Financial Gravity

- Financial gravity is a sense of how heavily interest rates weigh on markets and the economy. It accounts for both the level of the rate and the time at that level.
- The path that interest rates travel also greatly influences how heavy rates feel.
- Higher-for-longer interest rates would have a profound impact that markets are not pricing in.

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One of the puzzles in the financial markets currently is how little impact the rapid rise in interest rates—from 0% to 5.5%—has had on the U.S. economy. Many speak of the surprising resilience of the economy in the face of a huge shift in monetary policy. A popular argument for this resilience centers on how the economy has continued to shift toward services and away from manufacturing.

The argument goes as follows: With services being less capital dependent than manufacturing, the economy has become less dependent on debt and consequently less rate sensitive.

Manufacturing jobs have been on the decline since the 1950s, but the share of gross domestic product (GDP) tells a different story. Looking at real GDP (adjusted for inflation), manufacturing has hovered between around 10% and 13% since the 1950s.[1]

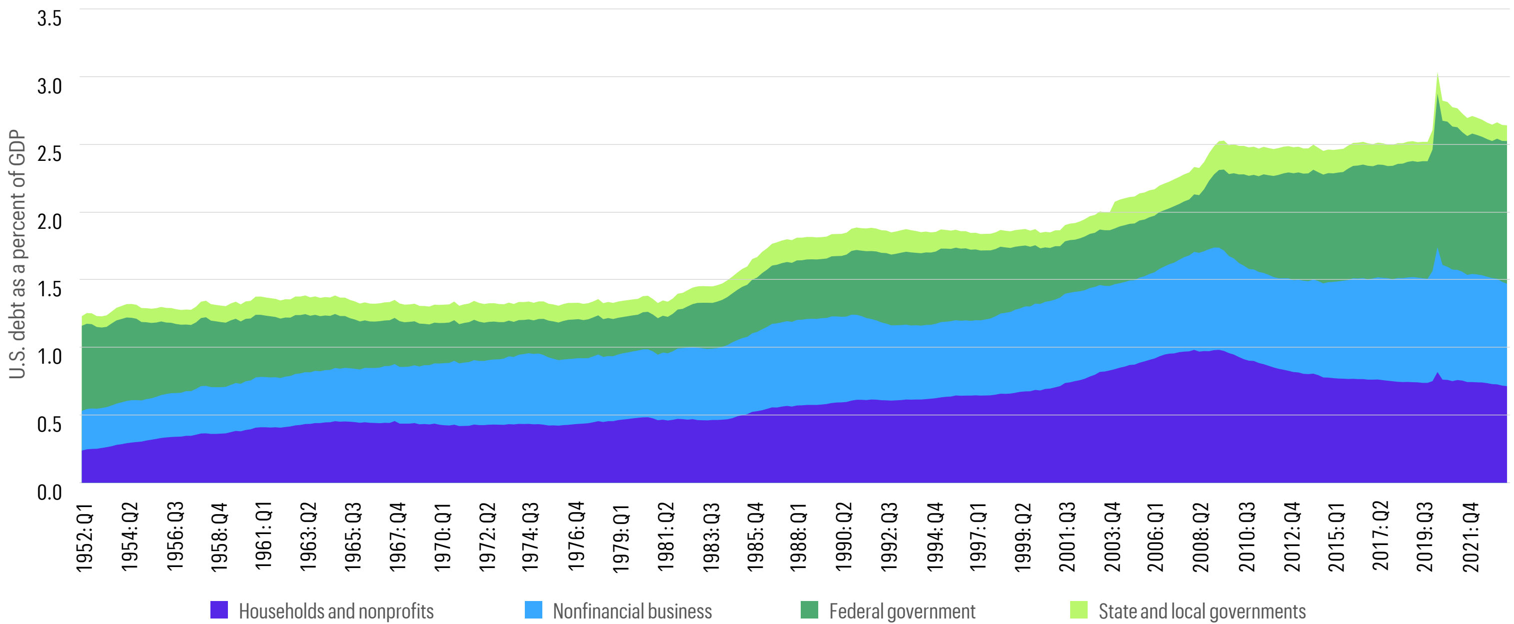
Output from manufacturing hasn't changed much, which casts doubt on the theory of a service-based economy reducing interest rate sensitivity. The balance between service and manufacturing matters little—what does matter is our dependence on debt.

