JULY 6, 2021

On the Radar

FAQS ON THE MARKETS AND ECONOMY

What might a bipartisan infrastructure deal mean?

After weeks of negotiation, President Biden and a bipartisan group of senators have agreed in principle to a framework for a $1.2 trillion infrastructure package. The agreement focuses on traditional infrastructure such as roads, bridges and waterways as well as broadband, and comes with no new taxes.

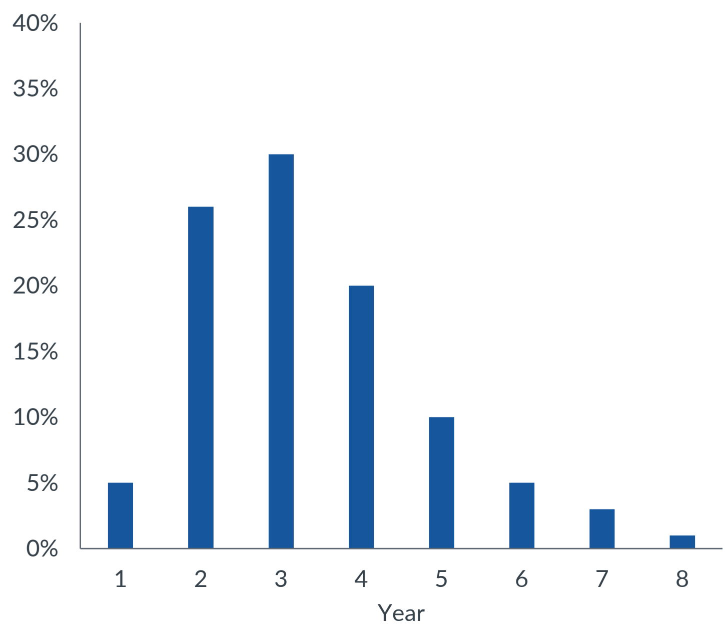
However, only $579 billion of the total outlays represent new spending with funding achieved by repurposing unused COVID-19 relief funds, tougher IRS tax enforcement, and a grab bag of other smaller revenue sources, including counting on the macroeconomic impact of infrastructure investment.

The agreement still faces significant headwinds to becoming law, and may ultimately hinge on the ability of Democrats to tie its passage with that of a much larger reconciliation bill later this year focusing on child and elder care, education, healthcare and the environment.

From an economic perspective, the new spending would add to GDP growth, but only modestly since the spending is spread out over eight years. Compared to typical fiscal stimulus, infrastructure spending also is implemented relatively slowly. This is largely because there are very few true shovel-ready projects – most infrastructure requires significant planning and review before investments are made. Multipliers for infrastructure spending, like the spending itself, also tend to be fairly drawn out, starting small and peaking after a number of years.

Infrastructure Spend-out Rates

% of Total Spending



Source: CBO.

From a market perspective, tax hikes are still on the table if a larger bill is passed through reconciliation, but the corporate tax rate might settle lower than initially proposed if a separate bipartisan deal is signed.

KEY QUESTIONS

Is consumption expected to stay strong for some time?

Was the recent labor report a blockbuster?

How can public pension plans take advantage of solid investment returns to strengthen sustainability?

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Is consumption expected to stay strong for some time?

Yes, it is. Due to the generous support from the federal government over the past year, and the reduced spending on many services during the past year, household balance sheets are incredibly healthy. This is very rare following most recessions; usually, they are highly levered.

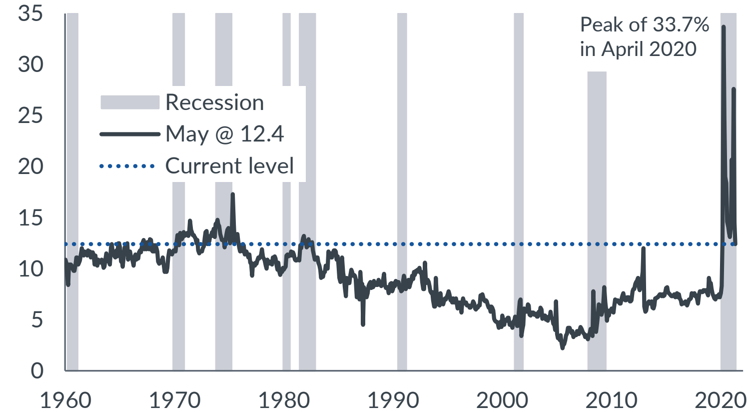
The savings rate currently stands at 12.4%. Although it is down from the recent highs, it still stands at historically elevated levels (chart).

