Investment Commentary

June 2024

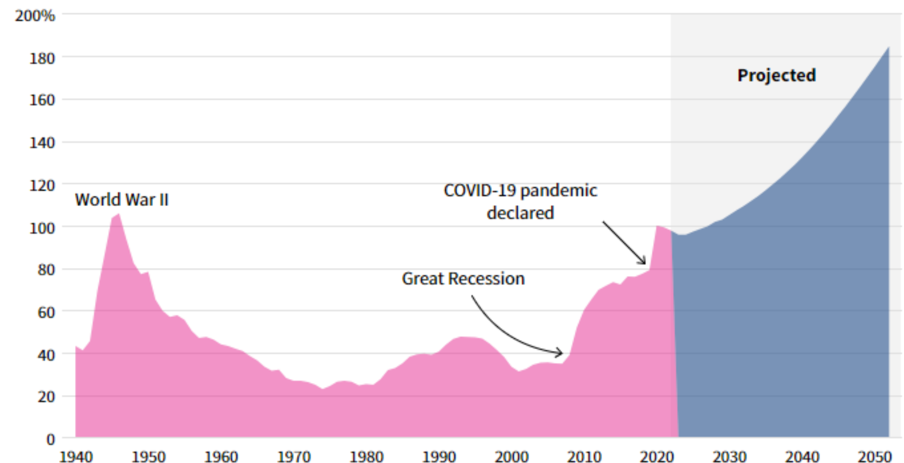
Stocks across the globe rallied in May after slumping in April. Bond returns also rebounded, as April inflation data was in line with expectations, and Treasury bond yields were down a little. Below is a brief recap of financial market activity in May:

- With strength from the technology sector and Treasury yields falling the S&P 500 was up close to 5%. Small-cap stocks performed slightly better and were up a little over 5% for the month.
- Foreign stocks were up 4% for the month, with European stocks leading the way up 6.5%.
- All sectors were up in May except energy, which was down slightly. The surprise performer was the utility sector with gains of 8% for the month.
- Annual U.S. headline CPI slowed to 3.4%, while core inflation (excluding food and energy) eased to 3.6%. As expected, Canada and the European Central Bank were the first G7 countries to cut interest rates in early June.
- With Treasury yields down for the month, U.S. core bonds were a solid performer with gains of 1.7%.

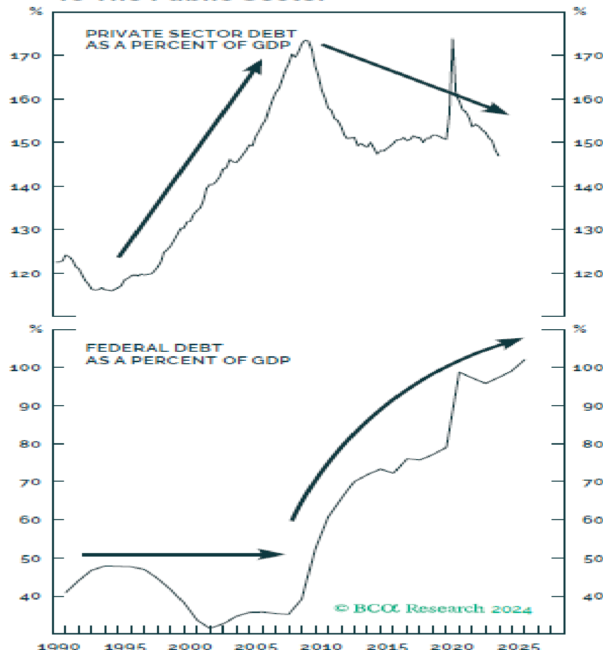
Below we touch on a couple of topics that we have been receiving a lot of questions about: **Is the growing level of debt in the U.S. a problem? Will Social Security run out of money?**

Is the growing level of debt in the U.S. a problem?

The short answer is no one really knows how much debt is too much or when it will become a problem. That is not a very satisfying answer, but it is the reality. What we do know is that Federal debt has grown dramatically since the Great Financial Crisis (GFC) of 2007-09. The chart to the right shows how current Federal debt levels have reached levels not seen since World War II and are projected to keep growing at a staggering pace in the decades ahead.

