DEEP KNOWLEDGE INVESTING

# Counter-Intuitive Inflation

## Can Federal Reserve Rate Hikes Cause Inflation?

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# Introduction:

During inflationary times, and especially when we have high employment and growing GDP, the Federal Reserve raises interest rates to reduce inflation. Raising interest rates is a crude tool, but historically, an effective one. Now, some economists and market commentators are suggesting that the same rate hikes the Fed uses to reduce inflation could also create more inflation. While counter-intuitive, I believe this argument is correct. Let's go over the idea and why I believe it's different this time.

This round of inflation was caused by massive Congressional overspending combined with a decade and a half of near-zero interest rates and countless rounds of quantitative easing (currency creation). This is a bipartisan problem. Neither political party has a working understanding of economics nor a plan to get overspending under control. Both parties deserve blame. However, the scope of this paper is to discuss economics, not to take a side in D vs R fighting.

# How Fed Rate Hikes Reduce Inflation – Classic Model:

Think of interest rates as the price of money and time. Then, remember the old economics maxim that the higher the price of something, the less demand there will be, and the lower the price of something, the more demand will follow. (Luxury items like wine, watches, and handbags are the exceptions.)

When the price of money goes up with higher interest rates, the hurdle rate for new investments and projects rises. This discourages incremental capital expenditures and reduces demand for equipment. Higher interest rates lead to higher mortgage rates. This makes housing more expensive and reduces demand for lumber, appliances, and other building materials.

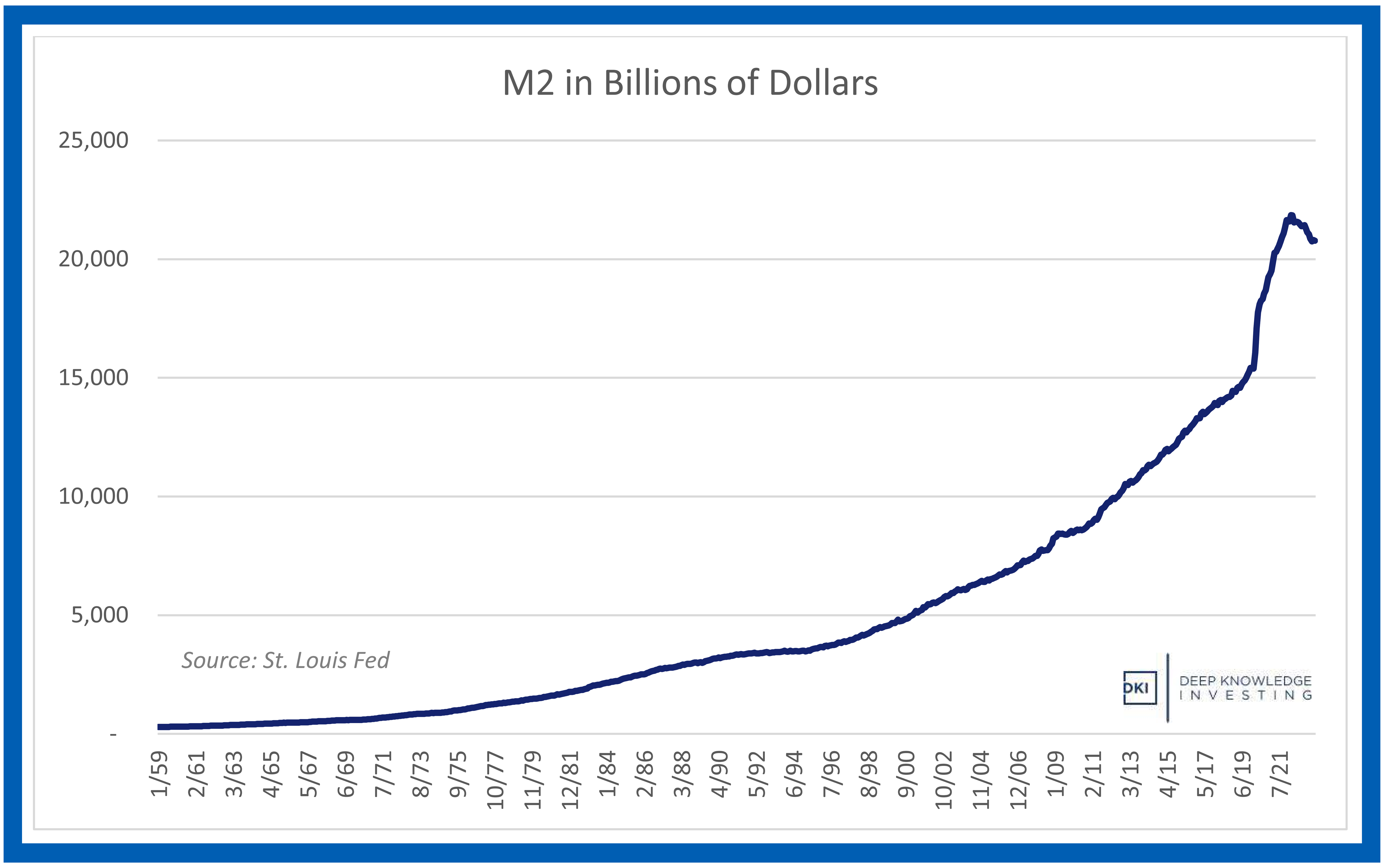
Higher interest rates raise the cost of pulling consumption forward either due to foregone interest income, or through higher credit card rates. All of this works to reduce demand which in turn, reduces pricing pressure throughout the economy.

## How Overspending Creates Inflation:

Right now, the US Congress is running a $2 trillion annual deficit. That's the on-balance sheet number, and the one we see associated with the $33 trillion national debt. When you include off-balance sheet liabilities for programs like Social Security and Medicare, the actual annual deficit is closer to $8 trillion. What happens next is that between Congress, the Treasury, and the Federal Reserve, more debt is issued which effectively increases the supply of dollars. Very little of this spending results in the creation of valuable long-term infrastructure. Instead, it's simply future consumption demand pulled forward.

This means that we have trillions of additional dollars chasing the same amount of goods. To make things worse, government programs often have the effect of incentivizing unproductive behavior meaning we end up with more dollars potentially chasing fewer goods. The result is inflation expressed as higher prices.

The original definition of inflation was an increase in the money supply. That definition has shifted over the years to mean an increase in prices. Either way, increasing the money supply leads to higher prices. So, while the definitions aren't exactly the same, they are linked.



