
[Ultralow Interest Rates Bring Opportunity and Danger to States.]

What's good for funding infrastructure is bad for pensions—and in the long run, bad for infrastructure, too.

It's no secret that U.S. infrastructure is in dire need of an overhaul. The American Society of Civil Engineers estimates a lack of investment will cost almost $4 trillion in gross domestic product by 2025. Measured per household, that's a loss of $3,400 a year thanks to congested roads, overworked electric grids, and other deficiencies.

With that in mind, the global trend of debt yields falling below zero seems like a massive windfall for U.S. states and cities. After all, they borrow for public works projects in the $3.8 trillion municipal bond market, where rates are within spitting distance of all-time lows. Just about every state can borrow at less than 2% for 10 years—a better rate than the federal government can get. If U.S. Treasury yields drop to zero, as some prognosticators expect, it stands to reason that those for Florida, Maryland, and Texas will go down, too.

But this is hardly a free lunch. With $3 trillion in pension assets, states also face a cumulative unfunded liability of more than $1 trillion, even after the longest economic expansion in U.S. history. What's worse, that shortfall likely underestimates the problem, as most plans assume annual returns of 7% to 8%. Were the U.S. to enter a recession, with bonds already yielding next to nothing, it would become virtually impossible to meet that target. Indeed, the two largest U.S. pension funds, representing California's public employees and teachers, respectively, each reported in July that they came up short in 2018, when the S&P 500 was down for the year.

By keeping interest rates at rock-bottom levels, central banks have made it ultra cheap for governments and companies to borrow, but they've eradicated any semblance of safe returns. This has major implications for defined-benefit pension managers, who are supposed to purchase assets to match long-term liabilities. In the 1990s, that was easy enough to do with 30-year Treasury bonds. The average yield throughout the decade was exactly 7%—mix in a little exposure to equities, real estate, and hedge funds, and it was a virtual lock to beat targets. But those higher-yielding bonds will mature soon, and reinvesting at less than half that rate will be painful. As with individuals saving for retirement, the only two choices are to contribute more money now or take on additional risk. With many states already cash-strapped and allergic to raising taxes, it's not hard to guess which option is politically more palatable.

Unless the risk-asset rally lasts forever, though, loading up on equities and alternatives won't be a long-term solution. More likely, states and cities will eventually divert a larger share of their budgets to supporting pensions. That means less funding for infrastructure.

For those who need to borrow and save simultaneously, the drift toward negative yields is very much a double-edged sword.

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