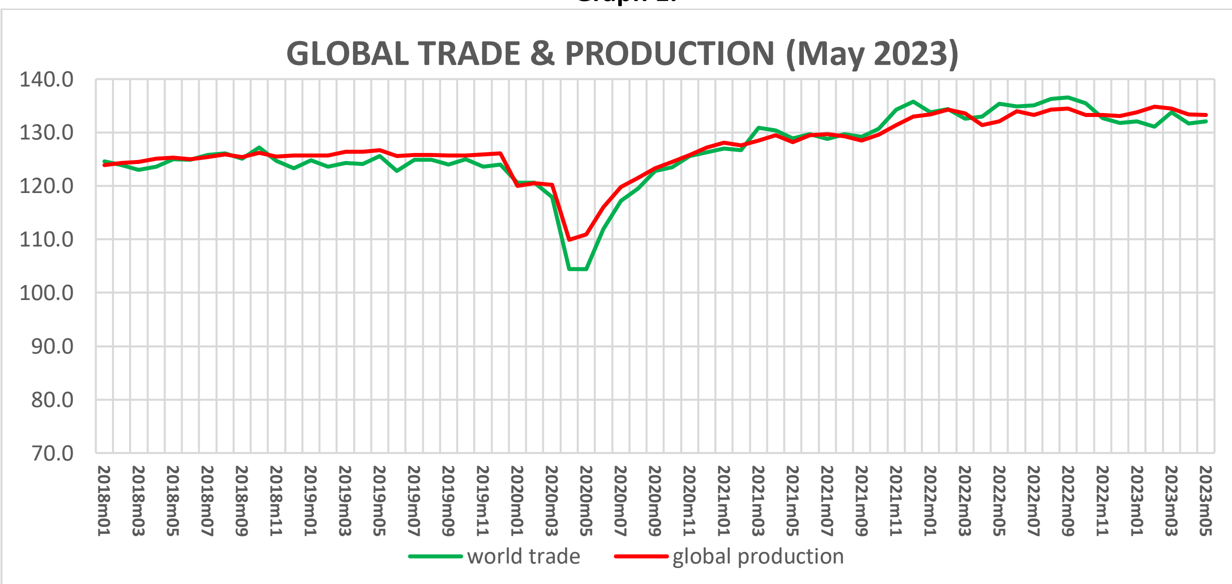
THE INTEREST RATE CONUNDRUM.

The FED today raised target interest rate by 0.25% from 5.25% to 5.5% on the back of an economy which continues to grow 'moderately' and with labour market remaining' tight'. This article examines why interest rates seem to have lost their effectiveness given that the rate above 5.25% represents a real interest rate of around 2.5% when adjusted for inflation.

The global economy.

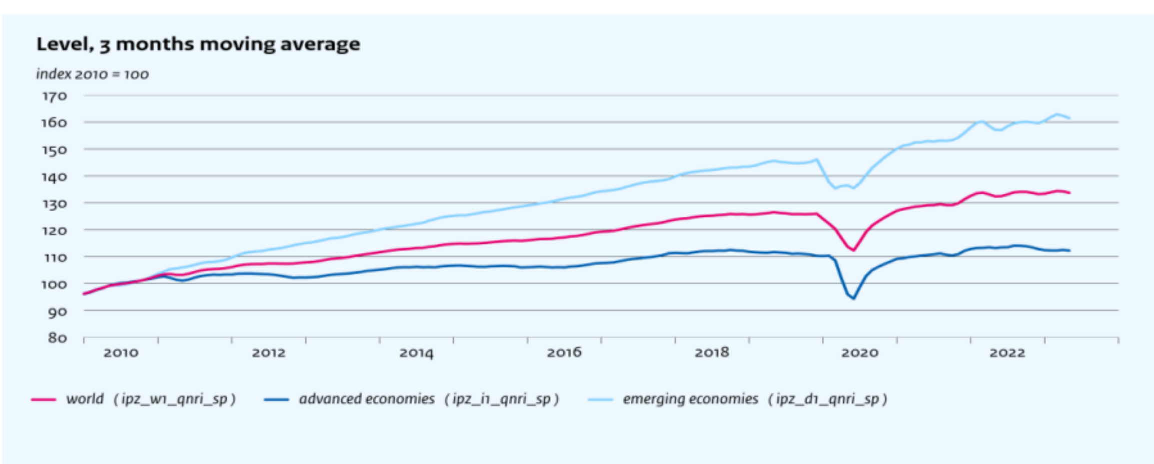
But first a quick look at the global economy as of May 2023. A few days ago the CPB brought out its latest *World Trade Monitor*. Comparing May 2022 to May 2023 we find trade to be down -2.5% while industrial production is up +1.0%. As we see in Graph 2 the increase in production occurred in developing countries.

Graph 1.



Graph 2.

INDUSTRIAL PRODUCTION VOLUME, CHART 1



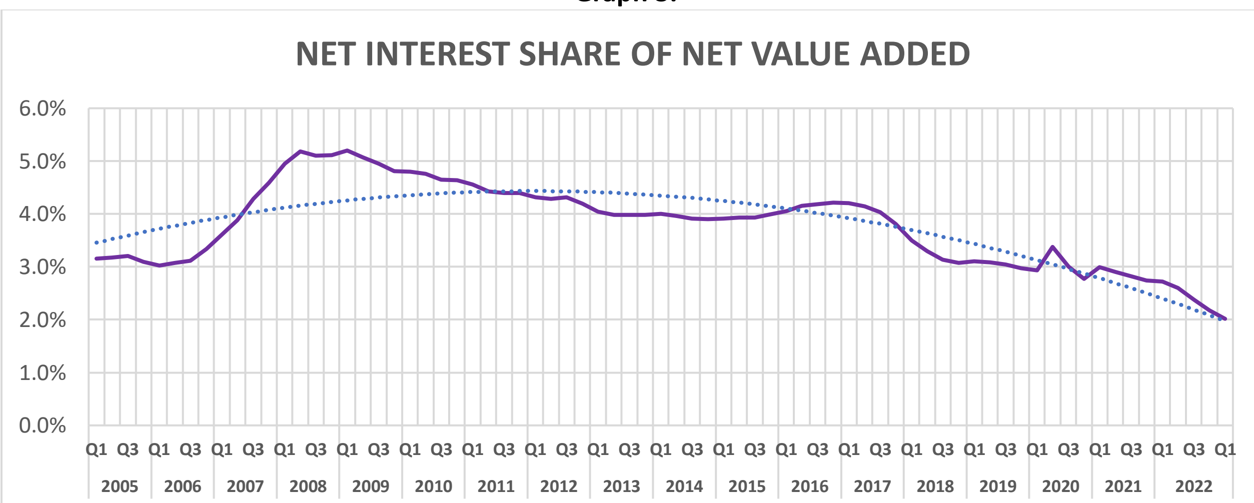
In fact since 2018 there has been no increase in industrial production in the developed economies.

