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WEEKLY ECONOMIC COMMENTARY

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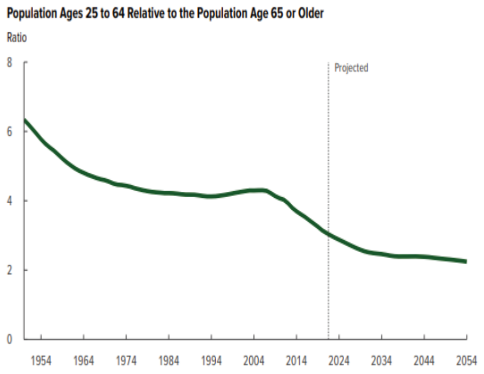
I still think of myself as a young man…until my back creaks getting out of bed and I get a good look at myself in the mirror. I can turn the clock back a little bit with a mouthful of vitamins and a hot shower, but there is no doubt that I have reached a certain age.

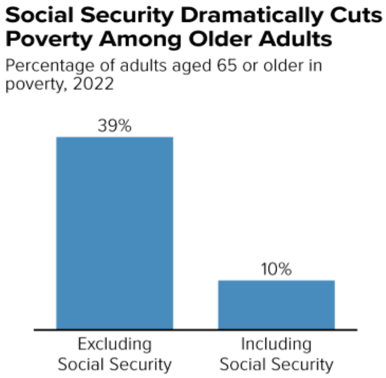
There is some small consolation in knowing that I am not alone. Around the world, the postwar generation is getting up in years. As much as we might think ourselves vigorous, we are not as dynamic as we used to be. The collective aging of societies is a significant economic and financial issue.

Developed countries should not be surprised at the demographic challenges that they are now facing. Wealthier nations tend to see their birth rates drop, as prospective parents stand to lose more income if they take time off to raise children. Life expectancy extends, thanks to better nutrition and health care.

In the United States, the Congressional Budget Office estimates a long-term fertility rate (the number of children borne by a woman during her lifetime) of 1.7, below the replacement rate and down from nearly 2.1 fifteen years ago. Life expectancy at birth in the U.S. is projected to extend to more than 82 years by 2050; at that point, a citizen who reaches age 65 can expect to live for a further 22 years.

The result is an elderly population that is growing more rapidly than the cohort that is still working. Worker shortages have begun to appear; health and retirement systems are starting to strain.





Sources: Congressional Budget Office, Center on Budget and Policy Priorities

The retirement system on which most Americans depend is Social Security. Half of recipients rely on the program for more than half of their monthly income; one quarter of recipients rely on benefits for more than *90%* of their monthly income. The program is critical to curbing indigence among the elderly.

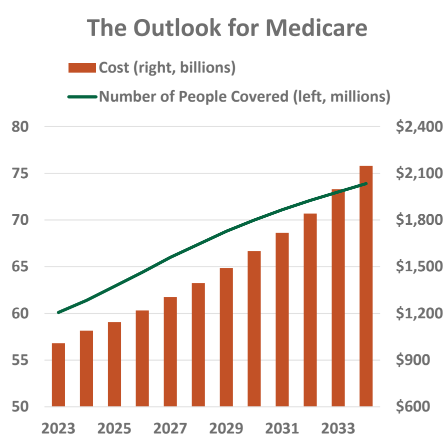
Social Security is not a traditional pension plan in which individuals have their own accounts. Instead, it is a transfer program: payroll taxes from workers fund benefits for retirees. For many years, receipts exceeded benefit payments, allowing the accumulation of balances in a trust fund. But that fund is projected to be exhausted in ten years. Absent intervention, benefits will be reduced by 23% across the board at that point.

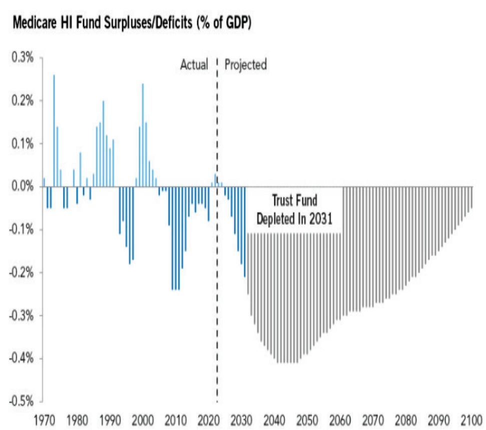
Past Social Security rescues provide a template for the next round of reform.

The solvency of Social Security can be restored with adjustments to payroll taxes, retirement ages and/or benefit formulas. It would be ideal to reform the program without waiting for the last moment, as remedies would be given more time to take effect. But the timeline and the sensitivity of the debate around Social Security make it unlikely that it will be a priority for the new Congress.

Providing medical coverage for citizens who have completed their working lifetimes is an expensive proposition. This year, an average of 11,000 Americans per day are celebrating their 65th birthdays. At that point, they are eligible for Medicare coverage, and many take that opportunity. Enrollment in the program is growing rapidly, and will continue doing so over the next decade.

