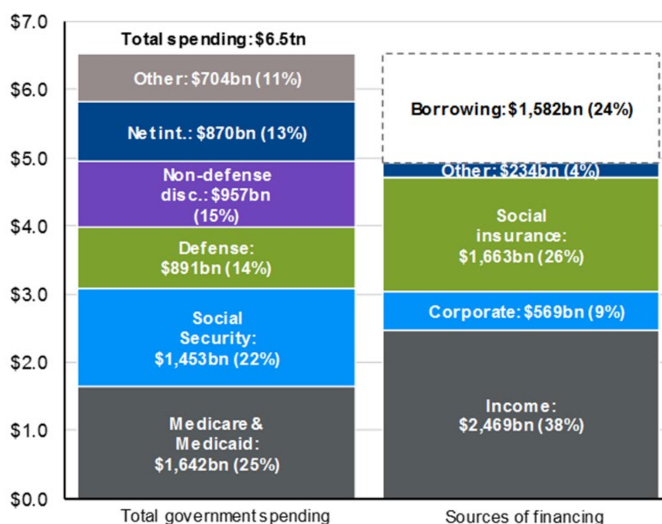
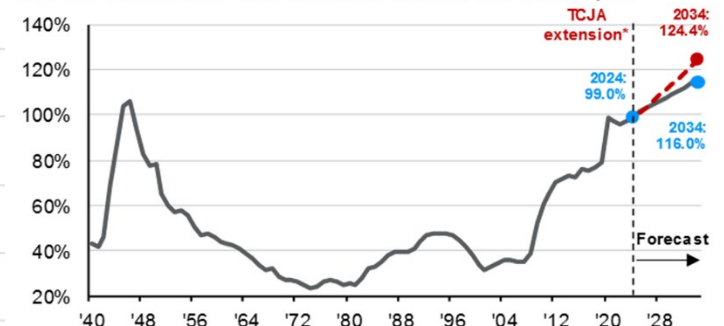
# Higher for Longer

The “higher for longer” narrative, as it relates to the Federal Reserve’s approach to interest rates, appears to have gained stronger footing to start the year. For those that tune into the financial news, you are likely aware of the frequently featured Fed members that opine on economic policy. Their comments are typically in sync, but recently, more have acknowledged the possibility of less rate cuts than expected. The Fed still anticipates three cuts in 2024, or a funds rate of ~4.75% by year-end, but recall the Fed also forecasted just three rate hikes for 2022, or a funds rate of ~1.0%, then raised at an historic pace to 4.25 – 4.50% by year-end. In contrast to the Fed, market consensus was initially six cuts by year-end 2024, however, recent economic data and Fed commentary have adjusted these expectations to just three cuts or less. This shift in expectations matter because the continued stock market rally is partially built on the anticipation of easing monetary conditions. While potential of “higher for longer” could bring volatility in the financial markets, it could also impact U.S. GDP growth, and more notably, U.S. debt levels.

The U.S. national debt levels increased sharply after the global financial crisis and the pandemic. The U.S. government spent ~7% of GDP on relief programs in 2008 and ~25% of GDP on relief programs throughout the pandemic. It is hard to argue against the emergency assistance needed by individuals and businesses during these economic shocks, but the massive scope of the pandemic programs in particular has greatly contributed to the record $34 trillion in U.S. debt, which is forecasted by the Congressional Budget Office to reach $48 trillion in 2034. The $5 trillion spent in response to Covid-19 does not include the costly CHIPs and Science Act and Inflation Reduction Act, which are more related to supply chain, climate, and industrial policy. Below and left is the 2024 federal budget, which shows an annual deficit of $1.58 trillion to be added to the U.S. debt level. Below and right is federal net debt as a percentage of GDP, which is expected to be 99% at year-end 2024.[i] Mandatory programs and defense spending are over 60% of the federal budget. Given America’s aging demographics and the current state of geopolitical affairs, these will only get more expensive moving forward. Social security used to be a self-funding program, however, this changed as the number of retirees continued to grow faster than the number of workers. Since 2021, the social security trust fund has assisted with payments, and without the political will to make any legislative changes, this fund will be depleted in 2034. Medicare and Medicaid costs will also increase considerably as the elderly population grows and people generally live longer.