What is diluting the effect of interest rate policies?

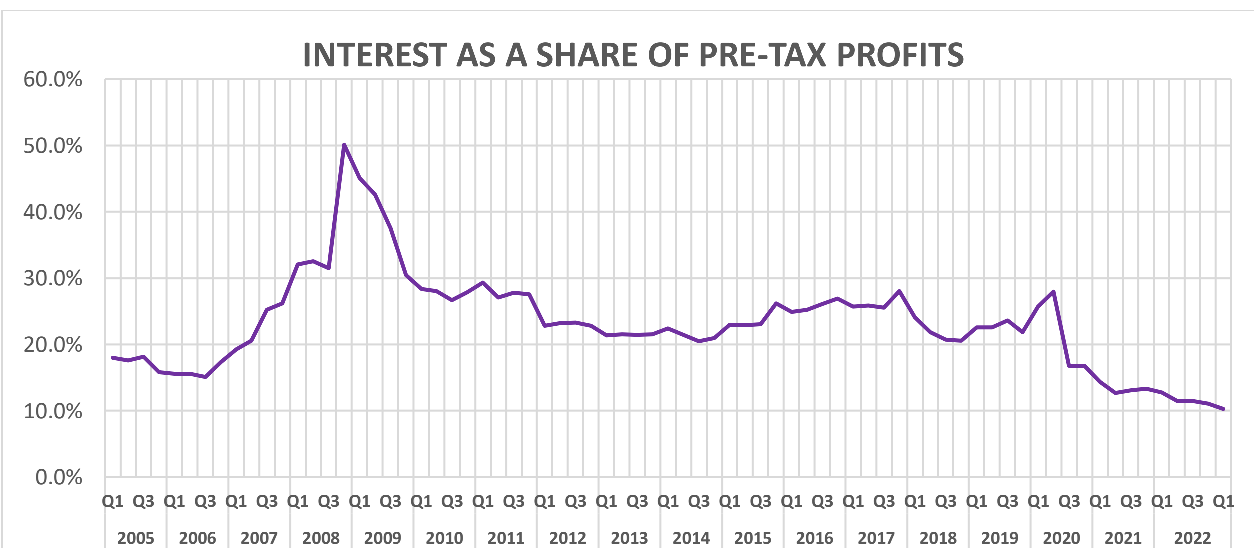
The first is that many US businesses gobbled up cheap loans when the going was good and they were the beneficiaries of up to $3 trillion in Covid funds either in the direct form of subsidies or indirectly through price rises engorging profit margins, which expanded them to historic highs. Secondly, the soaring fiscal deficit broaching 7% of GDP. Thirdly, inequality which has increased the spending power of the top 10% of income earners. Finally, the exuberant US stock markets.

We will deal with the liquidity of US corporations first. There has been a lot of discussion in the financial press recently about the following anomaly: despite the sharp rise in interest rates interest payments have actually declined relatively. Below are two graphs taken from NIPA Table 1.14 covering the period up to the first quarter of 2023. The data for the second quarter is a month away. Both graphs show the same effect. The burden of interest payments has fallen sharply.

Graph 3.

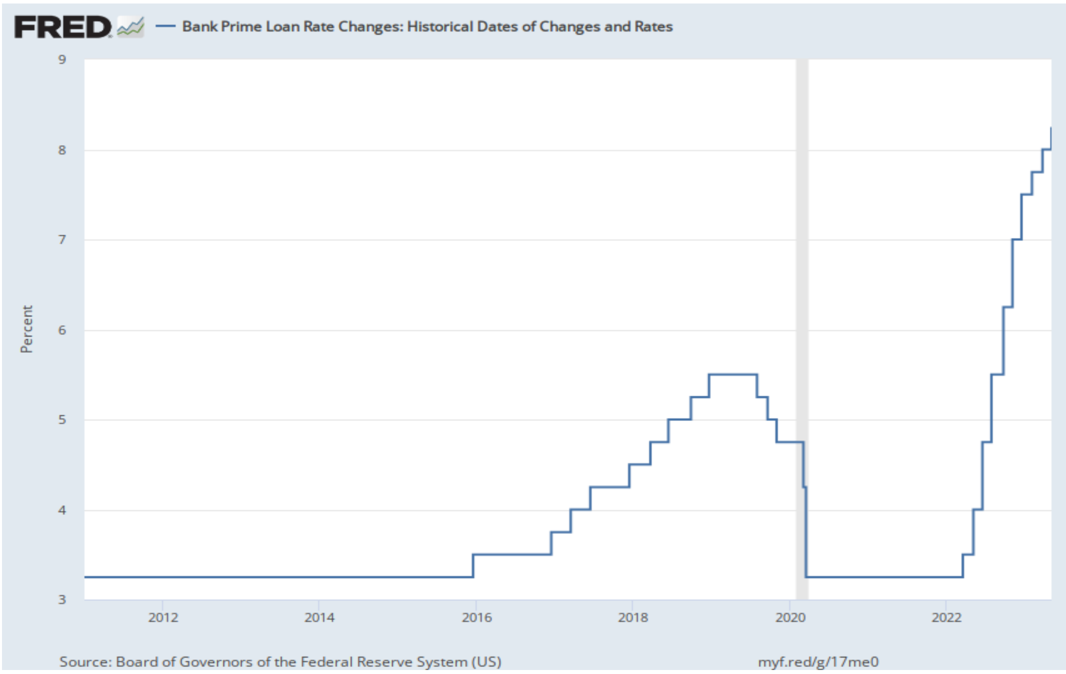


Graph 4.