All that money is not expected to be spent down. On the contrary, following two severe recessions in just over a decade, the belief is that households will want to retain a higher safety cushion of cash.

That said, households are sitting on more than $2 trillion in savings beyond the 2019 average. So there is a lot of money to go around.

Personal Savings Rate

%, seasonally adjusted



Source: Bureau of Economic Analysis as of May 2021.

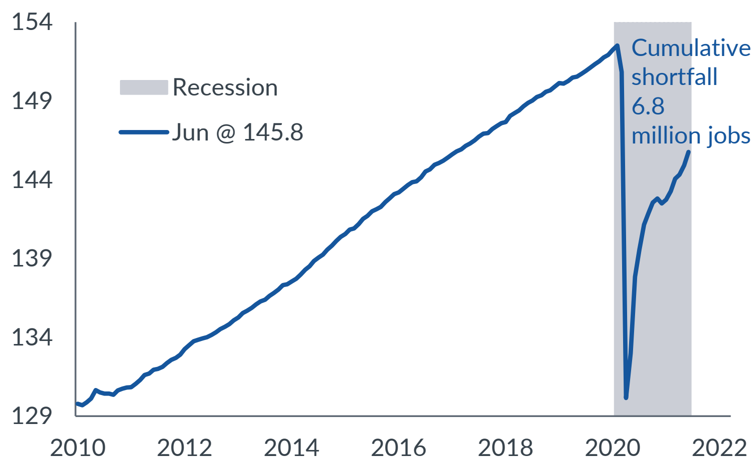
Was the recent labor report a blockbuster?

With the craziness of the labor market over the past year due to the pandemic, it is hard to define “blockbuster.” But compared to the pre-pandemic period, yes, the June report was a blockbuster. Payrolls jumped 850,000, the largest increase in ten months. In aggregate, 70% of the jobs lost since last spring have been recovered. The unemployment rate, calculated from a different survey, moved up a tad to 5.9% from 5.8%. That is due to more people entering the labor force.

Businesses are struggling to find enough workers to fill their open positions. This is attributed to many parents who are taking care of kids. This should correct itself in the early autumn when they return to school. In addition, some economists blame the enhanced pandemic unemployment benefits that may discourage some people from returning to work. About half the states terminated those benefits early, but they did so after this survey was completed. We will see the impact of that decision in next month’s labor report.

Nonfarm Payrolls

millions, seasonally adjusted



Source: Bureau of Labor Statistics as of June 2021.

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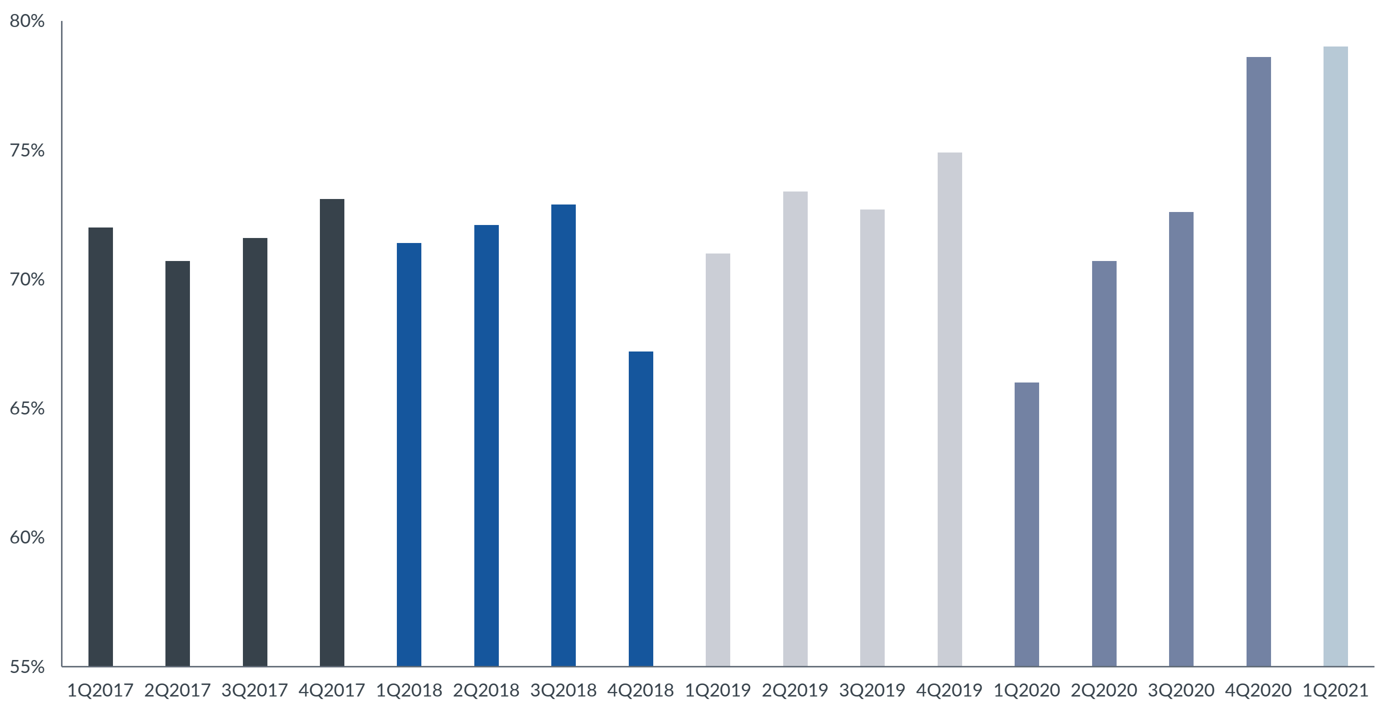
How can public pension plans take advantage of solid investment returns to strengthen sustainability?

