It’s All About Medicare

It’s been another excellent year for both the U.S. stock and bond markets. For 2012, the S&P 500 Index was up 16 percent while the Barclays Aggregate Credit Index was up 8 percent. Although the uncertainty of the presidential election did cause a decline in the stock market this fall, the market rallied 6 percent in the last six weeks of the year.

Of course, the real issue is what’s going to happen in 2013 and beyond. While markets have been volatile lately, particularly due to the focus on the “fiscal cliff,” we’re actually optimistic that we will have positive but below average stock returns in the coming year. We have decent valuations as the S&P 500 is trading at 14 times last year’s earnings, respectable but not great expected earnings growth, reasonable expectations about the economy that we should be able to satisfy, continued stimulus from both fiscal policy and monetary policy and a moderately improving labor market.

With respect to the bond market, interest rates are near all-time lows which means that bond prices are high and that means we should be very cautious. Over the longer-term, our high and growing federal debt will likely lead to higher interest rates. Given that long-term outlook, we feel investors should avoid the temptation to stretch for yield by investing in longer-term bonds. Of course, while higher interest rates would mean lower bond prices, we’d welcome the return to more “normal” yields where your bond investments actually earned a real return from their coupon payments.

Since the markets seem to be focused on the fiscal cliff, I want to take some time to share my thoughts on the topic. The fiscal cliff actually makes me both optimistic and nervous at the same time. My optimism stems from the fact that we’re finally discussing the real long-term issues that will affect us, our children and our grandchildren: we spend more than we take in, we already have too much debt and we’ve made promises for the future that we cannot keep. My nervousness comes from the possibility that our politicians will continue to “kick the can” down the road and not deal with the biggest underlying problem: government expenditures on healthcare (primarily Medicare and Medicaid).

While the fiscal cliff was averted as 2013 dawned, the agreement between Congress and the President was not the solution many had hoped for. Maybe it was too much to expect that the Republicans and Democrats would finally address the long-term structural issues that underlie our problems. We have been running annual deficits of more than one trillion dollars for each of the last four years and our elected officials appear unwilling to put partisan politics aside to construct a viable long-term solution to our deficit and debt problems.

SPENDING VS. TAXES

Currently, everyone seems focused on their divergent views as to how to solve our short-term deficit. To oversimplify the debate, Democrats would like to raise taxes on those with the highest incomes while Republicans would like to reduce government spending. At this point, I think most of us recognize that our debt has now risen to a level that we’re going to have to do both: cut spending and raise taxes. With that said, if you look at the chart on page 3, from a historical perspective spending appears to be more of a problem than taxes.

For me, there are three takeaways from this chart. First, over the last 66 years, taxes have averaged 18 percent of GDP while spending has averaged 20 percent. Second, over the past few years, spending has increased to 24 percent of GDP (4 percent above the historical average) while taxes have declined to 17 percent of GDP (1 percent below the historical average). A significant part of this dismal change has been caused by the recession as the government has been spending more to stimulate the economy and provide a safety net to those who lost jobs. Of course, tax revenue has decreased because there are fewer people working, payroll taxes have decreased and fewer capital gains are being reported. Third, if we want to avoid a situation in which our debt-to-GDP ratio explodes, our spending will have to decrease while our tax revenue will likely need to increase.

As we continue to debate these issues, it’s easy to recognize that reasonable people can disagree as to whether we should increase taxes or cut spending. The reality is that most citizens don’t want to pay higher taxes, but they don’t want their benefits cut either. While we continue to struggle with this debate, we must also recognize that this debate has a cost. We have great uncertainty with respect to taxes and their effect on the overall economy and this has made some businesses reluctant to hire employees and/or invest their capital. Unfortunately, this uncertainty will continue until we put together a long-term solution.
Our problems are deeper than what appears to be a short-term political dispute. As we have discussed in past articles, our government’s debt is reaching unsustainable levels. Our debt is now $16.4 trillion which represents a 7 percent increase over the last 12 months. This $16.4 trillion debt figure is a misleading number since it fails to tell the whole story. If you add the present value of the unfunded liability for Social Security and Medicare to this figure, our total liability is closer to $60 trillion. Unless we’re going to change (reduce) our promises, you should think about our unfunded liability as a debt. If you want some context when thinking about such large numbers, $60 trillion of “debt” is more than $500,000 per household!