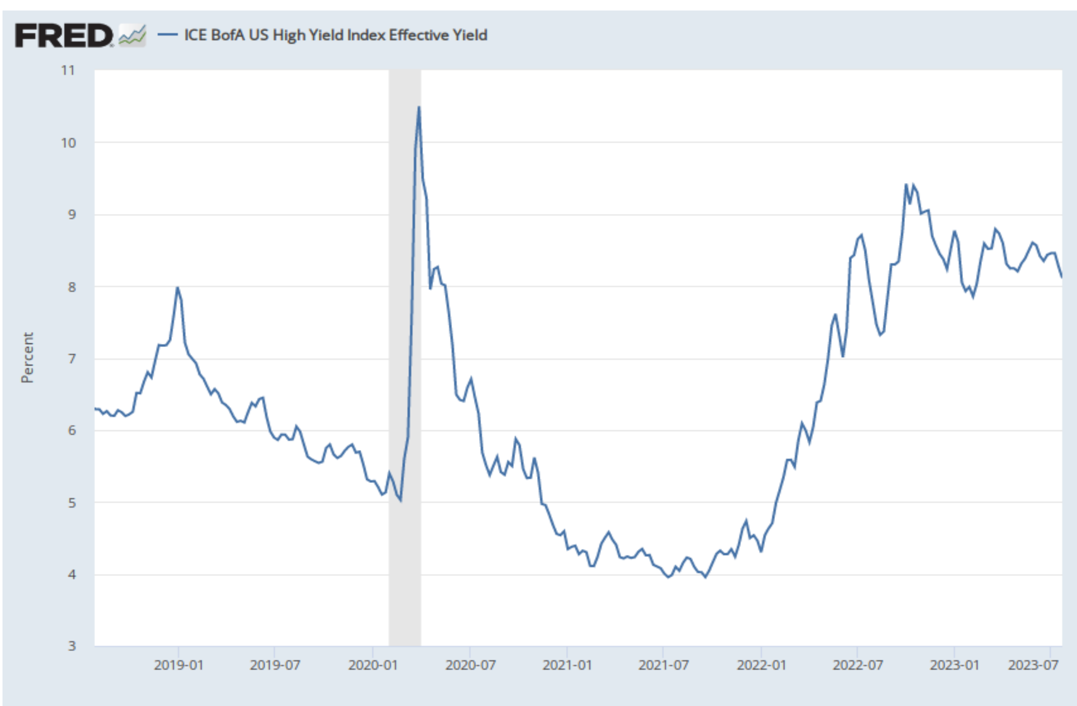
This has occurred despite interest rates for businesses more than doubling over 12 months from 3.25% to over 8% because of the rise in the FED's lending rate, rather than through the demand for loans.

Graph 5.



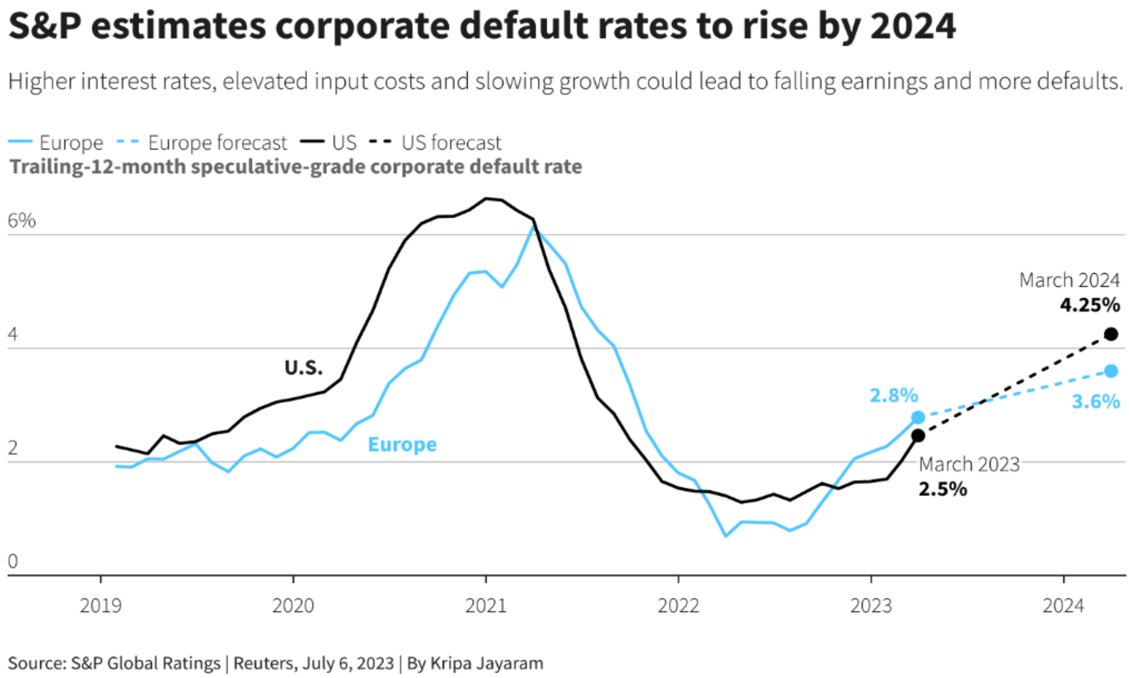
While interest rates for sub-prime bonds rose sharply from the beginning of 2022, they have stabilised over the last year and remain below the 10% level, the assumed distressed level.

Graph 6.



While higher interest rates have certainly impacted a number of companies and businesses, insolvencies while up, have not reached a critical mass. *Standard & Poor's reported more than 230 bankruptcy filings through April of this year, the highest rate for that period since 2010*. More defaults in the first half of the year than the whole of 2022.

Graph 7.



(Source: Reuters)

Here is an interesting counter factual observation. Many financial commentators are discussing whether the FED's rapid rise in interest rates, by far the fastest amongst Central Banks, will crater the economy. However the opposite could be the case. If the FED 'squashes' inflation by year end so that it can start cutting back on interest rates it could avoid a credit debacle beginning in 2024. "*During COVID, many borrowers attracted or refinanced debt at historically low interest rates and very borrower-friendly terms. This was due to a liquid debt market fuelled by government and central bank stimulus. The largest portion of this debt will mature in 2024 and 2025 – which means we expect a surge in borrower demand for refinancing in the next 12-24 months."* Thus if interest rates are on their way down by the time refinancing escalates, and given the hunt for yield when that happens, it could mean that refinancing would not be so burdensome. We shall see.

