Global Financial Private Capital

Should Our Government Issue More Debt?

SYNOPSIS

- Politicians are some of the most egregious fear mongers out there, and we are knee-deep in their busy season at the moment.
- Although the spending is out of control, our country can more than afford its debt, and the odds of a real crisis in the next several decades is infinitesimally small.
- The government should stop wasting so much money but also take advantage of interest rates at these levels before they begin to rise.

FEAR THIS

Without question, one of the most contentious issues leading into the presidential election is the level of debt that our country has accumulated over the last decade.

Debt carries a negative connotation, but in the hands of disciplined borrowers, it presents little danger. Healthy debt markets are vital to our economy because loans allow us to buy homes to raise families, cars to commute to higher paying jobs, and tuition to learn marketable skills.

Furthermore, one person's debt is another's asset. Buying a house creates a liability for the homeowner, but it also creates a source of profit for the bank. Government and high-grade corporate bonds are purchased by those who need income in retirement and by insurance companies and pension funds in order to meet future liabilities. For all intents and purposes, without willing lenders and borrowers, our economy would never grow more than a snail's pace.

The problem is not the debt itself but rather how it gets used, and I don't think I have to convince many that our fearless leaders in Washington are the antithesis of disciplined. For years, both parties have spent like drunken sailors and in the process wasted trillions of dollars.

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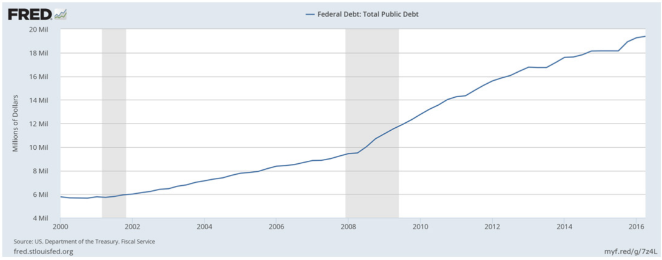
Politicians are a unique breed of fear monger, and they are acutely aware that any conversation regarding government debt becomes a lightning rod that strikes the emotional core of many Americans. They are masters at spin and have manipulated this story to their liking in order to get the only thing they want from any of us, which is our vote.

There is a big difference between irresponsible spending and a looming debt crisis, so let's first dispel the rhetoric being spewed by politicians and other fear mongers and then take a look at some recent events that offer insight into how our country could benefit from more debt.

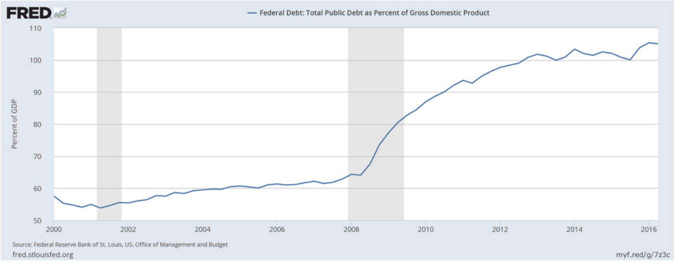
DEBT ANALYSIS

The chart below shows just how much debt has been issued by our government since 2000, which should come as no surprise to those who have watched the fiscal stupidity from both the Democrats and Republicans over the years.



The first rule in debt analysis is that the total amount of debt on its own is 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.

Debt must be put in context by using some tool of comparison. Some of the more sophisticated fear mongers love to use the debt-to-GDP ratio, which compares the total size of debt for the country to its annual GDP. The chart below shows that this ratio has also surged over the last decade, meaning the rate of new debt creation has exceeded the economic growth rate.



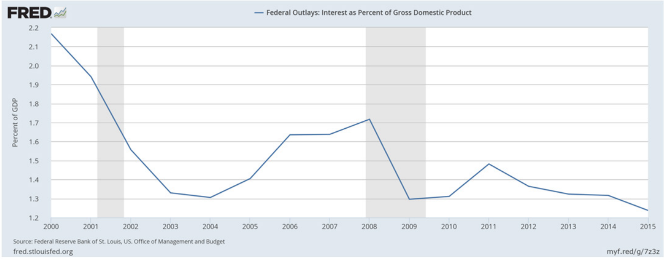
Currently, our debt-to-GDP ratio is slightly above 100%. Those who closely follow this ratio tend to get nervous around here, but on its own, it also carries no value.

