# THE US TREASURY RESPONDS TO HIGH INTEREST RATES IN A WEAKENING ECONOMY

*On Wednesday it was the US Treasury not the FED which began repressing interest rates. The FED controls the short-term end, while the Treasury, with the capacity to effect buy-backs controls the more important long end, that is ten years bonds and longer, the bonds which set most of the rates effecting consumption and investment such as mortgages and corporate bonds.*

For weeks the financial markets have been speculating about when and if the FED and its new chair Kevin Warsh is going to move on interest rates. Instead, it was Bessent and the Treasury who moved first. They have doubled their purchases of long-term bonds to drive down yields. The cap lasted exactly 24 hours before bond prices rose again. The only real effect was on gold which jumped 3%.

**Graph 1. (10-year Yield)**


Long term interest rates have been pushed to levels not seen since the financial crisis. This is due to the demand for capital by both the AI hyperscalers as well as the Federal Government to cover its growing deficit. The out of control and accelerating US Federal Debt finally hit $40 trillion this month driven by war and interest payments, both of which benefit only the rich. Higher rates in the US have driven up rates around the world as the competition for liquidity intensifies.

This is having knock off effects around the world particularly in Japan. Japan is the biggest foreign holder of US Treasuries. Its carry trade is known to have kept interest rates lower around the world as funds exited Japan's low interest rate environment to secure higher yields abroad. This is no longer the case. When the Yen weakened towards 160 to the Dollar, there were indications that Japan was preparing to sell US treasuries to obtain Dollars to bolster the Yen. To prevent the sale of US Treasuries which could have driven 10-year yields above the crucial 5%, the US, without informing the European Central Bank, sold Euros to buy Yen to strengthen it. Another example of round-tripping only this time on a global scale, done dishonestly. Here is a link to examine foreign holdings of US bonds which increased by only two and a quarter precent over the year from June 2025 to June 2026.

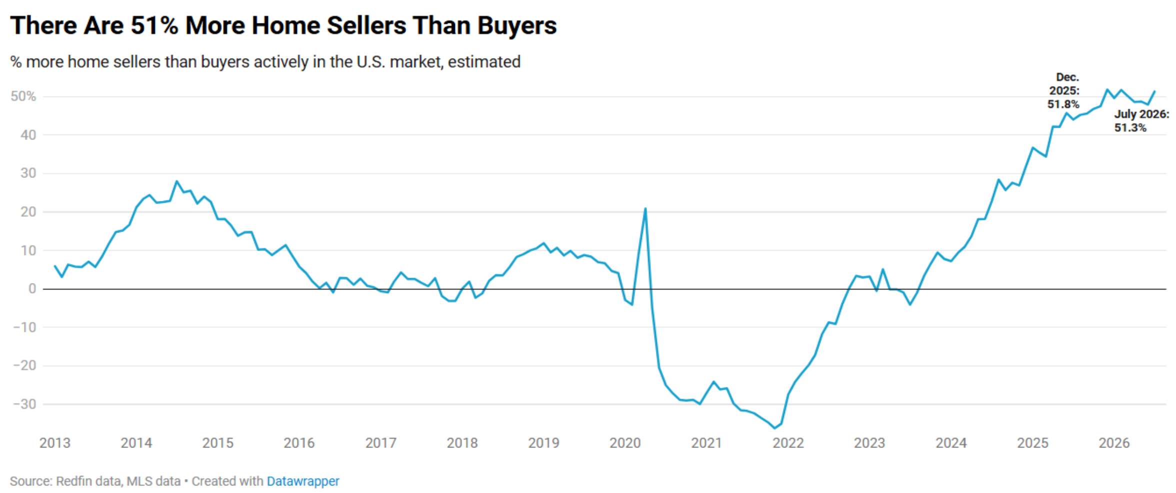
Clearly the lack of demand for US bonds and the lack of dollar usage for oil due to the blockade in the Gulf, has weakened the Dollar in recent times, despite the offset from the demand for US shares especially shares of the Big Tech corporations. In sum, as the graph below shows in recent weeks there has been a weakening of the Dollar. It is at a near 3-month low. The future of the Dollar depends largely on what happens on US stock exchanges where $22 trillion in foreign holdings sit. Any collapse in share prices will impact the Dollar as foreign funds exit trying to lock in exchange rates.