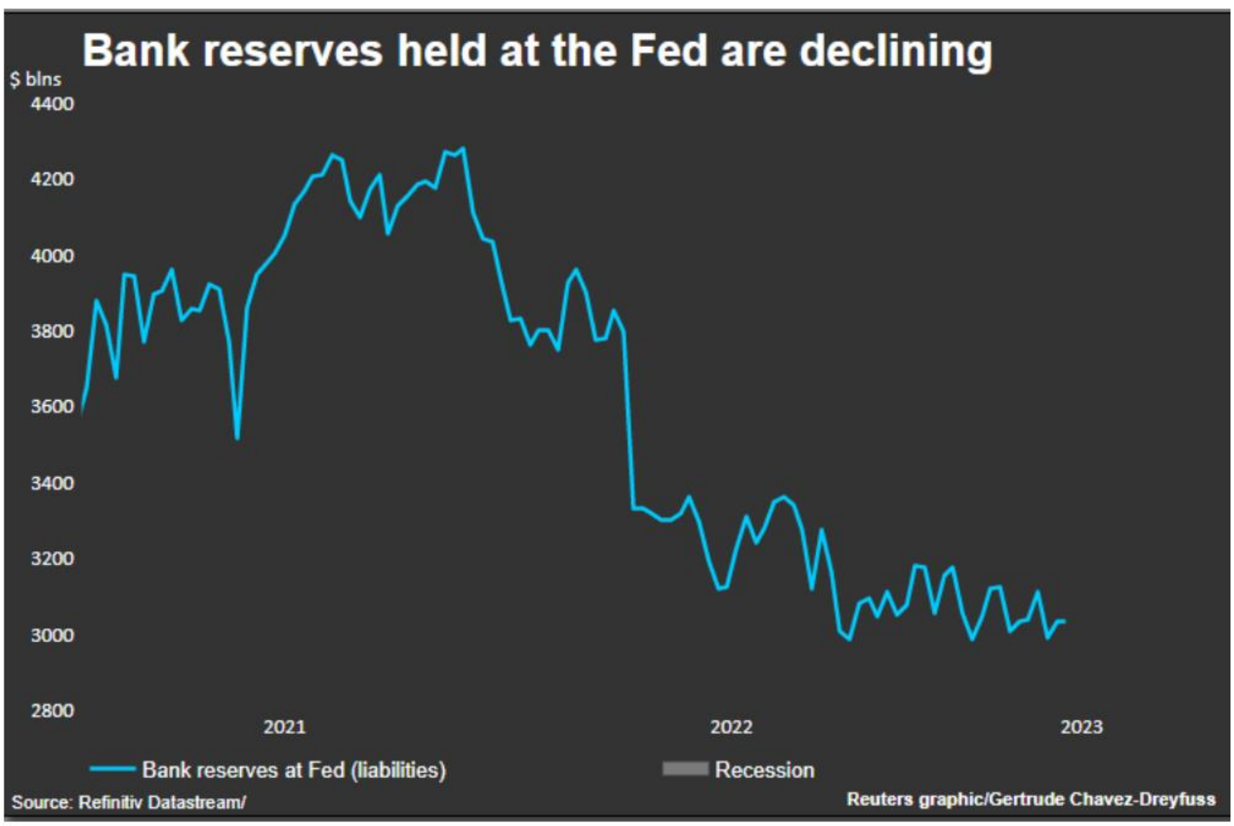
The Soaring budget deficit.

Currently the budget deficit for the first 9 months is $1.4 trillion. "*The federal budget deficit was $1.4 trillion in the first nine months of fiscal year 2023, the Congressional Budget Office estimates—$875 billion more than the shortfall recorded during the same period last year."* Annualised this amounts to 7% of GDP. Quantitative Tightening on the other hand only amounted to $457 billion. The federal government is thus giving more with one hand than it is taking with the other, about $1 trillion more in the first 9 months of this financial year.

Over the last 25 years the convention has arisen whereby the FED does not discuss nor dares criticise fiscal policy. However, it is clear that monetary policy and fiscal policy are working against each other. This has the effect of driving up interest rates above where they would normally be. The fiscal deficit in other words is blurring the 'optimum' level for interest rates which the markets so hanker to understand. The irony of course is that the higher the rate of interest the bigger the deficit because it drives up the interest payments on the public debt and bank reserves. The fastest growing expenditure by the government from $369 billion to $505 (+37%), about to overtake defence spending, is Net Interest on the Public Debt. And if we include the following also in the report: *"Remittances from the Federal Reserve decreased from $93 billion to less than $1 billion. Higher short-term interest rates raised the central bank's interest expenses above its income, eliminating the profits of most Federal Reserve banks."* By adding back the $92 billion, then total interest paid by the Treasury and the FED is well above the amount spent on the military.

It is worth investigating this $92 billion in greater detail. As I have said before, when the FED embarked on Quantitative Easing after the 2008 Financial Crash to restore the balance sheets of the commercial banks and other financial institutions, the funds resulting from the re-purchase by the FED of trillions of Treasury Bonds were mainly left on reserve with the FED, because the banks could not find profitable investment outlets for that money. Parked with the FED these reserves, the biggest idle hoard ever, earned interest. Its like a motorist being given a car and then being paid to park it on the road, ahh the life of bankers and rentiers, its so challenging. At first when interest rates were low, these reserves did not yield big payments. However now they do. Big reserves x big interest = big payments.

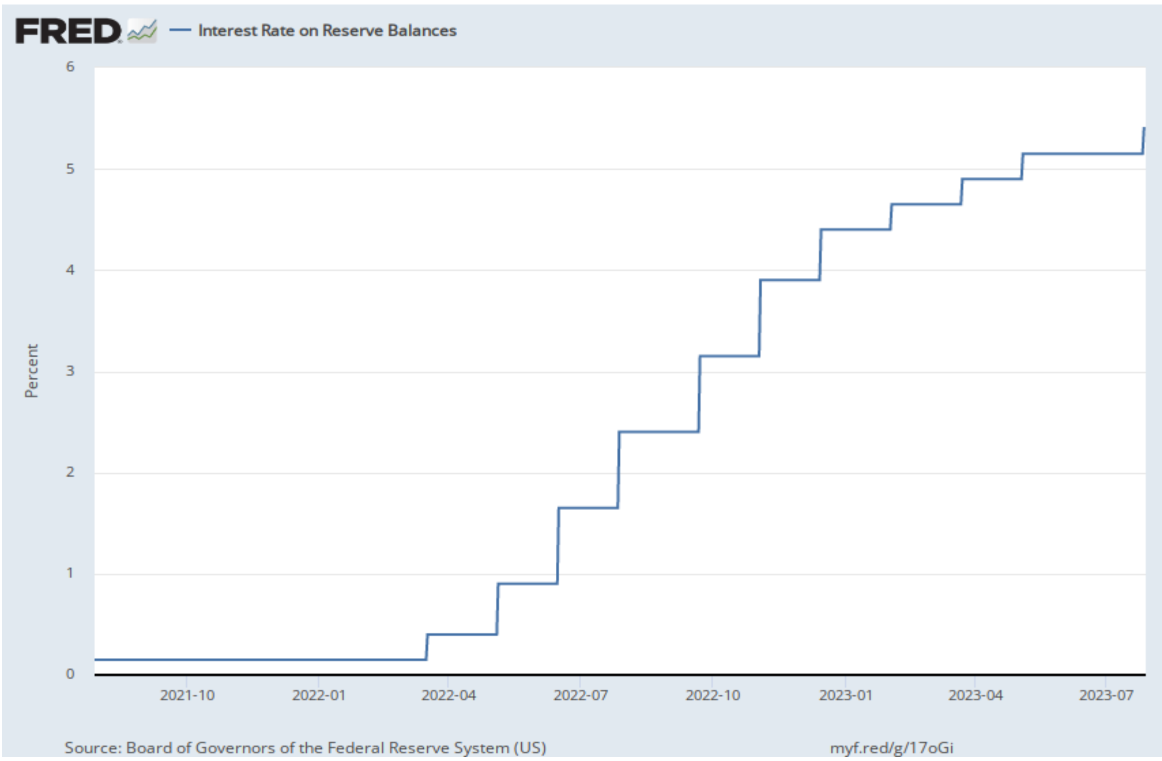
Graph 8.



