When Raising Rates Doesn't Do What It's Supposed to Do.

We need to talk about interest rates again, which—let's be honest—isn't exactly a thrilling topic for most people. But stick with me here, because what's happening in the world of monetary policy right now is kind of bizarre, and definitely worth a closer look. There's this idea floating around, once dismissed as fringe, that higher interest rates might actually be fueling inflation instead of fighting it. Sounds counterintuitive, right? But hey, this is economics we're talking about—where the only rule is that nothing works the way you think it should.

Understanding the Interest Rate Effect

So, the traditional story goes like this: Central banks raise interest rates to make borrowing more expensive. This, in theory, should slow down consumer spending and business investment, thereby taming inflation. It's a straightforward equation: higher rates = less money flying around = lower inflation. Except, as it turns out, that might be a bit too simplistic.

Market participants and economists have been intrigued by this idea for a while now. A paper published in 1997, "The Natural Rate of Interest is Zero," which, as the title suggests, posits that interest rates themselves have a lot to say about the money supply and, ultimately, the price level. But what's happening now is something new—something shaped by decades of economic evolution since the 1980s.

The Current Cycle: A New Economic Dynamic

Let's jump forward to the present. Remember 2008? Good times, right? Back then, we thought cutting rates would jumpstart the economy. Spoiler: it didn't work out as planned. Some argued at the time that slashing rates actually pulled a ton of interest income out of the economy, which ended up stalling growth rather than igniting it. So, instead of the roaring inflationary boom everyone was expecting, we got a sluggish, tepid recovery. The lesson? *Maybe rate cuts aren't the magic bullet we thought they were.*

Now, jump to today, and things are even more interesting. With the debt-to-GDP ratio hovering around 100%, those interest rate hikes are a lot more potent. They're jacking up government interest payments, which is pumping a ton of money into the economy. And guess what? That extra cash isn't just sitting around—it's getting spent, boosting demand. Yep, you heard that right: higher rates might actually be revving up the economy instead of slowing it down. It's a weird kind of fiscal stimulus, and if that sounds a lot like something Modern Monetary Theory enthusiasts (MMT) would endorse, well, you're not wrong.

The Misunderstood Role of Fiscal Policy

Here's where things get really fun. You see, when rates go up, the government's interest expenses balloon, which in turn expands the budget deficit. And right now, we're looking at a deficit that's getting bigger by the day, driven by these rising interest payments. But instead of dragging the economy down, this deficit spending is injecting even more money into the system. It's helping to support employment and growth—a dynamic that, unsurprisingly, traditional economic models tend to miss. They often assume people don't spend much of their interest income, so they totally underestimate how stimulative higher rates can be.

So, what does this mean under different administrations? Glad you asked.

Trump: If Trump gets another go, you can pretty much expect more fiscal free-for-all. Think lower taxes, higher spending on defense and infrastructure, and a total disregard for the deficit. The result? Probably an even bigger budget deficit, and with higher rates, more interest payments pouring into the economy. It's

fiscal stimulus on steroids, and it might just keep things humming along—at least until the bond market freaks out.

Harris: Now, if Harris takes the reins, the approach will look different, but maybe not in the way you'd expect. Sure, there'll be higher taxes on corporations and the wealthy, and more spending on social programs, healthcare, and climate action. But here's the kicker: all that spending is going to keep the deficit growing. And with higher interest rates, the government's interest payments will keep rising, feeding more money into the economy. So, despite the more progressive veneer, we could end up with a similar scenario: big deficits, lots of interest income, and an economy that's weirdly resilient to rate hikes. Cue the MMT crowd nodding in approval.

Looking Ahead: The Implications for Economic Policy

So, where does this leave us? Well, if you're a central banker, you might want to start rethinking the old playbook. The idea that higher rates automatically bring down inflation is looking pretty shaky in an economy where public debt is sky-high and interest income is driving demand. The ideas in The Deficit Myth are starting to sound a lot more reasonable in this strange new world.

In conclusion, we're in uncharted waters here. The old rules of economics are being challenged by new realities, and it's becoming clear that the relationship between interest rates, inflation, and fiscal policy is more complicated than we thought. Whether it's Trump's fiscal fireworks or Harris's progressive spending, the interest rate paradox is here to stay, and it's going to keep economists, policymakers, and pretty much everyone else scratching their heads for years to come.