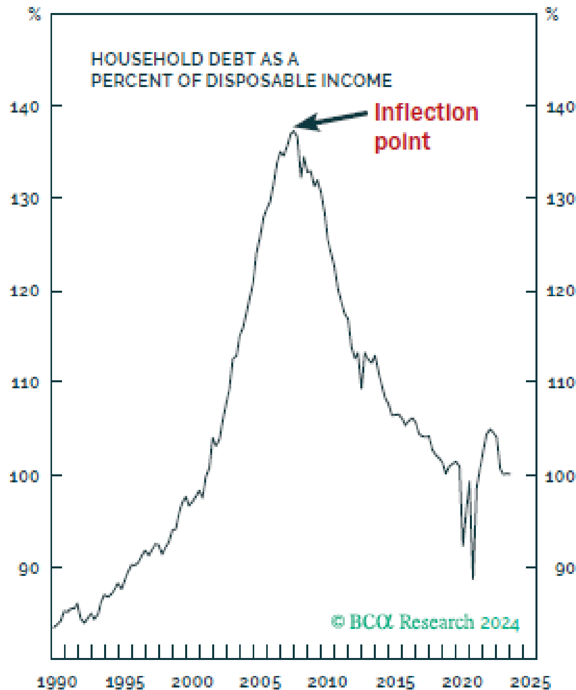


The GFC triggered an inflection point in the growth of debt for both consumers and at the national level. Post the GFC, consumers lost their appetite for taking on more debt and began tightening their belts, while the Federal government stepped in to fill the gap with excessive borrowing.



The chart to the right shows the decline in private sector debt compared to the explosion of Federal debt since 2008. The decline in private sector debt has left both consumers and corporations in much better financial shape than they have been in years. While the government's balance sheet has deteriorated.

The next chart shows how household debt as a percentage of disposal income is down sharply and close to its lowest level of the past 25 years. Overall, the private sector seems to be in pretty good shape.



Federal debt, however, seems to be on a more precarious growth trajectory. According to the Congressional Budget Office (CBO), if Federal debt stays on its current path, interest expense could account for roughly a third of government revenue by 2050. Although this path is unsustainable, no one knows when the financial markets will start to react to these numbers, it could be years down the road. Rather than trying to predict when the markets will react, here are a couple of things to keep an eye on.

Simply put, the limit to government debt will be reached when investors will no longer buy U.S. government debt at yields the economy can tolerate or when debt servicing costs (interest expense) reach unsustainable levels. With long-term interest rates currently around 4% the financial markets are clearly not worried about debt levels in the U.S. today. The interest expense is currently about 15% of revenue, again the markets seem to be taking this in stride. Rather than trying to predict when financial markets will negatively react to debt levels, we will focus on looking for signs that investors are refusing to buy Federal debt at reasonable interest rates or the interest expense becomes unmanageable.

Will Social Security run out of money?

If you have heard or read scary headlines about Social Security, it is easy to think it will soon be bankrupt. The reality is the Social Security Trust Funds are projected to run out of money in 2035, but under current law, Social Security will never fully run out of money and will never be bankrupt. The reason is that Social Security is funded by two sources:

- The Social Security Trust Funds, and
- FICA Taxes paid by workers and their employers

As long as employers and their workers are paying FICA taxes there will always be a source of funds to pay Social Security benefits. That is good news for people counting on Social Security income in retirement. The bad news is that unless Congress acts, benefits will need to be reduced in 2035 when the Social Security Trust Funds are projected to be exhausted. It is estimated that FICA taxes alone would only cover about 83% of the projected benefits payable to current and future beneficiaries, implying a 17% cut in benefits. Clearly, this would have an extremely negative effect on lower-income Americans counting on those funds in retirement.

There are only two ways to fix the problem, either raise more revenue (taxes) or cut benefits. Politically this is a 'hot potato', as no politician wants to be responsible for cutting the benefits of potential voters or raising taxes. Given the tightly contested presidential election this year we do not anticipate any actions taken this year, however, in the years ahead we expect this to be a hotly debated topic. There is a reasonable chance our politicians do nothing until the last moment, closer to 2035, and any solution will likely include a combination of higher taxes and reduced benefits.

In summary, the Social Security system will not run out of funds based on current law, but unless action is taken there will have to be significant cuts to benefits in the future.

If you have any questions regarding this commentary or your Social Security claiming strategy, please give us a call.

Best regards,

Steve Giacobbe, CFA, CFP®