(Source: Reuters)

And though these reserves have fallen by over 20% due to the draw down of Covid funds and Quantitative Tightening, this has more than been made up for by rising interest rates on those reserves. Since March 2022, the interest rates on reserves have risen to 5.4% which means that the FED is currently paying out over $150 billion in interest annualised, hence the $92 billion reduction in payments back to the Treasury. In the months to come the *shortfall* will transfer into a *subsidy* falling on the shoulders of the Taxpayer.

Graph 9.



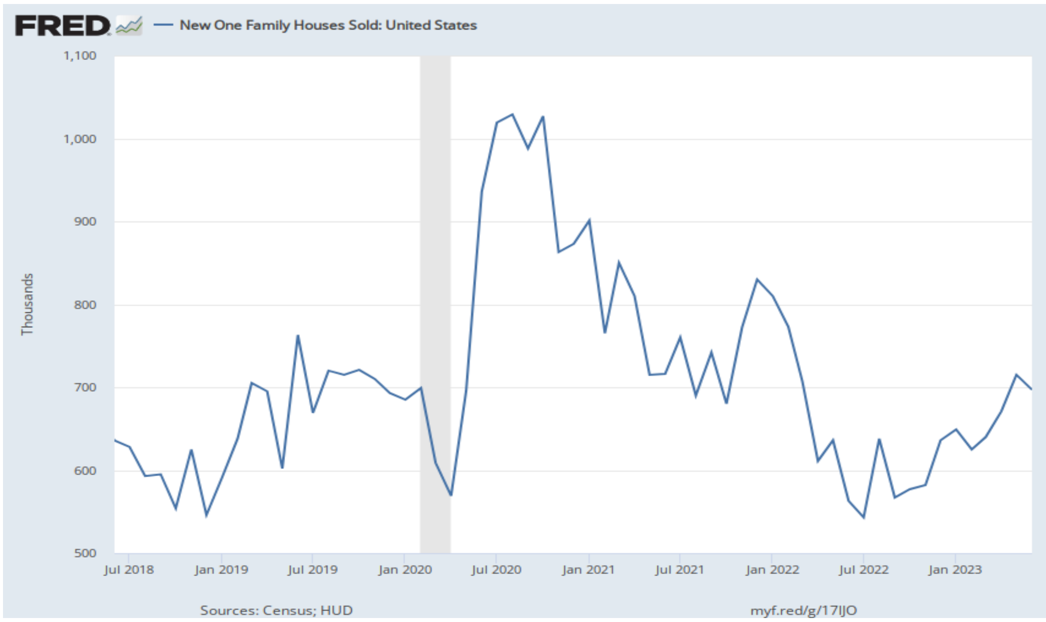
In conclusion. Instead of FED Powell mouthing off about tight labour markets frustrating his inflation plans at every press conference, he should be mouthing off at Congress for their lack of fiscal discipline in pursuit of economic autarchy. At 7%, the deficit stands 4% above the average pre-pandemic levels. This compares to positive worker renumeration which at best stands at 1.5% of GDP currently. It is clear which figure is boosting demand more. Never trust a one-eyed FED Chair who says he is driven by the data when he consistently ignores one of the most important factors driving demand.

Inequality.

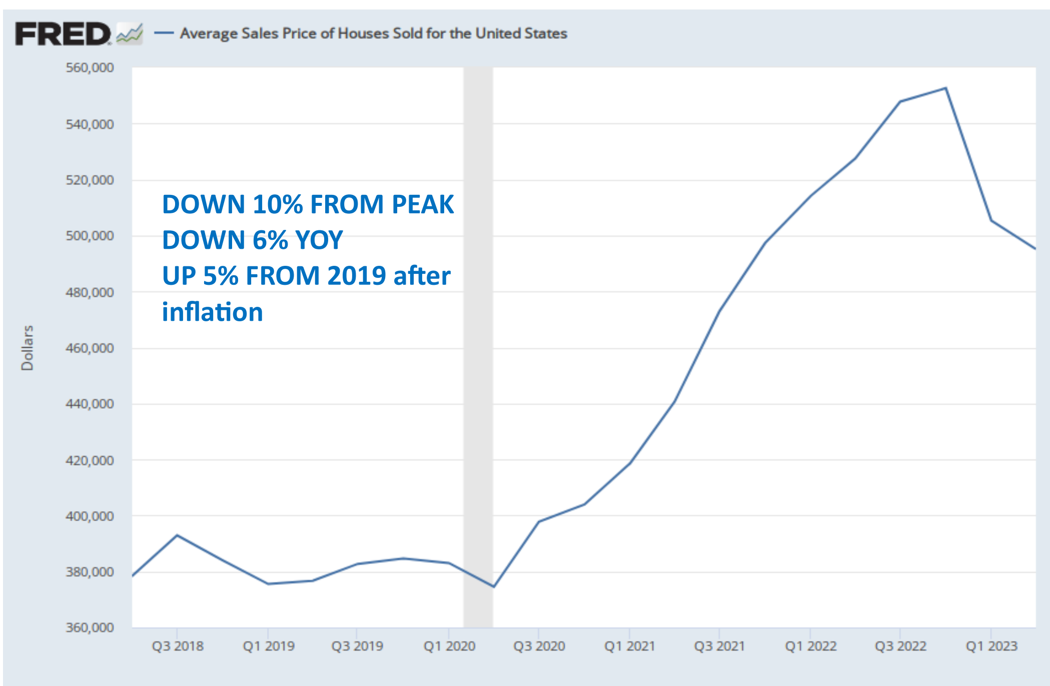
It appears that the spending by the top 10% of income earners is subsiding. Though less sensitive to interest rates because they can pay cash for most things, interest rates are having an impact. In addition the advent of generative language programmes blossoming (A.I.) and with it the prospect of future job losses on top of actual job losses, higher earners are cutting back. This can be seen in the latest reports of all the luxury goods houses such as Richemont and LMVH which show the weakest areas of global sales to be in North America, aka the United States. (However a confounding factor could be increased purchases abroad as international travel by US consumers abroad is up significantly.) It can be also seen in the car industry where rampant price increases are over. General Motors was only able to raise average prices by 2.9% and Ford's by 3.4%. This is the first sign of recent weakness in that industry.

