First Trust
Monday Morning OUTLOOK

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Higher Rates Won't Cause Debt Spiral

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For decades, investors have feared the national debt growing to unsustainable levels and destroying the US economy. Back in 1981, the public debt of the federal government was $1 trillion; today it's more than $21 trillion. At some point, their theory goes, additional debt is going to be the fiscal straw that breaks the camel's back.

The problem with this theory is that, in spite of the record high debt, the *net interest* on the debt – the cost to government to satisfy interest payment obligations – was only 1.4% of GDP last year, hovering near the lowest levels in the past 50 years.

One reason net interest remains so low relative to GDP is that the government itself owns about $6 trillion of the debt, and this doesn't even include the debt owned by the Federal Reserve. So, the "net debt," also known as the "publicly-held debt," is roughly $15 trillion.

The other reason, of course, is that interest rates have been very low.

So now - the pessimistic theory goes - with interest rates rising, it won't be long before interest costs spike upward, meaning the government will have to borrow just to pay the interest on the debt. They envision a debt spiral like Greece faced a few years back, but with no one big enough to bail us out.

But the pessimists are wrong again, here's why:

Today, the average interest rate on the publicly-held debt is roughly 2%. So, let's say at the close of business on Tuesday the entire yield curve moves up to 4%. And let's also assume that the following morning the Treasury Department rolls over the government's entire debt complex at that new higher rate of 4%, even though the average maturity of the outstanding debt is about six years.

Doubling the interest rate to 4% would mean net interest relative to GDP would double as well, going from 1.4% to 2.8%. That certainly wouldn't be pleasant, but it'd be no different than the average net interest on the national debt from 1981 through 1999. Then, as now, the US government was fully capable of issuing new debt and paying its bills without putting the economy at risk.

Don't get us wrong. We're not happy about the federal debt being so high. In fact, we'd prefer it to be much lower. We're just explaining that the higher interest rates we're likely to see in the next few years are not going to generate a fiscal crisis.

Even better would be if the federal government took steps to lock-in what are still relatively low borrowing costs by lengthening the debt, issuing a higher share of 30-year Treasury bonds, introducing 50s, and even considering 100-year debt. If Belgium, Austria, Ireland, Mexico, and even Argentina can sell 100-year debt, so can we. But even if no changes are made, investors should scratch a debt spiral off their list of worries.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
5-30 / 7:30 am	Q1 GDP Preliminary Report	2.3%	**2.2%**		2.3%
7:30 am	Q1 GDP Chain Price Index	2.0%	**2.0%**		2.0%
5-31 / 7:30 am	Initial Claims May 20	228K	**223K**		234K
7:30 am	Personal Income – Apr	+0.3%	**+0.3%**		+0.3%
7:30 am	Personal Spending – Apr	+0.4%	**+0.4%**		+0.4%
8:45 am	Chicago PMI	58.2	**56.6**		57.6
6-1 / 7:30 am	Non-Farm Payrolls – May	190K	**185K**		164K
7:30 am	Private Payrolls – May	190K	**185K**		168K
7:30 am	Manufacturing Payrolls – May	20K	**15K**		24K
7:30 am	Unemployment Rate – May	3.9%	**3.9%**		3.9%
7:30 am	Average Hourly Earnings – May	+0.2%	**+0.2%**		+0.1%
7:30 am	Average Weekly Hours – May	34.5	**34.5**		34.5
9:00 am	ISM Index – May	58.2	**58.2**		57.3
9:00 am	Construction Spending – Apr	+0.8%	**+0.8%**		-1.7%
Afternoon	Domestic Car/Truck Sales – May	13.2 Mil	**12.8 Mil**		13.1 Mil