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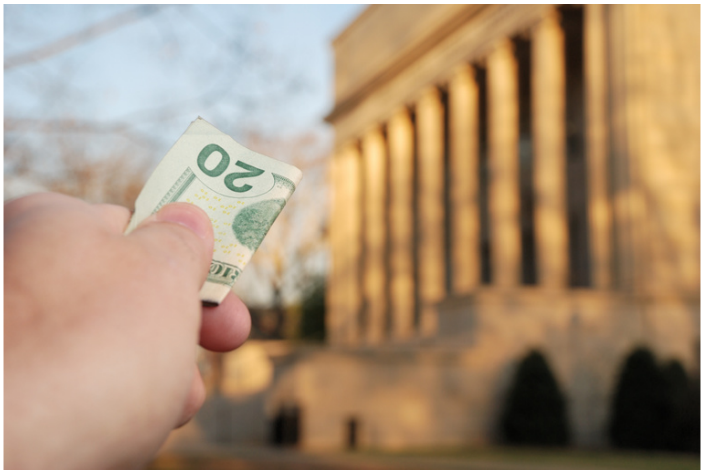
WILL FISCAL DOMINANCE STOKE NEVER-ENDING INFLATION?

A VICIOUS CYCLE EMERGING FROM ENORMOUS US DEBT AND DEFICITS MAY KEEP INFLATION HERE FOR GOOD

- What fiscal dominance is;
- Why fiscal dominance could put us into an inflationary loop;
- What recent bank lending statistics are telling us (it’s not what you think!);
- The impact of $7.6 trillion in US government debt needing to be refinanced in the next 12 months;
- How energy policy is adding to our issues;
- And more!



You may or may not have heard it before, but there is an economic phrase that you will likely be hearing with more frequency related to the economic backdrop: fiscal dominance. It may not be what you expect. In layman's terms, fiscal dominance is a condition where fiscal policy dominates monetary policy.

In and of itself, and depending on who defines it, fiscal dominance may not always be a bad thing. However, when you have the current US financial backdrop, it very well is.

The fiscal dominance that is being spoken of amidst our current financial situation is explained in an abstract to a recent paper by the St. Louis Fed.

They say, "As a matter of arithmetic, the trends of US government debt and deficits will eventually result in an outrageously high government debt-to-GDP ratio. But when exactly will the United States hit the constraint of infeasibility and how exactly will policy adjust to it? This article considers fiscal dominance, which is the possibility that accumulating government debt and deficits can produce increases in inflation that "dominate" central bank intentions to keep inflation low."

Let's explore that.

When a country has high debts and deficits, like the US does today, and high inflation, as the US does today, it means that the monetary policy meant to quell inflation won't work because it is dominated by fiscal realities, led by the giant debt burden.

This creates a vicious financial cycle. Increasing interest rates from monetary policy makes interest on our outstanding debt even more expensive. That increasing debt service widens the deficit. This requires more debt financing and, if recent history is a guide, monetization of the debt or "printing", which is inflationary. This leads to higher interest rates from policymakers and the cycle repeats again, with the fiscal situation dominating the impact of the monetary policy.

The economic conditions aren't helped by the reality of being at the tail end of nearly 15 years of low-to-no interest rate policy, where businesses and consumers alike loaded up on debt.

Normally, tighter monetary policy, including raising interest rates and shrinking the Fed's balance sheet via quantitative tightening (QT), would slow lending as policy intended. Economic commentator Luke Gromen of FFTT, LLC explored in a recent piece how things aren't following that pattern right now. He shared that Global Chief Economist at Arch Capital Group, Parker Ross, said on X (formerly Twitter), "Much to my surprise, total US bank loans & leases expanded by $42B over the 4 weeks ending Aug. 16, or slightly FASTER than the 2018-19 average of $35B."

Why would bank lending be expanding, not contracting? Gromen noted this scenario "brought to mind something a veteran hedge fund manager told us earlier this year…'Luke, in an EM [emerging market] I was involved in, when the central bank raised rates about a decade ago to choke off inflation, something very interesting happened: After a pause, all the banks lent like madmen so their average asset yield would increase (as the central banks' rate hikes had dramatically inverted the curve and as a result, hurt the banks' Net Interest Margins (NIM.) It created a massive spending spree and inflation accelerated massively. Higher rates leads to more lending."

Currently, the US has a balance sheet that looks more like that of a teetering emerging market economy, with debt exceeding the GDP. This, paired with the need to monetize further deficit spending, would likely lead to a currency crisis in an emerging market, as we have seen many times throughout history. What is unusual for the US is that such a balance sheet position is paired with being the global reserve currency, which has kept that scenario from happening- an odd place to be indeed.