Debt is an *amount* accumulated over several years, but GDP is a flow of income measured annually. Since the total amount of debt does not have to be repaid in a single year, it would be like criticizing a homeowner for not being able to pay off an entire 30-year mortgage with a single year of after-tax income.

Several countries have debt-to-GDP ratios that exceed 100% and are doing just fine. The U.K. has been above 100% for 84 of the last 173 years, and Japan has had the highest ratio in the world for decades, which is well above 200%. On the other hand, Russia has one of the lowest ratios in the world despite a dire economy.

The key to proper debt analysis, and what the fear mongers intentionally avoid, is to determine if the borrower can afford the debt. For example, if two neighbors have the same $1 million mortgage, but one makes $500,000 a year and the other $50,000, then the neighbor with the higher income should be far better off.

Within this context, the U.S. can easily afford its interest payments on outstanding debt. The chart below confirms this statement by comparing the amount of interest we owe (expense) against the country's GDP (income).



Despite the surge in debt creation, the interest we pay on that debt has been falling, not rising, over the last decade. Currently, less than 1.3% of our income as a country goes to paying interest on debt, which is extremely low.

For example, Italy and Portugal both exceed 5%, and they are considered to be "at risk" but still clearly operational. The U.S. would need to almost quintuple its interest payments while keeping GDP stagnant to come even close to the level of these two countries. The potential for our economy to average zero growth for enough years for this effect to take place is unlikely.

NOTE*: This analysis is similar to 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.*

The reason why our interest payments have remained anchored since the financial crisis has to do with artificially low interest rates (courtesy of the Fed). Even if interest rates continue to move higher, these payments remain fixed while our economy grows larger.

Simply put, the spending in D.C. is infuriating at times, but our country can easily afford its debt, and the chances of any real debt crisis in the next several decades is infinitesimally small.

SMARTER DEBT

Just this week, Italy issued over €5 billion in 50-year government bonds priced at a yield of 2.85% fixed. Buyers are now locked in for the next half century at a yield that is barely above any real measure of inflation from a country that is a complete and utter financial mess.

Shockingly, the demand was four times larger than the supply offered. Meaning, for every euro borrowed, investors were willing to loan them four euros, which is insane.

Italy is not alone, as governments across the globe are now able to lock in ultra-low borrowing costs that will span generations. Earlier this year, France issued a new 50-year security for the first time since 2010, while Ireland sold its first ever century bond in March. Yes, a century bond is a 100-year bond.

Ireland raised 100 million euros of bonds due in 2116 (not a typo) and locked in a rate of 2.35% (also not a typo) for the life of the bond. For scale, Germany's 10-year government bond offered around the same yield back in 2011. Said another way, five years ago, an investor could have seen similar returns in a bond that matured 90 years sooner.

Investors and market pundits are spending so much time trying to figure out who is buying and why, but does it really matter? It's not like this is the first time that irrational buyers have entered a market.

Sometimes it is best to ignore the "why" and take advantage of the situation, and there is a tremendous opportunity for our country at the moment. If entities are willing to loan our government that much money at such low rates for that long, then we should take on even more debt *under the condition* that it is used in a disciplined manner.

One example would be to raise cash to pay for infrastructure projects, which both Trump and Clinton have suggested throughout their campaigns. This is a great idea because infrastructure spending, when done correctly, is hugely beneficial to our economy because it creates jobs and other positive externalities.

NOTE*: Here's a fun fact. Nearly 10% of the country's bridges (58,495 out of 609,539) were considered structurally deficient last year and in need of repairs, according to the American Road and Transportation Builders Association.*

Spending on projects like these is akin to a company taking on debt to fund research and development, and the fruits of such labor could help our economy grow even faster, which could then lessen the need for more debt in the future to fund our entitlement programs.

The bottom line is that it sounds a bit whacky to think that even more debt could be a potential benefit to our economy, but it could work as long as politicians do right by their constituents.

Sincerely,

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