FINANCIAL FOCUS

PETERSON FINANCIAL SERVICES

Limited Liability Company ◆ Registered Investment Advisory Firm

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LAST QUARTER WE WARNED OF GEOPOLITICAL RISKS TO THE MARKETS. EXCESSIVE GOVERNMENT SPENDING IS ANOTHER RISK.

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QUARTERLY MARKET RECAP

Gains from the first quarter moderated in their pace, but continued upward momentum. But performance was mixed as certain asset classes rose while some retreated. The Federal Reserve's much-anticipated loosening cycle has yet to commence and speculation is now focused on a much-diminished schedule of rate cuts. Inflation figures continue to improve but at a glacial pace. Market volatility remains eerily subdued as we enter the dog days of summer.

Last quarter the DJIA edged down 1.73% after breaching the 40,000 level in May. Other indexes continued to hit new all-time highs during the quarter. The S&P 500 added 3.92%, and the NASDAQ gained a strong 8.26%, moving it into the lead year-to-date. The small-cap Russell 2000 is still trailing, shedding 3.62%. Global stocks added 2.18% to round out the equities. The bond market is still searching for a peak in yields after many false starts during this year. The Barclay's Aggregate Bond Index was essentially flat rising 0.0068% last quarter. We expected an upside reversal during the last quarter, and that didn't happen. Continued healthy labor markets, corporate earnings, and economic growth will likely continue through the year, as very little will fundamentally change in this election year. But as we mentioned in the last letter, in 2026 income tax rates will alter.

WE SIMPLY CANNOT CONTINUE TO HAVE GOVERNMENT CONSUME SO LARGE A SHARE OF THE ECONOMY

Over the years until recently, we always limited our concern for federal budget deficits to their size as a percentage of GDP, not their absolute numerical value. That is still the case, as economically, that is what matters. But not only have they spiraled into stratospheric dollar values, they have also more than tripled on the percentage level. This is becoming dangerous, mostly because there seems no will on either side of the aisle to address this. Just as bad, we have become inured to the intrusiveness of the government into our lives, suggesting this will only get worse and lead to catastrophe.

Many suggest it was the 2017 tax legislation that has led to outsized deficits. But a quick study of the data puts a lie to that. In fact, revenues have never been higher. The Congressional Budget Office reports that revenues this year are in line with the pre-pandemic 50-year average of 17.2% of GDP. Since GDP is growing, the dollar amount of tax receipts is also growing. But they further report that spending will hit 24.2% of GDP this year and remain at that level for the next decade. That is the 7% gap that represents a tripling of the historical deficit of 2.3% - 2.5% of GDP over the post-WWII era. This can't continue. Federal government spending before the pandemic only exceeded 24% of GDP in one year after WWII. That was the 2009 Obama-Pelosi "stimulus" blow out. Now, it's the norm. Lest we make the mistake of concluding this is down to defense spending, note that we are currently at only 3.8% of GDP, and are projected to dive to a post-war low of 2.8% in 2034. And as we outlined last quarter, that's not enough to meet our needs in our increasingly dangerous world. The $964 billion we spend on defense has been eclipsed by the $1.02 trillion we spend on interest on the debt. It is now our highest line-item expenditure.

Obamacare subsidies, student loan forgiveness, housing subsidies, transfer payments, entitlement programs, mortgage subsidies, and many more are all exceeding their earlier cost projections, and the politicians keep loading on more. And this is just at the federal level. State and local government spending has also sky-rocketed, along with the taxes we pay. And we are paying them. If spending as a share of GDP remained at pre-pandemic levels, the federal deficit would be $890 billion this year and the debt would be $13.4 trillion smaller than the CBO's 10-year projection, and the overall debt held by the public would be around 90% of GDP, not the 122.4% they calculate it will be. Keep in mind there is another $10 trillion of debt held by governments on top of all this, and it must be paid back someday as well.

The end of the pandemic emergency should have led to a reduction in all the excess spending we were told was necessary but temporary. But it hasn't. Medicaid enrollment has stayed stubbornly high in Democrat-led states where they still have many able-bodied people enrolled, even though they are no longer eligible. The CBO increased its forecast for Medicare spending by $50 billion this year and $314 billion over ten years. Fraud and waste go uninvestigated and uncorrected. It just never ends. And it's inefficient – it does not add to production or our national wealth.

The trajectory is illuminating. The CBO's economic outlook report projects another $22 trillion of debt will be added to the existing heap of $35 trillion over the next decade. At that time, debt service alone will exceed $1.7 trillion annually, if interest rates don't rise. As the government consumes more of the credit available in the markets, interest rates will rise for everyone. Annual Social Security outlays will rise an additional $1 trillion over the next decade, as will those for Medicare.

The two presidential candidates aren't talking about this. In fact, they've both ruled out any discussion of reining in entitlement programs, which are the drivers of these expenses. And senators and congressmen of all stripes appear to be in a spending bidding war with each other. And, in a year and a half, our current tax rates will expire and revert back to the higher Obama-era rates. This will be a burden on the economy that could cause a recession. The default option will be to let this happen because politicians are not known for being profiles in courage.

The real solution lies in making the hard choices about spending other peoples' money efficiently and justly. All of the rest of us must do this. We only have so much income to allocate to our priorities. As a result, we can't buy everything we want, all the time. But government has no such constraints because we don't hold the big spenders accountable at the ballot box. We've got to repeal the really damaging legislation, such as the Orwellianly-named Inflation Reduction Act. Tax rate increases won't solve the problem for two main reasons: revenues are not the problem because they aren't lagging, and rate increases never bring in the projected benefits because it hinders economic activity. Rate cuts, on the other hand, stimulate investment and grow the economy as a smaller rate levied against a larger amount, results in more actual income. But that must be coupled with spending restraint, and this has been the failure for decades. The pay day is coming.

Our freedom and sense of personal responsibility are being whittled away dollar-by-dollar. Entire generations of Americans have no problem living off the fruits of others' labors. Too many people are riding in the wagon and too few are still pulling it, and that gets worse each year.

"If a man is not a socialist by the time he's 20, he has no heart. If he is not a conservative by the time he's 40 he has no brain."

- Sir Winston Churchill

ABOUT PETERSON FINANCIAL SERVICES, LLC

As an aside, we wish to remind our clients of our various services. While we specialize in portfolio management, we continue to provide financial planning and insurance services. Longtime clients may have forgotten this, and newer clients may not be aware of this. Additionally, we build our business through referrals, and much appreciate them. Please keep us in mind as you come across friends, family and colleagues who might benefit from our financial services. We appreciate your business.

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