IeC Experience and Insight on Demand

Research Note **26 October 2012**

US Economy: Demographics the 'silent witness'

Most economists believe that constant growth has become normal in today's economy. Their view is based on the SuperCycle seen between 1982-2007, when the US economy suffered just 16 months of recession in 25 years[i].

Thus since 2009, most debate has centred on which policies – quantitative easing, austerity programmes, tax and/or spending cuts etc – will most quickly return us to growth.

This Note argues, in contrast, that the idea of constant growth is wishful thinking. It instead suggests that the major changes now underway in US demographics mean that low growth is likely to be the 'new normal'.

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Our argument is simple, and based on just one key assumption, that demographics drive demand.

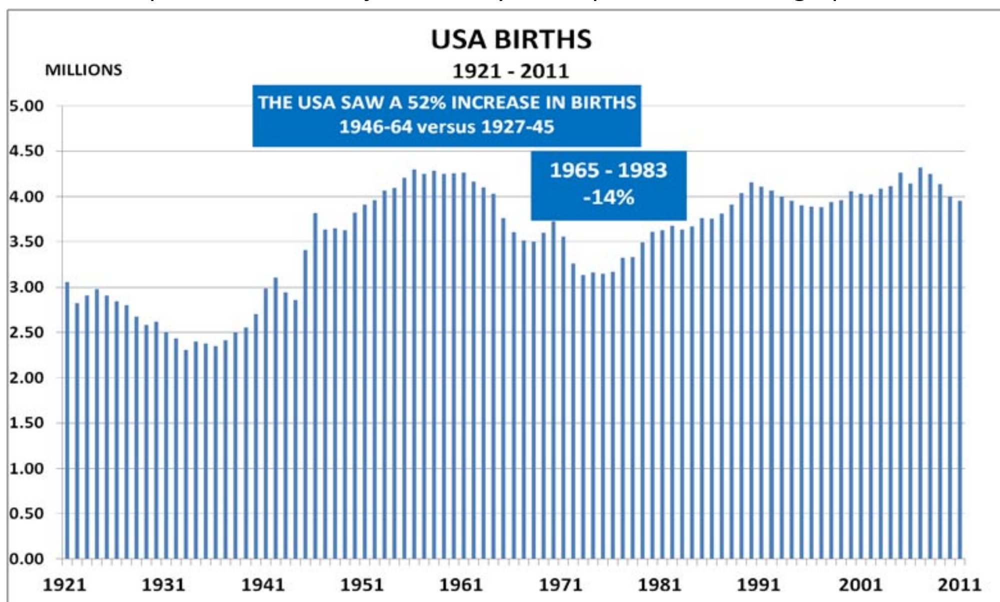

Chart 1: The BabyBoom generation is now ageing in the US

Chart 1 shows the size of the **demographic windfall** that boosted the US economy until recently. The US saw births rise 52% between 1946-70, compared to the previous 18 years[ii]. It added 26 million babies to its population – 75% of Canada's current population, itself a G7 member, and whose $1.7tn economy is a similar size to India's. As these babies grew up, and the US economy prospered, it therefore became almost inevitable that they would spark a growth SuperCycle on reaching the Wealth Creator 25- 54 age group, typically the period of peak consumption. They were, after all, the largest and richest generation that the world has ever seen.

