Is Student Debt The Next Bubble To Burst?

SYNOPSIS

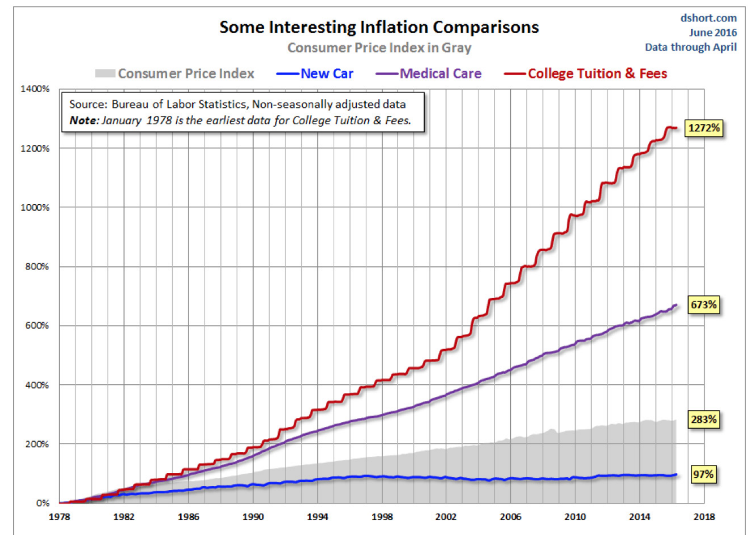
- Consumer debts have risen dramatically over the last six years, and many fear mongers consider this to be the next bubble to burst and take down our economy.
- Although consumer debt has been rising, it's not the amount of debt that matters but rather if one can afford his/her debts.
- Student loans have created a headwind for those saddled with too much debt, but for the most part, consumers and the economy are doing fine.

CONSUMER DEBTS ARE RISING

One of the big fears circulating the internet and financial news networks is an impending consumer debt crisis supported by two theories:

1. Borrowing has fueled most of the economic growth since the financial crisis. Consumer credit is up $1.1 trillion since mid-2010 through May 2016 (the largest increase in such a period), which cannot be explained as anything other than a "credit binge."
2. Student loans are the next "bubble," as the amount of debt has exploded by 275% since mid-2010, which accounts for two-thirds of the $1.1 trillion. Consumers will never pay these loans off, let alone afford to buy a house, car, or any other goods on credit.

The chart below shows a rather dramatic visualizations of the rise in tuition costs.



Source: www.dshort.com

The gray shaded area in the chart represents the rise in the Consumer Price Index (CPI), which is one of the most closely-followed measures of inflation. This index tracks a basket of prices of specific goods in specific quantities, and the overall price rise/fall is what economists use to determine inflation levels over time.

Excessive debt is one of the most powerful ways to derail a country, company, or even an individual's finances.

Inflation has risen 283% since 1978, but the rise in college tuition and fees has risen 1,272%, which is 4.5 times larger. For Baby Boomers, paying for college was similar to buying a car. Today, it's more like buying a house!

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Excessive debt is one of the most effective ways to derail a country, company, or even an individual's finances. Therefore, debt accumulation must be closely watched to ensure that its use is kept under control.

However, one of the most important rules in debt analysis is that the total amount of debt on its own is utterly meaningless. Some of the most successful companies in the world carry billions in debt, and they continue to operate for decades with little risk of default.

***NOTE**: This week, Microsoft sold close to $20 billion in debt to fund its purchase of LinkedIn, and investors showed no signs of concern that this amount would adversely affect their financials. In fact, there was over $50 billion in orders, which allowed Microsoft to secure an even lower interest rate than initially expected.*

Debt must be put in context by using some tool of comparison, which is effectively what a bank does when a buyer applies for a mortgage. Banks compare the monthly mortgage against a salary to see just how much the mortgage will constitute of the total income.

For example, if two consumers apply for the same $1 million mortgage, but one makes $500,000 a year and the other $50,000, then the consumer with the higher income should be far better off. When it comes to consumer loans, we need to conduct a similar analysis by determining if consumers can afford their new debts.

Brian Westbury is a well-respected economist at First Trust, and according to his research, total personal income is up $3.2 trillion over the same time period stated above, which is well above the $1.1 trillion in debt accumulation.

In fact, consumers' monthly mortgage, rent, car, and credit card payments today have been hovering at the lowest share of income since the early 1980s. This phenomenon is a result of (1) incomes growing faster than debt and (2) low interest rates.

Simply put, most consumers can afford their debts even though they have risen precipitously over the last six years.

IMPLICATIONS FOR INVESTORS

Allow me to be crystal clear on where I stand on the issue of consumer debt. Just because the data indicates that the recent surge in consumer credit poses little risk to our economy from a financial perspective, doesn't mean I like it.

I do not condone the use of excessive debt. I hate watching our government spend like drunken sailors, and I certainly don't think that an 18-year old with zero credit history should be given $200k to study something that could almost never generate a return on investment.

There is also no question that there are some being held back because their income has not kept pace with their debt. Millenials in their late twenties and early thirties are still living at home with their parents, and many recent college grads will carry much of this debt to their graves.

However, these concerns on their own are isolated to a small percentage of the country and

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certainly cannot cause an $18 trillion economy to fall apart.

The bottom line is that student loans have created a headwind for those saddled with too much debt, but for the most part, consumers and the economy are doing fine.

Sincerely,

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