It is also beginning to be seen in the weak June housing market data as well. New home sales are back to pre-pandemic levels with this difference. New houses being built and sold are generally smaller than pre-pandemic. In Q2 2023 houses selling below $400,000 accounted for [45% of sales] compared to 38.5% in 2022. This helps account for the 6% fall in average house prices year over year.

Graph 10.



Graph 11.



The exuberant Stock Markets.

It is clear from all the press interviews that the rise in the Stock Markets is frustrating the bankers who head the FED. They know full well that rising stock prices resulting in capital gains tends to stimulate consumer demand. In many ways the rise in the markets seems to be overturning traditional relations. In the past a rapid rise in interest rates was always associated with a fall in equity prices.

But then in the past we did not have the excitement fuelled by A.I. expectations, or better still, generative language programming. Of all the companies reporting in terms of AI, Microsoft stands out. Has it met expectations? Not really, a company on the cusp of a revolution tends not to announce a salary freeze nor 10,000 layoffs equal to 5% of its core workforce. But then its revenues only rose 8% yoy and which is expected to fall to 6.7% next quarter. (Its consumer software side only increased by 3%.) This explains why after announcing its earnings, Microsoft's share price was down six and a half percent over the week. In short, there is nothing as yet in the earnings to suggest a sharp uplift in A.I. contributions except some warm words in the commentary section. In sum its 36% increase in share price to date has little support from its earnings report as its operating income for the year only rose 6% while its net income was flat!

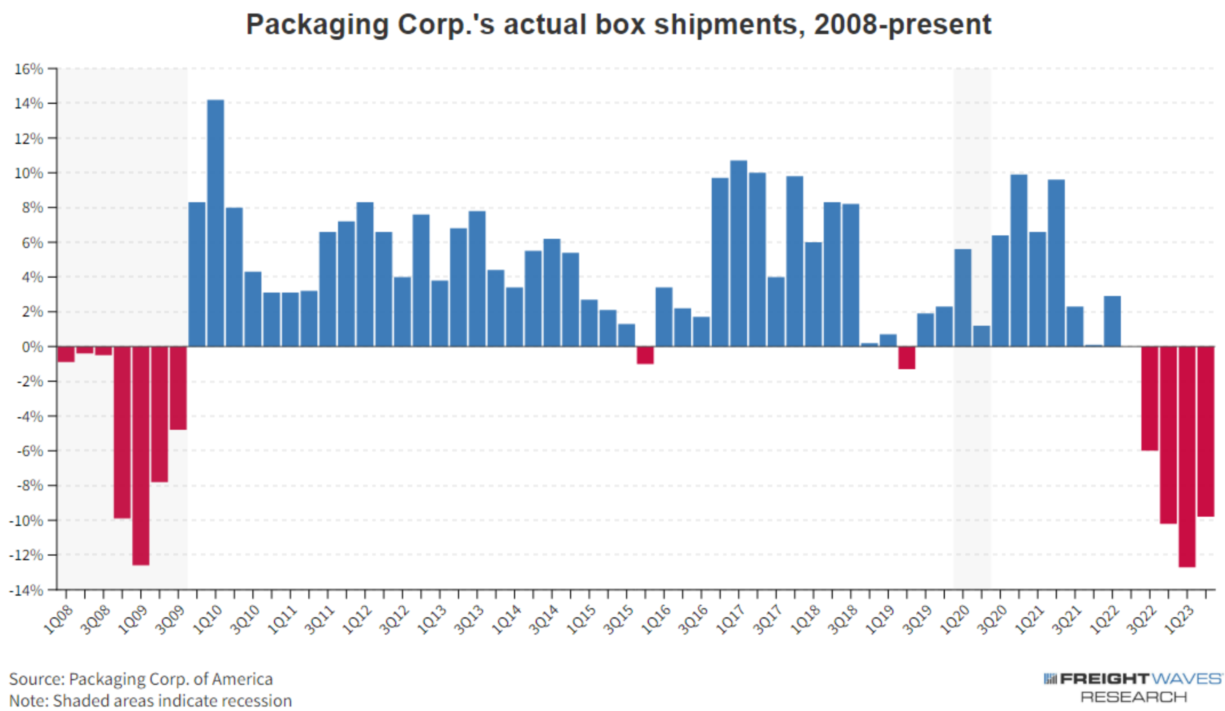
Both Meta and Alphabet did better. But this is merely a function of advertising and spying. Advertising spend with Meta amounted to 98.5% of its revenue and in the case of Alphabet it was 78%. They remain hostage to the overall growth in digital advertising in the USA. The growth in their revenue was in line with the 7.8% increase in digital advertising spend expected for 2023, the lowest annual increase since 2009. So once again the boost to their share prices is unsupportable.

What is supporting the market is consumer led companies such as Procter & Gamble. Generally volume falls have been more than offset by price rises. Volume falls in Q2 of around 2% puts these falls mid-way between the falls in Q4 2022 and Q1 2023 with the falls in Q4 being the steepest. Price increases have averaged 8% or double the CPI figure of around 4% for the quarter. Combine these price rises with the fall in the cost-of-sales and there has been a considerable boost to gross profits.

What is the importance of this observation? It is this. The rise in real wages (nominal wage rises less consumer inflation) has been exploited by these companies to jack up prices to more than compensate for the fall in volumes. These large corporations with their pricing power are indeed making inflation sticky only because their fingers are sticky. From this data there are no early signs of a consumer rebellion against higher prices. It is indeed very unusual for volume falls not to be followed by discounting, but this is not happening. Evidently as long as they can raise prices these corporations are not interested in market share.