**Graph 2.**


The Treasury acted for only one reason, the so-called resilient economy ain't so resilient after all. Given weaknesses all around, the current level of interest rates is unsustainable. No doubt the Treasury will continue to announce more buy backs, a QE lite, as and when it is needed to head off interest rate rises. For the time being, and in order not to spook the markets, the Treasury will confine itself to capping rates by buying the hard to sell long term bonds rather than embarking on a fully-fledged QE programme to drive down rates. That will happen only when recessionary signs can no longer be ignored.

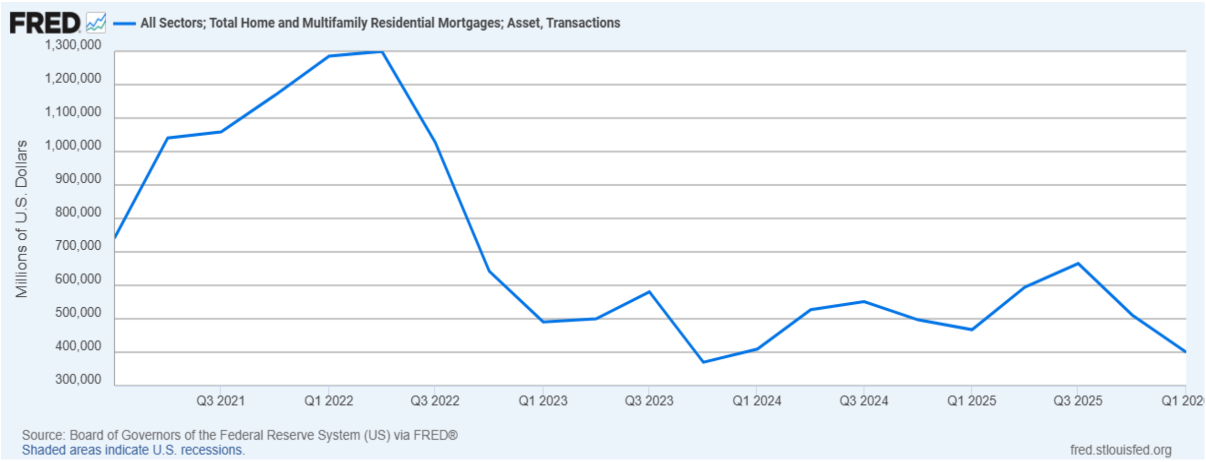
The 10-year yield via swaps is the crucial interest rate around which consumer and corporate rates revolve. One key debt market, by size, is the [residential mortgage market] in the USA which is valued at $13.2 trillion making it the biggest asset class. Foreclosures are rising at the rate of 30% p.a. More ominously high interest rates, a stagnant labour market and falling real incomes for 80% of the population, is freezing up the housing market. There are now 1.5 sellers for every buyer according to [Redfin] a near record high. [Housing starts] fell 13.5% yoy in July mimicking what is happening in China.

**Graph 2.**




This is confirmed by the collapse in mortgage applications.