The fastest growing part of the federal budget, however, will be interest expense, which will soon eclipse defense spending as a larger share of the budget. The implication of “higher for longer” means the cost of debt will remain elevated, and when coupled with a permanently larger deficit, the federal debt will continue to amass. As the U.S. government auctions treasury bonds to raise money and fund spending, a larger annual deficit calls for further treasury auctions. More bonds issued means greater interest expense, and the more bonds issued at high interest rates means an even greater interest expense. As the dollar remains the world’s reserve currency, there is still significant demand for treasuries, but the lack of fiscal discipline from the U.S. government will drive the yields on treasuries higher, all else equal. Given a perceived higher level of risk and the deluge of treasury bills, notes, and bonds into the market, significant buyers of treasuries may require greater compensation. For perspective, the $27 trillion treasury market has doubled in the last ten years, and is about six times larger from the early 2000’s. This is meaningful because prolonged periods of elevated interest rates, due to uncoordinated monetary and fiscal policy, will eventually have a negative impact on corporate earnings and GDP potential. The economic growth needed to sustain higher interest payments may not be as attainable as in years past. As structural changes in U.S. entitlement programs are a taboo topic for Congress, and undisciplined proposals like student loan cancellation persist, the debt burden left to future generations will certainly be a disservice.

Investor anticipation of rate cuts, coupled with a resilient U.S. economy, drove the equity market to its best start to the year since 2019, with the S&P 500 moving higher by 10% in the first quarter. The S&P 500, Dow Jones Industrial Average, and Nasdaq Composite, as well as the prices of Bitcoin and gold, all saw record highs. While technology stocks remained the dominant driver across the major indices (the “Magnificent 7” contributed ~36% of the S&P 500 Q1 return), market breadth also continued to improve. The cyclical sectors reached all-time highs, including industrials, financials, and materials, as well as specific industries, like the Philadelphia Semiconductor Index. Through the end of the first quarter, the S&P 500 had 21 trading weeks without a 5% pullback. The index has historically averaged a 5% pull back every 10 trading weeks and a 10% correction every 34 trading weeks.[ii] Additionally, as S&P 500 earnings per share growth was about flat in 2023, multiple expansion has been the primary driver of stock prices, resulting in an elevated forward P/E of nearly 21x for the index.[iii] Each of these facts imply a pullback in prices is likely, and strong corporate earnings will be critical to supporting equity prices at these higher levels. The U.S. fourth quarter 2023 GDP growth came in at 3.4%, much higher than the 2.2% growth that was expected. GDP continues to be fueled by elevated consumer and government spending, which respectively compose of 68% and 17% of total GDP. Consumer spending remains a strength to economic growth, however, savings have decreased considerably since 2019 and are much more concentrated in higher income groups, while auto and credit card loan delinquencies have continued to move higher. Notably, the last three months of inflation readings have shown that it is stickier than expected. The March readings of headline CPI and core CPI both rose higher than estimated, at 3.5% and 3.8% year-over-year, respectively. This lowered the expectation of immediate rate cuts for some Fed members and investors even further. As the expectation of “higher for longer” persists, the reality of higher interest rates is likely to be reflected in the equity markets and economy, and should be a significant consideration for investors and legislators alike.

[i] JP Morgan Asset Management
[ii] Northern Trust Asset Management
[iii] JP Morgan Asset Management

*The material provided in this commentary contains the current opinions of RMC Investment Advisors, a SEC-registered investment adviser. These opinions are subject to ongoing evaluation and could change due to economic and market conditions. This commentary is for informational purposes only and should not be considered as investment advice or a recommendation of any particular security or strategy. Please remember that past performance is not indicative of future results.*