

Good afternoon everyone,

I came to USC just over a decade ago to talk about the fiscal troubles that lay ahead for our country. I specifically wanted to spark the interest of the younger generations... because it was people like YOU that were the most affected by the enormous *generational inequality* going on at the time. I was naïve back then to think I could move the needle and probably am again today, but unfortunately, the fiscal outlook today looks much worse than I had imagined 10 years ago.

I know some of you might think, "I'm just starting my career, why should I care about this generational issue?" Let me tell you... you may not yet be thinking about retirement or your healthcare bill when you grow old, but if nothing changes... pensions tomorrow will be a fraction of what they are today and the gov't won't be able to pay for more than half of your healthcare bills. Think about it. In 20 or 30 years there will be fewer young workers, many more seniors that need support... and the starting point is the highest national debt in our history. So if you believe you will have as comfortable a retirement as the current seniors, think again. If you believe that we will have the resources to fight climate change, think again. The arithmetic just doesn't work out.

Let me give you some facts. The share of fiscal spending going to seniors has been growing dramatically since the 1960's when Medicaid and Medicare joined social security as federal entitlements. Today we spend 6x more per senior than per child in the US. Think social security vs education. Almost 40% of all our taxes are spent on seniors, and this trend is only starting. As the chart shows {Slide #2 below}, we are just getting under way in terms of the fiscal consequences of the grey boom. In 25 years, spending on seniors will grow to take 70% of all taxes. Effectively, with entitlements compounding away, everything else gets squeezed.

In this context, the fiscal recklessness of the last decade has been like watching a horror movie unfold. Look at this chart {Slide #3 below}. During the last decade, our debt grew from \$15T to \$31T today... a level of indebtedness only comparable to that after WWII. But what is worse is that this debt does not account for what the government has promised it will pay you in terms of social security and Medicare. It actually assumes these payments will be ZERO. In the 1950s this "off-the-book" debt was small as baby boomers were just being born so actual debt was a reasonable measure of the country's indebtedness. Not anymore. There are credible estimates that if you assume the government will pay the same to seniors in the future as it is paying today, the present value of that debt approaches \$200T. That's trillion with a "T".

What makes the last 10 years particularly horrific is that we had some golden opportunities to reduce the fiscal gap ahead of the demographic storm that is under way. After WWI and II, the US quickly repaid its debt by raising taxes and restricting spending. Contrast that with today. After the GFC but pre covid {Slide #4 below}, when the economy boomed in 2018 and the unemployment rate hit a 50-year low, and even under a Republican administration, the deficit could not go lower than 5% of GDP! And then post covid, we had a booming economy where tax revenues were augmented by high inflation, nominal growth of

over 10%, a windfall of taxes from capital gains due to the tech boom, all with 3.5% unemployment. So, you may reasonably ask, how much bigger was the surplus relative to that during the tech boom in the late 90'? Incredibly, as the chart shows, we ran a DEFICIT of over \$1T. Never in history has a booming economy produced a worse fiscal result. Never. Expect this trend to continue absent radical policy changes.

The arithmetic for your "entitlements" just doesn't work. Imagine asking yourself how much taxes need to be raised today to maintain the current magnitude of safety nets into the future. Economists call this a "fiscal gap" measure. Today that measure is 7.7% of GDP, up from 7.2% when I presented here 10 years ago {Slide #5 below}. This is equivalent to a 40% increase in all Federal taxes collected, or, an immediate and permanent cut of 35% in federal spending. These are dreadful alternatives and still they are probably being underestimated. Faced by this magnitude of tax increases, investment would inevitably falter and growth would suffer considerably, making it almost impossible to maintain the size of our current safety nets.