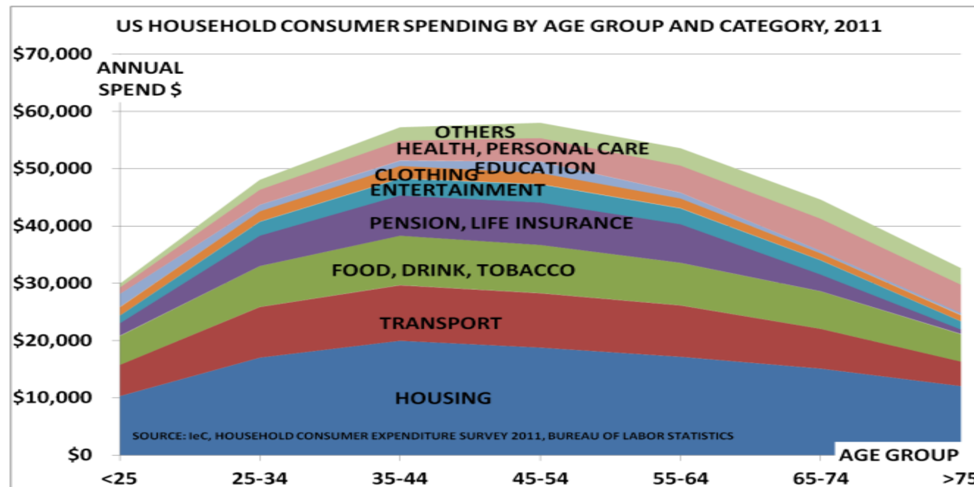

Chart 2: UK Household spend by age, 2010

But now, the Boomers are ageing fast. The oldest Boomers began to join the New Old 55+ generation in 2001, and it now contains 77 million Americans[iii]. They are 25% of the population, and their numbers are rising all the time. Growth will inevitably be very much slower than in the 1982-2007 SuperCycle years. The reason is straightforward:

- When people are young, they need to buy new things
- And the US BabyBoomers had lots of money to spend, particularly during the credit boom
- But now the kids have left home, and the Boomers don't need many new things
- Instead, they mainly buy replacement products, and only when these wear out

Chart 2 illustrates this point by reference to official US[iv] household expenditure data, by category. The survey presents a clear message: **spending peaks by the age of 55 years, and then falls away quite sharply as people age**.

US household consumption is 71% of GDP[v]. Thus such major changes in spending patterns clearly impact GDP growth. This clearly helps to explain the unprecedented surge in demand during the 1982-2007 SuperCycle, as the Boomers entered their peak consumption ages of 25-54 years. Equally, nothing lasts forever. Future economic growth must now slow as **more and more Boomers join the New Old 55+ age range**. As chart 1 showed, US births between 1965-83 averaged 14% less than in the Boomer years. The younger generation is therefore too small to compensate for their parents' spending slowdown.

This pattern on its own will have a major impact on economic growth and financial markets. The Boomers drove stock markets to record levels in their Wealth Creator years. But now they are becoming uncomfortably aware that their savings may prove insufficient to fund their extra decade of life expectancy compared to previous generations. Their focus is moving from return **on** investment, to return **of** investment, hence bonds of highly-rated countries often trade with negative real yields, such as for Japan, US, UK, Germany and Switzerland, the so-called JUUGS countries. Thus the ageing Boomers may well spend even less than the historical average.