The debt trajectory

Since the early 1950s through the end of 2023, borrowing as a percent of GDP is up markedly. Household borrowing is 3x the level of 1952. For businesses, it's 2.6x. The federal government's borrowing is up 1.7x, and state and local government averages are up 1.6x.[2]

1. YiLi Chien and Paul Morris, "Is U.S. Manufacturing Really Declining?" Federal Reserve Bank of St. Louis, April 11, 2017.
2. Source: Board of Governors of the Federal Reserve System, accessed at: https://www.federalreserve.gov/releases/z1/dataviz/z1/nonfinancial_debt/chart/#units:usd.

FIGURE 1: DEBT HAS BEEN TRENDING UPWARD SINCE THE 1950S



Sources: Allspring and the Board of Governors of the Federal Reserve, 01-Jan-52 to 31-Dec-23.

Borrowing scaled by GDP in the U.S. has continued to trend upward from a low of around 130% during the 1950s, 1960s, and 1970s to the current level, which is about double that (Figure 1 above). Even if we judge things in comparison with the borrowing highs of the Global Financial Crisis (GFC), we still see that borrowing by businesses since the GFC has kept pace with GDP and is back at all-time highs. Especially noteworthy here is the growth in borrowing by the federal government as a share of GDP, which is up 380% since the GFC. All of this makes it difficult to argue that the economy is less sensitive to interest rates than it was at some point in the past. The reality is that the U.S. economy (along with many other economies around the world) has become much more debt dependent. Economists have long argued that the use of debt should rise when interest rates fall and the use of debt should fall as interest rates rise. But they avoid the question of how borrowers get out of debt as interest rates rise. The current high debt levels make it even more important that we solve the puzzle of why the dramatic rise in interest rates has been less impactful than expected. To do this, we introduce the concept of financial gravity.

Financial gravity

To understand what is happening in the economy, it helps to introduce two concepts—first is the idea of financial gravity and second concerns a tale of a 4-foot man in a 5-foot hole.

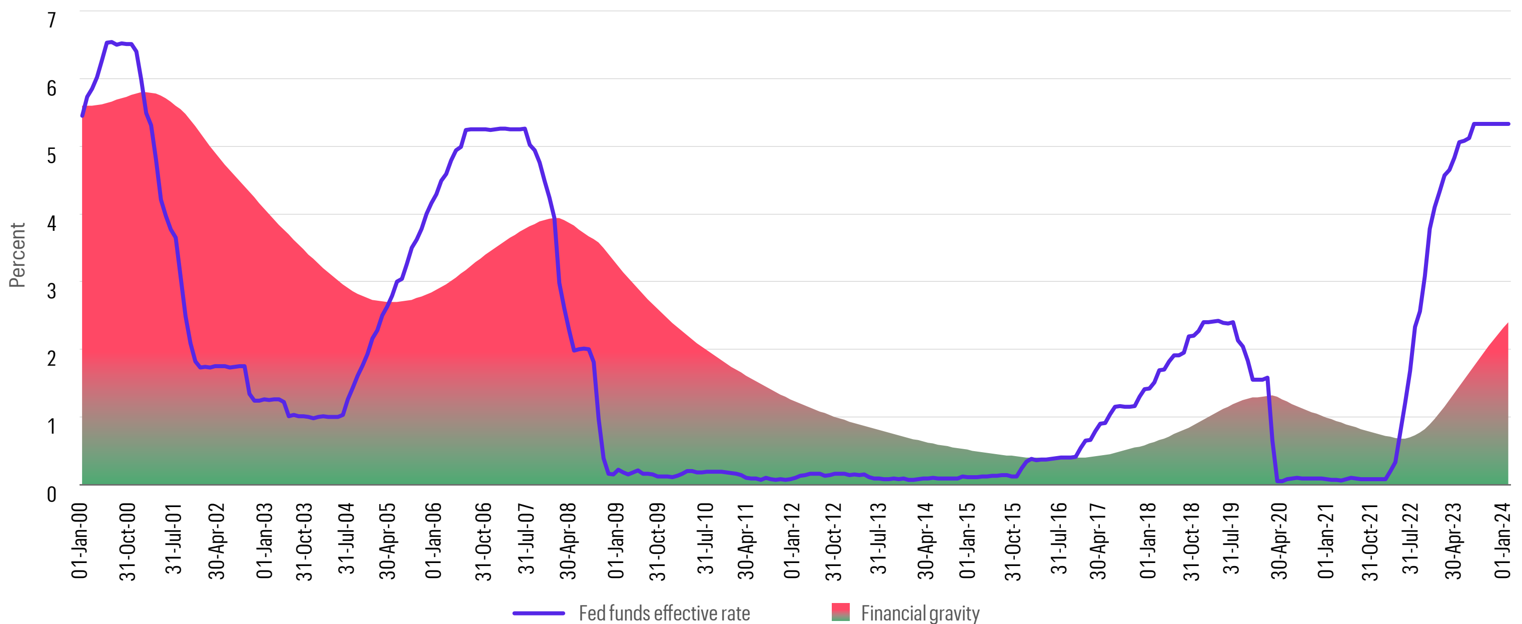
Financial gravity is the idea that the weight of interest rates on the economy is a function of the level of interest rates and the period of time rates stay at that level.[3]