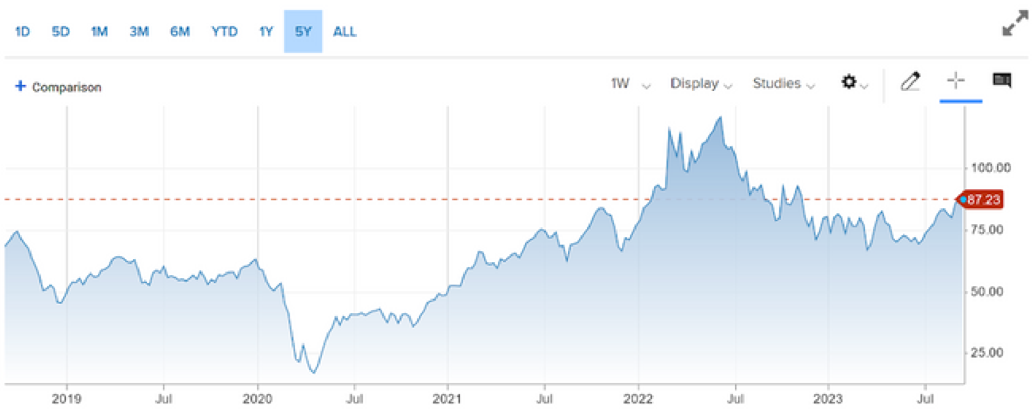
However, the basics of finance and monetary policy remain what they are.

The Fed's rate hikes should be a signal to the government to slow its spending, as it makes the cost of financing deficits materially higher. In mid-2022, the average duration of Treasury debt was five to six years. At the time, it was estimated that the interest rate on the US debt was a mere 1.4%. Now, new debt is being issued at rates that are hundreds of basis points higher. Almost a third of public debt, around $7.6 trillion, needs to be refinanced in the next 12 months, creating hundreds of billions of dollars' worth of incremental financing costs for the US government. This, as noted by Apollo Global Management, is a "source of upward pressure on US rates."

The increased costs to service the debt, absent any fiscal austerity, leads to widening deficits (currently projected at around a whopping $2 trillion for FY 2023). These larger deficits are financed with more debt, which likely triggers the need to print more money, which leads to more inflation. This feedback loop shows the impact of the fiscal dominance that we may be facing.

Add all of this to the slew of other issues facing the Treasury bond market that keep rates high and create inflationary pressures due to fiscal dominance that I discussed in my recent Goldline newsletter and this is beginning to look more like reality than theory.

Indirectly related to our discussions around fiscal and government policy dominating monetary policy are energy policy decisions. We have seen a slow creep back in oil prices. While not quite back to where they were during the first half of 2022, oil prices are on an upward trend vis-à-vis both recent months and the past five years.



(WTI Crude chart via CNBC.com; 5-year chart as of 9/8/2023)

Given that the US has not fixed any supply issues- and the Fed can't print oil- energy supply/demand imbalances are likely to lead to more sticky, long-term inflation as well.

So, where does this all leave us?

In a recent piece, CFA Daniel Ford of Oxford Financial Group wrote, "History suggests that US investors are likely to experience persistently above-target inflation, more pronounced cycles of inflation and stagnation and higher currency volatility than we've become accustomed to."

I agree that the likely scenario over the medium term is that we will live with persistent inflation, which has real impacts on your cost of living and wealth. Think of it in terms of weight. Let's say we all gained 9.5 pounds last year, but this year we "only" gained 3.5 pounds. Sure, that is slower growth in our weight gain, but it is still weight gain and now we are 13 pounds fatter! If we get stuck gaining weight at a few pounds a year, we will be obese.

This analogy applies to the erosion of purchasing power due to sticky inflation. Yes, inflation (a growth rate) is down, but we are still feeling that erosion. Households having to contend with persistent inflation, even in the 3-4% range, will be hurt materially on a cumulative basis.

As then-congressman Ron Paul and then-Fed chair Ben Bernanke agreed during the latter's 2008 testimony in front of the House Financial Services Committee, "Inflation is a tax".

Daniel Ford's suggestions, as a part of a well-diversified portfolio construction, as he mentions in his piece, includes, " A pro-inflationary environment also demands investing capital in real assets such as real estate, commodities and commodity producers and neutral reserve assets such as gold."

I agree. The thesis around fiscal dominance and the realities of the US fiscal situation supports the thesis for hard assets, including precious metals, and commodities.

If you haven't had an opportunity to hedge and diversify your portfolio, or perhaps you haven't hedged enough, consider giving my friends at Goldline a call to help you. Their knowledgeable account executives can assist in helping you navigate what might be ahead by using precious metals as a potential hedge, along with any other diversification and hedging strategies that might be appropriate for you.

The signposts are building: the US's debt and deficits are bound to cause chaos until they are addressed, and there is absolutely no sign that any politicians are going to get serious about addressing them. They won't take care of the US's financial future, so you better take care of yours on your own.

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Carol Roth is a "recovering" investment banker, entrepreneur, business advisor, creator of the Future File legacy planning system, TV and media business, finance and economic commentator, and author of the books "The War on Small Business" and the *New York Times* Best Sellers "The Entrepreneur Equation" and "You Will Own Nothing."

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