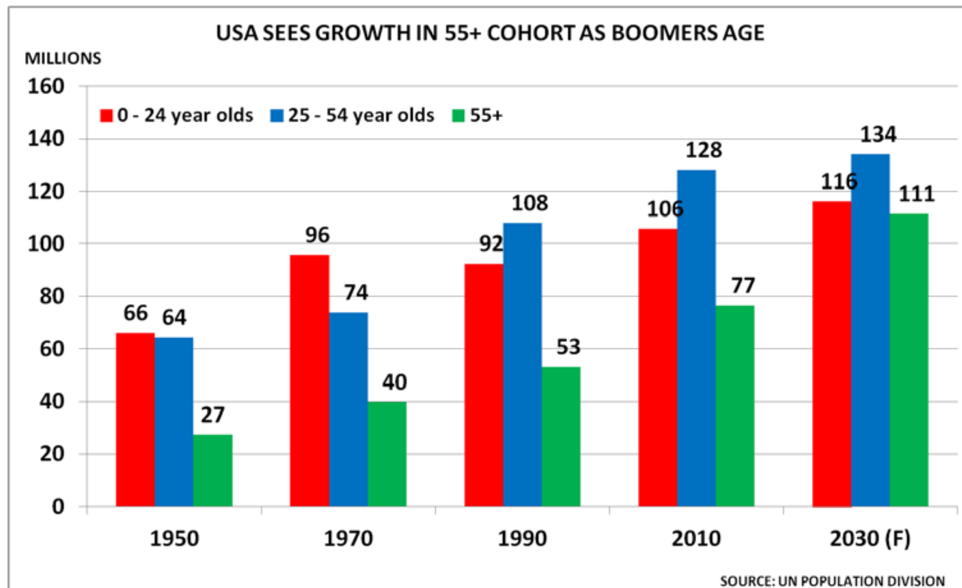

Chart 3: The New Old 55+ generation is the main growth sector in the US

Chart 5 shows that the New Old 55+ generation is now the major growth cohort within the US population. The numbers of those in the 0-24 and 25-54 age groups are already plateauing. This is another reason for today's slowdown, as most companies are still focused on the age groups that have gone ex-growth. They ignore the evidence of increased life expectancy, and imagine that the New Old 55+ generation only require Zimmer walking frames and sanitary products. This lack of available products and services is creating an entirely avoidable headwind for the economy.

The sun may not just be setting on Japan

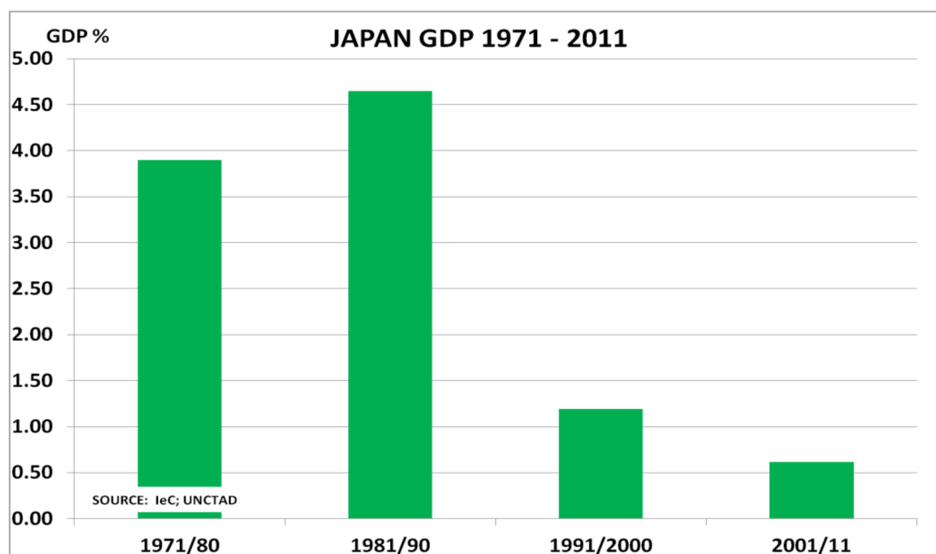

Chart 4: Japan's GDP growth slowed sharply as its Boomers aged, despite export strength

Japan offers a clear precedent for the impact of an ageing population on economic growth. Its BabyBoom was earlier than in the US and focused in the 1940-52 period. This meant that all its Boomers were in the Wealth Creator 25 – 54 age group between 1977-94. Its Nikkei stock market

index peaked in 1989 at 38,916 and its government bond interest rates at 8%. It introduced quantitative easing, and massive stimulus spending to try and kick-start growth after 1989. But as chart 4 shows, GDP growth has since averaged less than 1%/year, versus 4%/year in the Boomer years. This has clear implications for the US economy.

The Governor of the Bank of Japan has warned recently that in his view, "*the similarities far outweigh the differences*[vi]" between Japan's subsequent economic performance and the demographic position today in the US and Europe. He added that *"The implications of population aging and decline are very profound, as they contribute to a decline in growth potential, a deterioration in the fiscal balance, and a fall in housing prices Other developed countries will face the same problems despite some differences in timing and magnitude."*

Conclusions

The demographic evidence needs to be discussed

Demographics have been the silent witness in today's economic debate. Yet their evidence deserves to be heard, and discussed, by policymakers, governments, companies and investors. It suggests that the US havsalready entered a 'new normal' of much slower economic growth. But this should not be seen as a disaster waiting to happen, as long as we are sensible in our response. Today's increase in life expectancy represents one of the greatest achievements of the modern age. We have only ourselves to blame if we now turn this triumph into disaster.

US economic policy in the new normal

Policy-makers need to recognise that **today's financial crisis is a symptom of the impact of changing demographics.** The US **economy faces a clear risk of decades of lower economic growth** due to the structural decline in household expenditure and the growing emphasis on replacement-based consumption**.** But there is no reason for this to translate into 'lost decades', if policy makers accept the demographic reality and act to refocus the economy accordingly.