Financial gravity = % RATE x TIME

The markets seem to focus on how many rate cuts are likely this year. But to gain a sense of the impact of rates, one also needs to consider time. A more important question is whether rates will stay higher for longer. The higher-for-longer question incorporates both the interest rate level and some sense of the time over which it will be applied. A 500% interest rate for one minute might capture headlines but will have virtually no impact. However, a 5% federal funds rate for five years coming off of a near-zero rate for more than 10 years could crush the economy. We are currently not even two years into the higher-rate environment.

3. Financial gravity is probably best characterized by some combination of nominal and real rates times time. For simplicity and clarity, we limit this discussion to nominal rates. Interestingly, as of March 31, 2024, the financial gravity effect of real rates is slowly recovering from being strongly negative, which helps explain the muted economic response to the dramatic shift in nominal rates.

FIGURE 2: FINANCIAL GRAVITY LAGS CHANGES IN THE FEDERAL FUNDS RATE



Sources: Allspring and Bloomberg Finance L.P., 31-Jan-00 to 31-Mar-24

To ground this concept, it might help to look at past markets through the financial gravity lens. Consider the period post-GFC (Q2 2009) to the end of 2021 (Figure 2 above). This is a long period during which financial gravity was very weak, with base rates near zero for most of these 12 years. In that kind of environment, all asset prices should rise as there is little gravity to hold them down. Contrast this with the environment since the end of 2021. Rates rose rapidly in 2022, but it takes time for the weight of those higher rates to be felt. The equity market has been pricing in very low financial gravity, expecting significant rate cuts soon. In mid-April 2024, the market started to price in a higher-for-longer scenario and the impact of that for weighing down asset prices.