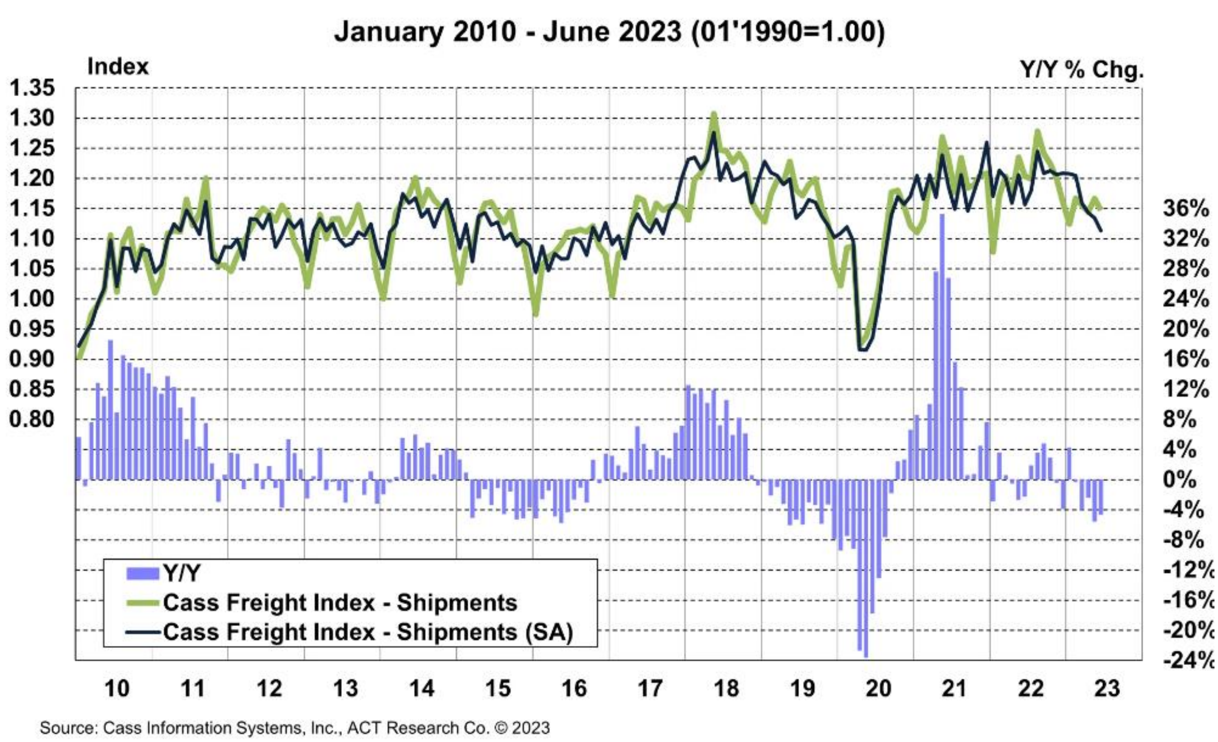
To gain an idea of the fall in volumes which appear to be greater than 2% overall, we turn once again to the Cardboard Box Index or CBI. Instead of an expected improvement their was a sharp fall in cardboard box demand, replicating the depth and extent last found during the financial crisis of 2008-9. In fact the recent cumulative fall of 37% in boxes cancels the 37% rise between 2020 and 2022 taking us back to 2019. Cardboard boxes are not only used in goods industries but very much so in the service industries as well. Transport which falls in the service sector carries boxes, lots of them. Hotels and tourist attractions have to feed their guests while cleaning up after them, all of which requires things carried in boxes, so it is a good guide for the economy as a whole. Finally, trucking and rail shipments also indicate a significant fall in volumes, as does air cargoes down 20%. Graph 12, representing the moving average for the Cass Freight Index is down 4%, which I am of the opinion is about right for the economy as a whole. So a rise in GDP of 2.4% is difficult to justify.

Graph 11.



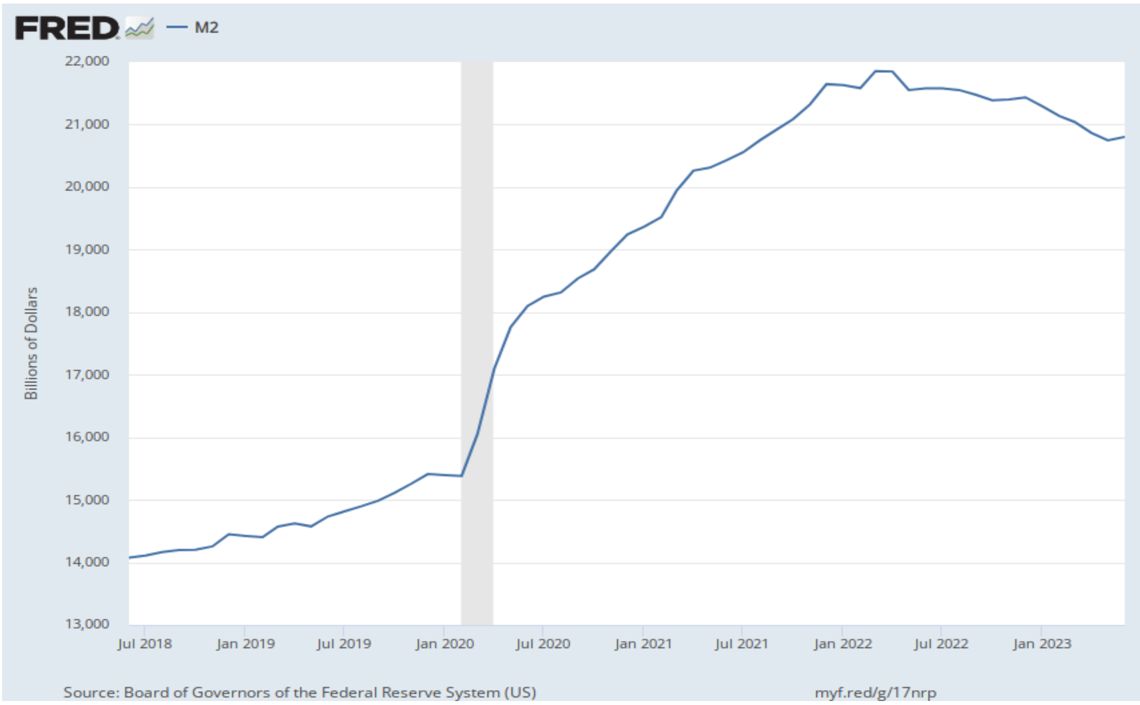
(Source: [FreightWaves])

Graph 12.

