

CMA Update: Public Pension Funds Facing a Slow Growth Economy

With the economy in recession, the Federal Reserve has lowered short term interest rates to Zero, which has lowered 5 year Treasuries to 2% interest return. Further, the benchmark of common stock mutual funds, the S&P 500, has been "flat in performance for 10 years", and currently has only a 2.2% dividend yield.

Many municipal pension funds utilize an asset allocation mix of approximately 60% in US Government debt securities of 5 years or less duration. At current 2% interest yields, these are providing very low returns, compared to 6% interest rates on these in 1999. ***With many stock mutual funds used by public funds paying 1-3% dividend yields, pension funds have low potential to achieve anywhere near the typically desired 7% annual hurdle rate of return on pension fund assets.***

This Pension Fund Rescue blog posting discusses the current state of the US economy, fiscal and monetary policy actions in place, and an outlook of what investors and pension fund trustees should be considering in selecting higher income investments towards hitting hurdle rates of return. Curing under funded pension fund deficits is of paramount concern to all fund trustees and investment managers.

There are important facts and ideas I want to discuss in this article. Much confusion is in the financial markets now on the "State of the US Economy", and how investors and pension fund managers should be focusing their investing dollars.

Fed on the Gas/Banks on the Brakes...The economy is facing a uniquely diverse situation...The Federal Reserve has put short term interest rates down to Zero for near a year, whereas these super low rates are intended to stimulate borrowing by consumers and small businesses. Yet, commercial banks "have the lending brakes on" with loan volumes and credit card limits contracting month after month. Without loan growth, it's difficult for the economy to grow.

We have witnessed: Japan, the second largest economy in GDP on earth has just completed its "second lost decade" of Zero growth in common stock values and interest rates below 1%...for 20 years!

What's in store for the US? First, the US economy is in a "Lame Growth Position"...it is stuck at or near the bottom of a recession. There is no big catalyst to turn it upwards, other than Zero interest rates and massive fiscal stimulus, which is not working to turn the economy. The 3rd quarter GDP up tick is a very small bounce from approximately 4 successive quarterly declines...and the initial 3.5% upswing was later revised back to just 2.8%....whereas unemployment still rose during that 3rd quarter up tick. The Feds are trying to give the economy gas, but falling bank lending is holding the economy back...**We are in a Lame Position.**

What is "not working" to turn up the economy, is the US Consumer. With 10% unemployment, a record low 33 hour workweek...from fulltime employees put to part

time, consumer spending is very weak on anything other than "staples"...necessities of life. The point of this rather depressing outlook is not to deflate nice positive expectations...rather to understand the reality this country will face over the next 3-5 years. There is little economic growth now, and not much acceleration ahead.

As was pointed out in the WSJ this week, consumer and small business lending continues to shrink at alarming rates from its July 2008 peak. Banks, month after month, are contracting their consumer and small business loans. Credit card companies continue to cut small biz and consumer credit limits. It's a vicious cycle of loan contraction.

This economy is powered 70% by consumer spending, and small businesses are the largest employers in the country, and have the potential to create the most new American jobs. Large public companies, that have very good access to bank and capital markets credit have a record of transferring jobs to lower labor foreign countries, and they cut hundreds of thousands of American jobs to-boot during this recession.

Small biz and consumers in the lending penalty box...The small business sectors are the most "starved for credit" at this point in the economy. Bank lending policy and CC limits...both in steady decline, are killing this vital area of the economy for future growth in new American jobs. Over the past two years, bank lending contraction has cut \$1.5 Trillion of lending from the economy to small biz and consumers...that equals about 12% of annual GDP. Fed interest and bank lending policies are "working in reverse of desired goals"...low interest rates to large public companies that push jobs overseas, and pull back on lending to small businesses that basically create the most American jobs.

Why is debt contracting?...The consumer debt securitization industry for CC receivables, auto loans, and non-US Govt backed home mortgages is down nearly 40% since the peak of mid 2007. Another factor that self-inflicts debt/credit reduction is the "voluntary efforts of consumers to lower their debt". 25 years ago, household debt was about 60% of household income. A few months ago that percentage peaked at 125% and now it stands just a little lower at 122%. Many years of consumer debt deleveraging are ahead, and a lower percent of household income will go towards discretionary consumption spending.

Who's hurting with low interest rates?...The FED is on the Gas with Zero percent short term interest rates to stimulate, while Banks and CC companies are going the opposite direction and lowering lending limits to consumers and small biz. It's like a driver standing on the Gas and the Brake...a lot of Revs, but no forward movement. There are bad unintended consequences to the FED's Zero rate policy...savers and those scarred to invest in financial markets are getting Zero interest rate income return on a record \$4 Trillion in money market funds today. It's crushing the senior age retiree community...throttling back their spending, even without them using any credit. Pension funds are receiving substantially lower interest returns of government and agency debt securities.

What are some of the best strategists saying about investing? (This does not include self-serving Wall Street.) They are saying that we will have a "New Normal" of 1-3% annual growth in GDP, not 3-5% prior to the financial meltdown and recession; plus low inflation; and near Zero interest rates on money funds, CDs, and savings accounts. Companies that sell goods and services to traditional pre-recession growth industry settings, will have a lower GDP growth rate to deal with. ***Growth stocks will languish in price, like they have already for the past 10 years.*** Some are looking for a "second lost decade" in stock market valuation growth.

This low-growth outlook, which I share is "bitter sweet". Low growth on the economy will keep inflation tame. Yet, low growth will prevent an emergence of P/E (share price earnings multiple) expansion...more likely a reversion to P/E multiple contraction in 2010. As an equity investor, you need to make the right choices between cash-like investments paying Zero, Treasuries at 2% yields, and positioning pension fund assets to some tolerable degree of risk to avoid the Zeros on return. Some investment strategists are avoiding "growth-focused" investing in growth stocks, speculative commodities, junk bonds, and avoiding highly cyclical or growth industry settings for their investments. They are focusing their investment dollars on high yield equity investments, at yields of 4% and higher.

What's available that speaks to the reality of the future economic course? .

As an illustration, the top 100 stocks in the S&P 500 index have an average dividend yield of 5% today. This is much higher than most growth mutual funds used by public funds that pay just 1-3% dividend yields. Pension fund trustees and investment managers need to consider "focused-investing" in the stocks of the higher dividend sectors of the major stock indexes.

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