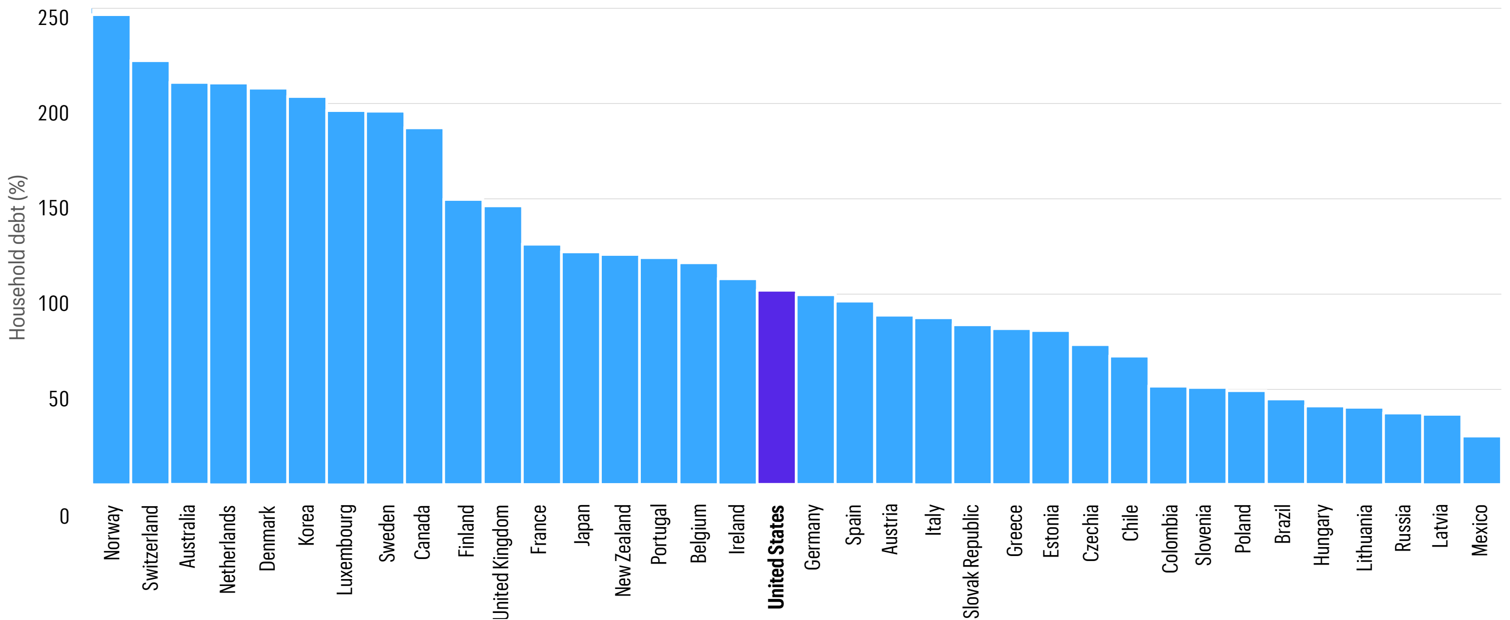
Why time matters

There are several reasons why time is so influential. First, it takes time for investors to change expectations, especially when the change in rates is dramatic. Investors tend to anchor on the past and expect conditions will revert to it. Early in the recovery from the GFC, the phrase “the new normal” was coined to try to convince investors that near-zero base rates were going to be the new normal. It turned out to be correct, but it took time for investors to adjust to that reality.

Second, how long it takes to adjust to a new rate environment is in part determined by the makeup of debt that is floating rate versus fixed rate. With floating-rate debt, the impact of rate changes is felt with little if any delay. With fixed-rate debt, rate changes are felt when the current debt needs to be refinanced or new debt needs to be issued. In the U.S., most debt is fixed rate (made up mostly of mortgages, student loans, auto loans, corporate debt, and government debt), whereas floating-rate debt is mostly limited to credit card debt, bank loans, Treasury Inflation-Protected Securities, and private credit. Heavy users of floating-rate debt—such as private equity—are already feeling the pinch of rate increases.

Outside the U.S., especially in Europe, most consumer debt (including mortgages) is floating rate or is fixed for a short period of around three years or less. The impact of financial gravity is larger the greater the reliance on debt, and financial gravity reacts more quickly to rate changes the larger the share of debt that is floating rate. The low rates post-GFC encouraged many Scandinavian and other European consumers to buy houses; they are now feeling the weight of financial gravity in a profound way that is not yet being experienced in the U.S.—but it is only a matter of time.

