John Dessauer Investments, Inc.

John Dessauer's market review and update as of Wednesday December 22, 2021

They did it! The national debt limit has been increased by $2.5 trillion. And given the rate of federal government spending, that limit will be reached in less than a year. What I find to be scary is that interest rates are likely to go up next year. The Federal Reserve is poised to start raising interest rates. The tapering of the monthly bond buying has been doubled to $30 billion a month. In just four months the bond buying program will be eliminated. Then the Fed can start raising interest rates to counter inflation. We don't know yet how many interest rate hikes will come next year. It could be one rate hike or as many as three, depending on how inflation behaves. The point here is that the cost of financing the national debt is going to rise and there is nothing the big spenders in Washington can do about that.

Worse is that the bond market may on its own push interest rates up because of the growing global government demand for credit. Demand for treasury securities from banks and money market funds has played a critical role, allowing the government to issue more than $3 trillion in debt since February without pushing yields significantly higher. The yield on the benchmark 10-year note settled last week at 0.694%, down from 1.909% at the end of 2019.

The combination of the pandemic and Washington flooding the economy with money had a major impact on the U.S. banking system. On one hand, the demand for loans declined and on the other deposits surged. That drove banks into treasury securities, providing the credit needed by the government. Money market funds also saw massive inflows of cash and they, like the banks, bought treasury securities.

Banks and money market funds have been so important in providing credit for the rising government debt that analysts are now worried about how the bond market will react as bank and money market funding settles down. Banks, for example, are expected to see demand for loans rise as the economy continues to recover. That will mean less demand for Treasurys from banks. In the case of money market funds some actually stopped taking in new money during the money flood. Investors tend to pull money out of money market funds once the level of risk settles down.

Banks and money market funds tend to buy Treasurys in the one-to five-year maturity range. With interest rates likely to rise next year the government wants to replace the short-term bills with longer term bonds. However, that entails appealing to foreign investors who are more willing to buy the long-term maturities. The problem is that foreign investor demand for U.S. government securities has been declining for the past several years. That is partly due to the fact that many other governments have also been running large deficits, offering investors an opportunity to diversify their holdings of government securities.

The bottom line is that the U.S. government is likely to have to start paying more in interest on the national debt to attract investors. How much more is unknown. The Federal Reserve will likely be cautious, and even after three rate hikes the level of interest rates will still be near record lows. The bond market is another question. The free market will respond to supply and demand. The supply of government securities is certainly going to rise. The great unknown is how high will interest rates have to go to stimulate enough demand to meet the growing supply.

President Biden and his Democrat supporters want to significantly increase the supply of government securities with a major spending plan called Build Back Better. The President says the cost of his plan over ten years will be $1.75 trillion. Critics, including the editors of the Wall Street Journal, have been saying that the real cost will be significantly higher. The Penn Wharton Budget Model has scored the 10-year cost at about $4.6 trillion, but the White House keeps claiming against all evidence that the cost is "zero." The editors of the Wall Street Journal call that the lie of the year.

The Congressional Budget Office (CBO) has also looked at the bill and found that the real costs are really significantly more than the President claims. For example, the CBO looked at 18 programs in the Build Back Better bill. The President and his supporters claim the cost of those programs over ten years will be $889 billion. The CBO calculated the real cost to be $3.477 trillion. No wonder there is resistance. The bill is a threat to the bond market and the whole economy.

No matter the details, government taxes are a transfer of money from the public sector to the government. There are limits as to how much the government can take without damaging the private sector upon which it depends. Running up the size and cost of government can do so much damage to the private sector that it is no longer able to provide the amount of tax revenue needed. That is what happened to Venezuela. That is the basic flaw in Socialism. In addition, Socialism destroys competition. The government takes over everything. As the brilliant economist Thomas Sowell says, “competition breeds competence.” Socialism by destroying competition, breeds incompetence.

The President’s critics are correct to be alarmed by the Build Back Better spending bill. The combination of inflation and the real cost of the bill should be knockout blows. Hopefully they will be.

As far as the stock market is concerned, rising interest rates are not the issue. The issue that can hurt stocks is inflation. The Fed is, at last, beginning to worry about inflation. Cutting the bond buying is a good first step. Raising interest rates next year should cool off inflation, especially if it begins to fall as supply side economic issues are resolved.

There is a lot to worry about. But the stock market loves to climb a wall of worry.

I will have the next market review and update for you one week from today on Wednesday December 29, 2021

Happy Holidays,

John Dessauer