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Public Finance Challenges in a Nascent 'New Normal' Economy.

Eighteen years of suppressed interest rates are behind us, and the demand for investment capital has swollen. States, localities and pension funds will need to take another look at their strategies as this business cycle plays out.

In early 2009, in the wake of the global financial crisis, top spokesmen at a premier bond management firm described the market's expectations of persistently low inflation and interest rates as a "new normal." For more than a decade thereafter, borrowers were blessed with generationally unprecedented low interest rates on mortgages and municipal bonds. Meanwhile, underfunded pension funds scrambled to find alternatives to low-yielding bonds in their portfolios. And with near-zero short rates, municipalities outsourced their shriveled cash-management function.

That was then. Lately, interest rates have risen steadily. After two decades of lackluster investment income levels, public treasurers and cash managers can now crow about earning healthy returns on their operating funds without taking big portfolio risks. On the other end of the yield curve, however, municipal bond issuers and long-term bond investors such as pension funds now face significantly higher rates. The "term premium" — the extra compensation that long-term investors expect — has returned in bond-land.

To formulate a strategy, public financial professionals need to understand both cyclical and secular trends. On the cyclical dimension, it's now been six years since the COVID-19 recession, and the stock market has gained about 250 percent. Unemployment rates are near historically low levels. CPI inflation at 3.7 percent has come down from the 9 percent level seen briefly in 2022 but remains persistently above the Federal Reserve's 2 percent target, thanks in part to the war-related spike in oil prices. Real GDP growth is running around 2 percent. By those measures, the economy is running warm but not too hot.

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