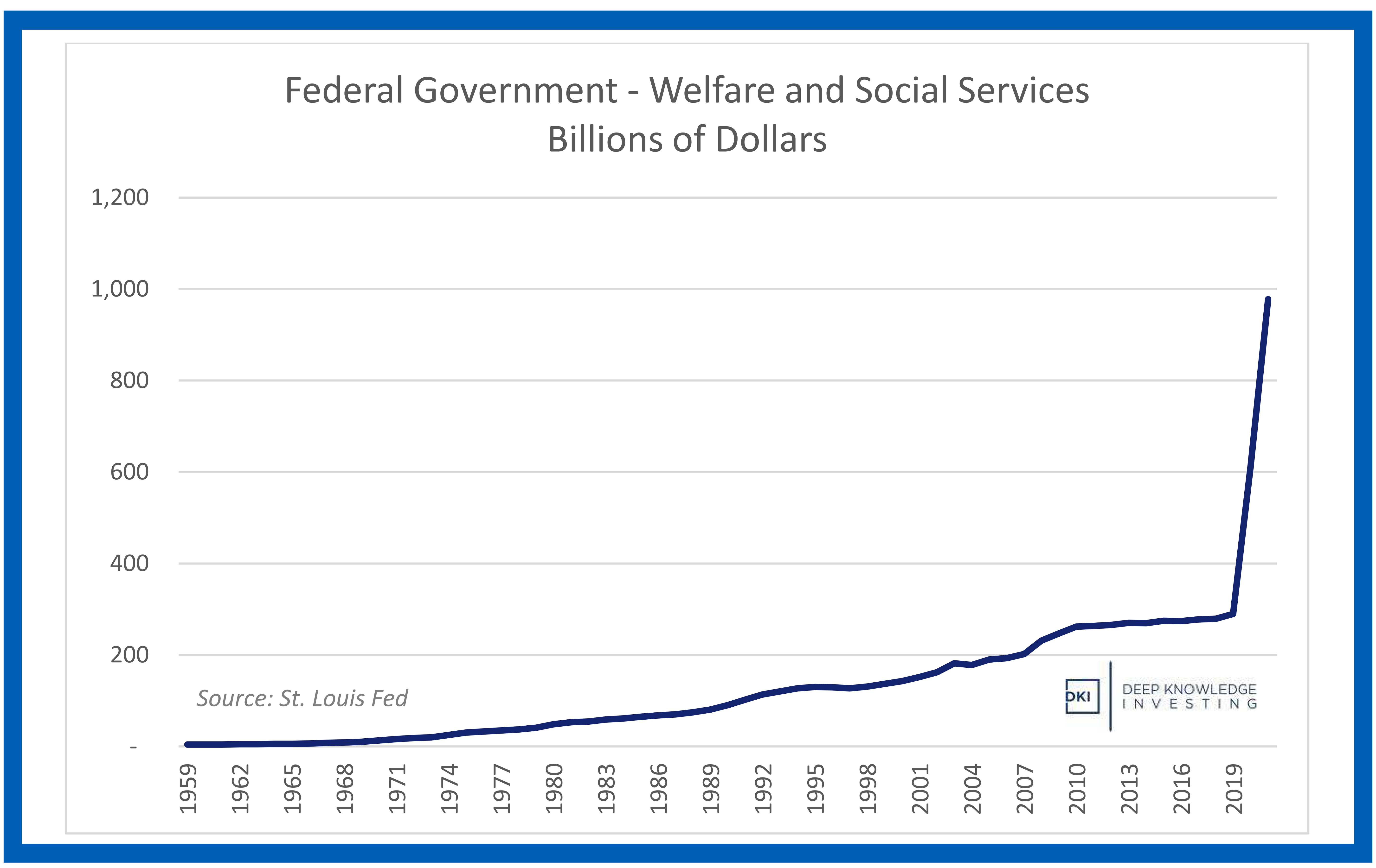

This kind of increase in the money supply was always going to lead to higher prices.

# Uncontrollable Spending Leads to an Unsolvable Problem:

There are three huge parts to the US Government's budget. Right now, there is no appetite to cut military spending, but that's going to happen in the future. The remaining two segments are social services/entitlement programs and interest on the debt. Let's start with entitlements.

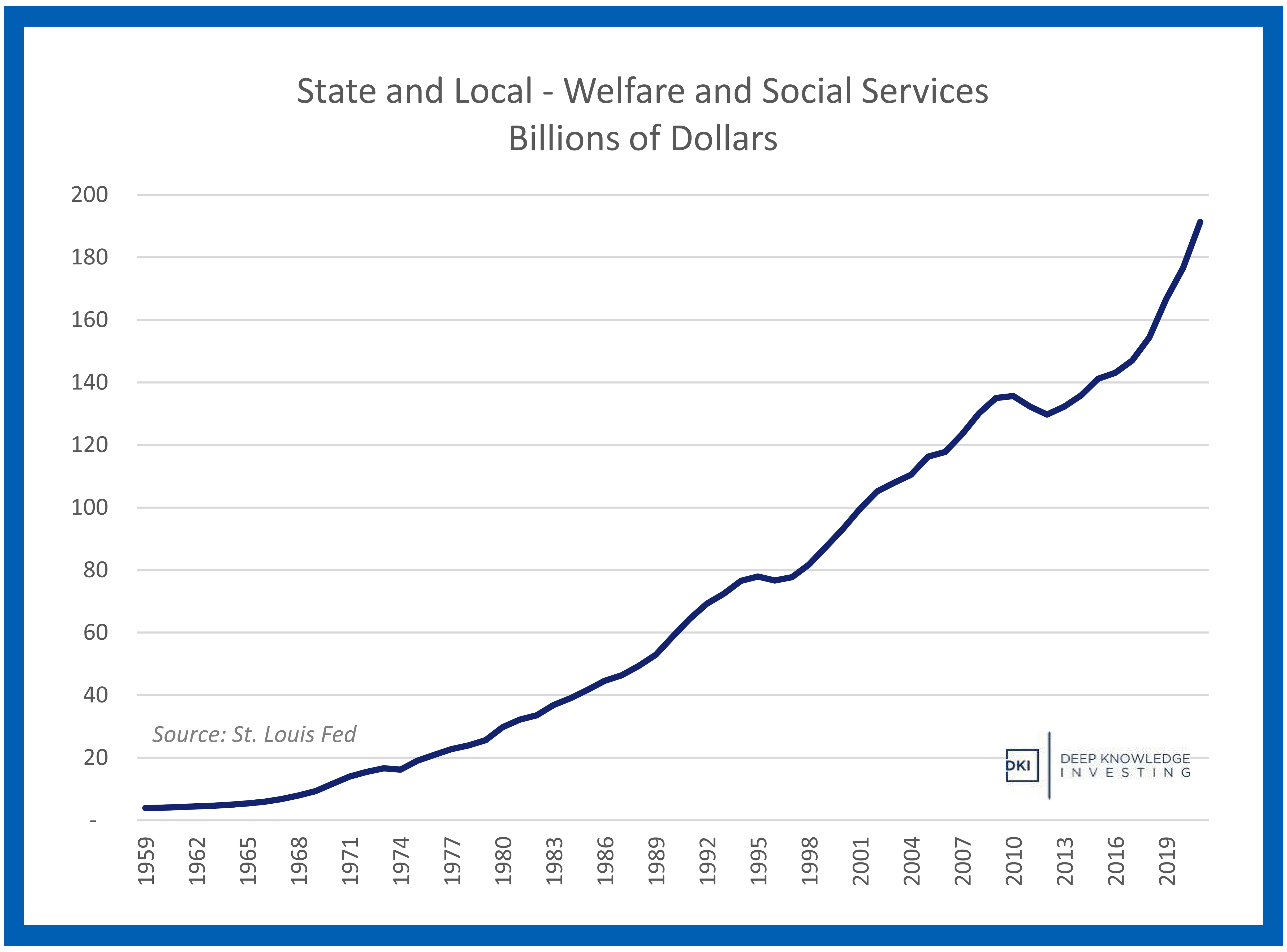
The topic of entitlement programs is polarizing. There are reasonable moral arguments that can be made in favor of caring for the sick, elderly, or unfortunate. DKI is not making arguments for or against your favorite government programs. US off-balance sheet liabilities for social welfare programs is approximately $200 trillion dollars. That, plus "official" debt or a stealth default where the government pays its obligations in dollars that are so debased that the value received is not meaningful. We have incurred obligations that cannot be met and everyone who holds dollars or does business in dollars will bear the cost. This is a practical economic observation, not a political preference for particular policies.

Regardless of your personal politics, try to look at the below charts with an open mind. From 1990 to 2019, Federal spending on welfare and social services tripled. The giant spike at the end was related to Covid. We can call Covid an exceptional one-time emergency, but government spending isn't decreasing meaning we now have "exceptional" continuous spending.