MEDICARE COSTS
Regardless of which side of the aisle you are on, the enormity of these numbers should be apparent. We have made promises for the future that we simply can’t afford. The primary promises that we’ve made involve Medicare, Medicaid and Social Security. In fact, Medicare and Medicaid now represent $38 trillion of our $46 trillion unfunded liability. This liability will continue to grow unless proactive changes are implemented. Unfortunately, we have to make some really hard decisions. It all boils down to whether we want to pay more in taxes and/or reduce benefits. Of course, our views are split by different political beliefs, different financial needs and different age groups.

As mentioned previously, from a historical perspective the growth in government spending appears to be more of a problem than taxes. There is really no way to increase taxes to the point that we can afford the promises that have been made. If we look at government spending, we can divide it into three broad categories:

1. Mandatory Spending
   Social Security, Medicare and Medicaid along with other retirement, disability and unemployment related spending

2. Discretionary Spending
   All non-mandatory spending items such as defense and education

3. Interest Payments on Debt
   Over the past 32 years, mandatory spending has been growing at a faster rate than discretionary spending. From 1979 to 2011, mandatory spending increased from 44 percent to 56 percent of total government spending while discretionary spending decreased from 48 percent to 37 percent.

   When you look even further into the increase in mandatory spending, you see that healthcare is the primary reason why mandatory spending is growing at such a high rate. The data shows that Medicare and Medicaid spending increased from 18 percent of mandatory spending in 1979 to 31 percent in 2011, while Social Security payments decreased from 46 percent to 36 percent of mandatory spending.

   It’s clear that the Medicare and Medicaid programs have been the primary drivers of spending growth and persistent deficits over the past 40 years. Unfortunately this trend is expected to continue. Medicare spending, which totaled $492 billion in 2012, is expected to increase to $895 billion in 2022, according to the Congressional Budget Office (CBO).

   This is not a new trend. According to the CBO, over the past 25 years, Medicare costs per person have grown 1.5 percent faster each year than the per-person GDP. Unfortunately, Medicare costs will continue to increase for a variety of reasons. The most obvious is the aging of the baby boomer generation. In addition, we’re spending more on each Medicare beneficiary and we are living longer. These factors result in Medicare’s expenditures rising faster than the economy grows. If we don’t find a way to reduce Medicare expenditures, they will continue to take a greater share of the national budget. This, in turn, will reduce our ability to fund other critical federal programs.

MEDICARE SOLUTIONS
In the near future, we’re going to have to make some very difficult decisions. Do we want to limit Medicare benefits? Do we want to raise the qualifying age that you must reach before qualifying for Medicare? Do we want to limit payments to providers — primarily doctors and hospitals? Unfortunately, there are no easy solutions. Voters may rebel against candidates who vote to cut benefits. Similarly, if we cut payments to providers, more doctors may not accept patients that are covered by Medicare.

So where does this leave us? A sustainable Medicare program will require a number of structural reforms. But we also will need to address the fundamental drivers of health care costs including: changing the way physicians are reimbursed, improving the coordination of patient care, avoid-
ing duplicative and unnecessary services, adopting electronic medical records, reducing fraud and abuse, having more Americans embrace healthy lifestyles and making sure everyone gets access to primary care. The long and short of it is nothing will be easy. But then, what are the alternatives?

The bottom line is that we shouldn’t be satisfied with yet another short-term agreement to resolve the fiscal cliff. In fact, I won’t be comfortable that our politicians are addressing our fundamental debt and deficit problem until they implement proactive changes that address the escalating cost of Medicare. Unless we solve this issue, any announced “solution” to the fiscal cliff is merely a smoke screen, one that increases the likelihood of much deeper problems down the road.

I am hopeful that our politicians will ultimately address the escalating cost of Medicare and the other structural issues facing our country. The question is when and whether they will act on their own or if the markets will force them to act. Unfortunately, I think it will be the latter. History has proven that politicians typically aren’t willing to make tough decisions until they are forced to act. Only time will tell what course our politicians choose to take this time.

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