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High Interest Rates Could be Here for a Long While, if History is Any Guide

Dow Jones Oct 10

S&P 500 -0.05%

As Treasury yields rise to decadeslong highs, propelled by record national debt and a costly war in Iran, an ugly truth emerges: The bond market moves in long cycles.

Very long cycles, measured not in months or years, but in decades.

The last regime ended in 2020 with the yield on 10-year Treasury notes at 0.5%, a record low, having fallen from 15.8% in 1981, Ronald Reagan's first year in office.

With the 10-year Treasury yield now above 5.3%, the highest since the early 2000s, it's fair to wonder if we are headed for another wild ride higher.

History isn't destiny. And outside of the late 1970s and early '80s -- a period of deeply entrenched inflation -- yields haven't approached double-digits since George Washington was president.

Still, a yearslong period of rising yields could cause damage throughout the economy. The 10-year Treasury serves as a benchmark for interest rates on mortgages, loans, credit cards, and other forms of borrowing. Higher rates make money more expensive, and can cause a chilling effect on business.

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In the 1970s, rising interest rates portended a period of low growth and rising prices dubbed stagflation. Like today, a Mideast energy crisis exacerbated the situation.

As yields crested 9% in July 1979, President Jimmy Carter went on national TV to warn of an "erosion of our confidence in the future...threatening to destroy the social and the political fabric of America."

Such a result wouldn't have surprised Ben Franklin.

"If you would know the Value of Money, go and try to borrow some; for he that goes a borrowing goes a sorrowing," Franklin wrote in Poor Richard's almanac of 1758, attributing it to "Poor Dick."

Yet America can be said to have been built on debt.

"[D]ebt...was the price of liberty," Alexander Hamilton wrote in his first Report on Public Credit, delivered to Congress in January 1790. "The faith of America has been repeatedly pledged for it."

Hamilton, the nation's first Treasury secretary, insisted the U.S. make good on its combined $75 million in federal and state obligations.

The old debt was replaced by 6% government notes, financed by federally imposed tariffs and excise taxes.

"The proper funding of the present debt, will render it a national blessing," wrote Hamilton, who predicted that within 20 years U.S. bond yields would fall to 4%, closer to rates in Europe at the time.

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Hamilton's program established the U.S. as a sound source of credit, and trading in the bonds helped turn Wall Street -- his old neighborhood -- into America's financial center. By February 1792, the bonds were selling for $1.20-on-the-dollar.

It was a choppy early ride, but yields finally fell to 4% in 1835, when President Andrew Jackson paid off the national debt for the first and only time in U.S. history.

It didn't last. Debt grew and yields spiked after the U.S. invasion of Mexico in 1846, and again with the Civil War two decades later.

Financier Jay Cooke helped pay off the war debt with a nationwide campaign marketing "5-and-20s," 6% government bonds that had to be held for five years and stopped paying interest after 20. There was also a 10-year bond paying 5%.

"A national debt, a national blessing," was a Cooke slogan, echoing Hamilton.

And much as Hamilton had established America's credit, Cooke both re-established it and created the blueprint for modern investment banking.

Outside of a jump around World War I, yields followed a long, downward trajectory after the Civil War until bottoming out at the end of World War II, at 1.7%.

On a longer time scale, yields have generally been falling since at least 1350, when Dutch perpetual bonds paid 10% to 12%. This reflects a world in which risk has, on the whole, been decreasing -- fewer conflicts, better governments, improved financing, rising standards of living. It's the whole package of civilization.

But the march of civilization doesn't follow a straight line, and neither does the cost of borrowing money.

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Signs of rising inflation started showing up in late-1960s America, amid increased spending on the Vietnam War and the Great Society social program. Two 1970s energy crises fed the price escalation. Investors demanded higher and higher yields in response, since inflation eats away a bond's value over time.

Days after his 1979 "malaise" speech, Carter nominated Paul Volcker to be Federal Reserve chairman, with a promise to raise lending costs until it hurt. The pain was felt throughout the nation.

Barron's wrote in 1984 of a homeowner with a variable-rate mortgage, on which he had been paying 10%.

"It was time to renegotiate with his friendly banker," we wrote April 23, 1984. "The money was available, but only at nearly 22%."

The situation isn't as bad now. Thirty-year mortgages surpassed 7% this August, up from around 2.8% in 2021, rising along with yields on Treasuries and government bonds worldwide. Risks have grown, with military conflicts in Europe and the Middle East, the U.S. and China engaged in a trade war, and an energy crisis driving up the cost of everything.

On top of it all, America's $40 trillion debt load has pushed the ratio of debt to gross domestic product to a record 120%. In contrast, Hamilton's $75 million represented around 30% of GDP, according to modern estimates.

Today, it's Scott Bessent and Kevin Warsh, Hamilton's and Volcker's current successors at Treasury and the Fed, who must find a way to keep the economy humming while slowing inflation at the same time. It's no easy task.

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As Poor Dick would say, he that goes a borrowing....

Write to editors@barrons.com

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