First Trust
Monday Morning OUTLOOK
March 4th, 2013

630-517-7756 • www.ftportfolios.com

Rising Interest Rates Won't Cause Fiscal Armageddon

Brian S. Wesbury – *Chief Economist*
Robert Stein, CFA – *Senior Economist*
Strider Elass – *Economic Analyst*

The fiscal situation in Washington is still a mess; deficits and spending are still way too high, but both spending as a percent of GDP and annual budget deficits are declining. After peaking at more than $1.4 trillion in 2009 our forecast for this year is a deficit of about $830 billion, or 5.1% of GDP. At the same time spending has fallen from over 25% of GDP at its peak to near 22%.

Long-term, that's not good enough. Even if deficits keep falling in the next few years, spending on Social Security and Medicare is set to soar. If those programs aren't reformed, we will eventually be swamped with either too much debt or growth-killing tax hikes.

For those who need a more immediate threat to satisfy their economic hypochondria, some bears have been harping on a different budget threat. The idea is that Bernanke's artificially low interest rates have covered up a serious problem. And once those rates go back to normal, interest costs are going to soar and – poof! – there goes all the progress on the deficit.

Right now the federal debt is $16.5 trillion, so, in theory, a 1 percentage point increase in rates mean an extra $165 billion in annual interest payments. That's a huge potential jump considering net interest for the federal government was $223 billion last year.

But this theory has holes. First, the relevant debt for calculating the impact of a change in rates is not the total $16.5 trillion debt. That includes debt the government owes itself (like for the Social Security Trust Fund) plus debt owned by the Fed (the interest gets paid back to the Treasury). Excluding these, leaves roughly $10 trillion, which means an extra 1 point in rates would add $100 billion to the deficit, not $165 billion.

Second, investors would be wrong to assume "normal" rates must be many multiples of what Treasury now pays. *New* Treasuries have very low rates. But much Treasury debt was issued back when rates were higher. As a result, the average interest rate on marketable debt is now around 2%.

The Fed thinks short rates will eventually go to a 4% average while long-term rates rise to 4.5%. Let's split the difference and say Treasury will eventually have to pay 4.25%, rather than 2%. If so, net interest, which is now 1.4% of GDP will rise to 3% of GDP, roughly the same as it was for much of the 1980s and 1990s, when the economy was doing quite well.

Last, and often overlooked, is that if interest rates are rising then the economy is probably stronger. This would mean tax revenue is rising faster as well. So any boost in interest costs would be offset somewhat by higher receipts. For example, an extra 1 point in real GDP growth *for only one year* should add more than $30 billion per year in revenue.

On the downside, it's true that rates may go even higher than the Fed now thinks, but with an average debt maturity of about 5 years, it also takes time for higher rates to feed through to higher interest costs.

Again, we are not suggesting things are fine with our country's fiscal situation. But among all our fiscal challenges, the last one we should obsess about is a crisis happening when the economy is better and the Fed is finally raising rates. The pouting pundits of pessimism are over-reacting once again.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
3-5 / 9:00 am	ISM Non Mfg Index - Feb	55.0	**56.0**		55.2
3-6 / 9:00 am	Factory Orders – Jan	-2.2%	**-2.0%**		+1.8%
3-7 / 7:30 am	Initial Claims – Mar 2	355K	**355K**		344K
7:30 am	Q4 Non-Farm Productivity	-1.6%	**-1.6%**		-2.0%
7:30 am	Q4 Unit Labor Costs	+4.3%	**+4.6%**		+4.5%
7:30 am	Int'l Trade Balance – Jan	-$43.0 Bil	**-$43.3 Bil**		-$38.5 Bil
2:00 pm	Consumer Credit– Jan	$15.0 Bil	**$16.0 Bil**		$14.6 Bil
3-8 / 7:30 am	Non-Farm Payrolls - Feb	160K	**192K**		157K
7:30 am	Private Payrolls – Feb	167K	**197K**		166K
7:30 am	Manufacturing Payrolls – Feb	8K	**20K**		4K
7:30 am	Unemployment Rate – Feb	7.9%	**7.8%**		7.9%
7:30 am	Average Hourly Earnings – Feb	+0.2%	**+0.2%**		+0.2%
7:30 am	Average Weekly Hours - Feb	34.4	**34.4**		34.4

Consensus forecasts come from Bloomberg. This report was prepared by First Trust Advisors L. P., and reflects the current opinion of the authors. It is based upon sources and data believed to be accurate and reliable. Opinions and forward looking statements expressed are subject to change without notice. This information does not constitute a solicitation or an offer to buy or sell any security.