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Our Great Challenge Remains Unaddressed and Unsolved

To begin, a high-level summary of the "state of things":

- As noted in several past issues of *Consilium*, the equity market had already discounted a great deal of potential bad news by the end of 2022, possibly including a recession.

- A recession and a reversal of the Federal Reserve's highly restrictive monetary policy has been, and remains, our base case – but the economy has maintained impressive forward momentum despite significant headwinds, which persist.

- Inflation has fallen by roughly half from its peak last year but is still well above the Fed's 2% target range thanks to the interplay of strong service sector spending, job growth, and wage hikes. Fed Chairman Jay Powell has made it clear in the last week that the lack of labor market slack is his main focus. The dilemma is that a looser labor market may only come about with even more restrictive monetary policy. In short, Fed officials may say they don't want a recession, but they may need one anyway.

- This scenario suggests a bumpier road ahead for stocks, notwithstanding their strong performance in 2023 (with the S&P 500 index generating a total return of 8.7% in the second quarter and 16.9% year-to-date). At a time when stock valuations (especially on the very largest companies in the index itself) are as high as they had been at any time in the 15 years prior to the pandemic, a pause in the current rally/recovery would be completely reasonable.

- Still, we remain wary of over-reliance on traditional investing rules in the (extremely unique) current cycle. A wide range of outcomes is possible, and we are open to them.

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Although not a factor in the market's behavior over the intermediate term, we can be confident in stating that the US is on track toward an unsustainable fiscal future, which if left unaddressed will likely lead to much higher interest rates, lower private investment, diminished growth potential, and lower standards of living. We do not know when this outlook will begin to matter to investors, but with each passing year a financial reckoning draws closer.

What is the problem, and how did we get here? In the simplest terms, publicly held government debt is growing faster than the underlying economy that generates the tax revenue needed to service the debt. Each year the government is spending more than it takes in and borrowing to make up the difference. Although the surge in spending during the pandemic --followed by major new programs such as the "Inflation Reduction Act" -- is often blamed, our predicament actually began in the aftermath of the financial crisis.

First, the Fed maintained a policy of extremely low interest rates and easy financial conditions, designed to stimulate recovery from the 2008-09 downturn. Low interest rates masked the underlying buildup of fiscal pressure and left Congress and two presidents feeling no obligation to address it. And when the pandemic hit, any such concerns were discarded in favor of immediate economic relief. But interest on the debt is now rising sharply as the Fed has tightened policy over the last 15 months. Higher interest rates applied to higher debt balances are creating a toxic surge in debt service costs, which are now the fastest-growing government outlay, and set to represent 26% of all spending by 2051, up from 8% today.

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Second, the earliest Baby Boomers reached retirement age in 2011, and the number of new retirees will grow predictably and meaningfully every year until the end of this decade. These retirees are now drawing on their promised Social Security and Medicare benefits, the latter of which are turning out to be significantly higher than expected. Health care inflation continues unabated, and indeed the demand for health care is exploding due to rising retirements, longer life spans, and expanded benefits.

It quickly becomes obvious how difficult this problem will be to solve: the government cannot control its interest expenses, and without legislated benefit cuts, cannot control spending on retirees. These three out-of-reach categories will represent over 70% of the federal budget by 2051 and will significantly restrict the government's ability to do much else, including providing for national defense – or addressing a future pandemic.

The surging debt is best seen in relation to underlying GDP, having risen from about 50% in 2010 to almost 100% today, near the peak of 106% at the end of World War II. Our current fiscal policy trajectory puts the debt-to-GDP ratio at 200% by 2051. But is there a specific level that is likely to spook the markets? After all, Japan's debt is already 227% of GDP. We cannot know for certain, but the side effects of the debt buildup will slowly accumulate, regardless: the US government will "crowd out" other borrowers, diverting capital away from productive private investment toward the purchase of government bonds. With reduced private investment, worker productivity will be pressured, as will wage growth, and in turn consumer spending. It all adds up to an economy performing far below its potential, with concomitant effects on returns to equity investors.

There are three factors that could work against worst-case outcomes. First, there is no reason to believe the US will ever default on its obligations, all of which are denominated in dollars – which it can print, if needed. And as bad as things may be here, the US may be seen as "the least ugly horse at the glue factory", as most of the world's major economies face similar prospects, particularly China. There is little chance that the US dollar will be replaced as the world's "reserve currency".

Second, small individual improvements across multiple programs could combine to yield significant cumulative benefits. Various governmental entities estimate that up to $500 billion per year in taxes, rightly owed to the Treasury, are not being collected. Whether it requires hiring more IRS agents, or upgrading out-of-date technology, or altering the mix of revenues raised between consumption and income, Congress and the government should not pass on this low-hanging fruit. Further, it is estimated that Medicare and Medicaid are making nearly $250 billion per year in improper payments to health care providers, owing either to clerical error or fraud. Simply tackling these examples of government incompetence could reduce the long term debt buildup by nearly half.

Finally, if the US can somehow break free of its 18-year productivity slump, and restore productivity growth to a pace resembling that of the era before the year 2000, the long run benefit to economic growth and tax revenues would dramatically improve the fiscal picture. **Is it possible that AI holds out such a promise? A question we will undoubtedly address in some future issue of *Consilium*.**

Sources: GAO, OMB, CBO, Peterson Foundation, FRB St. Louis, McKinsey & Co., FactSet

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