First Trust
Monday Morning OUTLOOK
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November 16th, 2015

Rate Hikes Won't Cause Debt Spiral

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Over the past several years, we have battled one economic scare story after another, from the damage that commercial real estate was going to cause, to the double-dip recession that was supposed to happen when the "hidden inventory" of unsold homes finally came to market. We've thrown cold water on recession talk when the Federal Reserve decided to taper and end quantitative easing and when bad weather temporarily hit the data.

We've been optimists. Not wild-eyed optimists looking for unicorns and rainbows, but clear-eyed optimists forecasting a resilient Plow Horse economy.

Faced with the horrible terrorist attack in Paris on Friday, it's clear that the civilized world is increasingly vulnerable to mayhem caused by those who don't support (but will take advantage of) the freedom offered in Western societies. Last Friday will not be the last battle between these terrorists and the West. It may get worse before it gets better, but we have faith that once sufficiently roused, the West will win.

In the meantime, we're certain that many investors will soon harken back to more mundane fears about the economy. In particular, with the Fed likely to start raising rates in December, one of the fear-mongers' favorite theories is about to be put to the test.

Over the past several years, we've heard many investors say that once the Fed raises rates back to normal, the federal debt is going to spiral out of control. The idea is that the US federal debt is $18.6 trillion and interest rates have been held down around 1% in the past several years (0% on the short-end and around 2% on the long-end). So, let's say rates go back up to 4%. That's 3 extra percentage points on $18.6 trillion, which brings the extra debt service to about $560 billion per year.

So, the theory goes, once rates return to normal, we'll be back to annual trillion dollar deficits as far as the eye can see. In turn, that'll buy the US a one-way ticket to economic collapse, but with no one big enough to bail us out.

But there are two major problems with this theory. First, not all the debt generates negative cash flow for the federal government. About $5.2 trillion of the debt is owned by the federal government itself, in accounts like the Social Security Trust Fund. And when the government pays interest on this debt, it's counted as gross interest, but no money actually leaves the government's coffers, so it's not counted as net interest. That leaves $13.4 trillion in debt that generates net interest.

Second, although newly-minted debt has been selling at very low yields the past several years, the national debt doesn't just include those relatively new securities but also debt that dates back decades. And if you weigh all the outstanding debt, both the new and the old, the average interest rate is already 2%. So if interest rates eventually go back up to 4%, it's not three extra percentage points on $18.6 trillion, it'd be two extra points on $13.4 trillion. So the extra debt service is $270 billion per year, a little less than half of the $560 billion calculated earlier.

To put this in perspective, an extra $270 billion means debt service would go up by 1.5% of GDP. But debt service in Fiscal Year 2015 was only 1.3% of GDP, the lowest in almost 50 years. Adding 1.5 points to last year's level would raise debt service to 2.8% of GDP, no different than the average in the 1980s and 1990s.

Eventually the Fed is going to raise rates enough to push up the average interest rate on federal debt and government debt service will head higher as well. In other words, the fear-mongers aren't completely wrong.

But they are grossly exaggerating the impact. Higher rates are just going to take us back to where we were in previous decades when the US economy proved it could not just survive, but thrive.

Sometimes, awful events come to pass. We can't underestimate the importance and horror of what happened in Paris last Friday night. Those are the kinds of dangers we have to be vigilant about, not another tale of economic doom that isn't going to happen.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
11-16 / 9:00 am	Empire State Mfg Survey – Nov	-6.5	**-5.5**	-10.7	-11.4
11-17 / 7:30 am	CPI – Oct	+0.2%	**+0.1%**		-0.2%
7:30 am	"Core" CPI – Oct	+0.2%	**+0.2%**		+0.2%
8:15 am	Industrial Production – Oct	+0.1%	**+0.1%**		-0.2%
8:15 am	Capacity Utilization – Oct	77.5%	**77.5%**		77.5%
11-18 / 7:30 am	Housing Starts – Oct	1.160 Mil	**1.157 Mil**		1.206 Mil
11-19 / 7:30 am	Initial Claims – Nov 14	270K	**270K**		276K
9:00 am	Philly Fed Survey – Nov	-0.0	**-2.1**		-4.5