CULROSS GLOBAL

Macro Outlook Summary

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Ultra low interest rates of 0% to 1% will always be associated in history with the deflationary and 'financial repression' era of 2008 to 2015 and then the Covid era from 2020 to 2022. Since then the world has changed a great deal, deflationary forces have been replaced with inflationary forces and the idea that rates could or should return to those levels seems inconsistent with anything other than the arrival of a severe US recession. Putting it another way, higher short term rates around 2% to 3.5% are the new normal and are here to stay.

The relevance of this is to those individuals, companies and countries who are over-laden with debt. Their debt servicing costs are likely to be much higher than originally expected and Western governments have a particularly dismal record in this respect. Rather than using the period of low interest rates to restructure and pay down debt, governments ballooned their borrowings to maintain strong government spending and stimulate demand.

The price to pay for heading off recession is a mountain of debt that has become worrisomely large. In 2007 US Federal debt was 35% of GDP. Today it is 125% and as any Italian from the 1980s knows the debt servicing cost then approaches a tipping point where it is no longer financeable from revenue and can only be covered by entering the doom loop of additional debt issuance. Overall US federal debt now exceeds $38Tr and is growing at over $2Tr per annum.

As a percentage of GDP it is running at 6%+ which makes the EU's attempt to put a lid on spending with the Maastricht accord setting a maximum of 3% look positively wise and prudent. We have all learnt that the electorate's appetite for austerity – the label given to debt reduction – is zero and politicians know their master. Institutional bond investors representing pension funds, insurance companies and sovereign wealth funds are showing their discomfort and have visibly held back at government bond auctions resulting in higher than expected yields.

Longer dated debt now has a moderate term premium as it should and yield curves are positive and normalised. For the time being there is an air of calm but this is highly dependent on reasonable economic growth being achieved and government revenues therefore being sufficient to service and pay down debt. An economic slowdown will bring the policy response of lower rates but surely not another round of fiscal stimulus and additional debt.

Some will argue that none of this really matters because central banks through QE can be the bond buyers of last resort and can step in at any time to prop things up. As many originally opined when QE was first adopted, were this to happen it may go down in history as one of the great moments of 'the emperor has no clothes'.

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