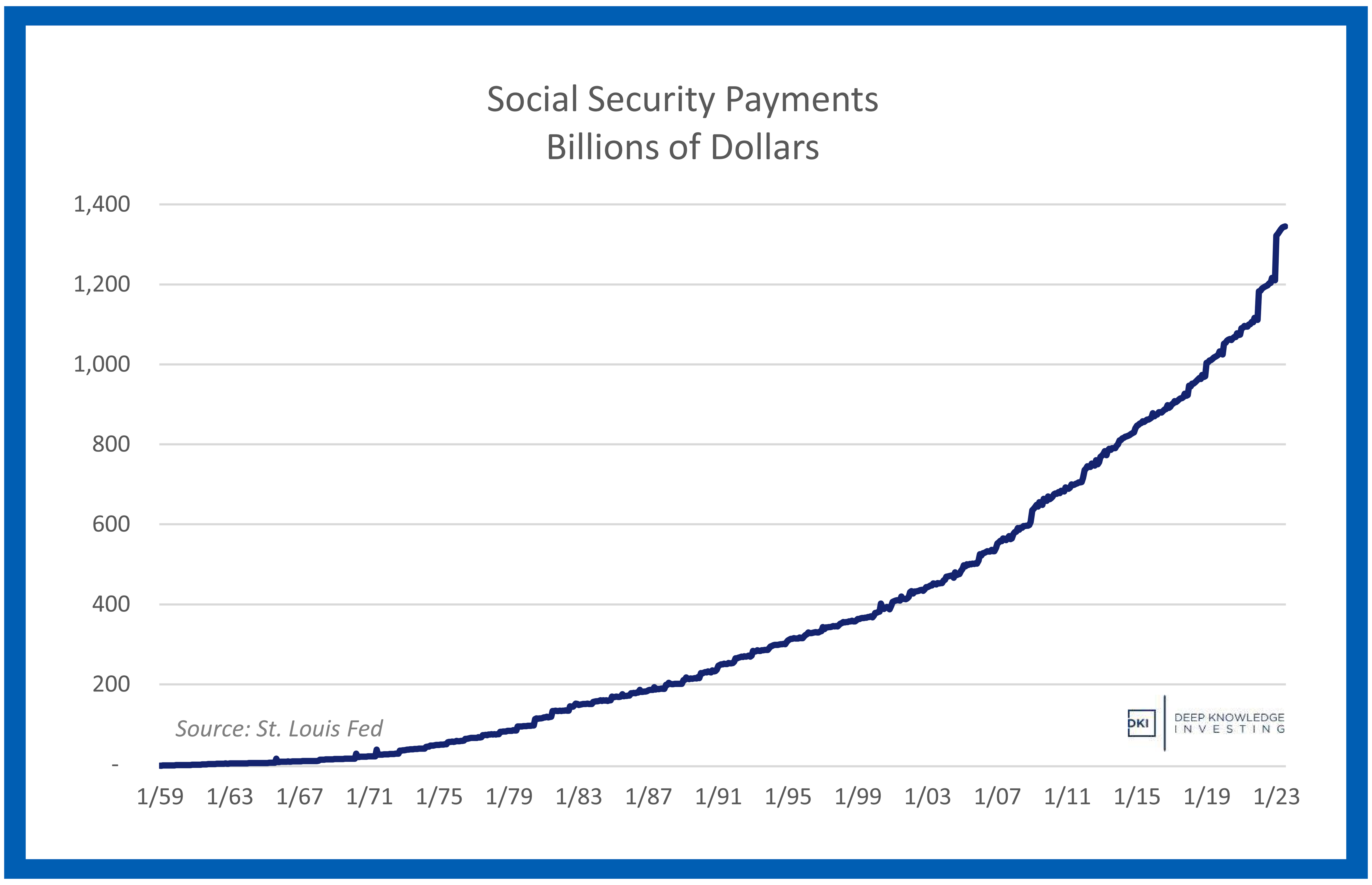

**This goes from unsustainable to insane. $1 trillion a year? You're not going to get the bill in your taxes. You'll pay for it in future inflation.**

This issue is understated as we tend to focus on Federal problems.
Let's add in State and Local spending:



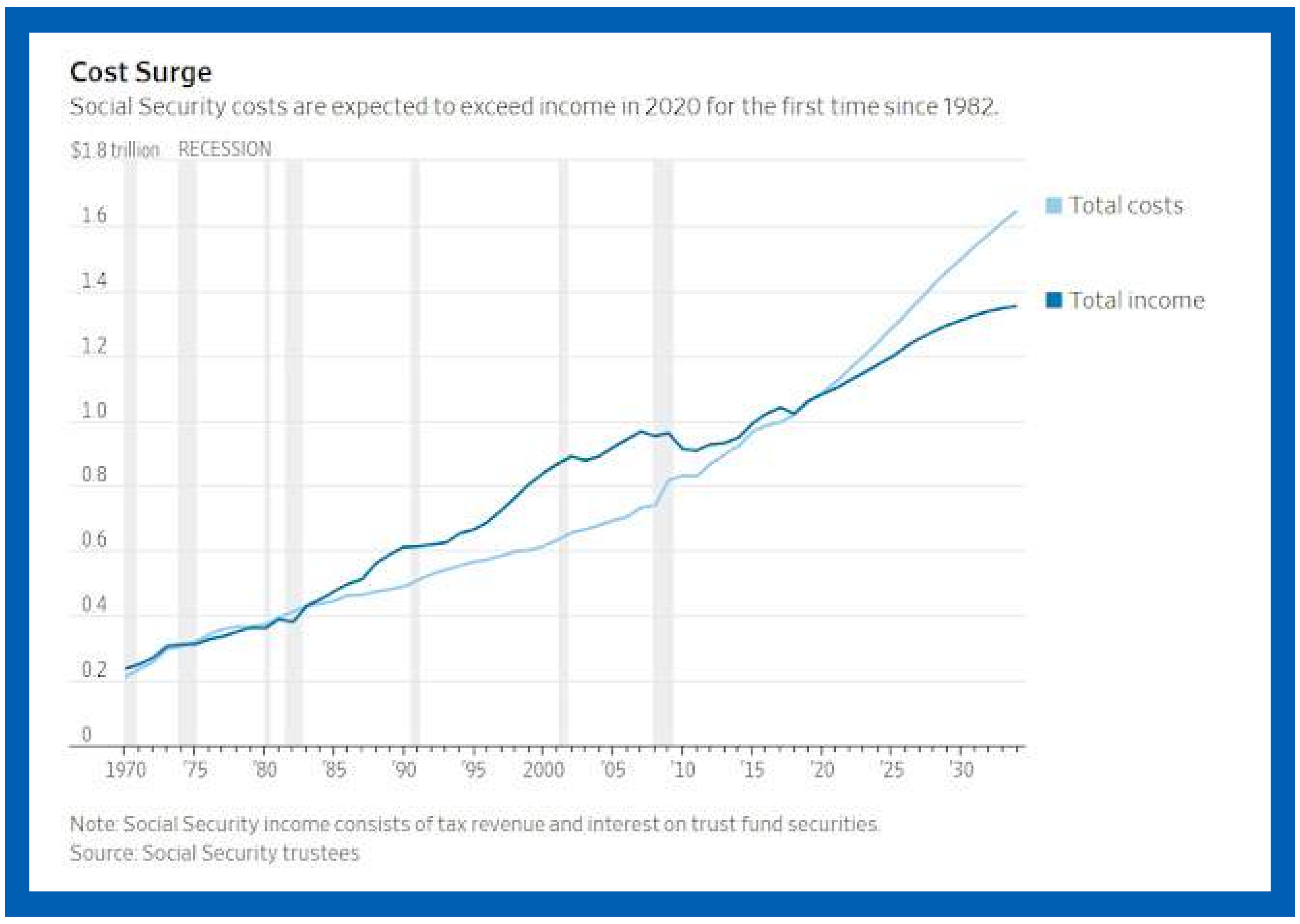

**Even the move of citizens from States that spend a lot on social services towards States that spend less isn't changing this trend.**

Here's social security spending. If you think this trend is scary and unsustainable, please realize we have a declining birthrate and many in the Baby Boomer generation are about to retire. We've made promises but have no plan for how to pay the bill.




**I've seen surveys indicating many young people believe aliens and UFOs are more probable than them receiving social security. This opinion is both crazy and correct.**

There is a myth that social security is pay as you go and self-funding. That was true decades ago. It's not anymore.




**Graph from the Economic Policy Journal.**

The title of this section is "Uncontrollable Spending Leads to an Unsolvable Problem". So, here's one more graph to show you how intractable our Congress is:

