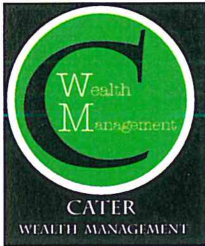

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10/16/2020

Greg Cater Sr. & Greg Cater Jr.

Interest Rates vs. Government Debt vs. COVID-19

In April of last year, we posted a note on our website, "Government Debt, Deficits and Interest rates". You can find it here: http://www.caterwealthmanagement.com/articles/DebtDeficitsIR.pdf

THIS WAS PRE COVID-19

Once again, we are being bombarded with so-called "experts" predicting higher deficits and debt that will have to be funded with increased Government bond sales which will in turn lead to increased inflation and sharply higher interest rates.

A good example is this article recently posted in the WSJ, "Investors Prepare for Higher Treasury Yields as Election Looms" which can be found here:

https://www.wsj.com/articles/investors-prepare-for-higher-treasury-yields-as-election-looms-11602581400?mod=searchresults&page=1&pos=7

This is the same old story we debunked in our April'19 note. Last April the yield on the 10-year US Government bond was 2.50%, today it is .74%. The yield on Japan's 10-year bond is still 0%. The pandemic and the ensuing fiscal and monetary actions to fight it have dramatically increased budget deficits in both countries, not to mention the rest of the developed world. Increased deficits combined with declining GDP (output) will most likely cause the US Debt-to-GDP to reach levels not seen since WWII. Our April note clearly shows and explains the negative correlation between US government deficits and the yield on the 10-year bond.

Higher Debt-to-GDP = Lower Government Bond Rates

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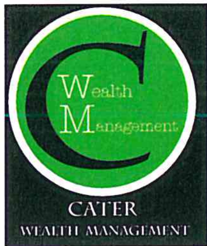

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What about inflation?

We have established that higher Government debt leads to lower interest rates, and in our June'20 note we learned from A. Gary Shilling Ph.D. Economics (Stanford) that "interest rates have a 60% correlation with inflation." From there we could assume that depressed interest rates combined with a sluggish economy would lead to muted inflation. Another way to get there would be to look at what has happened in the past.

The Federal Reserve adopted its official inflation target of 2% in 2012. To measure inflation, it uses the US Personal Consumption Expenditure Chain Type Price Index Year-Over-Year (PCEYOY). Even after all the stimulus pumped into the economy, PCEYOY is still below pre-covid levels. Pre-covid inflation levels that were, by the way, only at the 2% target rate 3 times since it set the target in 2012 (the rest of the time inflation was sub 2%).

It can be confusing to see the price of housing or milk increase and then hear us talk of lower inflation and lower interest rates. We wrote a note dedicated to just this topic. For those who would like to dive deeper into this phenomenon or could just use a more detailed explanation of the difference between price and monetary inflation, please look to our June'20 note.

The world has changed drastically, and there are an overwhelming number of moving parts to this economy. When we take a step back and look at the whole picture, we can see through both historical review and mathematical forecast that those changes are likely in the direction of slower economic growth, muted inflation, and depressed interest rates.

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TOTAL US FEDERAL DEBT AS PERCENT OF GDP VS US 10 YEAR TREASURY

(1965 TO 2020)