How ironic that France, with a fiscal gap of 2.3%, is already raising their retirement age to make it fairer to future generations. Meanwhile, here in the US, the only thing that Hillary Clinton, Biden and Trump can agree on is that entitlements should not be touched. And waiting only makes the problem worse as interest payments keep building. To give you a sense of how bad it could get {Slide #6 below}, with interest rates at 5%, interest payments every year would be as big as the entire covid relief of 2020. As the charts shows, interest payments go from 8% of outlays to 27% by 2050. This is a nightmare for future economic growth, investment and productivity, and, of course you, the future taxpayer.

It is time that we let go of the false pretense that cutting entitlements is a choice. It is not. Either we cut them today or we will have to cut them much more tomorrow.

As if the irresponsible fiscal behavior wasn't enough, around 15 years ago the Fed simultaneously decided to start courting with asset bubbles. Around the time I was here, Ben Bernanke embarked on QE2, another round of rapid expansion of the Fed's balance sheet. The Chairman feared a period like the 1930's and wanted to buy insurance to avoid deflation by not only keeping policy rates at zero but also by reducing long-term interest rates. At that time, he assured everyone this would be a temporary measure. I quote: "Monetization would require a permanent increase in the money supply to pay the government's bills through money creation. What we're doing here is a temporary measure that will be reversed so that at the end of this process, the money supply will be normalized, the Fed's balance sheet will be normalized, and there will be no permanent increase, either in money outstanding or in the Fed's balance sheet."

Since then, and despite these confident words and several periods of strong growth with very high inflation, the Fed never felt the need to meaningfully reduce its balance sheet. The balance sheet of the Fed today stands at just below \$9T, or 10 times as large as before the financial crisis. I repeat... 10 times. This Fed policy has enabled risky behavior from investors, banks and the government... it has driven unprecedented bubbles in both breadth and

magnitude. {Slide #7 below} The tech frenzy, the crypto craze, SPACs, the search for yield by investors and also by regional banks (!). While it has truly been an “everything bubble”, nothing symbolized it more than Doge Coin, which started as a joke and reached a market cap of 80bn. As I have repeatedly said, central banks should be in the business of *balancing rather than fueling* asset prices or risky behavior.

Some of the costs of the Fed’s loose policies are now apparent to all. Inflation has become part of our dinner conversations. So have bank runs. Unfortunately, by still owning a large amount of government debt, the Fed continues to create the false illusion that it can help with our fiscal problems. Take the spring of 2021. It was obvious then that we were not only avoiding a deep hole, but the economy was already booming and we were developing an inflation problem. Bizarrely, the Fed kept their foot on the gas and Congress kept spending. Congress spent another \$3T bringing their covid total to \$5T, with the Fed financing over 60% of all issuance. Powell’s Fed acted as a great enabler for these fiscal excesses. Had it not been for one Senator, Joe Manchin, they would have spent another \$3T.

Trying to correct the biggest mistake in Fed history, in the last year they have now raised rates 500bps. Better late than never, I guess. Still at the first signs of trouble, the Fed last month and in just 4 days, undid most of the small progress they had done in reducing their balance sheet. This asymmetric Fed response is what feeds the lack of serious structural action in DC from both sides of the isle. It allows the Biden administration and Congress to avoid having to address our long-term dilemmas. It helps the Republican House talk a tight budget while leaving entitlements off the table even though we all know that there is simply not enough left to meaningfully reduce spending. It allows the Biden administration to suggest the need to increase the rate of spending and label the Republicans already timid proposal as “wacko.” It is hard to overstate the myopic absurdity of the current policy and the predicament we find ourselves in.