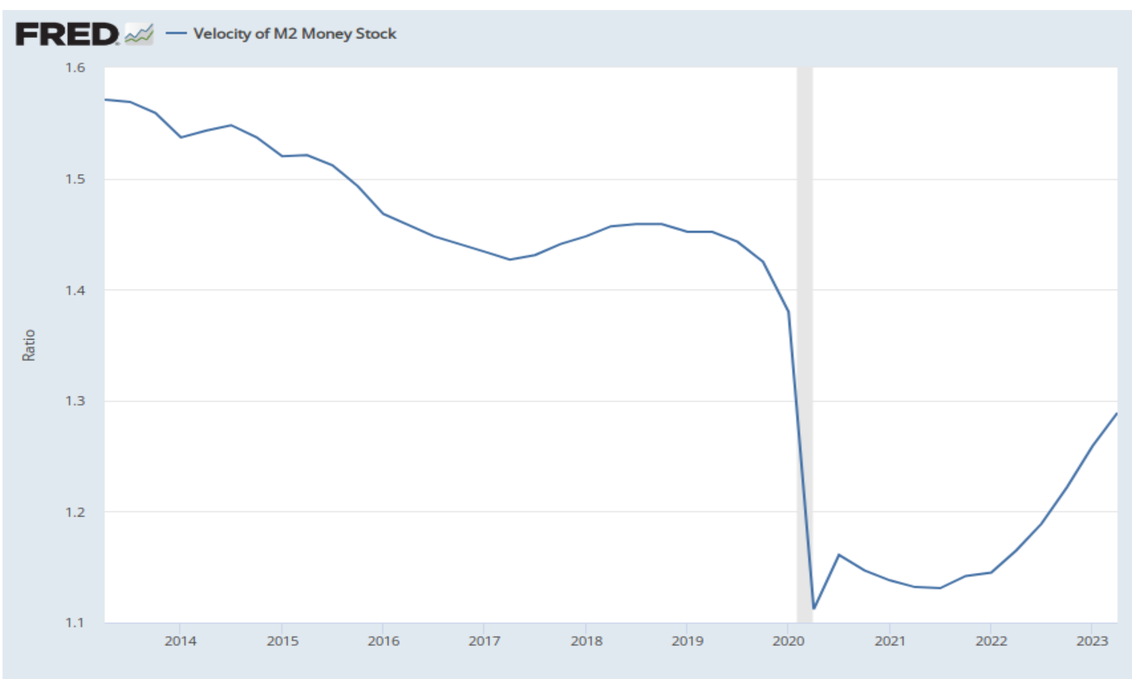


Finally this contraction is consistent with the fall in the money supply and the still subdued velocity of circulation though the latter is less important because nominal GDP is inflated.

Graph 13.



Graph 14.



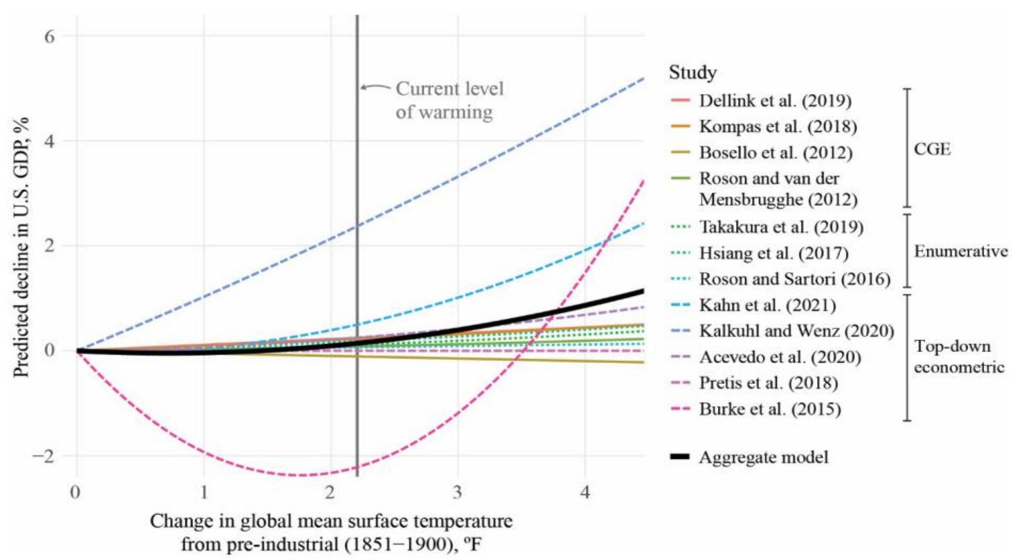
From global warming to global boiling.

UN Secretary-General Antonio Guterres summed up that we are now phasing out of global warming into global *boiling*. Well said as always. June was the hottest month on record as will July be according to the Copernicus Institute, and with El Nino straining at the leash and Solar 25 raging, so will August, so will September and so on. CS help us in 2024. No that does not stand for Christ the Saviour but Class Struggle. Only the emancipated international working class has the power to protect our planet now and forever.

It seems only the markets and the Biden Administration is blind to what is coming. Recently his Committee of Economic Advisers published their estimate for losses resulting from global boiling. A mere 1% loss in GDP. Come on man, even the desert Cacti are keeling over in Phoenix.

Graph 15.

Figure 1: Individual Damage Functions and Aggregate Function Used for Scenarios including Physical Climate Risks in the FY 2024 Long-Term Budget Outlook



Conclusion.

I had expected this quarter to be the one where pricing power was going to hit the interest rate buffers. It was not to be. As a result the fall in profits will be more muted. I will not comment on the GDP report until the next release of GDP when it will be possible to use my favourite and only deflator, the corporate sector deflator, found in NIPA Table 1.14. Already, examining a few dozen earnings reports which provide both revenue and volumes, we can see the deflator will be considerably higher than the GDP deflator used by the BEA to reduce nominal GDP to real GDP.

Of course the quest to understand why interest rate policy has had so little effect on the economy goes on. One theme for future ongoing research is the benefit to the US economy from the crushing of Chinese Tech competition which has helped shore up the US Stock Market by insulating US corporations.

Brian Green, 28th July 2023.