- Demographic trends therefore need to be properly understood by policy makers. At the moment, they are being widely ignored. It has been too easy to assume that Japan's issues are associated with policy errors, rather than the inevitable result of an ageing population. Ageing is a global mega-trend, and impacts China due to its 'one child policy' as well as other BRICS.
- Policy makers also need to recognise that managing population ageing is rather like captaining a supertanker. Short-term manoeuvres have little impact, and may unintentionally create additional hazards. Instead, they need to navigate with their eyes firmly on the long-term horizon – clearly a major challenge in today's Twitter-age of focus group-driven policy.
- **Continuing to ignore demographics will be extremely dangerous for the economy.** Lower growth may make it harder for the US to pay down its debt burdens as tax receipts will come under increasing pressure. It may also make it more difficult to deal with the rising costs associated with ageing populations, such as medical care and state pensions.

Doing business in the new normal

Most executives have moved up the corporate ladder during the economic SuperCycle. Thus they now have to unlearn much of what they have learnt about critical success factors. 'If you build it, they will come' is no longer a viable strategic mindset. Over-optimistic market assessments will no longer be rescued by seemingly constant growth and the arrival of 'pent-up demand'.

- Executives, like investors, will find themselves buffeted by markets which exhibit ongoing and high levels of volatility, uncertainty, complexity and ambiguity, as the economy transitions to the new normal**.** In addition, they may well have to cope with continuing waves of unhelpful, though well-meaning, interventions by policy makers. The unintended consequence of liquidity injections in raising oil prices, as discussed in our note last month, is just one example.
- Executives will therefore need to learn new tools with which to sustain growth. Business model innovation will be essential, in order to meet the needs of those market sectors with future growth potential. One example of these is the opportunity to develop new products and services to meet the needs of the New Old 55+ generation.
- Technical innovation will also be essential, as the successful products of the future are likely to be based on 'needs', rather than 'wants'. Affordability, rather than premium pricing, will be key, as markets re-segment themselves into a large 'value' sector and a small 'luxury' segment, with little middle ground in between. This will be quite unlike the SuperCycle.

Investing in the new normal

The distorting effects of aggressive monetary stimulus measures have led to correlation trading across major asset classes in alternate 'risk on, risk-off' mode. This is extremely dangerous, as it means markets are failing to perform their true task of price discovery. Today, **no major market currently knows what it is pricing, as fundamentals are being overwhelmed by liquidity flows.** This creates a challenging environment for investors in terms of asset allocation.

- Unsurprisingly, many investors have increasingly focused on ensuring **the return of their capital, rather than a return on capital.** The bonds of the **JUUGS markets (Japan, UK, USA, Germany, Switzerland) may therefore continue to deliver record low yields** for many more years to come, despite credit downgrades, if domestic political stability is maintained.
- Oil markets have also been badly affected (see our note 'Central banks will make downturn worse', last month). Central bank liquidity is currently driving them to a second successive year of record high annual prices, despite worsening fundamentals. These high prices are further eroding already weak consumer spending power, and corporate profits.
- This liquidity has also blindsided investors on the inflation issue. Weak global demand means that inflation is unlikely to become a major problem, unless quantitative easing is taken to extreme levels. Instead, we are now seeing a secular reversal of the inflation initially created in the 1970's as the early Boomers joined the 25-54 Wealth Creator age group, and the SuperCycle began to develop. Deflation may be a far more potent medium-term risk for portfolios.

References

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[i] US National Bureau of Economic Research
[ii] Births data from US Center for disease control and Prevention, Vital Statistics
[iii] Population data and projections from UN Population Division, 2010 Revision
[iv] US Bureau of Labor statistics, Consumer Expenditure Survey 2011, Table 3
[v] World Bank, OECD countries, Household Consumption % of GDP
[vi] Masaaki Shirakawa, Lecture at the London School of Economics, 10 January 2012

About IeC: IeC is a London-based strategic consultancy advising numerous Fortune 500 and FTSE 100 companies, investment banks and fund managers.

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