FIGURE 3: MANY EUROPEAN COUNTRIES HAVE HIGH HOUSEHOLD DEBT WHICH IS MOSTLY FLOATING RATE

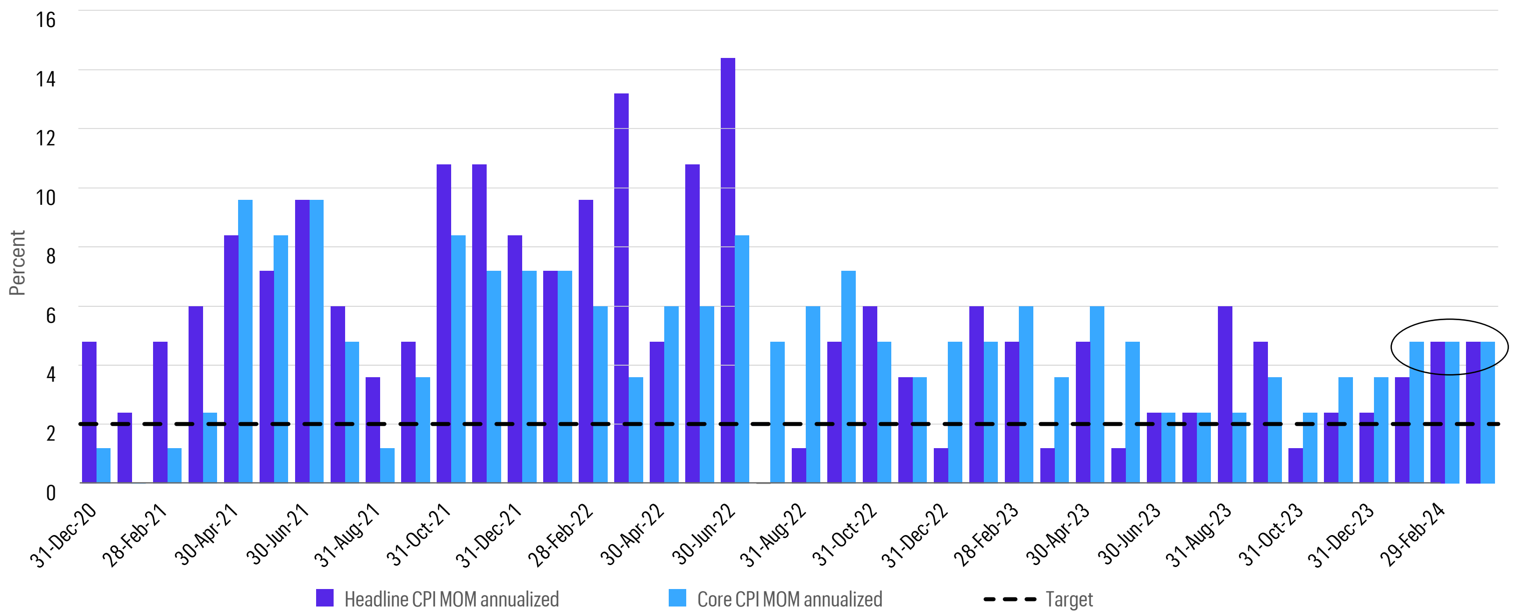


Source: OECD (2024), household debt (indicator). doi: 10.1787/f03b6469-en (accessed 17-Apr-24)

Figure 3 above plots household debt as a percent of disposable income by country. Many of the countries with the most indebted consumers are in Europe, where the combination of high debt to disposable income and a large portion of debt that is floating rate mean the recent rate changes weigh heavily on European consumers.

The third reason that time matters is that the more time that passes, the more old debt that has to be refinanced and the more new debt that is struck at the prevailing rates. The tale of a 4-foot man in a 5-foot hole illustrates this problem. In this tale, an investor who can only afford a base rate of 4% is 4 feet tall and the depth of the hole he's in is determined by the prevailing base interest rate—currently 5%. A 4-foot man in a 5-foot hole cannot get out of that hole. He cannot afford the new loan payments, and he cannot afford to refinance. Again, path dependency matters here. If an economy moves from a base rate of 10% to 5%, the vast majority of debtholders can afford a base rate of 10% or more. The move from 10% to 5% reveals a bunch of tall people in waist-deep holes. These borrowers can refinance their debt, and many new borrowers—those 6-, 7-, 8-, and 9-feet tall—can now also afford to borrow. In the current situation, we moved from a long period with base rates near zero, and now the base rate has moved to 5%. There are a lot of 1-, 2-, 3-, and 4-foot-tall people currently stuck in 5-foot-deep holes. This means that a higher-for-longer environment may spark many more defaults when borrowers cannot refinance. Time and rate—financial gravity—determine the impact.

FIGURE 4: INFLATION IS STILL A WAYS FROM TARGET



Sources: Allspring and Bloomberg Finance L.P., 31-Dec-20 to 31-Mar-24. This is a simple annualization of the month-over-month numbers.

