Investment Insights

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Federal Budget Issues - Entitlements and Interest Rates

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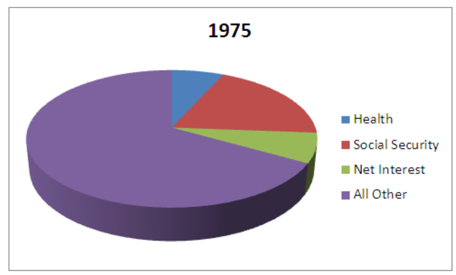
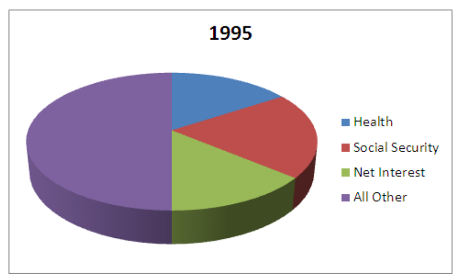
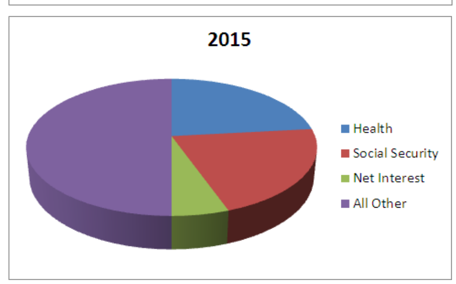
During the past five years we have seen a marked decline in the US federal budget deficit. After exploding to all-time highs of over $1 trillion for four consecutive years, the budget deficit for fiscal 2015 (ended on September 30, 2015) declined to $439 billion. While this is well below the levels earlier this decade (and the smallest deficit in absolute dollars since Fiscal 2007), there is a signficant chance that deficits will grow substantially beginning in the latter part of the decade. There are two major drivers of the budget deficit that put an increasing percentage of Federal spending on "cruise control" - entitlements and interest on the national debt.







As recently as fiscal 1975, total federal spending on all healthcare related issues - which includes Medicare and Medicaid - totalled 6.74% of overall spending. Social Security accounted for 19.46% of the budget, and interest on the national debt was 6.99% of spending. Debt stood at 24.5% of GDP. Moving forward 20 years to Fiscal 1995, spending on healthcare jumped to 17.27% while Social Security and interest on the debt consumed 22.16% and 15.31% of the budget, respectively. Debt was 47.5% of GDP.

The recently concluded Fiscal 2015 saw healthcare spending soar to 26.07% of the budget. Social Security spending rose marginally to 23.85% of Federal spending, while interest on the debt declined meaningfully to 6.10% of total Federal spending. This was due not to declining levels of debt, but rather to the artifically low interest rate environment we have been in since 2008. Debt is currently 75.1% of GDP. So even with current extremely low interest rates, over 56% of Federal spending is established before Congress begins working on the budget. The change in these programs can be seen on the charts nearby.

* All figures are sourced from www.whitehouse.gov

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Clearly, healthcare spending is continuing its relentless climb. This will not change under current law and assumptions. What will change is the rapidly growing portion of federal spending that will be required to pay interest on the debt. With the knowledge that interest rates will be moving at least modestly higher over the next several years, we can easily see the percent of the federal budget dedicated to paying interest on the growing levels of debt doubling from the current depressed levels. These will continue to squeeze out the available dollars for all other budget issues. With Congress and the Executive branch loathe to reduce spending, the obvious sources of funding become higher taxes and increased borrowings.

The most recent Federal budget projects net interest expense rising to over 11.1% of expenditures by Fiscal 2020, with spending on both Social Security and Healthcare continuing to tick higher. It is evident the increasing portion of Federal dollars going to these three areas is unsustainable.

As shown above, in the most recent fiscal year 56% of spending went towards Medicare, Medicaid, Social Security and net interest payments. Approximately another 11% of spending went towards non-healthcare entitlements such as welfare and food stamps. With a full two-thirds of the budget dedicated to these "untouchable" programs, the US could be headed for a budget disaster at some point in the next 10-15 years if these issues are not addressed.

While neither Congress nor the White House have had the intestinal fortitude to work on remedying these issues, we believe that modest changes scaled in over an extended period of time would significantly slow the growth trajectory in entitlement spending. Some widely discussed changes include slowly raising the retirement age, raising the wage base subject to social security taxes, and reducing the growth in benefits for the wealthiest of seniors. None of these changes are painless, but together they would help extend the solvency of Social Security. Medicare and Medicaid spending is more challenging due to their design, but these programs need to restructure to become closer to traditional healthcare insurance provided to most working people. Again, this will be challenging but changes must occur before the programs collapse under the sheer numbers of people in the programs. Combining these changes with pro-growth fiscal and economic policies would lead to higher than projected growth in GDP, and a subsequent amelioration of the expected rise in debt over the coming decades.

At Tandem we consistently focus on risk management of our clients' investments and do not advocate for either side of the political spectrum. This issue of **Investment Insights** was written to highlight one of the potential long-term risks for investors, rather than to endorse any particular solution.

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