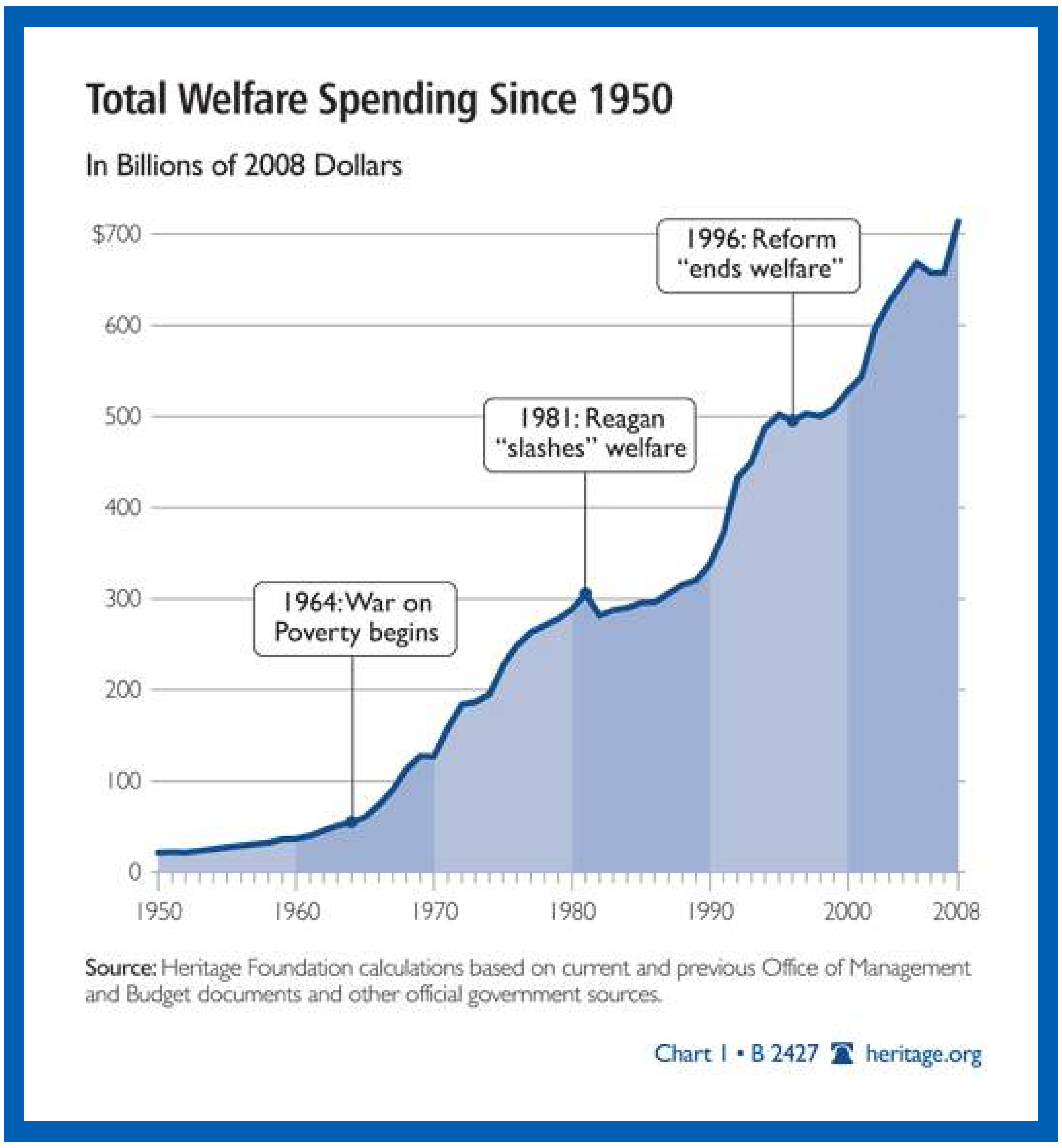


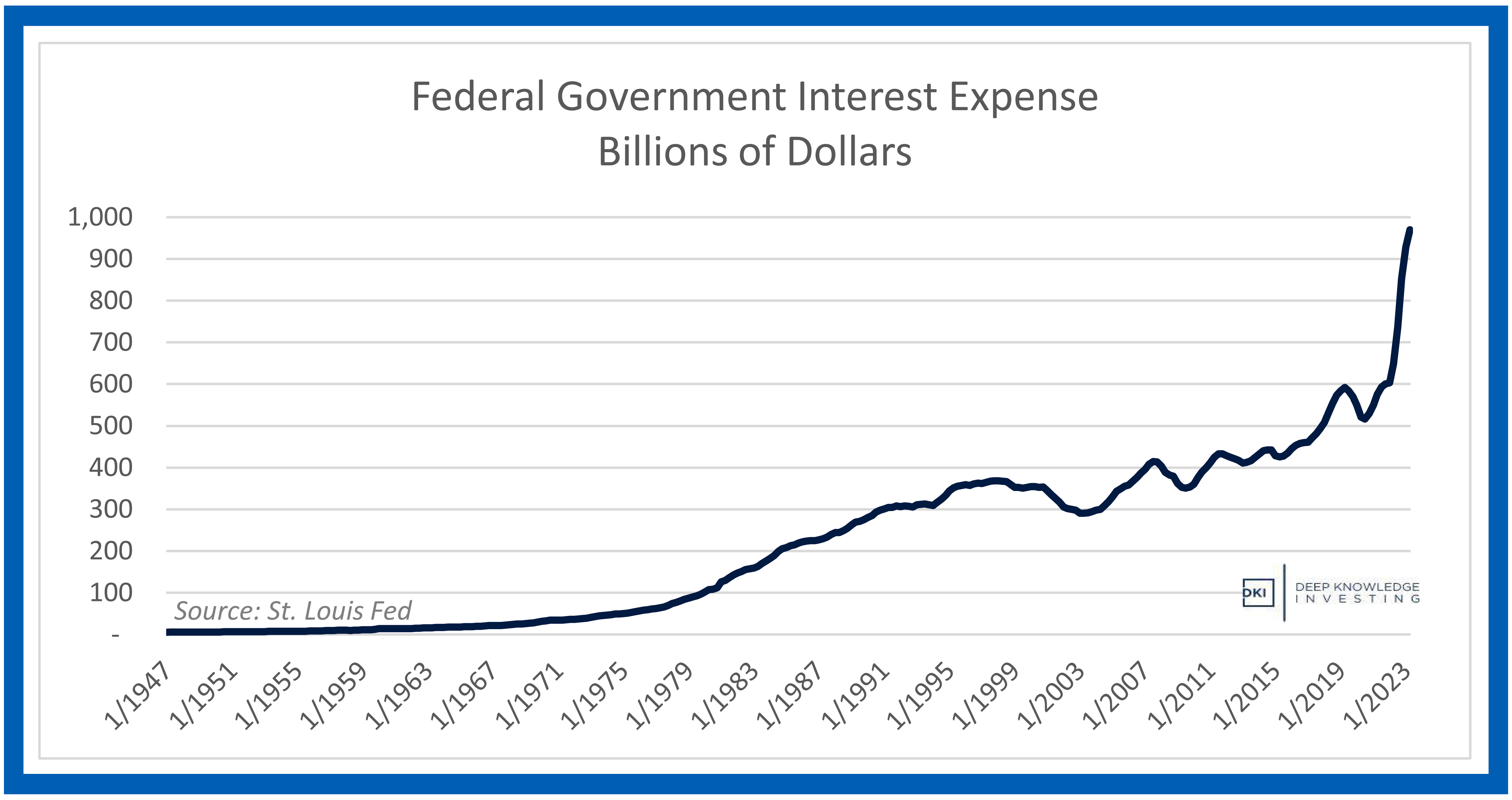

**Chart from The Heritage Foundation**

Please notice that there are never any meaningful cuts. Republicans claim to be the party of financial conservatism. Democrats claim Republicans want to slash spending to hurt the less fortunate. Neither characterization is true. Even when Republicans have complete control of the government, they don't cut spending. The next time there's a budget, spending, or debt ceiling debate in Washington DC, look carefully at the language used. There's always talk about slashing spending, but that almost always means a slight slowing of the rate of growth.

Growing government spending slightly more slowly is not the same as cutting anything. I'll suggest the following: Both parties are lying about any spending cuts, and no one in Congress is serious about slowing the massive overspending we've seen in the last few decades. That means regardless of who we elect, the government is going to spend until the dollar is worthless and the bond market refuses to absorb the next trillion dollars of additional unpayable debt. What can't continue won't continue, and neither party has a plan or a desire to deal with the issue until forced to do so. At that point, it will be too late to save anything.

## How Rate Hikes Can Be Inflationary and Why It's Different This Time:

What we've shown above is how overspending leads to inflation, and that the US government has no plans to curtail spending. For now, that includes military spending. That leaves interest expense as the remaining significant part of the budget. There's a trend here as well:




**Federal government interest payments are already at $1 trillion/year.**

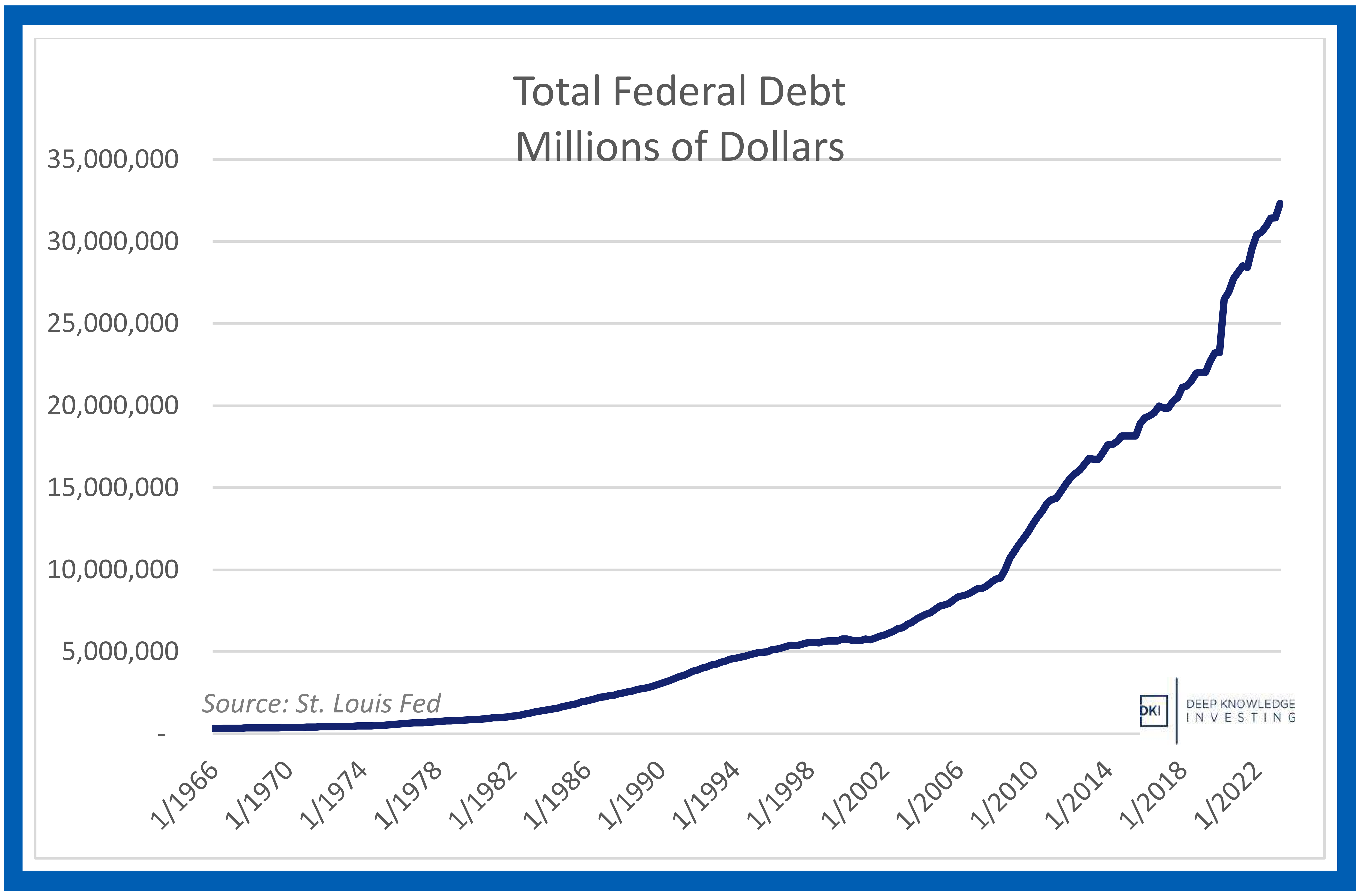
These expenses have risen by approximately $600 billion dollars in the past decade. The only reason the increase has been so small is because we've had near-zero rates for most of that time period.