A brief case for higher for longer

Building the case for a higher-for-longer scenario warrants a thorough treatment. For brevity, we touch on three key reasons to think that higher for longer might be the way things unfold: inflation, government debt, and strength of the U.S. economy.

01 **Inflation:** Inflation was initially seen as under control, then deemed transitory, and soon after clearly out of control. Lately inflation has been bending to the will of the Federal Reserve (Fed) but is proving to be stubborn (Figure 4 above). It seems the trip from 9% to 5% was easier than the trip from 5% to 2%. Currently both headline inflation (with food and energy) and core inflation (without food and energy) are running at an annual pace of just shy of 5%. This is a meaningful step from the 2% target.

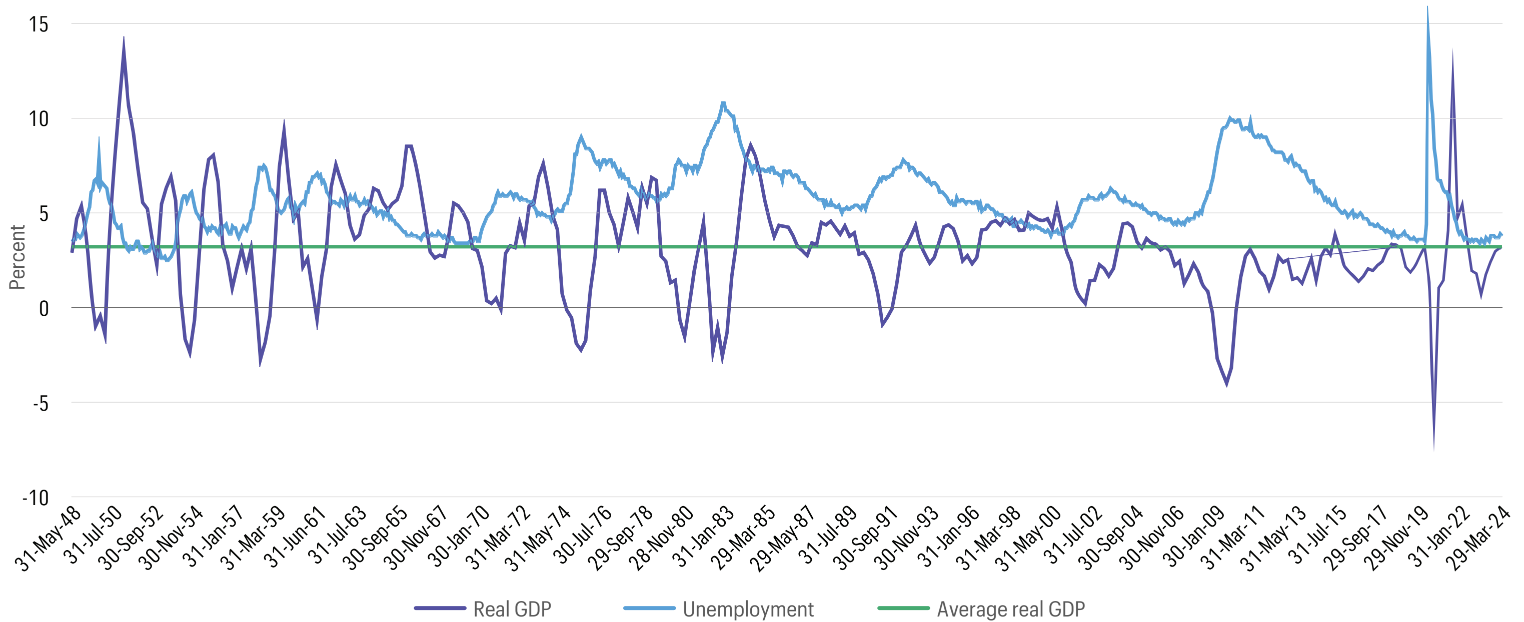
It will be very difficult for the Fed to cut rates before it is confident that inflation will not rebound strongly on the back of any rate cuts. This is especially true as, with the benefit of hindsight, the Fed was late to recognize inflation was running out of control and brought inflation down from its highs with aggressive monetary policy and strong rhetoric about the importance of getting inflation under control even at the expense of the economy. This suggests higher for longer.

