Financial Commentary

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Wealth Management

Interest rate increases can be taxing

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In my last newsletter, I discussed the increase in bond interest rates that we've observed this year, and some of the factors driving rates higher. In this newsletter, I'm going to point out some of the increasingly visible ways that higher interest rates are filtering through the global economy. I'll also share my thoughts on the implications of higher rates for the future, and how to position investments to manage through this.

One of the most visible impacts of higher interest rates is the fiscal strain in France, which recently led to widely publicized protests that devolved into property destruction and looting. With interest rates rising, investors have fretted over the ability of France's gridlocked government to pass spending cuts. French Finance Minister Roland Lescure has announced that the French government is prepared to invoke a clause of the French constitution which allows for passage of laws without a vote in the National Assembly, in order to push through $48 billion in spending cuts for 2027. The situation in France is an example of how societies have become hooked on government borrowing to finance unsustainable spending, and the challenge of cutting back on spending when debt levels become difficult to manage.(1)

Of course, France is not alone when it comes to an overspending government. Recent financial headlines have also called out the UK government's need to cut spending. Here at home, the U.S. government has had its own problems with overspending over the past several decades, which has pushed U.S. government debt to over 100% of GDP this year, up from 31% in 1980. Last month, I cited the burgeoning U.S. debt load as one of the factors that has caused the recent increase in interest rates. In fact, the U.S. is neck and neck with France in the IMF's ranking of countries by public debt to GDP. The advantage the U.S. has over France is the U.S. dollar is still considered the world's reserve currency, and investors are still buying Treasuries. If that starts to change at some point, you have to wonder in what ways Americans will adjust. The looming insolvency of the Social Security retirement trust fund in 2032 will be an interesting test case, as Americans will be forced to either vote for changes to shore up Social Security's finances, or face an approximate 20% reduction in benefit payments.(2)(3)(4)

So, we've started to see higher interest rates filter through national finances. As an American, perhaps the most visible impact of all from increased interest rates is the volatility on display in U.S. financial markets over the past few months. You probably know that over the past several years, the U.S. economy has experienced a tremendous amount of spend on infrastructure in support of "Artificial Intelligence" (if you haven't heard about this, I'm slightly jealous of your lifestyle).

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Well, the spend on infrastructure for artificial intelligence has proceeded at a breakneck pace, in sort of a “shoot first, ask questions later” manner. By that, I mean that investors haven’t asked for much in the way of details of how the companies spending trillions on AI infrastructure will make enhanced revenue and profits from the money they’ve spent. The increase in bond interest rates over the past couple of months has spooked investors. Higher interest rates make it more expensive to borrow and finance the continued spend on AI infrastructure, and investors have grown nervous about the ability of the different stakeholders to continue their spend and keep the boom going. We’ve seen these concerns filter through the stock prices of several companies investing in AI infrastructure, as recent earnings don’t appear to have lived up to investor expectations. Of course, we’ve seen these types of jitters in the past, so we can’t know whether they represent a durable change in investor sentiment versus a passing spasm of fear.(5)

Considering the different risks stemming from higher interest rates, how should an investor position themselves? Investing is all about managing multiple risks at the same time. While fear about bubbles, market corrections, and market crashes grab the headlines, other factors, like inflation, quietly destroy wealth. For example, I’ve never seen a headline stating that inflation has destroyed your wealth by 53% over the past 30 years. But that’s exactly what’s happened. And unlike market crashes, which have historically recovered over time, the 53% wealth destruction from inflation is permanent.(6)

Why am I bringing up inflation? As I mentioned earlier, higher interest rates will make it more expensive for the U.S. to service our debt. We’re already heading towards a situation with Social Security over the next few years that will require difficult decisions. But as shown by the turmoil in France, society has gotten used to high benefits and low taxes, and both are difficult to change. That’s why I continue to believe inflation will play a meaningful role in managing the U.S. government debt. By allowing inflation to run, a government can decrease the value of its existing debt.

I look at inflation as an indirect tax. Allowing inflation to run is a way of making existing debt worth less, without having to raise taxes or cut spending. It’s a tax because it increases the cost of everything. It’s indirect because no government official appears on TV and announces they’re going to let inflation run in order to manage the debt. Instead, letting inflation run is done quietly within the walls of the Federal Reserve.

When you consider an asset allocation to carry you through the future, it’s important to consider your risk tolerance and financial market volatility. But it’s also critical to consider the role inflation will likely play in managing our government debt. Crashes and corrections are temporary if you have access to the right advice and don’t make the wrong decisions. Losses from inflation are permanent. Managing these different risks involves trade offs, since the investments shown to best protect against inflation also come with a greater degree of volatility. I encourage you to consider all of these factors, along with your risk tolerance, when considering your asset allocation.(7)

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Sources: (1) The Wall Street Journal 10/7/26. (2) The Wall Street Journal 10/11/26. (3) The Federal Reserve. (4) Committee for a Responsible Budget. (5) The Wall Street Journal 11/5/26. (6) Bureau of Labor Statistics. (7) Jeremy Siegel: Stocks for the Long Run.

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