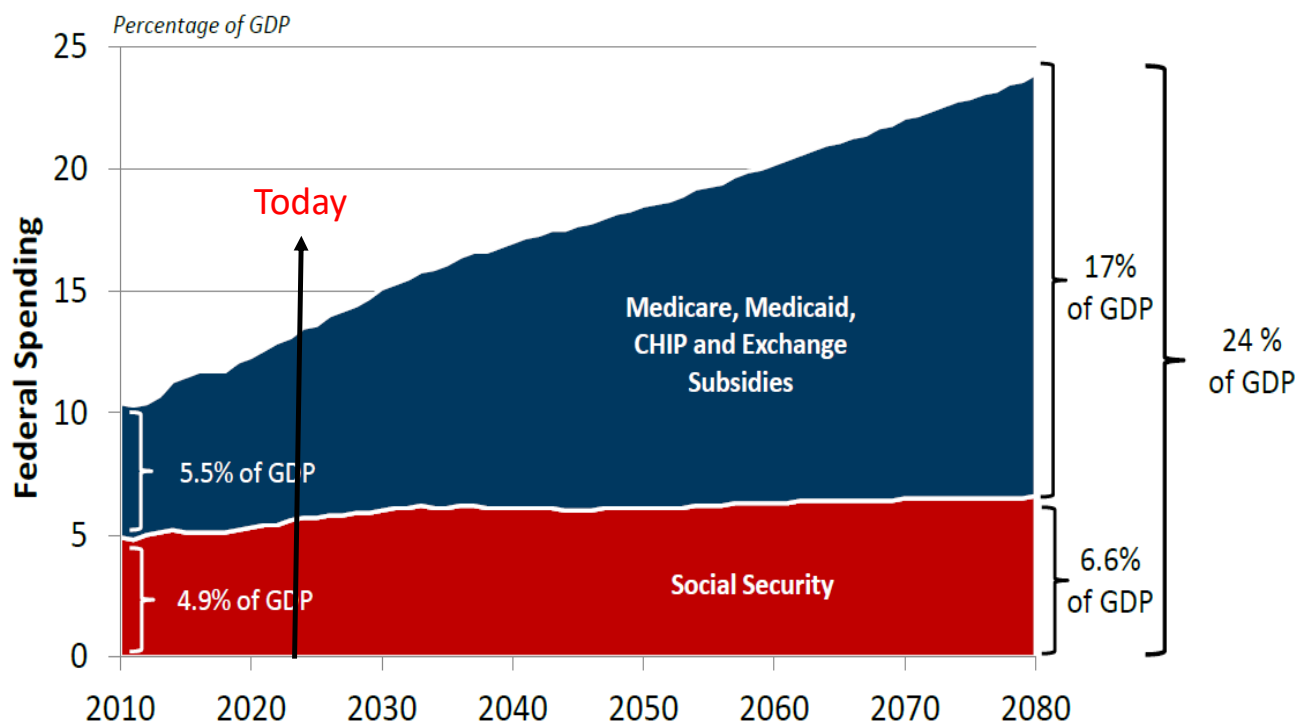
To conclude, I greatly admire your generation’s focus on the long-term implications of climate change and your willingness to take action. I urge you to also take action against the bipartisan myopic abuse of our “seed corn” at the expense of future investment and growth. American exceptionalism and innovation have been on display my entire career. We led the PC revolution, we led the development of the internet, the move to mobile and cloud, and blockchain and are leading in Generative AI. Indeed, the cover story of the Economist two weeks ago, Riding High, documented the astonishing success of American capitalism over the last 30 years. Further delay in addressing the fiscal gap threatens a future of us not “riding high” but rather sinking into malaise, decay, and the end of the American Dream. It will embolden autocracies in places like China and Russia. And tragically risks a lack of wealth to make sufficient investments to address existential crises like climate change; and a lack of growth to afford programs for the least well-off among us.

US exceptionalism at risk?