**Graph 3.**

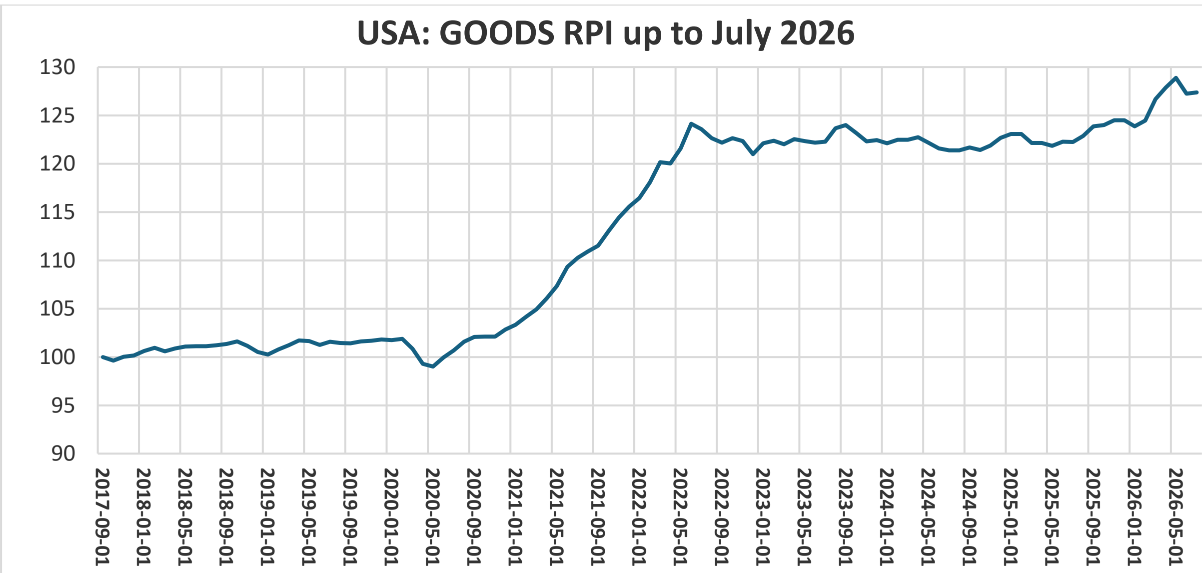



The labour market too is in the doldrums. There has been no job creation for months. Total hours worked are flat. The all-important tax data confirms this soft data. Total taxes rose by 3% yoy or below the rate of inflation of 4.3%. This implies a contracting economy despite the official figures saying otherwise. Even more so, now that the distortion caused by the Trump tariffs on tax receipts has been eliminated.

Within the overall tax receipts payroll taxes rose by 3% as well. As average weekly earnings rose by 4% this implies a fall in employment. I consider the tax data to be the more authoritative.

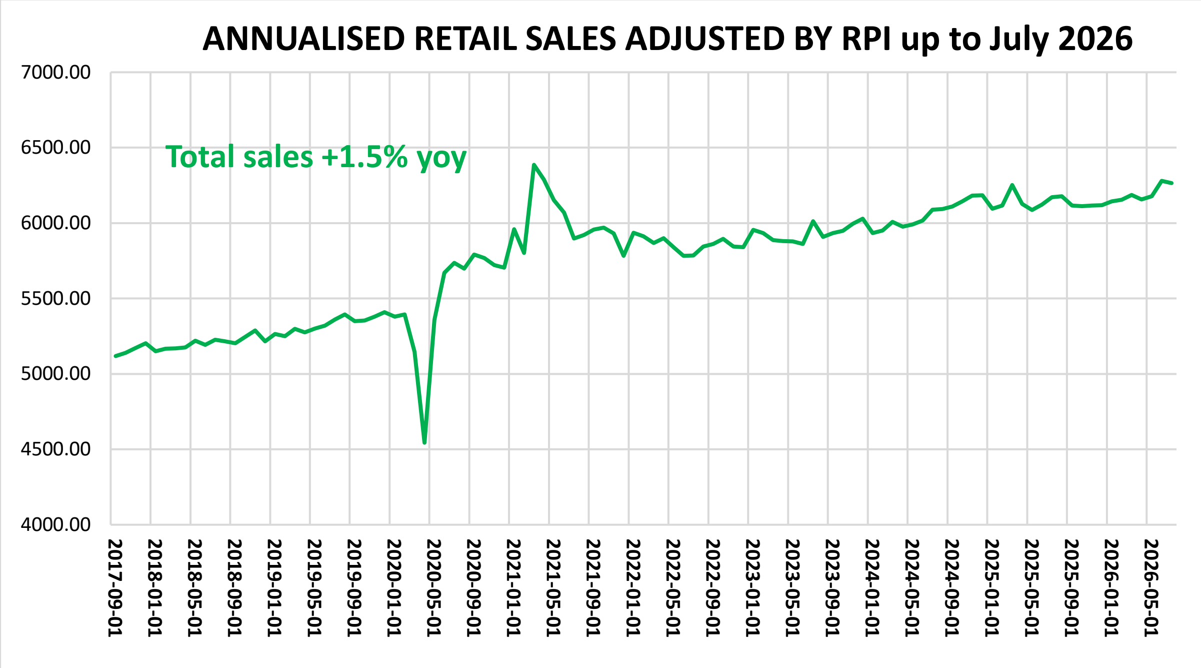
The same applies to retail sales, always the bellwether in an economy driven by personal consumption led by the top ten percent of income earners. Below are the price adjusted retail sales up to July. It appears that consumer inflation peaked in May.

