At the beginning of the year, most market strategists were in agreement that interest rates were going to rise in 2017. The reasons varied: some saw inflation climbing, pushing yields higher; others worried about bigger budget deficits; a few blamed the Federal Reserve, which was thought to be planning to raise short-term interest rates two or three times and shrink its balance sheet. Whatever the reason, interest rates were expected to head higher, so seeing the 10-year U.S. Treasury yield here at 2.3% is a surprise.

To many pessimists on the economic outlook, the drop in yields on the 10-year from 2.6% is a sure sign that the economy is weakening. After all, this expansion is almost eight years old and it is reasonable to expect a slowdown or even a recession. The disappointing employment report for March showing only 98,000 jobs were created may have been the first sign of trouble. Others believe the uneven start of the Trump administration in putting its pro-growth agenda to work is a reason to buy bonds and avoid the risks of increased equity exposure.

One political factor that may be influencing interest rates is the concern that the new administration under Donald Trump may not get much legislation through Congress. The failure to repeal the Affordable Care Act was the first sign of legislative difficulties. Recent reversals of positions by the president include China as a currency manipulator, NAFTA as a bad trade deal, involvement of the U.S. in Syria and Afghanistan, NATO as an obsolete alliance, Russian relations and renewing Janet Yellen’s term as Federal Reserve Chair. These reversals confused voters and investors on where the president really stands and diminished confidence in the positive pro-growth outlook. Some of his conservative supporters feel he is letting them down. This disappointment may be reflected in the lower interest rates and the modest stock market correction we have seen since March.

Students of economics may look at the growth of debt as a negative. World debt is a discussion issue in almost every meeting I have with clients. According to a study by Ned Davis Research, world non-financial debt has increased from $37.5 trillion in 2000 to $103.5 trillion in 2016, an almost three-fold rise. In the United States federal debt has more than tripled from $6 trillion in 2000 to $19 trillion today. This enormous surge in debt has not caused substantial investor alarm. Even many conservatives, who adopted the credo that we cannot pass on a huge debt obligation to our grandchildren, have virtually stopped talking about it. You would think that these higher debt levels would push interest rates up because they represent increased financial risk, but that has not happened.
We have actually been blessed by this decline in interest rates in the United States. In 2000, the total interest cost of servicing the federal debt was $360 billion, based on a blended interest rate on government bonds of 6%. Today, the blended interest rate is 2.1% and the total interest cost is $400 billion, only $40 billion more on a debt burden three times the size of its 2000 level. If interest rates on government securities rise 1%, the cost of debt service would increase almost $200 billion, offsetting most of the budget cuts being proposed by the Trump administration.

Why have interest rates declined when debt has increased and the economy is growing? I have long believed that at least part of the answer is the considerable expansion of central bank balance sheets. The surfeit of liquidity around the world may be playing a role in keeping interest rates low. Central banks in the U.S., continental Europe, the United Kingdom and Japan have increased their balance sheets by $10 trillion since 2008. In my opinion, as much as three-quarters of those funds found their way into financial assets, inflating price-earnings ratios and keeping interest rates low. Only one quarter of that increase was invested in the real economies of those countries and regions that were the intended beneficiaries of the monetary expansion. Now many of the managers of that capital are risk-adverse and are searching for places to park their money until the outlook improves. That is why you have negative interest rates in Europe and Japan.

The upward pressure on interest rates will not come from the corporate sector. As reported by 13D Research, the “animal spirits” in corporate borrowing for projects that would increase growth have quieted down. The current capital spending improvement is largely caused by a rebound in the energy industry as the price of oil has risen. Corporations are flush with cash and do not need to borrow for new initiatives. Also, capacity utilization is at 77%, revealing plenty of slack and unutilized manufacturing capability out there. In many industries no new capacity is needed.

The economic evidence supports the view that the U.S. economy is continuing to grow. The Economic Cycle Research Institute report, which aggregates a number of indicators, is at a cycle high, and I have found their studies reliable. Unemployment is low and wages continue to rise. The energy industry is reviving. Global leading indicators are rising sharply. The National Federation of Independent Business survey shows this group is optimistic, and they are responsible for creating most jobs. There are some signs of softening in the housing sector and retail sales, but based on current news, the economy seems to be accelerating rather than losing steam, so real GDP growth should be at least 2% in 2017 whether Trump gets his pro-growth agenda implemented or not. A recession would appear to be at least two years in the future.