LEGAL STUFF

CURRENT MARKET DATA IS AS OF 8/27/2024. OPINIONS AND PREDICTIONS ARE AS OF 8/27/2024 AND ARE SUBJECT TO CHANGE AT ANY TIME BASED ON MARKET AND OTHER CONDITIONS. NO PREDICTIONS OR FORECASTS CAN BE GUARANTEED. INFORMATION CONTAINED HEREIN HAS BEEN OBTAINED FROM SOURCES BELIEVED TO BE RELIABLE BUT IS NOT GUARANTEED.

THIS PRESENTATION (THE "PRESENTATION") HAS BEEN PREPARED SOLELY FOR INFORMATION PURPOSES AND IS NOT INTENDED TO BE AN OFFER OR SOLICITATION AND IS BEING FURNISHED SOLELY FOR USE BY CLIENTS AND PROSPECTIVE CLIENTS IN CONSIDERING GFG CAPITAL, LLC ("GFG CAPITAL" OR THE "COMPANY") AS THEIR INVESTMENT ADVISER. DO NOT USE THE FOREGOING AS THE SOLE BASIS OF INVESTMENT DECISIONS. ALL SOURCES DEEMED RELIABLE HOWEVER GFG CAPITAL ASSUMES NO RESPONSIBILITY FOR ANY INACCURACIES. THE OPINIONS CONTAINED HEREIN ARE NOT RECOMMENDATIONS.

THIS MATERIAL DOES NOT CONSTITUTE A RECOMMENDATION TO BUY OR SELL ANY SPECIFIC SECURITY, PAST PERFORMANCE IS NOT INDICATIVE OF FUTURE RESULTS. INVESTING INVOLVES RISK, INCLUDING THE POSSIBLE LOSS OF A PRINCIPAL INVESTMENT.

INDEX PERFORMANCE IS PRESENTED FOR ILLUSTRATIVE PURPOSES ONLY. DIRECT INVESTMENT CANNOT BE MADE INTO AN INDEX. INVESTMENT IN EQUITIES INVOLVES MORE RISK THAN OTHER SECURITIES AND MAY HAVE THE POTENTIAL FOR HIGHER RETURNS AND GREATER LOSSES. BONDS HAVE INTEREST RATE RISK AND CREDIT RISK. AS INTEREST RATES RISE, EXISTING BOND PRICES FALL AND CAN CAUSE THE VALUE OF AN INVESTMENT TO DECLINE. CHANGES IN INTEREST RATES GENERALLY HAVE A GREATER EFFECT ON BONDS WITH LONGER MATURITIES THAN ON THOSE WITH SHORTER MATURITIES. CREDIT RISK REFERES TO THE POSSIBLITY THAT THE ISSUER OF THE BOND WILL NOT BE ABLE TO MAKE PRINCIPAL AND/OR INTEREST PAYMENTS.

THE INFORMATION CONTAINED HEREIN HAS BEEN PREPARED TO ASSIST INTERESTED PARTIES IN MAKING THEIR OWN EVALUATION OF GFG CAPITAL AND DOES NOT PURPORT TO CONTAIN ALL OF THE INFORMATION THAT A PROSPECTIVE CLIENT MAY DESIRE. IN ALL CASES, INTERESTED PARTIES SHOULD CONDUCT THEIR OWN INVESTIGATION AND ANALYSIS OF GFG CAPITAL AND THE DATA SET FORTH IN THIS PRESENTATION. FOR A FULL DESCRIPTION OF GFG CAPITAL'S ADVISORY SERVICES AND FEES, PLEASE REFER TO OUR FORM ADV PART 2 DISCLOSURE BROCHURE AVAILABLE BY REQUEST OR AT THE FOLLOWING WEBSITE: HTTP://WWW.ADVISERINFO.SEC.GOV/.

ALL COMMUNICATIONS, INQUIRIES AND REQUESTS FOR INFORMATION RELATING TO THIS PRESENTATION SHOULD BE ADDRESSED TO GFG CAPITAL AT 305-810-6500.