the United States’ federal debt profile has increased from 80% to 98% of GDP as of Q1 2022⁶.



PRODUCTIVITY GROWTH HAS SEEN A BOOM SINCE THE IMPLEMENTATION OF PRODUCTIVITY-ENHANCING TECHNOLOGY BEGINNING IN THE 1980S. THIS TECHNOLOGY BOOM HAS BEEN ADDITIVE TO GDP GROWTH, SHIFTING THE AGGREGATE SUPPLY CURVE TO THE RIGHT AND PRESENTING AN ADDITIONAL HEADWIND FOR INFLATION.



growth—is restrained when one side of the equation is growing more slowly³. Aging societies typically add marginal savers (rather than spenders) to the economy; this can shift the aggregate demand curve to the left, presenting a headwind for inflation.

Productivity growth has seen a boom since the implementation of productivity-enhancing technology beginning in the 1980s. This has been additive to GDP growth, shifting the aggregate supply curve to the right and presenting an additional headwind for inflation. Although it is difficult to argue against future gains in productivity, currently productivity growth seems to be in a state of modest but stubborn decline⁴, a point we will cover later.

Since the GFC, private-credit growth has been curtailed as regulators have placed size and composition limits on banks’ balance sheets. Consider that today non-bank financial companies (“NBFCs”) are the marginal lender of capital⁷. NBFCs, which fall into the realm of the “shadow” banking system, are fragmented and have much higher costs of capital than their commercial-bank counterparts; therefore, NBFCs cannot scale their lending programs as efficiently as those of deposit-taking commercial banks, which are backstopped by taxpayers. This shift in the marginal lender of credit to a less efficient lender dampens money velocity (or the amount of GDP created by one unit of money) and places constraints on aggregate demand and inflation.

³ <https://www.census.gov/library/stories/2018/03/graying-america.html>

⁴ <https://fred.stlouisfed.org/graph/?g=QiS3>

⁵ <https://www.cmegroup.com/education/featured-reports/interest-rates-and-long-term-fiscal-trajectory.html>

⁶ <https://fred.stlouisfed.org/graph/?g=QiSv>

⁷ The commercial banking system still plays an important role in credit creation given that it is a ~\$20 trillion system, included in which is leverage to the NBFCs; the capital markets also play a role in credit creation to NBFCs via the securitization markets (e.g., ABS, CLO).

THE CASE FOR RISING RATES

Globalization has led to lower goods inflation since the early 1990s, but a reversal in this trend to “deglobalization” or “reshoring” could lead to higher inflation as supply and production chains are moved to higher-cost locations. By itself, this would argue against ever-cheaper consumer goods in the best scenarios and sustainably higher goods inflation in the worst scenarios.

As previously discussed, since the 1980s business spending on capital expenditures (“capex”) has greatly augmented worker productivity; however, the productivity gains were not shared proportionally. As a result, an increasing share of business profits were retained by business owners at the expense of their employees. More recently, however, businesses have been reluctant to maintain the historical pace of capex⁸. A continuous deceleration in capex could eventually lead to an inexorable decline in workforce productivity, which would likely tilt the share of profits in favor of employees and lead to higher sustained inflation. In addition, the manner in which society ultimately agrees to produce its energy requirements could also cause structurally higher inflation. Recently, capex for fossil-fuel energy sources has fallen as financial resources have been diverted to fund the green-energy transition. At this time, there appears to be a gap between the demand and supply for total energy (demand is greater than supply). If this perceived gap persists, it could lead to structurally higher inflation. In addition, in order to keep the trend rate of GDP growth politically acceptable, economies need to produce energy at a quantity and growth rate that satisfies the acceptable GDP rate. If the cost of producing total energy turns out to be permanently higher, it could lead to structurally higher inflation.

Money-supply growth in combination with higher money velocity could also cause higher inflation and higher interest rates. This argument has fallen short until recently, as strong government stimulus spending (i.e., aggregate demand shifting to the right) was pitted against erratically persistent supply chain-related issues (i.e., aggregate supply shifting to the left). Although it is debatable, the United States’ version of fiscal stimulus during the COVID-19 period (i.e., direct checks to consumers) seems to have “cracked the code” of what has been ailing the US economy since the GFC—moribund private-sector credit growth and by extension falling money velocity⁹—which has hamstrung demand in the traditionally private-sector-led US economy. A sustained increase in direct-to-consumer fiscal spending through significantly higher budget deficits, however improbable it seems at this time, could cause structurally higher inflation¹⁰.

CONCLUSION


Many other perspectives exist that favor either rising or falling interest rates, and of course there are always unforeseen exogenous shocks to consider—e.g., war and natural disasters. We believe the risks of higher or lower interest rates are well balanced, and any skew towards certainty or a sense of inevitability for rising rates doesn’t account for the broader picture. Based on the evidence we’ve seen so far alongside historical developments, we believe falling rates is the higher-probability outcome.

⁸ In real terms and as a percentage of GDP.

⁹ https://centerforfinancialstability.org/amfm_data.php

¹⁰ This argument counters the over-indebtedness argument presented earlier. In summary, countries that are currently overindebted and experiencing slow growth did not rapidly implement a sufficiently large stimulus to allow their economies’ growth rates to reach “escape velocity”.



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