**Graph 4.**



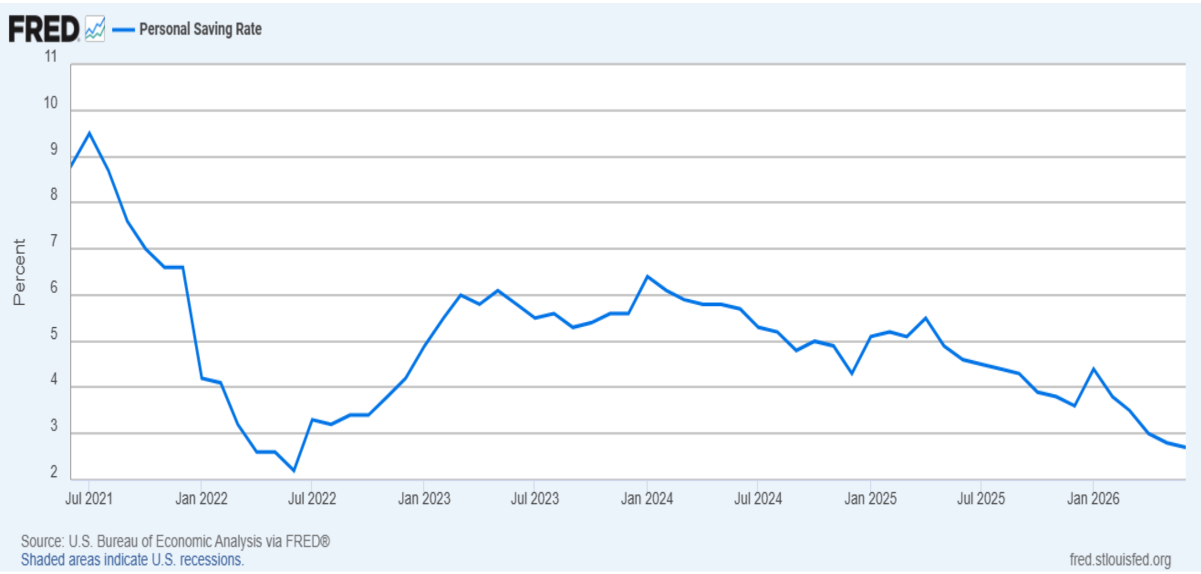

The sales data below is price adjusted showing volumes. In nominal terms sales in July fell by 0.6% when they were expected to rise by 0.1%. Part of that was Amazon's big sale which moved from its traditional July date into June. Within that data big ticket items such as cars and furniture fell suggesting a softening in purchases by the wealthier end which has propped up sales.