State and local government pension plans with a June 30 fiscal year-end (FYE) are likely to report robust financial market performance well above their assumed long-term investment assumption. A 70/30 blended return of the S&P 500 and Barclays U.S. Agg indices (a pension plan proxy) delivered a 12-month return above 28% through 6/30/2021. With its March 31 FYE, New York State (a special case) disclosed that one of its pension funds returned more than 33% for FY 2021. Moody's recently projected investment returns for many public pension systems will likely reach 25% or 30% for FY 2021 ending June 30, based on their composite indices meant to reflect a typical public pension asset allocation.

On the surface, excess returns help close the gap between assets and unfunded liabilities, which would ordinarily reduce government contributions at least over the near-to-medium term, so long as actuarial assumptions are met going forward. For pension plans that calculate contributions with asset smoothing, whereby actuarial gains and losses flow through to contributions over several years, the impact is likely somewhat muted for a given year. While we expect current-year experience to reflect unusually high investment returns, forward returns could moderate, or worse, drop below those assumed by pension plans. In response, taking advantage of excess returns to deploy risk mitigation strategies is a prudent approach by plan sponsors to guard against market risk and improve long-term sustainability.

There are many kinds of risk mitigation strategies public pension plans could utilize. Decreasing the long-term investment return assumption (i.e., discount rate) is a way to increase the confidence level of the return assumption being met in the future while reducing volatility. Additionally, lowering the investment return likely correlates to adjusting the asset allocation into less volatile assets, which reduces asset swings and contribution volatility in future years. CalPERS, for example, has a policy that seeks to use a portion of excess returns to lower the discount rate. Today, most plans' discount rates are closer to 7%, a gradual improvement from more than 8% several years ago. Also, more conservative amortization, or the paydown of unfunded liability, could pull forward repayment in lieu of costs ramping up over time. In some instances, which are occurring with some plan sponsors, making supplemental payments into the system despite expectations for reduced contributions [from asset gains] can help fast-track funding. Strategies may increase costs over the near term for the government, but, in exchange, place the plan on firmer footing over the longer term.

Milliman 100 Public Pension Funding Index



Source: Milliman.

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Index Definitions

S&P 500 Index (S&P500) is a stock market index that tracks the 500 most widely held stocks on the New York Stock Exchange or NASDAQ. It seeks to represent the entire stock market by reflecting the risk and return of all large-cap companies.

The Bloomberg Barclays US Aggregate Bond Index, or the Agg, is a broad base, market capitalization-weighted bond market index representing intermediate term investment grade bonds traded in the United States.

The Milliman 100 Pension Funding Index projects the funded status for pension plans included in our study, reflecting the impact of market returns and interest rate changes on pension funded status, utilizing the actual reported asset values, liabilities, and asset allocations of the companies' pension plans.

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