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## Swiss Re's solution for the macro-economy: Infrastructure

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By Editorial Staff    *Wed, Jun 24, 2015*

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*The global reinsurer points out that support for asset prices doesn't produce real growth, and that an aging population doesn't bode well for growth, but that developing a liquid market for infrastructure bonds might be the ticket to true recovery.*

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[“Financial repression: The unintended consequences”](#) is the title of Swiss Re's latest assessment of the impact of the low-interest rate policy practiced by the U.S. Federal Reserve and the European Central Bank since the 2008-2009 financial crisis.

Neither alarmist or sanguine, and containing few surprises for anybody who follows central bank maneuvers, the global re-insurer's report nonetheless makes good reading—because of the authority of the source and because of its relevance to the retirement industry.

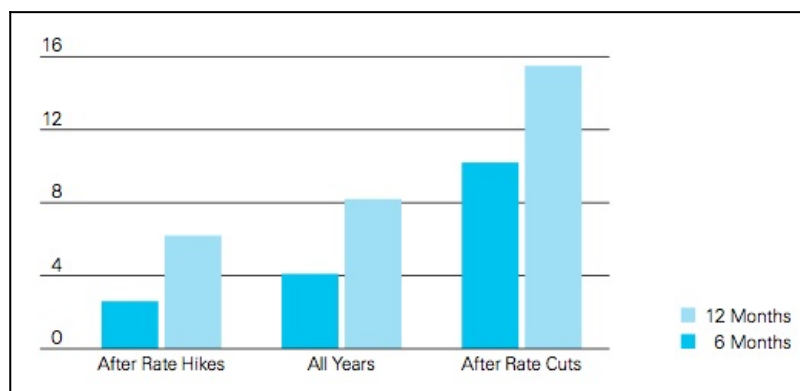
The report offers some historical perspective for the Fed's exit from zero-interest rate policy, a consideration of the interplay between global aging and the financial markets, and a blueprint for a “Global Project Bond Market” for financing trillions of dollars in new infrastructure projects. Here are a few excerpts from the report:

### **\$1 trillion more per year on infrastructure**

- “Some USD 50-70 trillion will be needed to finance infrastructure globally through 2030,” the report says. “Thereby, we estimate that the current spending of roughly USD 2.6 trillion annually will have to increase to around USD 4 trillion by 2030. This emerging financing gap, estimated at roughly USD 1 trillion annually will have to be met in order to support economic growth.”
- To help banks, insurance companies and governments finance infrastructure projects, Swiss Re recommends that “private market participants [should] work together with the public sector in creating a ‘Global Project Bond Market’” and “a tradable asset class [that] would unlock the long-term investor asset base.”
- “A recent S&P study estimated that a USD \$1.3 billion infrastructure investment would likely add 29,000 jobs to the construction sector and USD \$2 billion to US real economic growth.”

### **A baby-steps exit from ZIRP**

- “With growth below the long-term trend and inflation tame, the Fed's rate hikes are likely to be gradual. A repeat of the 1994 bond market collapse, when the Fed's policy rate increased by 300 basis points in a single year, seems unlikely.



- “The hiking cycles in 1990-2000 and 2004-2006 are better comparisons. In 1999-2000, the Fed raised rates by 1.5 percentage points. The Barclays Aggregate U.S. Bond Index<sup>19</sup> lost just 0.8% in 1999 before rebounding 11.6% in 2000. In 2004-2006, the Fed raised rates 17 times, from 1.0% to 5.25%. During those three years, the Barclays index delivered positive returns.
- “An important difference, however, is that yields were higher in the two previous episodes noted than they are today (though investment grade spreads were fairly similar to today), offering more income to offset potential price declines.
- “The equity market’s initial reaction in all three instances was a sell-off, with the S&P 500 Index ending down by an average of 3.2% after a one-month period. The average price rise over six-month periods after the start of each rate-hiking cycle was still positive at 2.6%. After 12 months, the average return was 6.2%, 200 basis points below the long-term average annual price change...
- “Market volatility is likely to pick up, and central bank policy errors have the potential to be more detrimental. There is a good case for seeing a different equity reaction to the eventual tightening of rates in the current cycle.” (See chart above for average historical S&P 500 Index responses to interest rate hikes and cuts. Source: Swiss Re and S&P equity research.)

### **Boomers will “disinvest”**

- “Population aging is likely to become a bigger focus for financial market developments in the coming years, especially as the dependency ratios in many major economies are to rise significantly. The available labor force will decrease, and the elderly will increasingly make up a larger proportion of the population.
- “With most governments already facing unsustainable debt, rising age-related spending only aggravates the problem. Moreover, there is a risk that the financing need will further create incentives for governments to implement even more expansionary policies.
- “Putting this aside, several question marks emerge related to current financial repression policies: According to the life-cycle hypothesis of consumption and saving, during retirement an aging population reduces its savings and disinvests its asset holdings in order to support consumption. This means that the “wealth effect”, as reflected by policies to support the equity market for fuelling consumption growth, will be even less effective.
- “At lower interest rates, more needs to be saved on aggregate for an aging population in order to maintain the consumption level post-retirement when the accumulated savings are spent.”