The costs of the program are growing commensurately, rising from 3% of federal spending in 1972 to 12% today. By the middle of this century, Medicare will represent 18% of the national budget. An excellent overview of the program's finances from the Kaiser Foundation can be found here.





Sources: Congressional Budget Office, Peterson Foundation

Rising enrollment isn't the only element increasing the costs of Medicare. Per capita spending in the program has been escalating at a pace of more than 5% per year. The introduction of new therapies and pharmaceuticals, some of which are very expensive, will add layers of costs to Medicare. For most of us, medical costs peak in the final years of life; that phase still lies ahead for the majority of baby boomers.

The urgency of addressing Medicare is much higher than it is for Social Security. The costs, and the rate at which they are rising, are far greater. The Medicare Trust Fund that pays claims for hospitalization insurance will run out of money in the next few years; absent a payroll tax increase to bolster reserves in the fund, providers will eventually face an 11% reduction in reimbursements. That could be enough to put some medical providers out of business.

The menu of options for making Medicare more sustainable is a long one. Recalibrating reimbursement rates, updating premiums and deductibles, and more extensive case management are among the broad categories to be considered. All of these are very intricate, and all of them are surrounded by fierce debate and lobbying.

Make no mistake: it is a good thing when people live longer. But if economies have not prepared for that outcome, they can struggle. Shrinking labor forces hinder output and raise inflation. Substantial fractions of national budgets must be devoted to old age support, raising debt and limiting the resources that can be invested for the future.

The impact of aging on U.S. medical costs is immense.

To deal with our demographics, the United States will have to adopt sound policies. Immigration must be given a fair hearing as an avenue to better demographic balance. Our Social Security system must balance revenue, retirement ages and benefit levels to remain solvent. Medical systems must optimize the length and quality of life at a cost that does not place undue burdens on old or young. Unfortunately, neither Republicans nor Democrats have advanced clear agendas for addressing the aging of America.

Much as I might wish it were possible, there is no way to return to my salad days. The best that I can do, and societies can do, is accept everything that comes along with aging and make the best of it. That mindset will be essential to making our golden years golden.

High Stakes

Political strategists understand that foreign policy does not usually win elections; domestic issues determine voters' decisions. But Europe is very much interested in the foreign policy that will emerge from the U.S. balloting next month.

The economic relationship between the U.S. and Europe is the world's largest, with over $1.5 trillion worth of goods and services traded annually. In the wake of the Ukraine war, America has become a top supplier of energy to Europe, providing almost 20% of liquefied natural gas imports. The linkages extend to capital flows: America is the European Union's (EU) largest investment destination, accounting for 55% of total direct investment into the U.S. Commercial linkages between the U.S. and Europe are a source of direct employment for over 9 million people on both sides of the Atlantic.

The cooperation extends to defense, with European security organized with the United States through the North Atlantic Treaty Organization (NATO). An insecure region is less likely to enjoy economic prosperity, so the stability of NATO is an important foundation for European growth.

The relations between the two regions are thriving. European analysts expect ties to be well-sustained under a Harris presidency, as prospective changes to economic and defense ties will be subtle in this scenario. Addressing U.S. trade imbalances with European member states like Germany is unlikely to be a critical priority for a Harris administration. She has also pledged support to NATO and Ukraine.

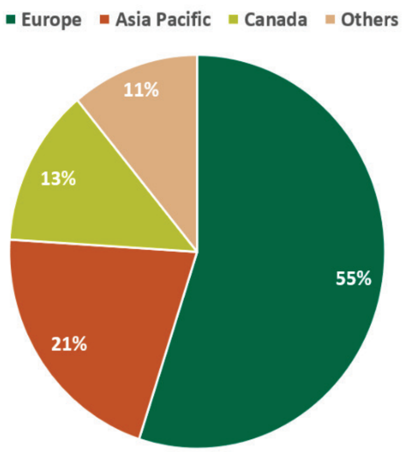
A second Trump administration, however, could renew trade tensions between the two centers. President Trump imposed tariffs on imports of European steel and aluminum in 2018; the EU retaliated by levying tariffs on certain American-made goods. A truce was reached in 2021, but the Republican platform calls for 10% to 20% tariffs on U.S. imports from all regions.

Steel and aluminum tariffs could return, and the former president has threatened new levies on European autos. Additional duties could also be assessed on over $2 billion worth of imports from five eurozone nations to retaliate for their digital services taxes. Pressure on the continent to decouple from China would be more significant under this election outcome.

