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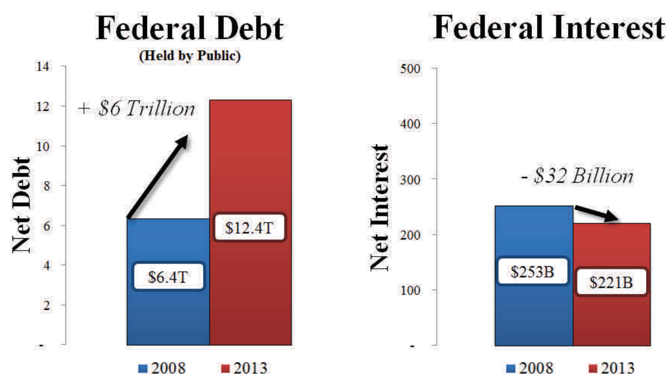
The Principal Principle

Given the six-year anniversary of the 2008 financial cataclysm it is instructive to assess what has since transpired with our nation's private and public debt. Our banking system is much stronger now – having paid down more than $3 trillion of its obligations – while our government has, largely due to its desire to help the banks, added an even larger amount of debt to its balance sheet[1]. This process has been financially energizing to the economy, but we are skeptical as to how long a model of unbalanced fiscal discipline can continue should the numbing camouflage of historically low, manipulated interest rates eventually dissipate.

More is Less?

First, let's lay out some numbers from the last six years with regard to federal debt (held by the public) and federal interest expense as reported by the Federal Reserve[1]:



Looking across the entire economy, the increased federal debt has been offset by a $3.2 trillion reduction in financial sector debt and a $0.7 trillion reduction in household debt. On a macroeconomic basis, the fact that our country essentially substituted more federal debt in exchange for smaller reductions in financial sector and household debt has thus far been nothing short of remarkable. Though corporate debt has increased (more on that later), our banking system is again strong; and the stock, bond, and real estate markets have all celebrated. Before pointing out the potential risks in the future, let's first draw a practical contrast between modern day Federal Government debt and the kinds incurred by banks, persons, states, corporations, and non-profit organizations.

Lacking Principal

The distinction is that unlike these other entities, the Federal Government has been able to issue increasing amounts of debt at ever lower interest rates, rather than being forced by the financial markets to pay it down or face injurious interest rates. If the principal of the federal debt is never actually paid down, then the only immediately apparent "cost" of borrowing is the annual interest paid. Federal interest expense does get accounted for in the federal budget, but as you look at the exhibit you see that this line-item has actually *gone down* in the last six years, despite the addition of trillions in new debt…something that is, shall we say, "quantitatively easy" to understand given the low interest rate environment the Fed created.

Thus, when banks faced high interest rates *and* trillions of principal maturities to repay, the fact it could be replaced by nearly twice as much federal debt, at extraordinarily low interest rates, was wildly stimulative. It is the same effect you would expect if consumers

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1) Federal Reserve Flow of Funds Statistical Release for First Quarter 2014. June 5, 2014

were told that they could spend more than they earn by getting low-interest loans without ever having to pay them off. (Sound familiar from the real estate crisis?) Just think how much more an indebted family could spend each month if theirs was an "interest only" world like Washington, D.C.

Incidentally, we did not include numbers for state and local debt since it has remained fairly constant over the last six years. Notable, however, is that non-financial corporations (like Johnson & Johnson and Walmart) have added almost $2.0 trillion in low-interest debt since 2008, and collectively bought back a comparable amount of their own shares with the proceeds[1]. This opportunity, created by historically low interest rates, is no doubt a contributor to the ongoing upward pressure on stock prices despite slow growth and continued underemployment.

In essence, then, the last six years of federal stimulus has resulted in benefits many have enjoyed, arguably without anyone having to directly pay for it. We expect this to continue in the short-term since we see no motivation on Washington's part to change since their practice of funding deficits with low "interest-only" loans has worked well… so far.

What If?

It is incumbent upon serious financial analysts to ask what happens if interest rates rise meaningfully? Older readers remember short-term interest rates of around 20% in the 1980s and cringe when they see that all this federal debt "costs" the government about 2% annually[2]. If interest rates were to rise to even 5%, we could see Washington wrestling with massive spending cuts and/or tax increases as they watch the budgeted interest burden grow in future years. Incidentally, since the federal interest payment may ultimately end up driving fiscal policy in the future, perhaps Congress should debate a cap on interest payments rather than having showdowns on the so-called debt ceiling limit?

To summarize the last six years, our banking system is much stronger, corporations have repurchased shares and lowered their debt costs, and consumers are buying houses and cars again with cheap financing. Meanwhile, the government has added trillions in debt that, so far, nobody is really paying for in the form of more taxes or lower federal spending. If interest rates were to rise significantly, it stands to reason that tax rates will likely go up and federal spending will have to be cut—something we are prepared for when positioning portfolios in ways that are not overly reliant on discretionary consumer or federal spending.

At Hamilton Point, we are greatly comforted that our banking system is strong again. Accordingly, we do not expect another shock equivalent to 2008 since the next adjustment—perhaps from higher interest rates—will not likely be met with bank failures, which turned a real estate correction into a full-scale Wall Street meltdown previously. We foresee that even mild future increases in interest rates may create buying opportunities in the markets and have been diligent in building a strong bench of companies that pass all of our quality screens, save for valuation. These stocks will be welcome additions to our buy lists of high quality Global Core and Equity Income holdings when the opportunity presents.

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Hamilton Point Investment Advisors, LLC is an independent and independent-minded wealth advisory firm. Please contact us for a complimentary review of your portfolio. In addition, visitors to the firm's website, www.HamiltonPoint.com, can read past investment newsletters.

1) Federal Reserve Flow of Funds Statistical Release for First Quarter 2014. June 5, 2014
2) Treasury Direct. Average Interest Rates on Marketable Securities as of August 31, 2014.

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