Chart Focus:
Real Problem for Real Yields

In Dec 2021 some 21 months ago the Fed rate was 0.25% and 10-year yields were 1.5%. Today the fed is at 5.5% and the 10-year is at 4.8%. Still inverted so the yield curve is still expecting a recession or at least a moderation in GDP or inflation.

This last 3 months has seen weakness in the long end. And it's not inflation's fault, it is investors wanting more real yield. Real yields have risen by 120 bp in the last 3 months. So, what is it that is driving this pick up in real yields.

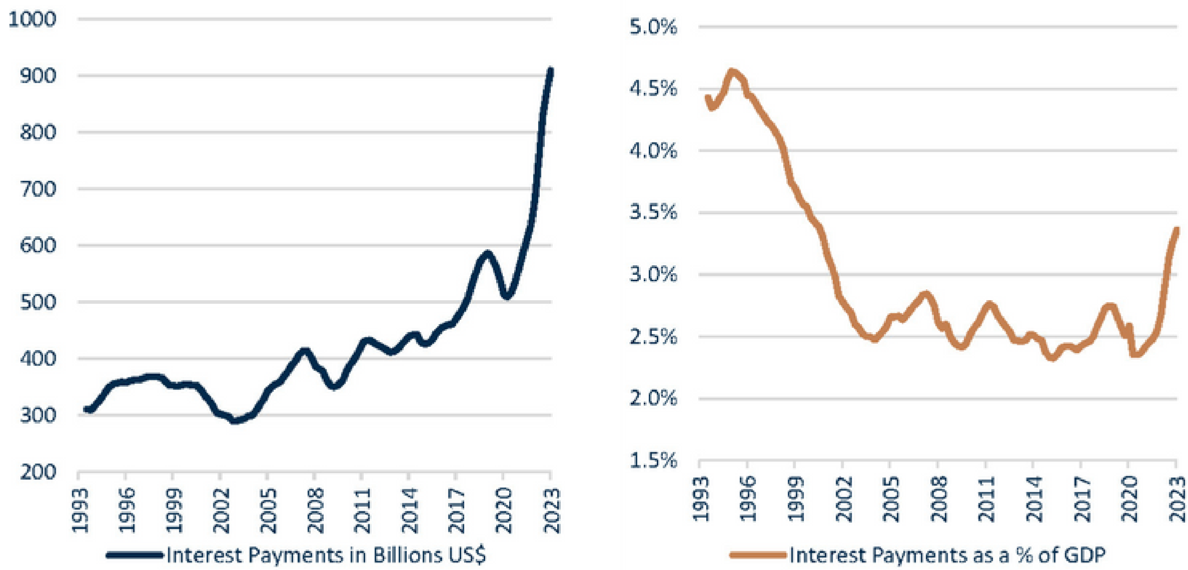
Chart1: US 10-Year Real Yields (The yield investors receive after inflation)

Source: Bloomberg

Everyone has their opinion on this: inflation, Chinese selling of US treasuries, Moody's potential downgrade and of course the fiscal deficit.

Of course, it could be all of the above, but my favourite 2 reasons are:
1. Interest payments as % of GDP are at 22-year highs and will certainly get higher now with higher long rates.
2. The Fed has stopped buying.

Below are graphs of Interest Payments and Interest Payments as a % of GDP.



Source: Bloomberg

The thing about budget deficits is that we never know where the tipping point is. The UK got their answer last year. South Africa has got some time ago but has a strategy of prayer and hope.

There is no magic number for when fiscal deficits get too high but when interest payments start gobbling up the bulk of your fiscal space then there should be some alarm bells. Over the next 3 to 5 years the funding of the deficit and rolling over of existing debt will certainly be done at higher rates than the last 5. (The 10-year averaged 2.2 % over the last 5 years).

The Fed and the USA government did a fantastic job of restoring GDP growth during Covid. The Fed re embarked on QE to keep the long end down, the Government handed out stimulus checks. Yes, the budget deficit went up but because rates were so low the interest payments as a % of GDP remained low. And hence Real yields remained low.

In essence this has been the playbook since the financial crisis of 2008. Because inflation remained so tame until post Covid this merry go round was very successful.

The inflation post Covid put a spanner in the works. The thought was rates would cause inflation to come down, rates would stay low, and the fed could quietly stop QE. Unfortunately, inflation stayed higher for longer, USA GDP stayed higher, wage inflation stayed high, and then the Fed stopped QE.

