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Reap What You Sow

In 1935, the government of Australia introduced a foreign toad species to stop grey-backed cane beetles from ravaging the country's cane fields. It turns out these cane toads weren't very good at hunting the problematic beetles but were prodigious breeders. Their numbers increased from 60 thousand in 1937 to about 1.5 billion today. Lungworms were subsequently introduced to kill the cane toads, but unfortunately, they were a curse to native tree frogs, a species the authorities intended to help. Modern central bankers have something in common with Australia's past ecological authorities.

Genetically modified (GM) interest rates[1] originated in the United States as a response to the global financial crisis, and quickly spread to Europe and Japan. There is wide agreement that lower interest rates were the key to an economic recovery, but what seeds were sown in the process? Low GM interest rates have feasted on their larger organic free-range counterparts, which have now become an endangered species. There are many predators in the global financial system who once thrived on high interest rates. One such beast is the defined benefit (DB) pension plan.

American pension plans were hurt during the global financial crisis when the stock market crashed, reducing assets available to pay benefits. To add insult to injury, the solution to the crisis (quantitative easing) made already expensive pensions outrageously expensive. Even after a 10-year bull market in stocks, US state and local pension plans still have DB unfunded liabilities (present value of pensions minus assets) estimated at $2 trillion as of 2016.

To compound the problem, many of these government pension plans estimate their liabilities by assuming future investment returns of 7-7.5% per year. If bonds are priced to deliver 2-4% per year, how likely is it that stock markets and alternative investments will deliver the implied 10-12% per year implicit in these pension plan discount rates? The American Legislative Exchange Council (ALEC) has been sounding the alarm for some time, stating that the discount rates used by state pension plans are far too optimistic in a low interest rate environment. They estimate that the true unfunded liabilities exceed $6 trillion as of 2017, using risk-free interest rates found in US Treasury bonds. The official actuarial reports show that there are about 70 cents for every dollar promised, but ALEC suggests a more realistic estimate of 35 cents per dollar. Their conclusion is that US state pensions are unaffordable and unsustainable.

Cutting pensions to teachers, police, firefighters and other public servants by at least 50% would create massive political and social instability. On the other hand, forcing taxpayers to make up the funding gap would also be disastrous. Real estate values and economic activity could collapse in the states with the worst per capita funding burdens, as people and businesses fled for higher ground. Needless to say, an honest debate about public pensions is a real killjoy. This is why public pensions are considered the third rail of politics: if you touch it, you die. So the can keeps getting kicked down the road.

Investors and ratings agencies have taken notice of pensions crowding out state and municipal budgets. Take the City of Dallas and the State of Illinois, for example, who both have seen their credit ratings drop because of pension concerns. In the case of Illinois, downgrades have brought it to the brink of junk status. Investors can make the obvious decision to avoid investing in bonds issued by the least creditworthy governments, but the problem is too big to be contained. Furthermore, underfunded public pensions are not an issue unique to the US, or confined to public sector employees. Corporate pension plans and social security programs in the developed world are also struggling in a world of low interest rates. The good news in Canada is that public plans are much better funded and assume more conservative investment returns than in the United States.

Many investors are preparing their portfolios for an inflationary future. A collapse of public pensions, however, could be deflationary as governments raise taxes while squeezed pensioners spend less. In the solution to the last crisis, authorities planted seeds with a very long incubation period. An investment portfolio should therefore be prepared to be resilient in both inflationary and deflationary futures, because we don't know which one we'll get.

[1] With credit to Grant's Interest Rate Observer for the analogy