**Graph 5.**



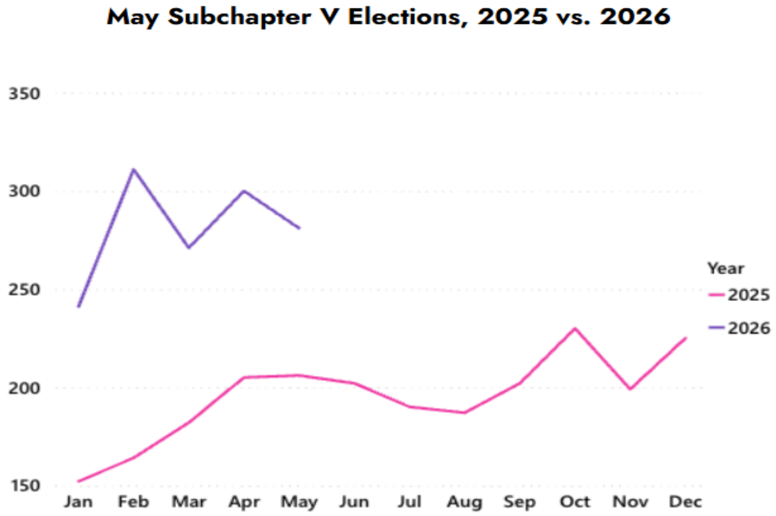

The outlook for retail sales looks bleak. It appears the bump from tax rebates is over. Walmart announced its slowest sales growth in 6 years. In addition, the official savings rate is low.

**Graph 6.**




However, I take the savings rate with a pinch of salt as it is a balancing item in the national accounts rather than a true figure. The earnings releases of the big banks show deposits increasing rather than decreasing. In the case of Bank of America, they were up 2% in the quarter. JP Morgan Chase was up 3% and Citi Bank was up 10%. Nevertheless, with inflation still hot and Trump hazy, the outlook for the US economy remains grim despite AI.

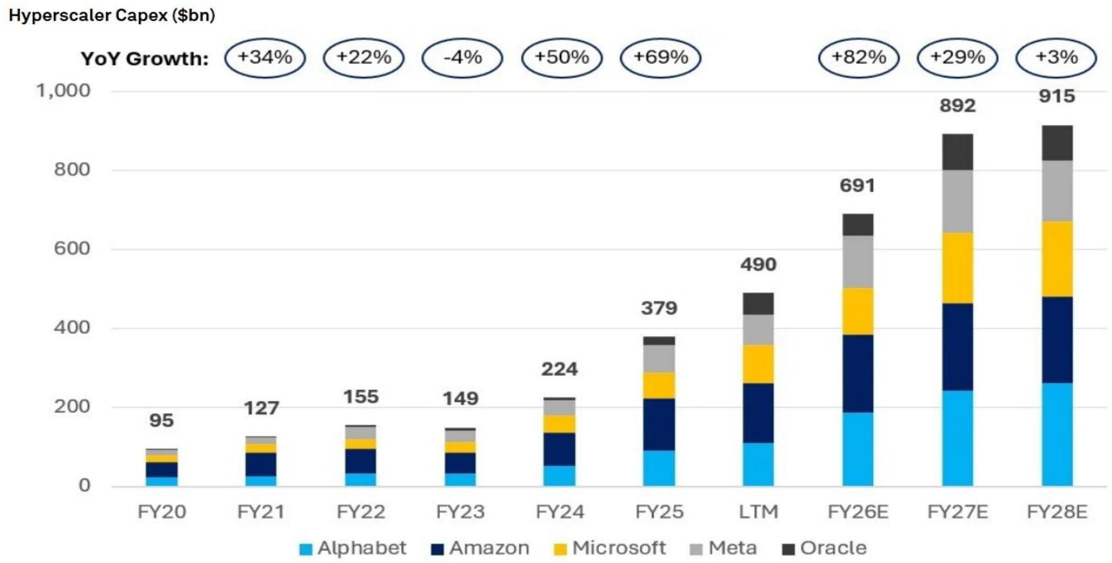
Commercial bankruptcies are hitting small firms hard as the graph below shows. Bankruptcies for larger firms have not risen as much.




