Rate Hike? ... Pffft!

By Briton Ryle
Written Monday, August 29, 2016

Janet Yellen and her Fed cohorts can tell you they are "watching the data" all they want. They can observe that inflation remains below target. They can note that global growth remains weak. But those aren't the reasons they continue to leave interest rates at historic lows...

By any sane measure, the Fed should have hiked rates to at least 1%. 1.5% wouldn't be ridiculous, either. The U.S. employment rate is damn near full employment. You can cite low-quality jobs and low wages if you want, but you gotta know that low wages are rising. Starbucks and Chipotle both say that wage inflation is here to stay, as it takes more cash to keep workers happy. Bank of America says that the bottom 20% of wages are rising at a 4% annual clip, faster than they have in over a decade.

And as for people losing their jobs, well, the U.S. economy is setting records there, too. New unemployment claims have been under 300K for 72 straight weeks, the longest such streak since 1970.

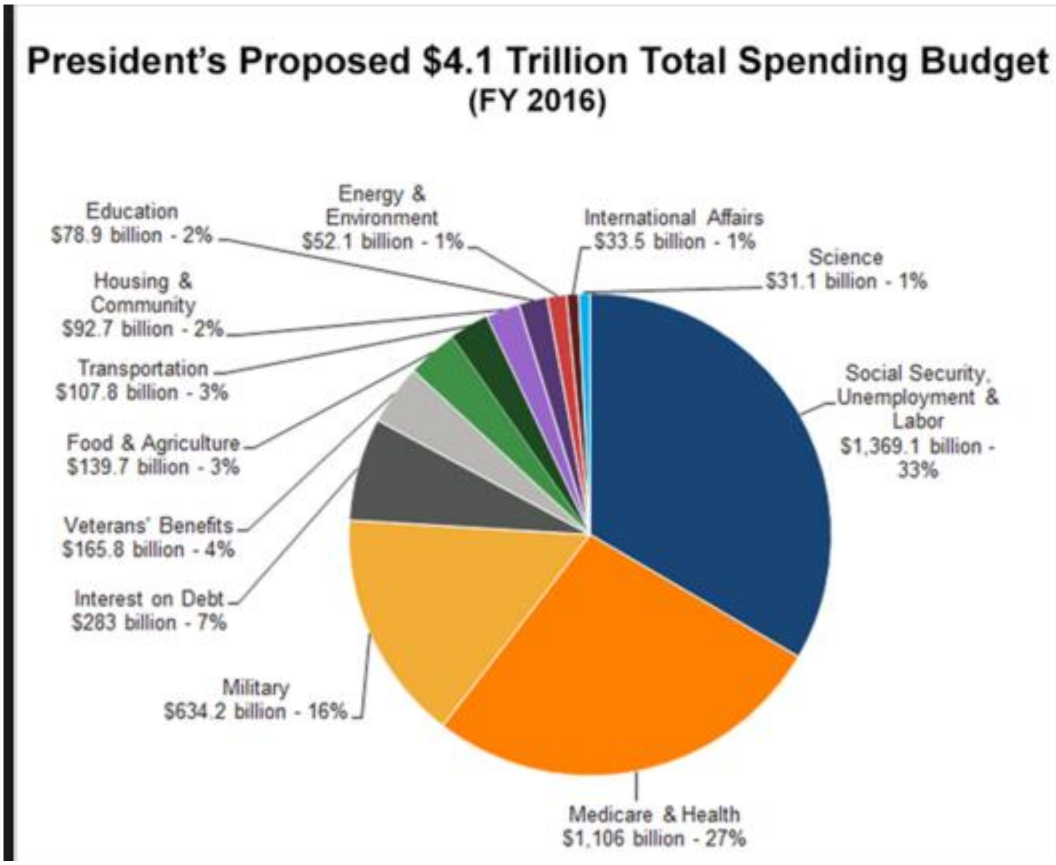
I suppose if you wanted to bring up the worn out reasoning that "U.S. growth is tepid and could be brought down if global growth weakens more," you'd have half-assed justification for once again leaving interest rates on the floor, where they've been for eight years. But again, this isn't the real reason the Fed continues to sit on its hands...

No, the real reason rates remain stupid low is economics, and I don't mean economic theories and models that don't work and nobody understands anyway. I'm talking about basic economics: the kind you and I live with every day, where paying out more than you take in blows a hole in your budget that takes a long time to fix.

The simple fact is that it's just too expensive to raise interest rates.

What It All Costs

Last year, 2015, the U.S. government paid out $218 billion in interest payments on T-bills and bonds. That amounted to 6% of the total annual budget. Now, for a little perspective on that, let's look at the proposed budget for 2016, which, of course, won't get ratified or even dealt with by Congress because when it come to doing nothing, that bunch is even better than the Fed...



First off, notice that interest rate expenses will rise this year to $283 billion, or 7% of the federal budget. That's three times as much as we spend on education and twice what we spend on veteran's benefits (oh yeah, we'll spend $600 billion on planes and bombs and current salaries, but when it comes to taking care of the men and women who serve, well, sorry about that).

In this day and age, how you can have a science budget of $31 billion, a tenth of the interest expense, I have no idea. Does anyone get that the key to America's advantage is rooted in education and rule of law? The biggest concern should be that if we don't foster and support education and scientific advances, we will fall behind. China or India or Europe — somebody will come along and knock us off the perch.

Anyway. Let me get back to my point. Interest rates aren't going up because it's too expensive to raise them.

In 2015, the federal budget deficit was $439 billion. Surprisingly, that's the lowest deficit since 2007, right before the financial crisis. But unfortunately, things are going the wrong way — the 2016 deficit is expected to hit between $550 and $600 billion. Subsidies for Obamacare exchanges will rise 44%, from $27 billion last year to $39 billion this year. Medicare expenses rose 14% in 2014, 16% last year, and the $31 billion addition in Medicaid spending this year represents an 8.8% increase. Total health care spending from the government will rise by 11%, or $104 billion this year.

So adding another ~$100 to the budget deficit by hiking interest rates is a no-go.

Penny Wise, Pound Foolish

Right now, the risk of leaving interest rates where they are doesn't seem so big. After all, headline inflation remains tame. And we're not seeing any investment bubbles because money is cheap and plentiful. Or are we?

There's no doubt that the U.S. oil revolution was a bubble that was fueled by low rates. Companies could easily sell bonds to fund drilling to yield-hungry investors — to the tune of ~$500 billion in loans and bonds. And there should be no doubt that there is a bubble insubprime auto loans. Low interest rates have also encouraged foreign companies to sell U.S. dollar-denominated bonds, around $1.5 trillion worth.

When we talk about a bubble, we are talking about money that is being invested on a false premise. That is, the beliefs that support the investment are wrong. Like with all those U.S. shale oil companies. They and their investors believed that their investments were safe because oil could never fall much below $100 a barrel. The Saudis put the lie to that belief.

Today, investors are reacting to the Fed's low interest rate environment. When rates are higher, investors like insurance companies that need a solid rate of return, say 5%, can simply buy Treasuries. They can't do that today. So they buy foreign U.S. dollar-denominated bonds. Or they buy securities backed by subprime auto loans...

It may not look like the Internet bubble or the housing bubble right now. But that can change quickly if auto loan delinquencies rise (which they are) or foreign companies can't pay their bills.

The Fed may be doing the right thing by keeping rates low and sparing the federal budget another big hit. But in doing so, it is creating a scenario where investors are taking on more risk. That's the very definition of penny wise and pound foolish. Because its actions could be much more expensive down the road.