SOCIAL SECURITY: MONSTER OF ALL CARRY TRADES TO OFFSET SOME OF COVID-19 PAIN

For the long-term benefit of American families and workers, it is time to think differently about the Covid-19 induced economic shock and policy response. All Americans are aware of the dramatic reduction in economic activity since the outbreak began in February 2020. The U.S. economy is suffering from reduced output and weaker consumer demand. Just as important is the dramatic increase in uncertainty about the U.S. economic future. Uncertainty about the future is why financial news outlets report the dual effects of high stock price volatility and a large reduction in U.S. interest rates.

Before Covid-19, the U.S. stock market[1] changed by an average 172 points per day, less than 1% of the value of stocks. After Covid, the average daily stock market change is up almost five-fold, to 826 points per day. In an economic crisis, uncertainty and fear also drive U.S. interest rates down. The United States is still the safest port for large global investors. U.S. long term interest rates have fallen by over half, to well below 1%. An investor can now earn more income in U.S. stocks than in U.S. bonds. Specifically, the average U.S. stock yields 2.2% in dividend income, compared to 0.7% interest on U.S. government bonds. This is a large and unusual gap favoring dividend yield over U.S. interest rates. The gap provides an opportunity to fix a long term problem with social security funding, a problem made much worse by the pandemic. Said differently, Covid-19 has simultaneously amplified the issue of social security underfunding and provided a solution.

What is the problem with social security?

The Social Security Administration ('SSA') Old Age and Disability trust funds are currently managed by a group of Federal Government agencies, led by U.S. Treasury Secretary Steve Mnuchin. In 2020 the social security trust funds will tip into deficit, beginning the steady depletion of $2.8 trillion in reserves. Based on the 2019 SSA trust fund report, the 75-year deficit is an astounding $13.9 trillion. The gaping long run deficit is driven by an unavoidable set of U.S. demographics. Unaddressed, the social security deficit is expected to result in a combination of lower benefit checks, up to 25% lower, and higher payroll taxes. The Covid-19 induced shock opens a window of opportunity for Congress to save the social security trust funds and meet our obligations to hard working, payroll tax paying, American families.

How does the Covid-19 crisis help solve the social security problem?

An analogy with Airbnb entrepreneurs well explains the opportunity to trade off stock market losses with interest rate declines. Many Americans have borrowed money to purchase vacation rental properties. The properties may be listed for short term rental on Airbnb. Vacation property owners make money as long as rental income exceeds the fixed costs of the mortgage payment, taxes, cleaning and utilities. This time-tested money making strategy is called a carry trade. The U.S. government can engage in the same type of carry trade by purchasing U.S. stocks with money borrowed from global investors. The global investors will get paid less than 1% per year in interest, and the Social Security trust fund will collect 2.2% in income from U.S. stocks, plus any appreciation in the stock market. If global investors want to own U.S. long term bonds at interest rates under 1% then we should sell them as much as possible. The U.S. Treasury should seek immediate authorization from Congress to issue up to $2 trillion of Social Security Administration linked bonds. The $2 trillion special social security financing program would be about half of what has already been passed in Covid-19 bailout bills. However, this program has a generational benefit by eliminating the 75-year trust fund deficit.

Is fixing social-security now a free lunch?

All economic benefits have tradeoffs. However, there are at least five important features of what has happened to the economy to make the carry trade beneficial. First, Covid-19 paid the cost forward, already causing significant economic damage. Second, U.S. families can lock in gains at the expense of global investors overpaying for U.S. bonds. It is true that efficient markets means we cannot say for sure U.S. interest rates are too low. However, efficient markets do not mean bond investors are always correct. Mispricing happens all the time. Third, the U.S. dollar is the globally dominant currency, and for good reason. With liquid capital markets, strong financial and legal institutions, negative real borrowing costs, tame inflation and a thriving U.S. corporate sector there is more opportunity in America than any other country in the world. We can offer all American workers a share in home country entrepreneurship and productivity. Fourth, carry trades of all types have worked for almost all of recorded economic history. Fifth, the risk of carry trades is too much debt, liquidity crises, and sudden spikes in borrowing costs. This risk is not as urgent as the U.S. government owns the printing press and a globally dominant currency.

Fixing social security with the monster-of-all carry trades is the greatest investment U.S. congress can make in the American worker. All taxpayers will have a stake in the success of American enterprises like Apple, Amazon, Costco, Caterpillar and JP Morgan. If American's believe that social security is more secure after the crisis, consumer demand and the U.S. economy will bounce back strong in 2021.

1. Represented by Dow Jones Industrial Average sourced from Yahoo! Finance.

Author bio: Dr. Andrew Root is a lecturer on the faculty at Regent University. From 2011 to 2016, Root was division director, head of U.S. Equities, and member of the Board of Directors for Macquarie Capital USA. Root also was head of U.S. Research for Macquarie. The U.S. research team was composed of 70 analysts and associates covering approximately 600 stocks, across five offices. Root has worked with Alkeon Capital, founded the Redtail long short equity fund for OTA Asset Management, and was a managing director in the Investment Research division of Goldman Sachs. He has a B.Sc. in Biochemistry from McMaster University and an MBA from Regent University.