Where's The Interest in Interest Rates? *(SB News-Press)*

(August 24, 2013) The U.S. economy has for five years now been propped up by artificially low interest rates. But that crutch is now being removed (tapered), and the unsettling truth about the fragile underlying economy is quickly coming into focus. Like external braces temporarily supporting a weakened building façade after an earthquake, so too have the Fed's repeated phases of quantitative easing (QE) kept teetering GDP and poor employment from completely collapsing – but just for a time, and that time is ending. It's become more and more obvious that the return to true market-level interest rates will have a negative impact on the U.S. economy, exposing its poor fundamentals and lack of strength. In the last four weeks alone, the Dow Jones has dropped almost 800 points (lost 5 percent) from 15,658 to under 14,900 as stocks are devalued because rising interest rates will reduce future profits.

So what exactly happens when the Fed completely stops buying debt from the Treasury? That fake demand has kept T-Bill, T-Note, and T-Bond prices much higher than they would normally be in an efficient free market, pushing yields to historic lows of zero-percent Bills, 2-percent Notes, and a 3-percent 30-year Bond. This allowed the prime rate to stay at only 3.25 percent for almost five years now – even as banks cut back on both commercial lending and home mortgages. What can be expected when true market rates return to 3 percent Bills, 5.5 percent Notes, and 7.25 percent Bonds? Or worse, could the U.S. economy endure a return to higher inflation with a prime rate north of 6 percent and a 30-year T-Bond yield over 9 percent?

The interest in interest is that higher rates increases the cost of capital throughout the economy – from student loans to credit cards, business financing to mortgages, auto loans to government debt. Low interest makes products and services more accessible to buyers. It spurs the acquisition of capital goods by companies, and the purchase of consumer and durable goods by households. Higher rates make all financing terms more expensive, and that slows demand, even as it puts inflationary pressure on prices. As the Fed gets out of the U.S. debt market, demand for Treasuries will fall, prices will then fall, and yields will rise. The market competition for credit at higher returns will cause banks to raise their prime lending rate, while the Fed raises its internal federal funds rate and discount rate.

If "prime" increased two points to 5.25 percent, here's the domino effect in the economy. First, all business borrowing becomes more expensive. For every $1M of inventory loans at prime, the interest to carry would go up from $32,500 for one year to $52,500 – over a 60 percent increase in that cost to businesses who then have to pass that extra cost on to buyers by raising prices. That $20,000 difference on each $1M highlights how much less 'free cash flow' firms will have to invest in projects, expand operations, enter new markets, and hire more workers. And while $20,000 by itself may not seem like much, that two full percentage point increase on the average $1.27 trillion in annual U.S. inventory financing translates to $25 billion in reduced cash flow for the overall private sector. Sure firms can make that up with higher prices, but that means goods and services become less affordable, inflation resurfaces, and there's lower overall demand.

Second, financing a home will move beyond the reach of many potential buyers. Are consumers ready to return to the 6.25 percent 30-year mortgage? Reuters just reported that mortgage applications are down for the second straight week as interest rates continue to move higher. A current 4-percent fixed-rate 30-year mortgage on $240,000 costs $1,145 per month ($300,000 home with a 20 percent down payment). But at 6.25 percent, the mortgage payment goes up to $1,477 – almost $4,000 more each year.

Are car buyers ready for a 'typical' loan to be 8 percent? The new car market has been barely holding on primarily due to zero-percent and similar low rates (0.9, 1.9). Even less-than-average-credit buyers have been getting rates around 6 percent. When rates go up, a typical $15,000 36-month auto loan will increase on average $45-to-$55 per month, or about 10-to-15 percent higher than with current rates. Additional impacts will hit student loans – where the current 6.4 percent PLUS loan and 6.8 percent Stafford loan will likely increase into the 9 percent range, and credit cards – where 9.5 to 11.25 percent current rates are expected to jump back into the 15 or 16 percent range.

But wait, higher rates will also severely impact government debt. At $17.25 trillion, federal debt has expanded $7.25 trillion (up 72.5 percent in just five years of Obama). The interest on that debt is $223 billion, or just 1.28 percent average interest on the principal – 6 percent of federal spending. However, this is with artificial rates from QE. Refer back to my earlier point about true market Treasury rates (3 percent Bills, 5.5 percent Notes, 7.25 percent Bonds). A return to those levels would increase average interest to 4.14 percent, or $714 BILLION on the $17.25 trillion – almost 20 percent of total federal spending. Obama knows the end of QE will add that half-trillion dollars to the annual deficit, and that's why he'd like to maintain QE.

Am I advocating keeping QE? Not at all. I'm simply underscoring that QE did NOT spark the economy to sustainable 5 percent annual GDP with robust job creation and 4.5 percent unemployment. President Obama's continued love affair with $3.6 trillion federal deficit-spending and record debt, near-trillion dollar government "stimulus" programs, higher taxes, no entitlement reform, and his steadfast commitment to the regulatory nightmare and escalating costs of deficit-laden Obamacare have crippled any chance for true recovery – even with artificially low interest rates. As QE is tapered and then eliminated, the prospects for another recession become more likely. So why doesn't this crucial economic issue get much interest?