First Trust
Monday Morning OUTLOOK

Brian S. Wesbury – *Chief Economist*
Robert Stein, CFA – *Dep. Chief Economist*
Strider Elass – *Senior Economist*
Andrew Opdyke, CFA – *Senior Economist*
Bryce Gill – *Economist*
Nate Gerze – *Economic Analyst*

630-517-7756 • www.ftportfolios.com October 7, 2024

The Politics of Limits

The federal debt is already $35 trillion and currently rising by roughly $2 trillion every year – with no end in sight. As a result, some investors are worried that the US could become a 21st Century version of Argentina: completely bankrupt and unable to pay the bills.

We don't think that's going to happen. It's not that the national debt doesn't matter, it does matter. Instead, it's because the recent surge in the interest on the national debt is going to have big effects on government policy.

The best way to measure the manageability of the national debt is not the top-line debt number, $35 trillion in the case of the US. Instead, it's the net interest cost of that debt relative to GDP. Think about it like a national mortgage payment relative to national income.

Back in the 1980s and 1990s the US was regularly paying Treasury bondholders roughly 3.0% of GDP. From Fiscal Year 1982 through 1998, the interest cost on the debt relative to GDP hovered between 2.5% and 3.2%. At this level, even politicians felt the pain. Both parties enacted policies that led to budget surpluses and interest costs relative to GDP plummeted. Between FY 2002 and 2022 the interest burden averaged roughly 1.5% of GDP and stayed between 1.2% and 1.9% of GDP.

We call this period the "Age of Candy." What happened during the Age of Candy? We cut taxes in 2001, 2003, and 2017. In 2004 the US added a prescription drug benefit to Medicare. In 2010, with Obamacare, we enacted the first major expansion of entitlements since the 1960s – not by coincidence, another period when the interest burden on the debt was low.

Why did all this happen? We are sure others can come up with plenty of ideas, too. But we think a large factor is that when the interest burden of the debt was low (which meant they didn't have to pay bondholders as much) politicians realized they had a lot of extra money sitting around to buy our votes. And that's exactly what they did.

But the Age of Candy is finally coming to an end. In FY 2023 the interest burden hit 2.4% of GDP, the highest since 1999. And in FY 2024, which ended exactly one week ago, the interest burden is on track to hit 3.0% of GDP, the highest since 1996.

In the twelve months ending in March 2021, net interest totaled $315 billion. In the past twelve months it's totaled $872 billion. That's an increase of 177% in less than four years.

A big part of the problem is that the Federal Reserve was holding interest rates artificially low. The Treasury Department could have issued long-dated debt to lock in lower interest rates for longer. But like homebuyers between 2004-2007, they borrowed at short-term rates, which were even lower and that meant more room in the budget to spend, spend, spend.

High inflation finally forced the Fed to raise interest rates back to normal levels. Unfortunately, this inflation only represents part of the problem. The bigger long-term problem is that by holding rates artificially low, the Fed fooled politicians into believing the cost of deficits was minimal. Hopefully, America will look back on this period and realize that Fed policy and all that spending was a mistake.

Ultimately, however, we think the spike in the amount that the government has to pay bondholders will lead to more focus on controlling the budget deficit in the years ahead. Unlike the homebuyers who defaulted on their mortgages in the Great Financial Crisis, government can buy itself time. During the period from 1982-1998, the Politics of Limits took place.

Think about what lawmakers did during that timeframe. In 1982, there was a bipartisan deal to raise the payroll tax. In the mid-1980s we had a bipartisan trio of Senators (Gramm-Rudman-Hollings) push legislation to try to control the growth of spending. In 1990 George Bush the Elder cut a deal with the Democrats to violate his "no new taxes" campaign pledge, raise taxes, and set spending caps on military and social spending. Then Bill Clinton and Congress raised taxes even more, kept the Bush-era spending caps in place, and reformed Medicare and welfare to reduce spending.

That was the Politics of Limits. Don't be surprised if by 2026 the bond market vigilantes have their machetes fully sharpened and once again bring politicians to heel. The Age of Candy is coming to an end. Will politicians react the same way in the years ahead? We hope so, because if they don't inflation will not go away and investor fears may be warranted.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
10-7 / 2:00 pm	Consumer Credit – Aug	$12.0 Bil	**$7.4 Bil**		$25.5 Bil
10-8 / 7:30 am	Int'l Trade Balance – Aug	-$70.5 Bil	**-$70.4 Bil**		-$78.8 Bil
10-10 / 7:30 am	Initial Claims – Oct 5	230K	**225K**		225K
7:30 am	CPI – Sep	+0.1%	**+0.1%**		+0.2%
7:30 am	"Core" CPI – Sep	+0.2%	**+0.2%**		+0.3%
10-11 / 7:30 am	PPI – Sep	+0.1%	**+0.1%**		+0.2%
7:30 am	"Core" PPI – Sep	+0.2%	**+0.2%**		+0.3%