02 **Government debt:** The huge swell in government debt initially during the GFC and then compounded during the pandemic (Figure 1) creates a few problems.

- **Crowding out:** The crowding-out effect of so much government debt pushes interest rates up as more debt competes for the same funding, and this debt must pay a higher interest rate to attract more capital.
- **Interest expense:** As interest rates have risen, so has the interest cost on that debt. The Congressional Budget Office projects the federal government's interest expense alone will be 3.1% of GDP in 2024 (double that of 2022) and that the interest expense will represent more than half of the projected annual budget deficits for the next 10 years (ranging from 52% to 68%).[4] More borrowing will be required simply to service the old debt. More borrowing means more crowding out, leading to higher rates.
- **Credit concerns:** While not a major concern yet, the option-adjusted spread on U.S. 10-year Treasuries shot up from near zero in late 2021 to 20 basis points (bps; 100 bps equal 1%) and has nearly doubled to 38 bps since then. If concerns about debt repayment rise with increased deficits, this would also put upward pressure on interest rates.

4. Sources: Allspring and Congressional Budget Office, "The Budget and Economic Outlook: 2024 to 2034," accessed at https://www.cbo.gov/system/files/2024-02/59710-Outlook-2024.pdf.

FIGURE 5: UNEMPLOYMENT AND GDP REMAIN STRONG



Sources: Allspring and Bloomberg Finance, L.P., 31-May-47 to 31-Mar-23. Real GDP is smoothed over the trailing 12 months.

03 **Strength of the U.S. economy:** The strength of the economy makes it difficult for the Fed to justify cutting rates. Unemployment of 3.8% remains near a 50-year low, while real GDP growth remains strong and stable near the long-term average of 3.2% (Figure 5 above).

Investment implications

Given the potential impact of a higher-for-longer scenario, it's important to consider the investment implications. Below we briefly highlight key points for investors:

01 Shall we ride the yield curve? Up or down? Higher for longer implies the curve will steepen. But financial gravity tells us that higher for longer will lead to recession, and the inversion in the yield curve is telling us the same thing. The curve is likely to flatten but not in a nice way. Rates are not likely to come down in some immaculate state of no landing—they will come down out of necessity as the economy shrinks, unemployment spikes, and demand for capital wanes.

02 The equity market has priced in a no-landing scenario because it has extrapolated into the future the current lack of impact from raising rates. Financial gravity tells us that this is a mistake and that the combination of rates and time will weigh heavily on the economy. If you have been waiting for a meltdown, be patient—equity markets will crack along with the economy.

03 Europe is expected to lead the next global recession as over-leveraged consumers spend more to service their debt and consume less.

04 Rate-sensitive assets such as real estate have tried to put off reality by not transacting. Financial gravity is not their friend and neither is time.

05 Is private equity the emperor with no clothes? Was much of the brilliant performance simply the use of cheap leverage? Private equity will likely struggle to return capital in a falling market and will pay more on debt than expected. Bankruptcies by private equity–owned firms would then spike.

06 Will private credit remain the current market darling? Everyone loves floating-rate debt when rates are rising—except the debtors. The biggest user of private credit is private equity. Lots of private equity positions could go into default when higher rates become unaffordable. Private credit may suffer defaults few thought possible. And as the economy slows and rates fall, investors may prefer fixed-rate over floating-rate debt. Private credit has their money now but will struggle to raise new capital. (To read more about our liquidity research and investment implications, see "The Dragon Turns Two: Revisiting Our Liquidity Research in Light of 2022 and 2023 Events.")

07 Possible winners in this higher-for-longer scenario include gold, high-quality, medium-to-longer-term fixed-rate debt; trend-following strategies; long-volatility strategies; and market-neutral strategies.

Defy or deny gravity

While it is tempting to extrapolate into the future the muted impact of raising interest rates from near 0% to over 5%, we suggest that it is the combination of the level of rates and the time at those rates that determines the impact. We are only starting to feel the impact of financial gravity. As time passes in this higher-for-longer state, the true weight of those higher rates will be felt in a way neither asset prices nor the economy currently reflect. As they said in the 1970s: *That's heavy, man.*

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