**Keeping the 10-year below 2% for years isn't sustainable.**

As I write this, the yield on the 10-year Treasury has just exceeded 4.5%. With interest expense of $1 trillion on total debt of $33 trillion, we have a current cost of debt of about 3% for the Federal government. As more of the low-cost debt issued in the last decade matures, the new Treasury auctions will be at the new higher rate. While Powell hammers home the "higher for longer" message, the annual increase in cost for the new debt will start to approach $500 billion. (Note: While this piece was in edit, the 10-year treasury yield rose from 4.3% to above 4.5%.) The government plans to overspend by an additional $2 trillion in the next 12 months which at 4.5% would add another $90 billion in interest expense. This means that in the next year or two, annual interest expense will be heading for somewhere in the $1.6 trillion to $2.0 trillion range.

Again, there are no plans to cut spending. Congress, the Treasury, and the Federal Reserve will conspire to print another trillion dollars of currency each year to cover incremental interest cost. As discussed above, large scale currency creation causes inflation whether we're talking about an increase in the money supply or in prices for the consumer. That subsequent additional inflation will put pressure on the Federal Reserve to raise interest rates which in turn, increases interest expense. Wash, rinse, and repeat for a few cycles and you can see why it's called a debt death spiral. This is the US version of what DKI has been warning about in Japan for the last year. If you're starting to think this is a little like a Ponzi scheme, you're close. The reality is it's exactly like a Ponzi scheme.

The reason it's different this time is the amount of government debt has ballooned out of control. In the past, debt levels were low enough that the Fed could fight inflation without causing the budget deficit to explode. The other reason it's different this time is the US has never had this level of excessive spending during (relative) peacetime and when the economy wasn't in a horrible recession. Congress is engaging in massive stimulus spending at a time when we don't need it, have too much debt, and a terrible budget problem.




**Trying to get inflation under control when debt is under $1T is different than when it's $33T.**

The market has been conditioned to think rates of zero are normal and appropriate. I've seen constant wailing for the last year and a half that the Fed has over-tightened interest rates and is destroying the economy. The Federal Reserve deserves plenty of blame for their part in our current and future fiscal problems, but I don't agree that they've been too hawkish. First, the 10-year is currently at 4.5%. I love this chart because, while a bit dated, it gives a very long-term view of where interest rates have been:

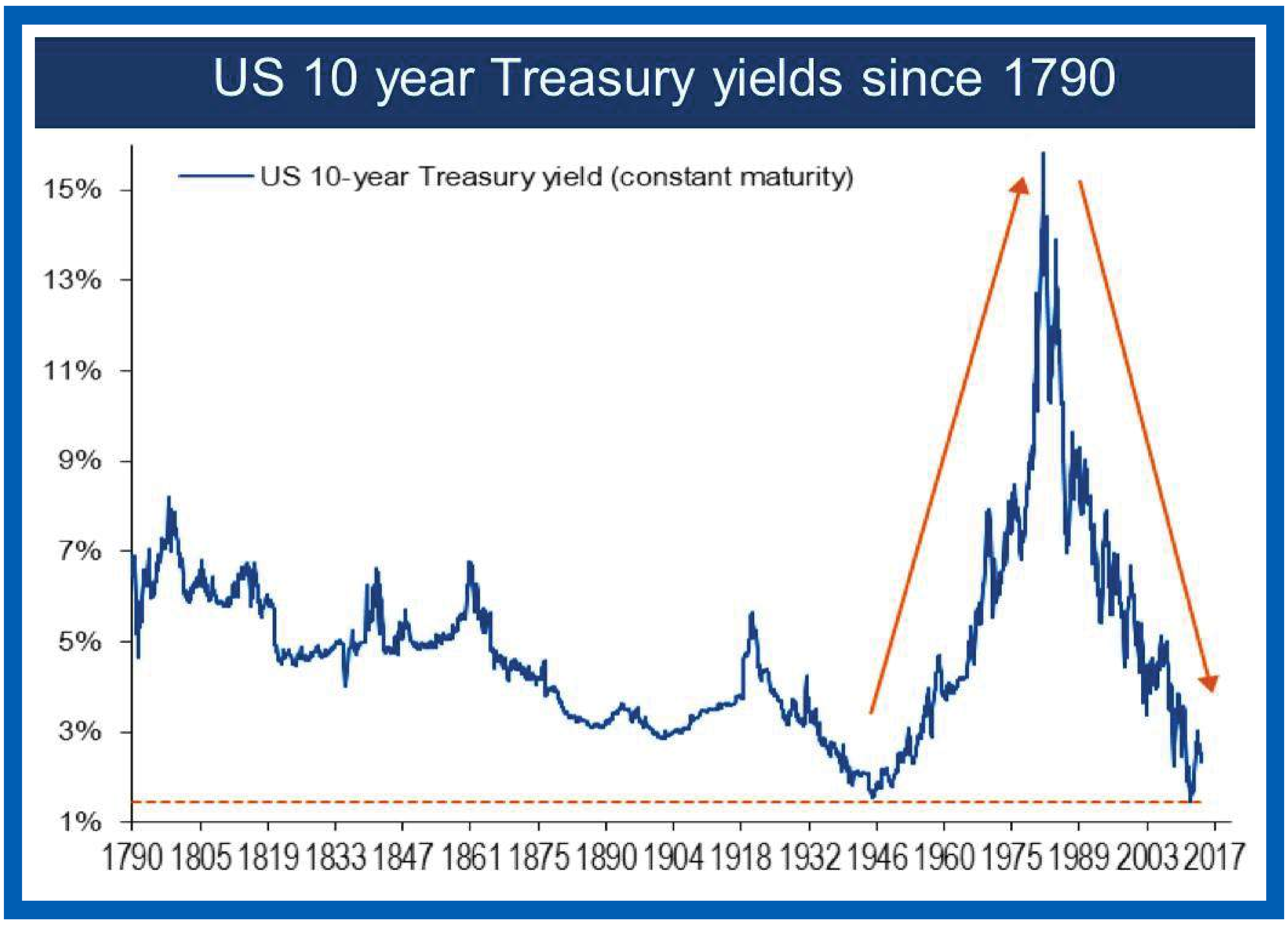
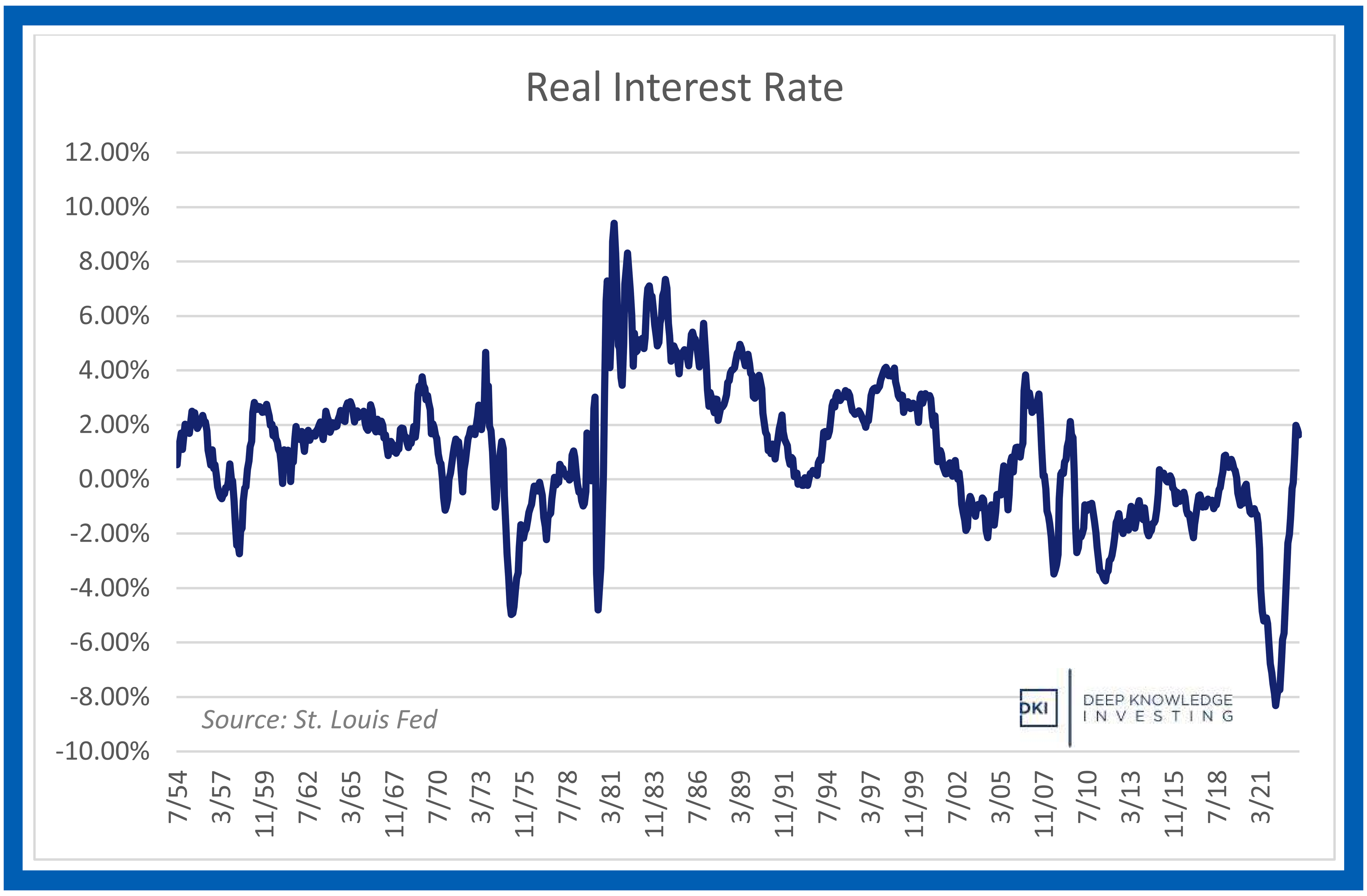