**Some of the air is going out of the AI Bubble.**

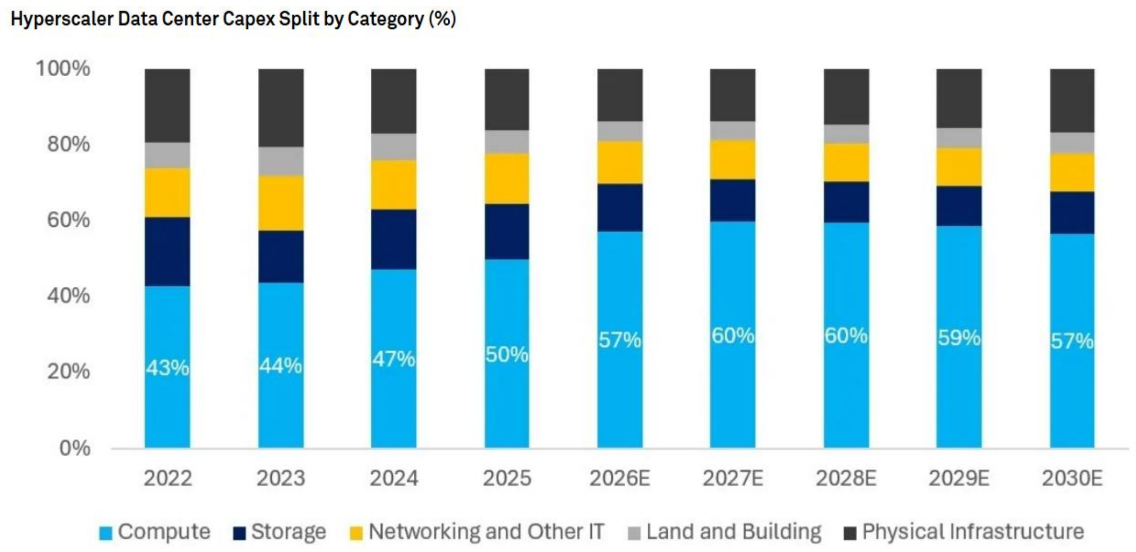
The scale of the building out of data centres remains staggering, as the graph from [FactSet] below shows, which includes only the five biggest hyperscalers. Much of the increase in 2026 is due to inflation rather than volume.

**Graph 7.**




While the market treats the data centres as real estate, in reality 75% of their value is inside them - chips and circuits. Thus, the valuations should reflect the insides of these centres rather than the structure and the land they sit on. While some have argued, that whereas buildings depreciate over decades, chips should depreciate over 3-4 years due to new designs emerging. FactSet argues against this. "*For now, the market evidence supports the longer schedules as contracted GPU leasing rates and second-hand prices are holding up well even for models launched 3-6 years ago (Nvidia's H100 and A100), indicating the chips remain economically useful within that range, partly reflecting today's compute scarcity.*" But there is a caveat. Prices reflect *today's compute scarcity*. All of this can change when there is no longer scarcity and these centres become white elephants.

**Graph 8.**




The amount of debt to fund this investment has mushroomed. *"S&P Global calculated that hyperscalers and "related entities" like Nvidia have issued $225 billion in bonds so far in 2026, representing a 973.7% jump through midyear. They are on pace to issue $400 billion for the full year."* Thus 60% of their 2026 investments will be funded by debt. Fortune Magazine provides estimates that their total debt stands at $3 trillion which requires paying $150 billion in interest p.a. assuming a conservative 5% coupon rate. In comparison a 2025 MIT Study shows that 95% of enterprises had shown no measurable return from their AI investments. In contrast a more recent Morgan Stanley study covering 5 countries found an eleven and a half percent improvement in productivity. The picture remains murky. More to the point is how much of this $150 billion is covered by earnings. (I will analyse coverage in a forthcoming article once total corporate profits has been released by the BEA.)