Stan Druckenmiller

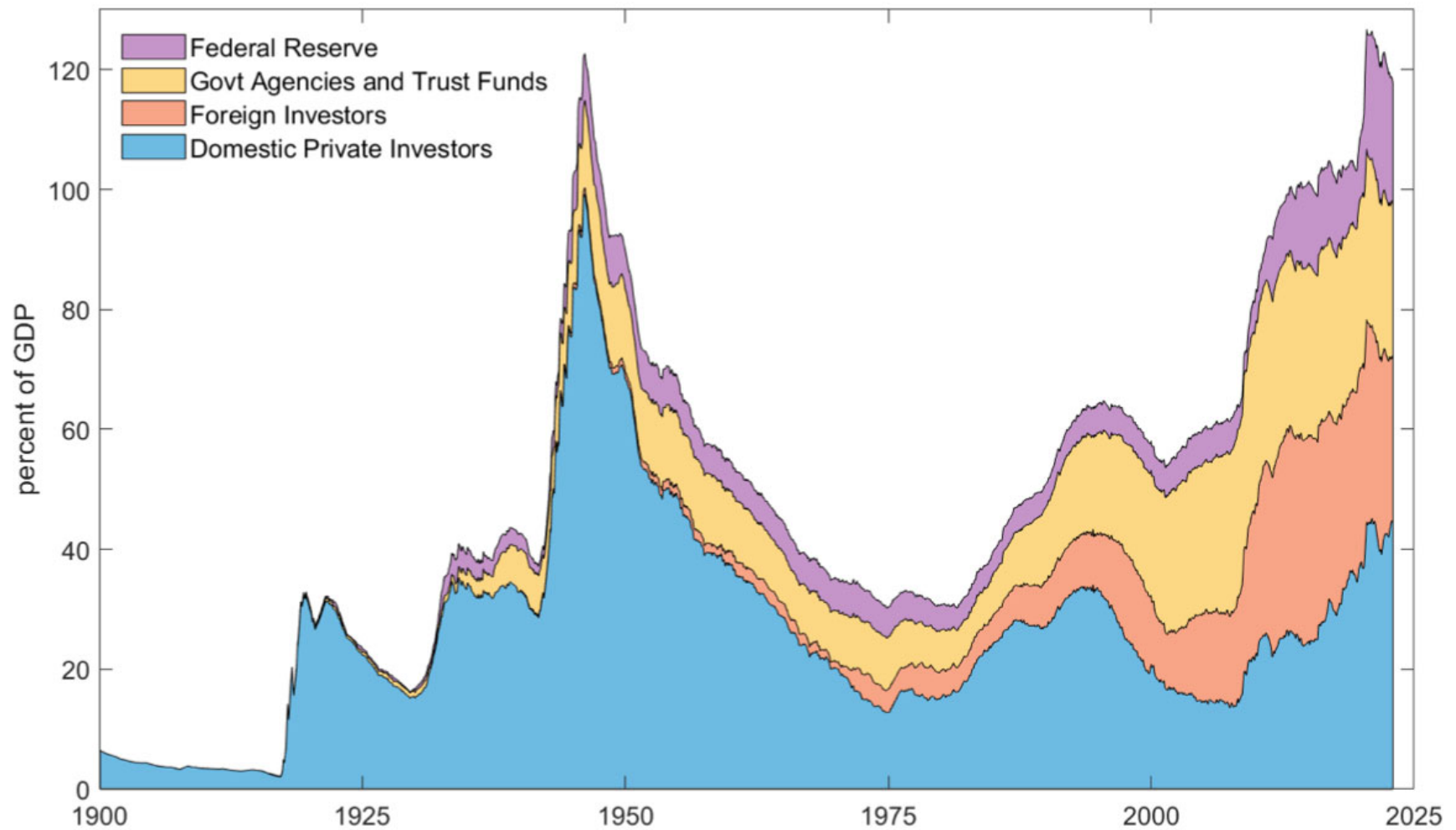
USC Marshall Student Investment Fund
2023 Annual Meeting
May 2023

The demographic storm is just getting under way. We are already spending almost 40% of all taxes in seniors. In 20 years entitlements' will cover 60% of all taxes.