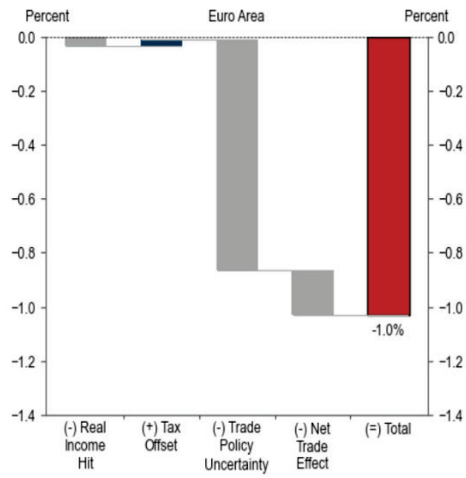
A second Trump administration could also have a bearing on the continent's security policy. The former president wants Europe to meet the defense spending targets required of NATO members, as only 23 of 32 NATO nations are expected to fulfil the 2% spending commitment this year. Trump has threatened to go as far as pulling out of the military alliance. A full withdrawal seems unlikely, as it would require Congressional approval. But his administration could force a significant pullback of U.S. involvement in the alliance.

Deteriorating relations triggered by higher tariffs and national security concerns will not only dent trans-Atlantic trade, but will deter foreign investment and invite market volatility. All of this could result in significant losses of output. Goldman Sachs has estimated that the Republican trade platform could deliver a negative shock of up to 1% of the eurozone's real gross domestic product.

U.S. FDI Cumulative Stocks By Origin



Cumulative Effect of U.S. 10% Universal Tariff on Real GDP



Sources: EIU, GS

Post-election policy from Washington will impact a number of European capitals.

Sensing what could lie ahead, the European Commission has been making preparations to expand its trade and military options. The Anti-Coercion Instrument, which entered into force in 2023, will allow retaliation against threatening trade policies from other nations. Countermeasures will include the imposition of tariffs, restrictions on trade in services, and limited access to foreign direct investment and public procurement.

The European Commission listed economic security and statecraft as the first pillar of its new foreign policy agenda. Expanding free trade is no longer the primary objective; maintenance might be the best case. Coordinating policy across member nations will likely be an issue, given varying national interests and competencies in a union of 27 countries.

The formation of a union has forced European nations to balance domestic and foreign interests. But the United States has shown a recent tendency to keep its own interests in the forefront, and this is what has European capitals concerned. You can bet that European leaders in the will be up into the early hours of November 6, watching the American election returns.

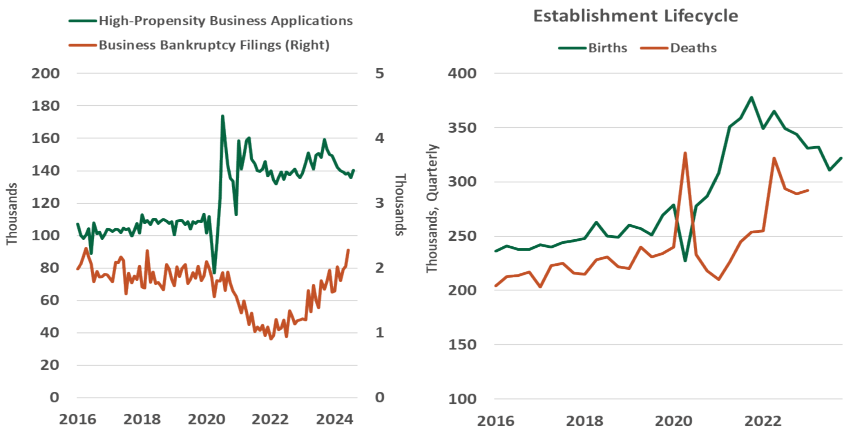
Hanging Shingles

While we don't miss the uncertainty of the pandemic, it did offer an opportunity to reset. I took up distance running and substituted books for television at night. I'm happy to report that I have mostly maintained those habits.

I'm also happy to see the U.S. small business community has learned to sustain a higher rate of activity. The rise in new business filings that began in 2020 initially looked like a lockdown quirk:

Time away from day jobs allowed more people to explore new ventures, and the cushion of stimulus money didn't hurt. Though those effects are well in the past, new business applications are still holding at an high level.

The software firm Intuit QuickBooks publishes aggregated accounting data from its clients. They report that firms with up to nine employees grew their headcount by over 600,000 workers from January 2020 to August 2023, with a steady trend since. Younger firms witness their strongest job creation in their first five years, outpacing hiring by more seasoned establishments.



Sources: U.S. Census Bureau, Administrative Office of the U.S. Courts, Bureau of Labor Statistics, Haver Analytics

Small businesses are a vital component of the economy.

The rise in formation data is also an artifact of the disruptions to small businesses. Some closed temporarily and are reopening under a new license. Others reflect a change in control as older owners retire by selling their ownership interests; the buyout may appear as a new business filing.

The news on nascent businesses is not entirely good. Intuit shows that average real revenue at very small businesses is in gradual decline, as they deal with higher costs and less fervent demand. Business bankruptcies are also on the rise. Much like consumer credit delinquencies, business defaults fell to unusually low levels as government support programs offered a lifeline during the COVID disruption. Now, they have returned to levels last seen in 2017. Estimates of business births and deaths are lagged, but they tell a story of all aspects of the establishment lifecycle stepping up, including closures.

New businesses are vital for the job creation and innovation that are needed to keep the economy growing productively. But new ventures entail risk, and success is not guaranteed. The higher rate of both formations and closures suggests the entrepreneurial economy is going the distance.

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