Of this $3 trillion, 55% or $1.65 trillion is off book debt, that is to say it does not appear on their balance sheet as liabilities yet. Despite this, as in 2008, the rating agencies are laid back about the accumulation of liabilities these corporations are gathering up, continuing to rate them as strong.

With their debt levels stretching balance sheets, the hyperscalers have reached out to the unregulated money centres. Nvidia launched a $500 billion fund to basically buy its chips which includes Apollo, BlackRock, Blackstone, Brookfield, Goldman Sachs and KKR. New AI centre investors, other than the hyperscalers themselves, will be able to tap this fund. This MOU is intended to broaden the market for Nvidia's chips. Here we have another example of round tripping where the tech companies provide finance to buy each other's products. This is not to be confused with trade credit. Trade credit is provided only after a sale has been completed. Round tripping occurs before the sale occurs. Its purpose is to fund future sales which may or may not occur.

As an aside, the sheer scale of investment upends the argument that immaterial production is cost free. The greatest wave of investment in the history of capitalism lies in the field of immaterial production. Instead of reducing the composition of capital, this burst of investment is bound to increase it. While locals are not protesting about the rise in the composition of capital, they are certainly protesting the siting of these centres in their locality, especially when this is driving up the cost of electricity.

The composition will rise further, this time from the opposite side, as and when the mass layoffs finally materialise. The first signs of this are appearing in the form of a reduction in new entrant positions. Staff are retiring but companies are not hiring new employees. 22% of companies which have implemented AI have stopped hiring in some of their departments. 49% of companies according to this study intend to reduce junior recruitment in the future. While Forbes estimates that Entry Level Hiring is already down 80% in companies which have adopted agentic AI. Gives new meaning to the term the no hiring economy. A recently released Goldman Sachs study finds that AI is creating an employment drag for new entrants which is three times higher than for employed workforce.

But for the economy wide composition to rise, the sectors outside the AI bubble need to increase their fixed investment as well. Once we strip out computers and allied products, orders for manufactured goods barely kept pace with inflation with a growth rate of 4.4% p.a. It appears the shimmer of what is happening in AI is obscuring what is happening elsewhere in the economy.

Based on the recently released earning reports covering the second quarter, the profit of the five companies mentioned above remain robust. Until their profitability changes, and the first step in that direction will not be a fall in profits, but a deceleration of pace in their increase. That will be sufficient to spook the markets.

But these is already one looming danger. Chinese competition. Chinese LLMs keep getting better and it is no longer a question of catch up but of price. These systems can process the same instruction for just one tenth the cost of their US equivalent. But the more serious challenge comes from the slimmed down versions which can be run on laptops costing less than £2000. Being open source, they are more secure, can be more easily configured and they do away with the necessity of using cloud computing and therefore large data centres. They will be adequate for many corporate needs.

**Conclusion.**

Bessent's twist did not work. By the market close on Thursday interest rates had reversed their falls from the day before with the ten-year yield back above 4.7% on Friday. Wall Street took note with shares falling by more than 1% continuing a week of falls. All the forward indicators in Japan, the EU, China and the US predict a further weakening of these economies and with it the world economy.