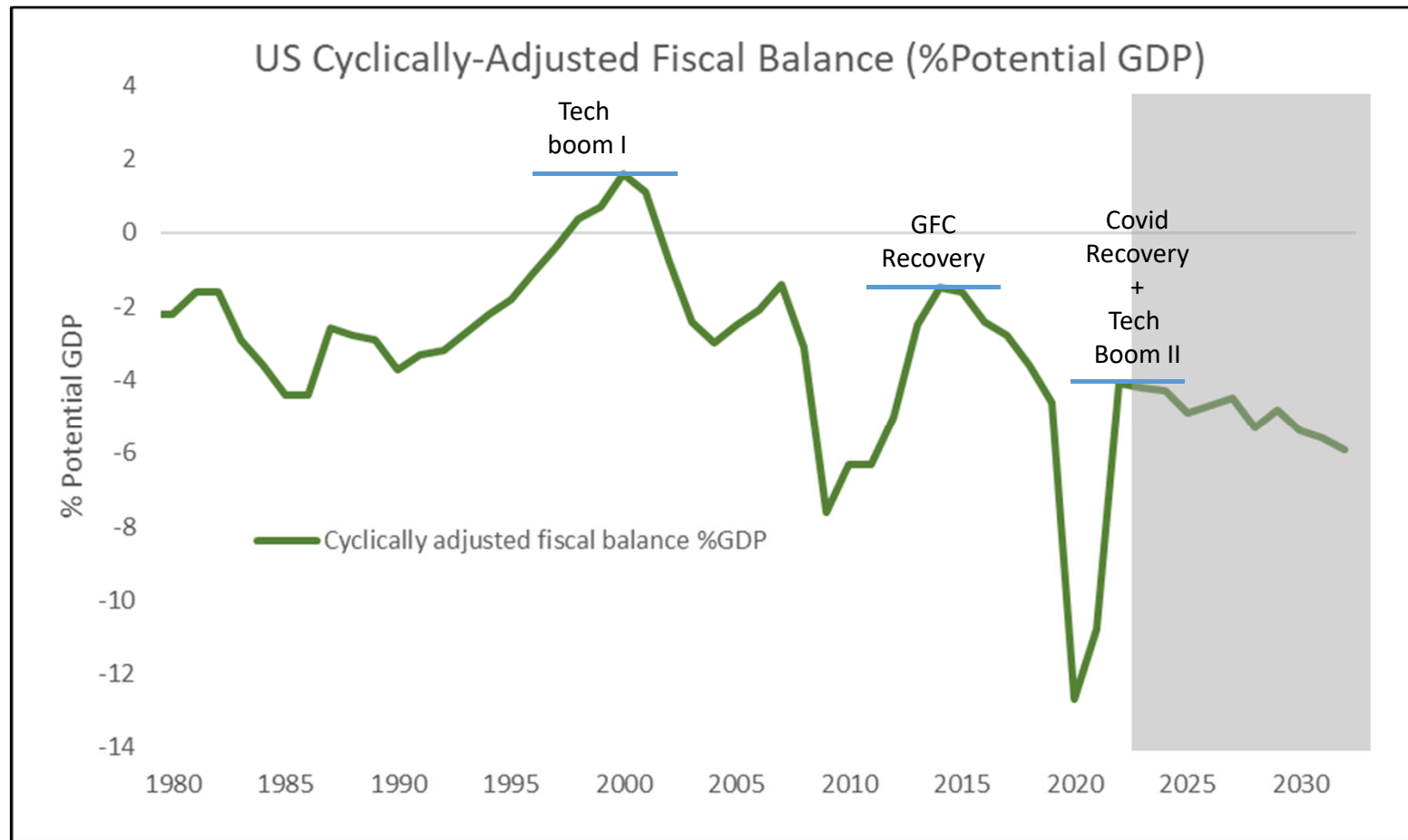
Source: Based on CBO (September, 2013)