Right now, there has to be some concern over who will buy all these extra treasuries' that the fed has stopped buying. The numbers are not small. The fed has not rolled over 900 billion of the debt it bought. To put this into perspective the USA deficit was 1.4 trillion. Total USA debt (corporate and sovereign is 51 trillion). So, as you can see when a big buyer goes missing it does create an impact. Other central banks have also slowed their QE programs. The ECB has stopped at the total level but still buys 40% of Italian debt. The Bank of Japan still does QE.

Will the fed embark on QE if a new crisis arises. I think the answer is a definitive yes if inflation is under control. If inflation is at 3% then I don't really know. The fix ultimately needs to be done at the Federal Budget level.

The USA debt was fairly manageable until 2 events. The first was Trump handing corporates a massive tax windfall in 2016. In fact, corporate tax rates have been falling since 1950 but have accelerated over the last 20 years. Secondly Covid added a huge amount which has probably pushed the USA close to what hysterical economists would call a debt trap.

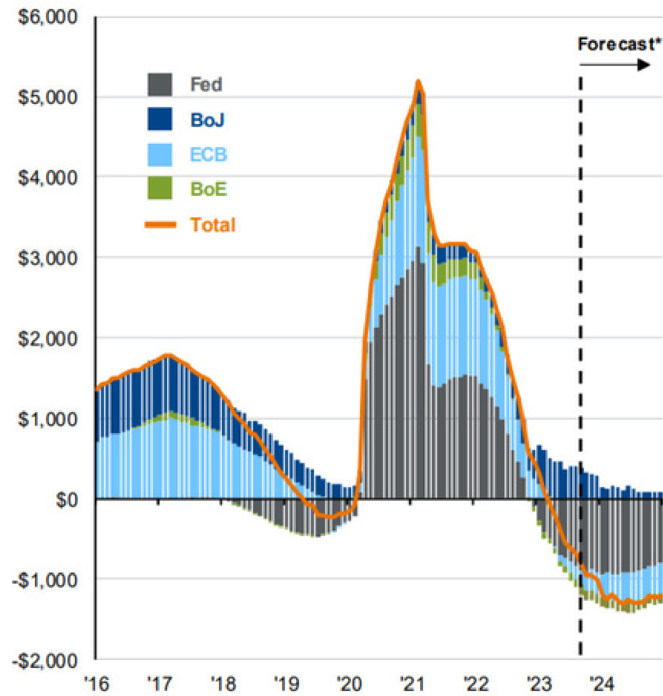
Debt trap is normally too strong a word for most developed countries as it is more about political will. In Italy there are more than enough assets to tax to address the problem. In the USA corporate tax rates probably should go up and tax breaks (yes, you private equity) should go down.

USA corporate Earnings have been very resilient at the operating level for the last 20 years. Over the last 20 years falling taxes and interest rates have boosted EPS. This has now run its course.

Unfortunately for the world this fiscal situation exists in the 80% of economies. This fiscal situation described above applies to most EU countries, Japan, China, and a bulk of emerging market countries.

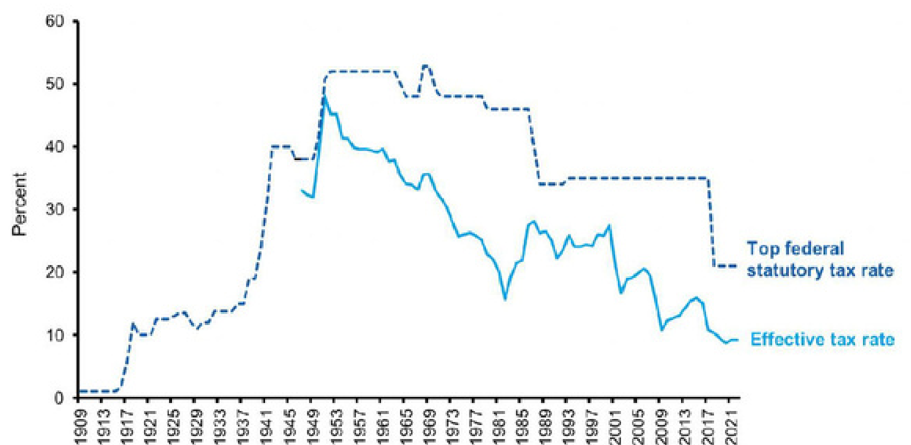
Real yields are here to stay.

Chart 3: Central banks QE 12 month rolling flow



Source:BIS, Bloomberg FactSet, J.P. Morgan Asset Management, Bank Of England (BOE),Bank Of Japan(BoJ) ,European Central Bank(ECB) Federal Reserve System (Fed) J.P. Morgan Global Economic Research

Chart 4: Top Federal and Effective Tax Rates for US Corporations; 1909-2022



Source: Tax Policy Center; FRED at the Federal Reserve Bank of St Louis; Counterpoint Global