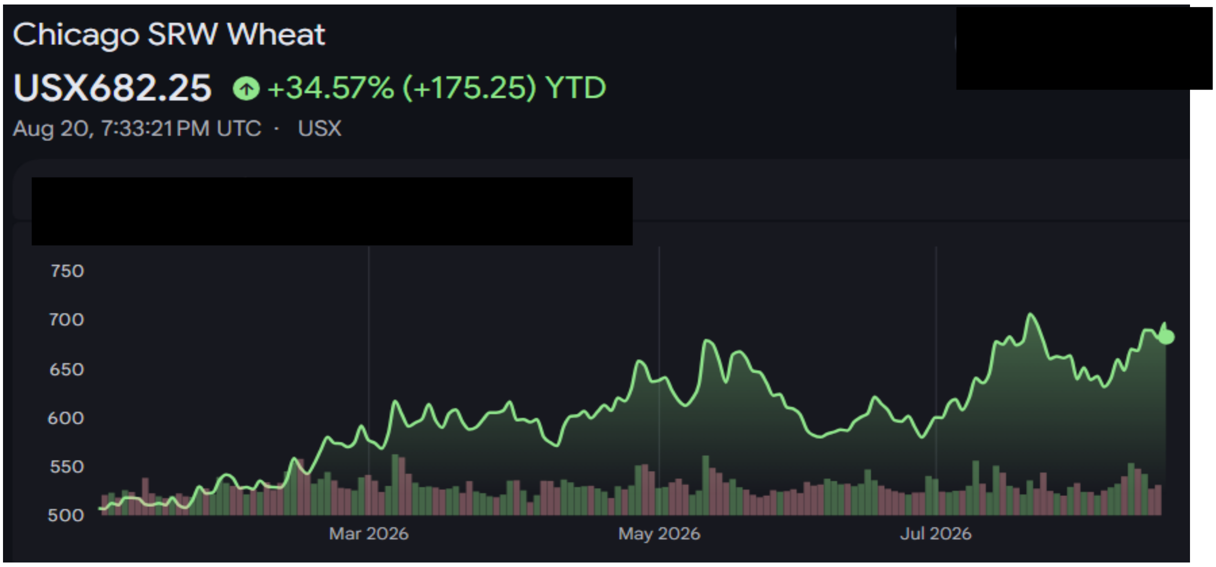
The first signs of stress are appearing in the REPO markets where lenders obtain overnight cash. The REPO market is the lubricant for the entire financial plumbing. The Secured Overnight Financing Rate (SOFR) hit 3.66% on August 15 but has fallen since then. It is likely that the modest Buy-Backs by The Treasury at the head of this article is explained by the fragility in the REPO market which relies on government bonds as collateral. Commercial Paper Outstanding, always a sign of stresses within trade credit, is up by a third since January 2025. (I will examine private credit in the next article.)

The Straits of Hormuz remain closed with Iran at the helm. Trump continues to flail around making his usual elaborate sounding threats. It seems that having destroyed Iran's military capabilities, the US is now unable to militarily confront Iran, instead substituting bone but not bomb crushing economic sanctions. Adds a twist to the old slogan; *war is concentrated economics* into *economics is failed war.* In the graph below we see Brent Crude trading above $90 a barrel compared to below $70 before the outbreak of the war in the Gulf. In the US, the price of gasoline, at the height of the driving season, stands above the politically sensitive $4 per gallon. For Trump that is political immolation. Diesel crucial for transport and farming the is now over $200 a barrel.

**Graph 9. (Brent Crude futures)**


In the meantime, the planet warms up. Add in the wars forged in Washington, London and Berlin dislocating supplies, and food prices are on their way up as well. Wheat, the staple grain, has risen by 34.5% this year. Fortunately rice and corn have risen only in single digits. But it is only the beginning. Predictions are strengthening that [El Nino] could be the strongest in a lifetime. All this ratchets up the cost-of-living crisis already impoverishing billions.

**Graph 10.**




The USA's hold on the Gulf is slipping. The question which is posed: will saving-face be more important for the Whitehouse than the pressure from the economic consequences of holding firm. The answer in the end will be the amount of economic pain the world economy can sustain. Despite the AI boom, the weakening US economy deals Trump a weak hand. But until he capitulates, severe damage will have been done to the world economy, exactly at the very moment the most acute climatic event in decades is unfolding. Truly, capitalism is imperilling us all, personified by Trump.

Brian Green, 21st August 2026.