**Chart from Sevens Report Research**

It's the ultra-low rates of the last decade and a half that have been the anomaly. There's nothing wrong with a fed funds rate between 5.0% and 5.5% and a 10-year that's still below 5%. Also, inflation is still a problem. Real interest rates (the fed funds rate less inflation) is below 2%. So, after the loss of purchasing power, cash deposits are still earning under 2%.



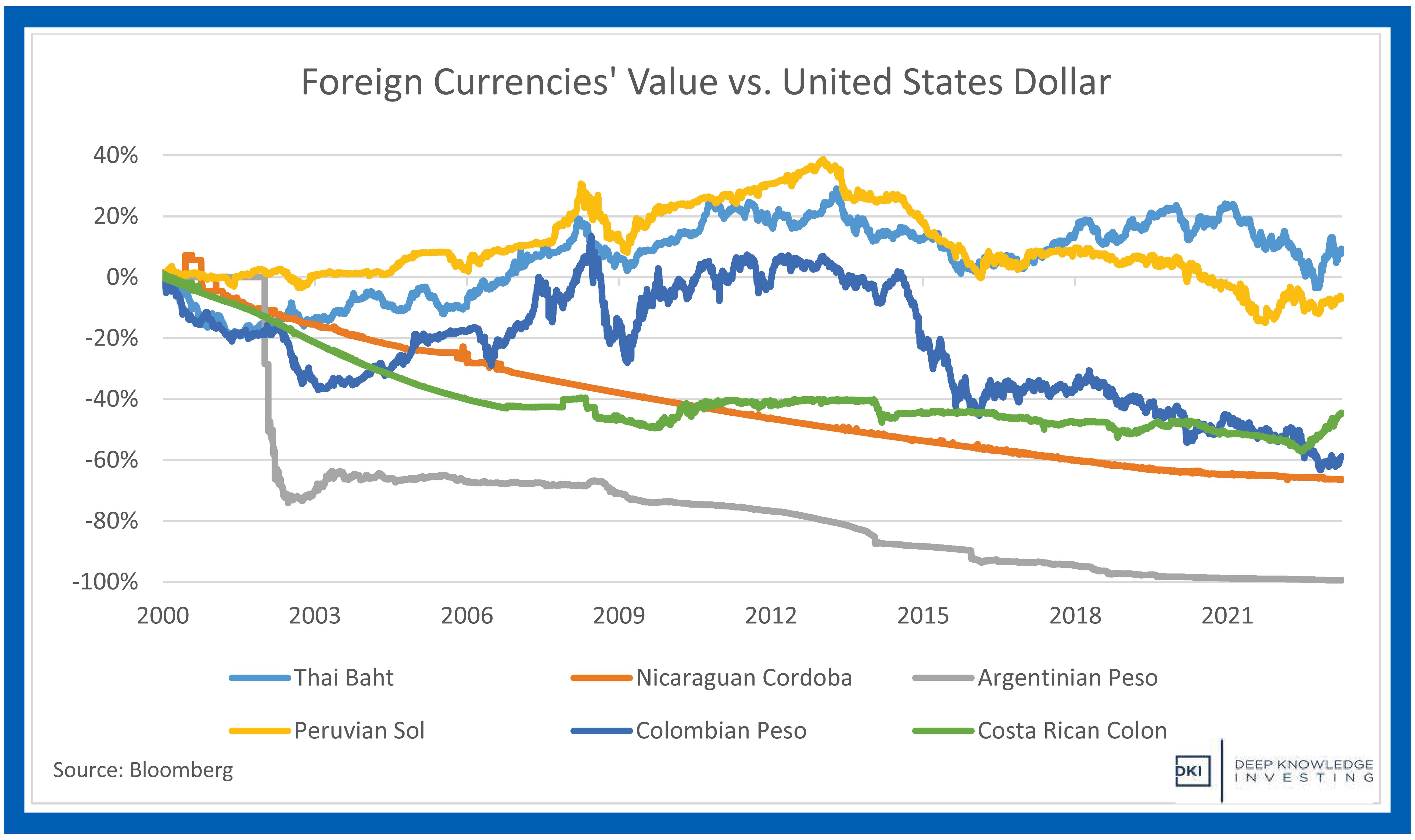

**The Fed was too loose with monetary policy previously. That doesn't make them too tight now. With the increase in M2 and debt, rates should be above the long-term average.**

I point this out because we're going to take on an additional $4 trillion of debt between the summer debt ceiling agreement and the next election in 2024. Add to that the extra interest expense discussed above, and we're facing a massive amount of additional currency creation. The result will be more inflation. Powell is on a treadmill where the faster he runs, the faster the treadmill moves beneath him.