The fiscal outlook has gotten worse and is now worse than post World War II



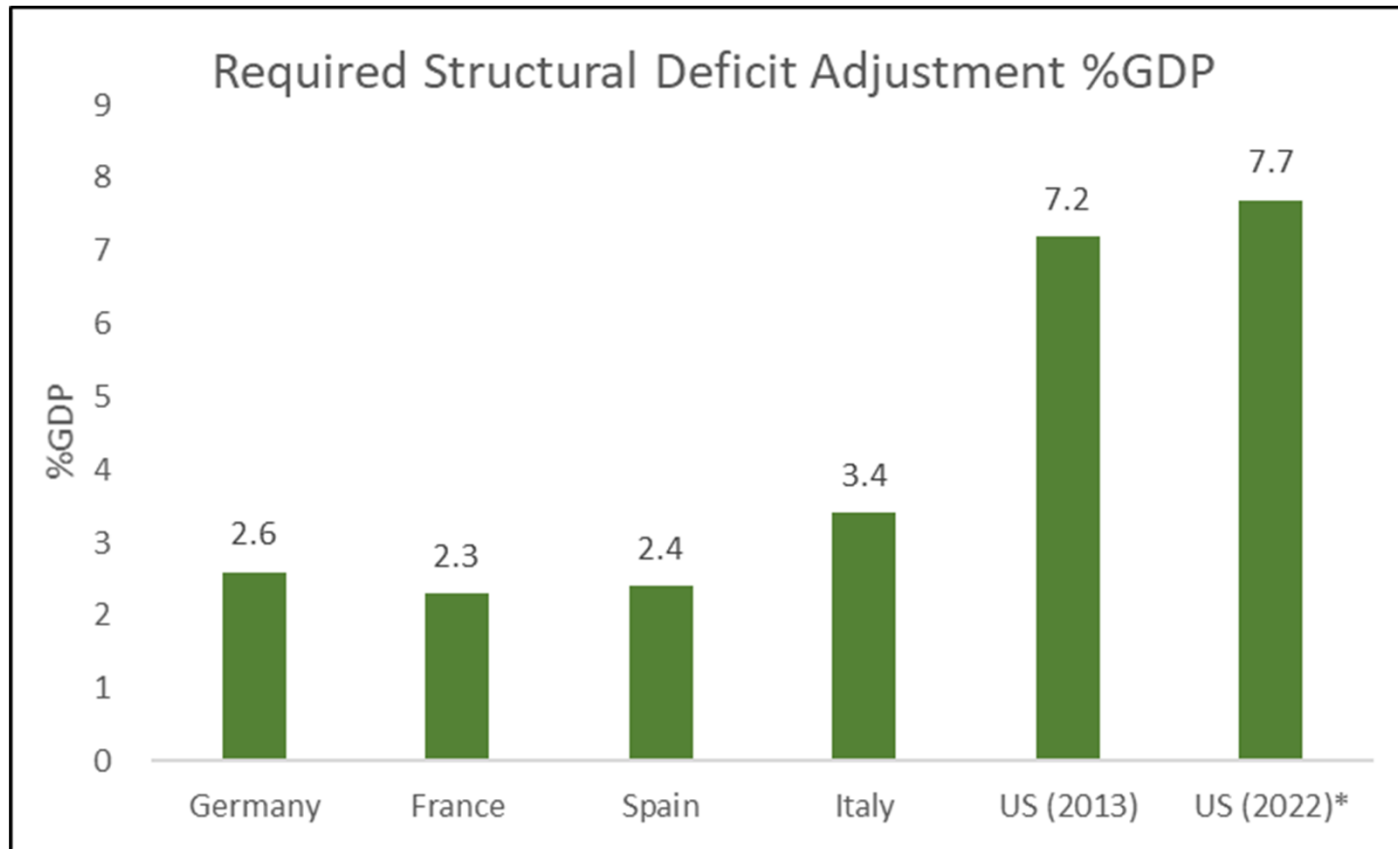
* Source: Sargent and Hall (2022), "Three world wars: Fiscal-monetary consequences"

Some missed golden opportunities. Booming economies in 2018 and 2022 never had worse fiscal results. Unless something changes, this Bipartisan “Ratcheting effect” will continue.