Just as there has been little focus on the level of national debt and the financial burden it places on our future, you have not heard much recently about unfunded liabilities. Medicare alone represents $32 trillion in obligations over the next 75 years, although some economists believe it is as high as $45 trillion. According to Strateas Research, Social Security obligations are $11 trillion over 75 years. At the state and local level, there is currently a $1.9 trillion negative obligation gap, about 10% of our present GDP. These projections indicate upward pressures on budget deficits everywhere. The Trump administration’s economic program including tax reform is designed to be revenue neutral, meaning it will require no increase in the budget deficit, but recent Washington sentiment indicators show a willingness to run a modest deficit, considering the current excess of expenditures over receipts is less than 3% of GDP.

We are all complacent about these debt levels because they are refinanced so easily when the bonds
mature and the servicing costs (interest rates) are low. While a coterie of economists continually wringing their hands about the growing debt problem, their shrill complaints are not likely to inflame the public broadly until interest rates start to rise. The lack of public concern may be attributed, at least in part, to consumer net worth being in the best shape ever. This factor has risen from $60 trillion when the recovery started in 2009 to $95 trillion now. Despite the increase, we all know that net worth is far from evenly distributed. Twenty years ago, according to a study by Emmanuel Saez at the University of California at Berkeley, the bottom 90% of the U.S. population held 36% of household wealth and the top one-tenth of 1% held 7%. Today the bottom 90% hold 23% and the top one-tenth of 1% hold 22%. The inequality gap has grown wider in the new millennium.

How did this happen? Wealthy people own the expensive real estate where they live, and may have other expensive properties as well. They are also likely to own common stocks. Both the real estate and the equities have appreciated. The less affluent tend to be renters with limited equity holdings. Many live paycheck to paycheck and their personal wealth has not appreciated significantly. About 50% of households own no assets at all, according to Marc Faber of the Gloom, Boom & Doom Report. We know from a Federal Reserve report that one-third of the population in the United States would have to borrow to meet an unexpected $400 expenditure. In spite of the wealth disparity, inequality does not seem to be a major political issue at this time.

I have often argued that the world economies began to change significantly in 1980 and one implication was wealth inequality. In that year, the Japanese began to sell consumer electronics and automobiles in world markets and globalization began in earnest. Also in 1980, Apple introduced its first computer, which led to the internet and the smart phone and technology became an important productivity-improving force throughout the world. These two developments had a positive impact on world growth but also increased inequality. In 1980, the CEO-to-average worker compensation ratio was 30 times; today it is over 300 times, albeit down from a peak of 376 in 2000, according to the Bureau of Economic Analysis. This increase has roughly tracked the performance of the stock market since 1980. At the same time, according to the Bank Credit Analyst, the real income of the top 1% of the U.S. population has increased 54%, but is flat for the 90th percentile and below. Given the combination of rising debt obligations with growing inequality, the economies of the major industrialized economies may be headed toward a dangerous point. Looking at one example, as a result of increasing longevity, the cost of supporting the population which will need assistance that cannot be afforded by the immediate family could be great. That may be one major unintended consequence of medical breakthroughs.

There are two ways to deal with the inequality problem. The first is increased redistribution, which, although not endorsed by me, is supported by Bernie Sanders and Elizabeth Warren. The second is increased growth, which is the objective of the Trump economic program and would benefit people at all income levels. Right now, that growth initiative looks like it will be delayed. There are some who fear that Trump’s entire agenda is in doubt because of dissension in Congress on the part of both Democrats and Republicans. In addition, there are a number of problems that the new Trump Administration must face beside the aging demographics. Only three-quarters of those attending public high schools graduate, and many of those who do lack the reading and quantitative skills necessary to hold a good job in today’s competitive workplace. Environmental problems like air and water pollution are increasing, but budget for the Environmental Protection Agency has been cut. Globalization and technology continue to provide challenges to the economy; while these factors may increase growth
and productivity, they do tend to displace jobs.

We are now on the brink of artificial intelligence invading the white collar workplace and reducing the number of jobs in healthcare and the legal profession. Economic progress appears to be associated with increasing the ranks of the unemployed or marginally employed. Retraining those affected or finding alternative employment is one of the important challenges facing society today. Increasing real growth from 2% to 3% is going to be difficult, but necessary both to improve the standard of living and provide the resources to deal with future needs.

Taking a hard look at unfunded obligations, increased taxes may well be necessary over the long term, but we will probably not tackle these problems until a crisis is upon us. While this is usually how major challenges are dealt with, that crisis is coming, and one worry I have is that the new administration is already too overwhelmed by the immediate problems to be focusing much on the future. The irony is that interest rates are declining at the federal level when they should be rising in anticipation of future borrowing needs. The market is making new highs but there is plenty to think about. I find myself getting up in the morning before the alarm clock has rung.

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