## The Question I Can't Answer is Timing:

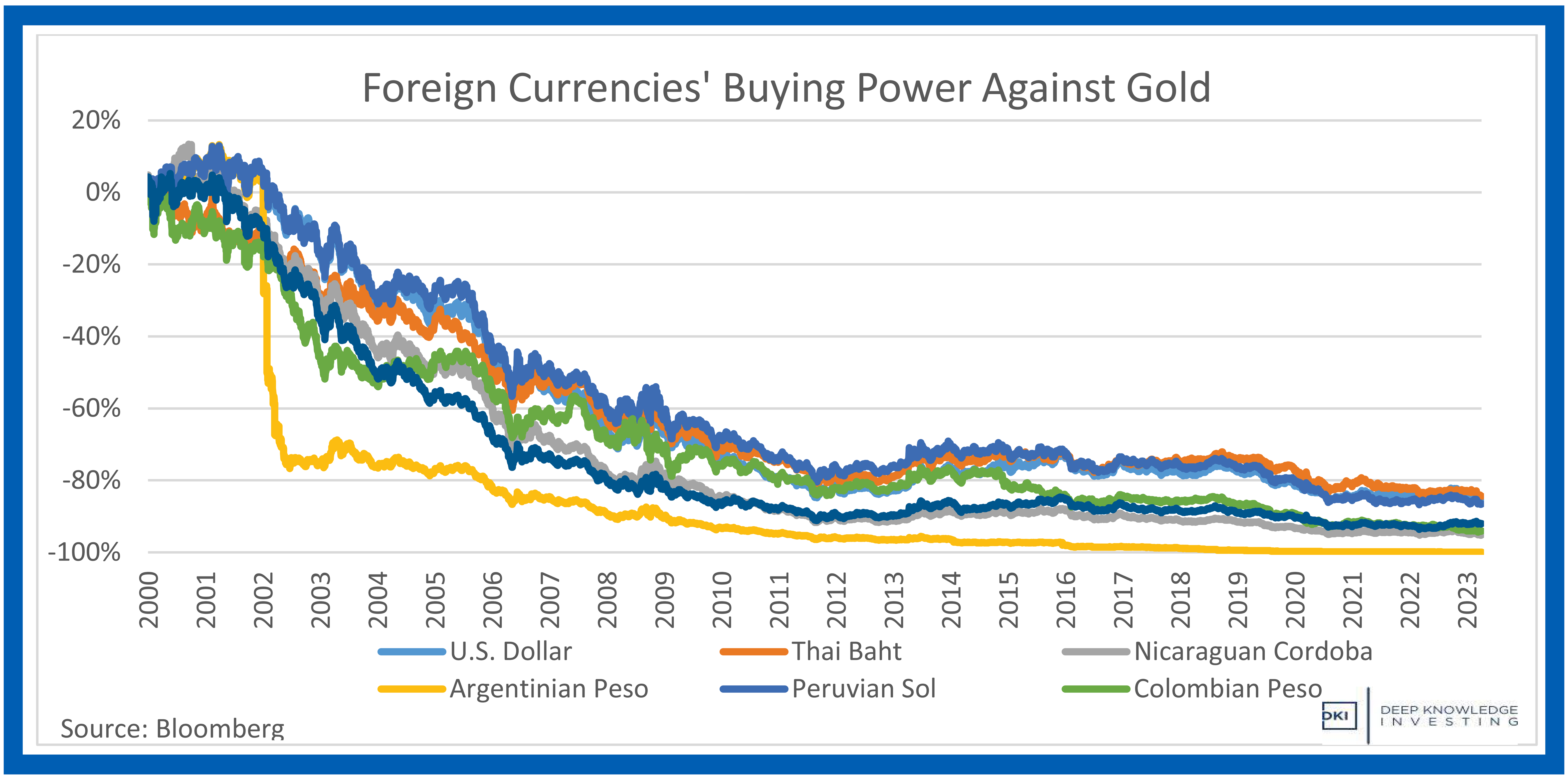
I think we can all agree that as we close in on $250 trillion of obligations that this can't possibly be paid. There is no level of taxation or asset confiscation that results in being able satisfy those obligations. Further, with Congress overspending by $2 trillion a year (cash), $8 trillion a year (including off-balance sheet liabilities), and facing another $1 trillion a year of extra interest expense, no one is even pretending to try to pay our debts. At some point, the US will either default on its debt like Argentina or Greece have done many times, or will simply print so many dollars that we pay what we owe in dollars that have little value. I believe we'll end up with the second alternative which I'll call a stealth default. I'm sure most of you are wondering when this will happen. I don't know and it's worth the effort to explain why.

First, nothing happens in a vacuum. Given the size of the US economy, it's natural for many US citizens to focus on domestic finances. One reason the US has gotten away with obscene levels of currency debasement is because other governments and citizens of other countries want to hold US dollars. Imagine you live in Argentina. Dumping pesos to hold dollars is a fantastic trade when your inflation rate is over 100% annually. Most of you know I travel extensively. Let's take a look at the currencies of some of the places I've visited the past two winters:




**Argentinians, Nicaraguans, Colombians, and Costa Ricans love the dollar.**

While there is still understandable huge international demand for the dollar, it's still losing purchasing power. Over the last couple of years, there has been a lot of talk in financial circles about the strong dollar. If you're a foreign exchange trader, that's true. If you're an American who wants to buy a home, buy groceries, or fill up your gas tank, you experience the dollar as weak and losing purchasing power. The easiest way to show this in a chart is to compare these currencies with gold:

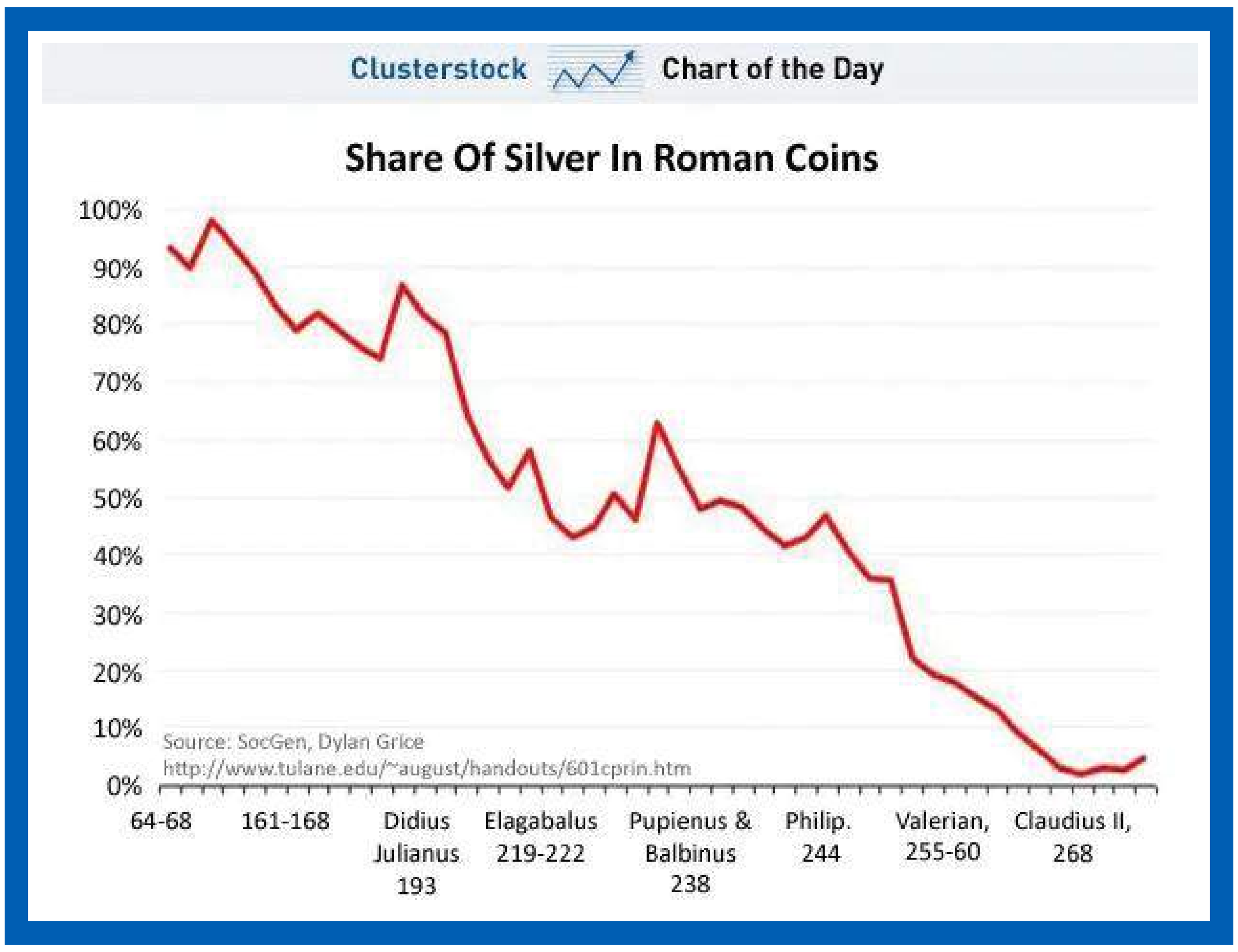



**When I say the dollar is the best house in a bad neighborhood, this is what that looks like.**

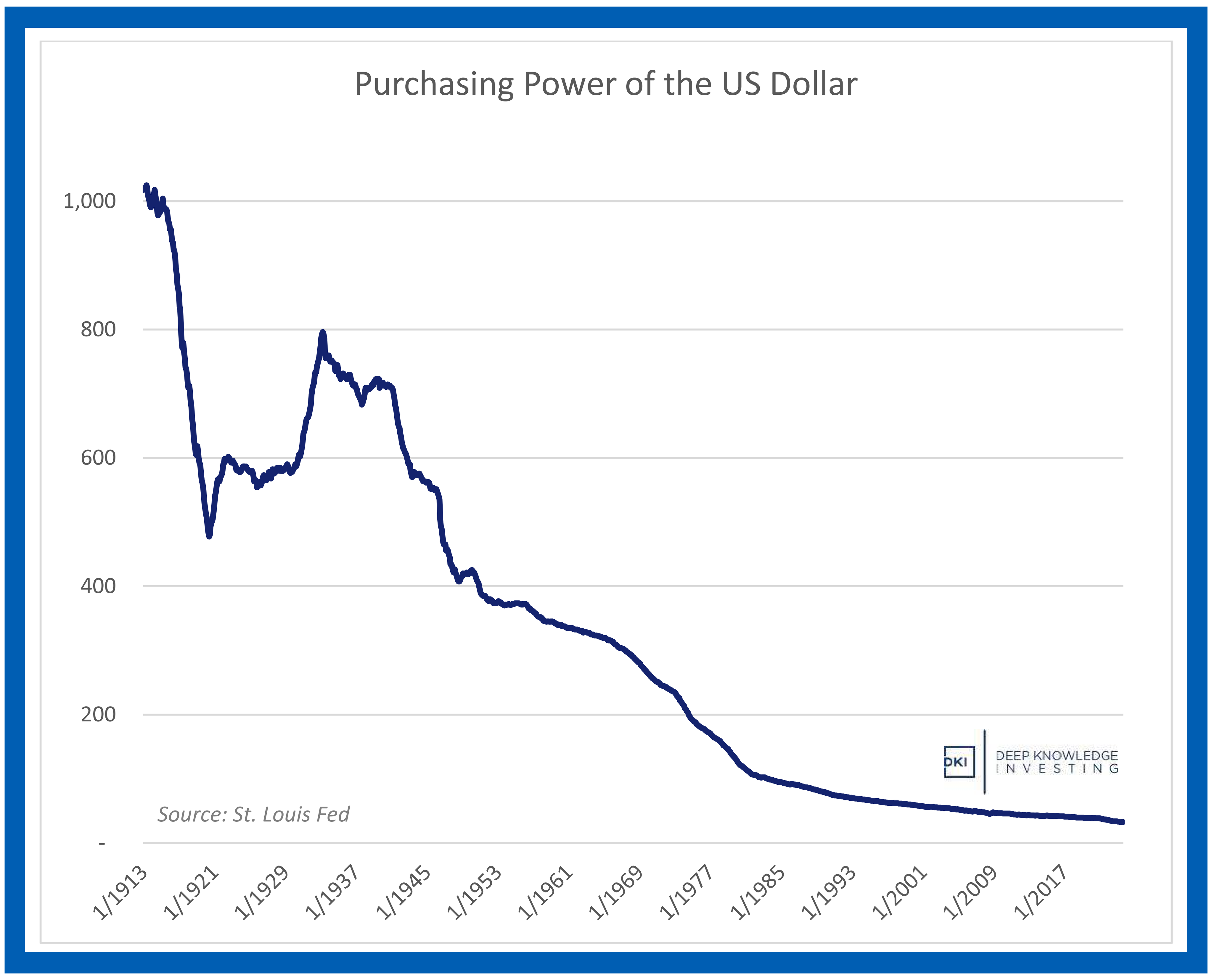
Many people have been dismissive of discussions by the BRICS countries about creating a new reserve currency. While I acknowledge that doing so will be a challenge, that coalition has grown to include over three dozen countries comprising well over 50% of the people on the planet. I don't know how or when they'll make this work, but I do know that when more than half the world wants less exposure to the dollar, that means a decrease in future demand. At some point, the US will be unable to print the incremental trillion dollars and shove it down the throats of the rest of the world.

It's beyond the scope of this piece, but Alexander Macris wrote a fantastic book about the creation and decline of the petrodollar called "Running on Empty". In it, he explains why international demand for the dollar will decline in the future. He was kind enough to ask me to write the foreword to the book. If you'd like a complimentary copy, just click the above hyperlink.

The second reason I can't give you the timing is these things can play out over decades or centuries. I know we've already hit unpayable and unsustainable, but don't know when the bond market will refuse the next offering at pricing set by the Federal Reserve. (Technically, the market sets the pricing, but as of now, the fed funds rate still has great influence.) Reserve currency status has changed hands many times over millennia, but the best comparable the US has is Rome which was the world hegemon for centuries. Unfortunately, Roman politicians had the same appetite for debasing the currency that the US Congress has.




**This is how a hard currency becomes a worthless fiat currency. Chart from Business Insider.**




**This is the decline in purchasing power of the dollar. Look familiar? This is history rhyming.**

Rome spent 200 years debasing their currency. The creation of the Federal Reserve a little over 100 years ago began the debasement of the US dollar. That unfortunate process was accelerated in 1971 when President Nixon took us off the gold standard. Do we have another 100 years of dollar dominance left? I think that's doubtful. The dollar won't collapse and disappear in the next year either, but there's no way we create a quarter of a quadrillion dollars of value that can be used to pay our obligations. So eventually, there will be a real default or a stealth default. That can't be stopped.

## Conclusion:

Right now, the Federal Reserve is doing the right thing. Inflation is a long-term problem, and sticky services inflation combined with rising energy prices mean the disinflation story is dead for now. Raising interest rates is the correct move. Chairman Powell can't control Congressional spending so he's using the tools available to him. Congress is going to want/need to monetize an additional $2 trillion of excess spending a year plus, we've just seen $400 billion of interest expense become $1 trillion. As higher rates make their way into the average borrowing cost of the government, and as the government takes on additional debt at current borrowing rates, interest expense could trend towards $2 trillion a year.

These are real obligations, and very large ones. Powell's interest rate hikes are both the correct move and will create more inflation as the government has to monetize more interest expense on $33 trillion of debt which is growing quickly. As I write this, Deep Knowledge Investing remains well-hedged against the kind of inflation and currency debasement that we will continue to experience in the future. Premium subscribers are invited to reference our Current Recommendations page where we outline our hedging strategy. For those of you who have the same concerns we do and want some help protecting your portfolio, please reach out at IR@DeepKnowledgeInvesting.com. We can help.

## Epilogue:

There's no avoiding the fact that US government liabilities are already at a level that can't be paid, and Congress is going to continue spending us further into bankruptcy (super-bankruptcy?). I want to provide some clarity on what has me upset and worried, and where I think there's hope.

The part that makes me angry is the dishonesty of using currency debasement as the method of paying for popular giveaways instead of taxation. In his excellent book, The Bitcoin Standard, Saifedean Ammous writes about how fiat currency makes endless war possible. Historically, a king or ruler had to tax his people to fund overseas wars. If the people were taxed lightly and saw the benefit of new lands and resources, the enterprise would go well. However, if the king wanted to expand his empire for his own glory, and taxed his people into poverty, he'd quickly lose the support of his subjects.

In the earlier days of the US, we tended not to run long-term deficits so in the short to medium-term, citizens paid for government programs in taxes. When politicians wanted to expand the size and scope of government, citizens felt those ambitions in their wallets and at their dinner tables. In this way, household budgets became a check on expanding government power and resulted in high-spending politicians being voted out of office.

All of this is a lie based on misdirection. You are not being taxed for your generously awarded government largesse. Instead, the government simply takes on more debt and prints more dollars to fund guns and butter, bread and circuses. This spending increases the money supply, debases the currency, and leads to massive inflation. As DKI has pointed out before, if you get a $1,000 stimulus check and your monthly expenses rise by $200 due to inflation, you're going to pay for your "free stimmies". Politicians never accept the responsibility for what they've done, and instead, blame greedy businesses, rich people, leaders of other countries, and the other political party.

All of this obfuscates the true cost of running a government that claims to be able to provide all people with all programs necessary for a materially comfortable and meaningful life while also conducting endless foreign wars. The average citizen has no way to connect government spending levels consisting of numbers not comprehensible to human beings with their declining quality of life and decreasing freedom. Citizens shouldn't need an advanced understanding of economics to grasp how the government is stealth-stealing from them.

Taxation is annoying, and may be immoral in some cases, but at least people know where to point when they can't pay their bills. With the current fiat system, the connection between spending and paying for the cost of that spending is hidden. This is dishonest and deserves our contempt. Despite living in the wealthiest country that's ever existed, the US does not have unlimited resources, and is for all intents and purposes, bankrupt.

Unfortunately, I don't see a way to reform and save the system. There are far too many people now dependent on social welfare programs, and there's an enormous bureaucracy actively trying to increase the level of that dependence. Given the promises made, there is no fair or moral way to roll back the clock for those now dependent on the government. There is no fair or moral way to push unpayable responsibilities onto American children and grandchildren. DKI has many non-US subscribers, and I suspect they may also be tired of having to deal with debased dollars, especially when it comes to the price of oil. The BRICS countries are actively looking for a way out, but what about the rest of us?

Here's where I have hope and confidence: The best we can do is to protect our portfolios, our homes, and our families from the coming abuse of non-transitory inflation. There are things we can do to insulate ourselves from theft by fiat currency debasement. We started writing about this topic in November of 2021 and recommended alternatives like gold, oil, energy, and Bitcoin. DKI exists to help people like you do better in environments that others consider "bad". The situation is indeed bad, but we can still make money from it as investors. Feel free to reach out if you'd like some help.

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