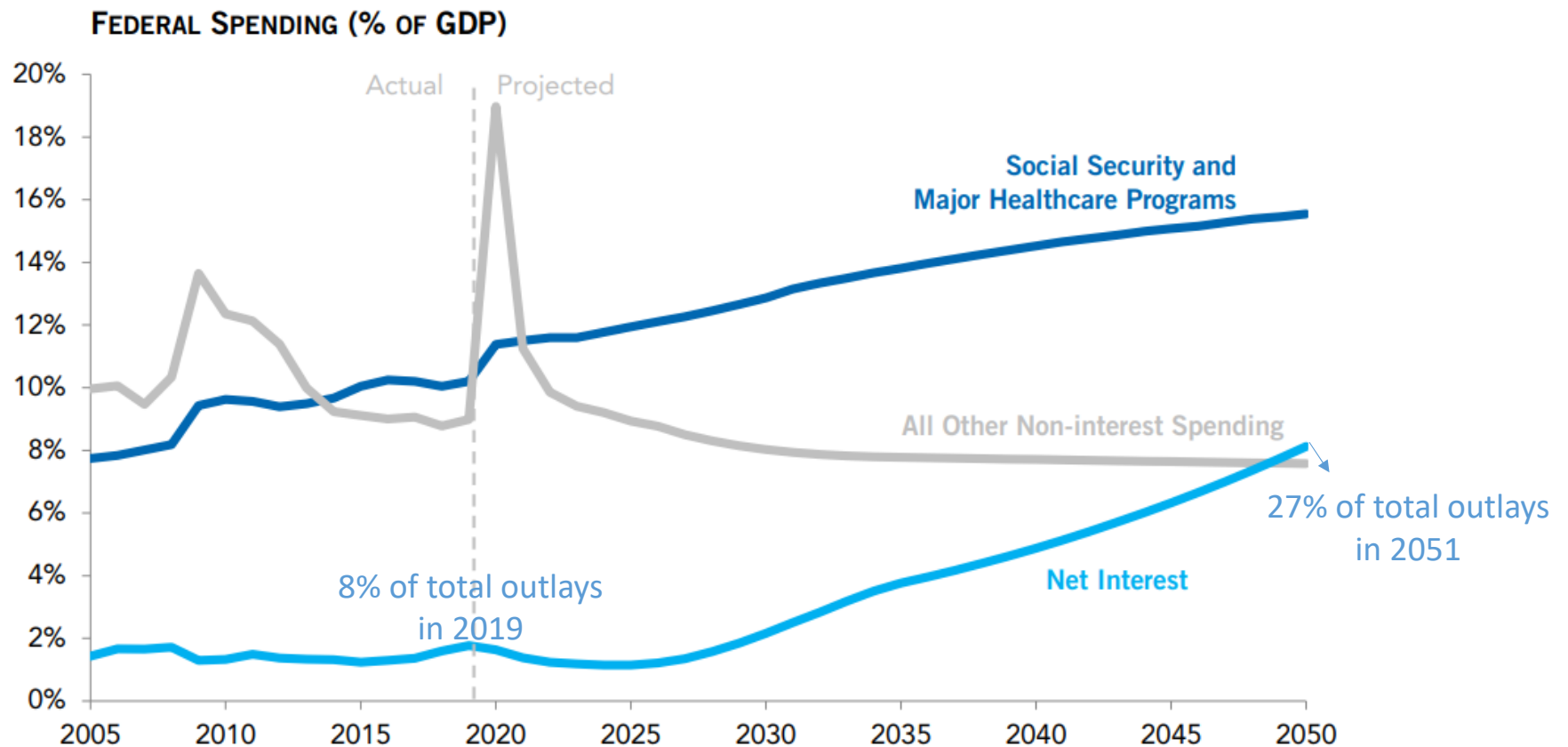
*Source: CBO

The US “fiscal gap” has grown from 7.2% of GDP in 2012 to 7.7% today. This is 3x that in the Euro Area. The more we wait, the worse it becomes.



*Source: European Commission. For comparison purposes US structural deficit should be 0.8%GDP higher to reduce Debt/GDP to 60% that DE/FR/SP/IT numbers include

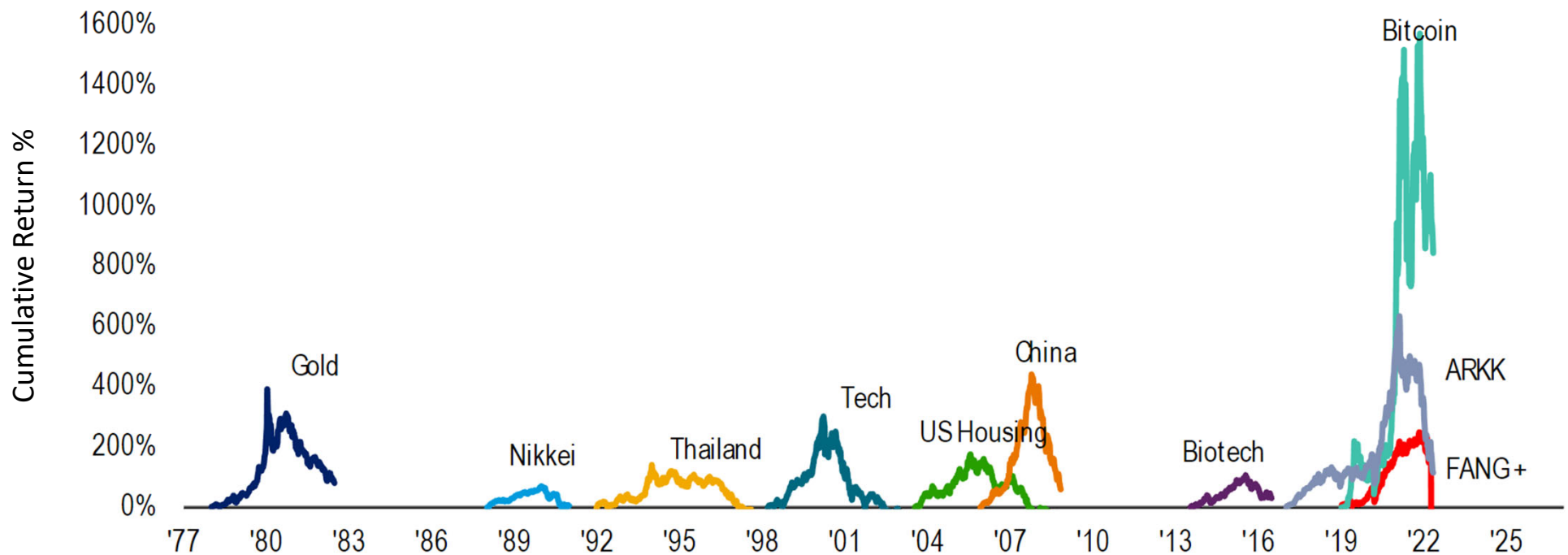
The Fed can't save us. A larger b/s temporarily hides and postpones the problem, making it an even worse nightmare once it happens. With 10y rates at 5%, interest payments **EVERY YEAR** will be as big as the COVID fiscal relief.



SOURCE: Congressional Budget Office, *The 2020 Long-Term Budget Outlook*, September 2020.

Free money ushered in by Bernanke, Yellen and Powell has enabled reckless fiscal behavior and an asset bubble of historic proportions

History of asset bubbles



Source: BofA Global Investment Strategy