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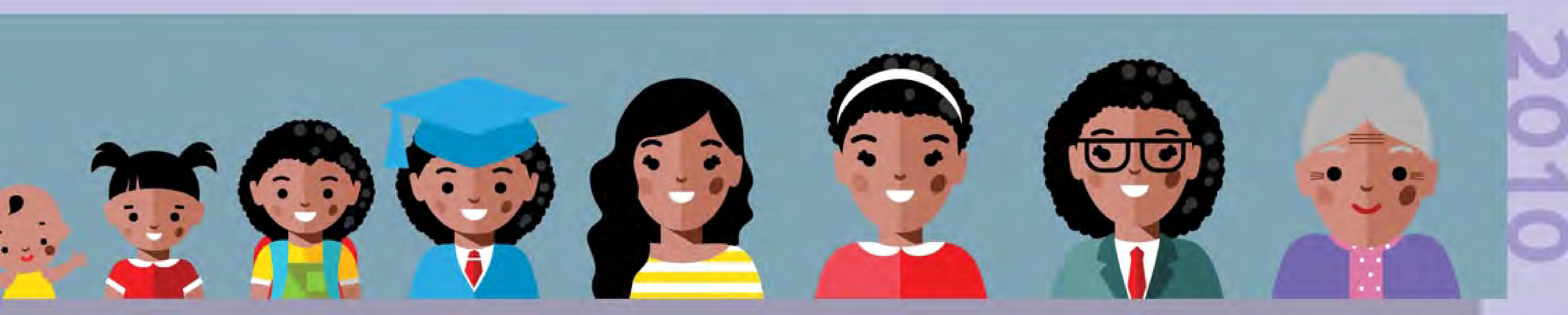
Adapting to the Global Demographic Shift

India's Lubricant Market

ADAPTING TO

CHANGING



GLOBAL

By Paul Hodges

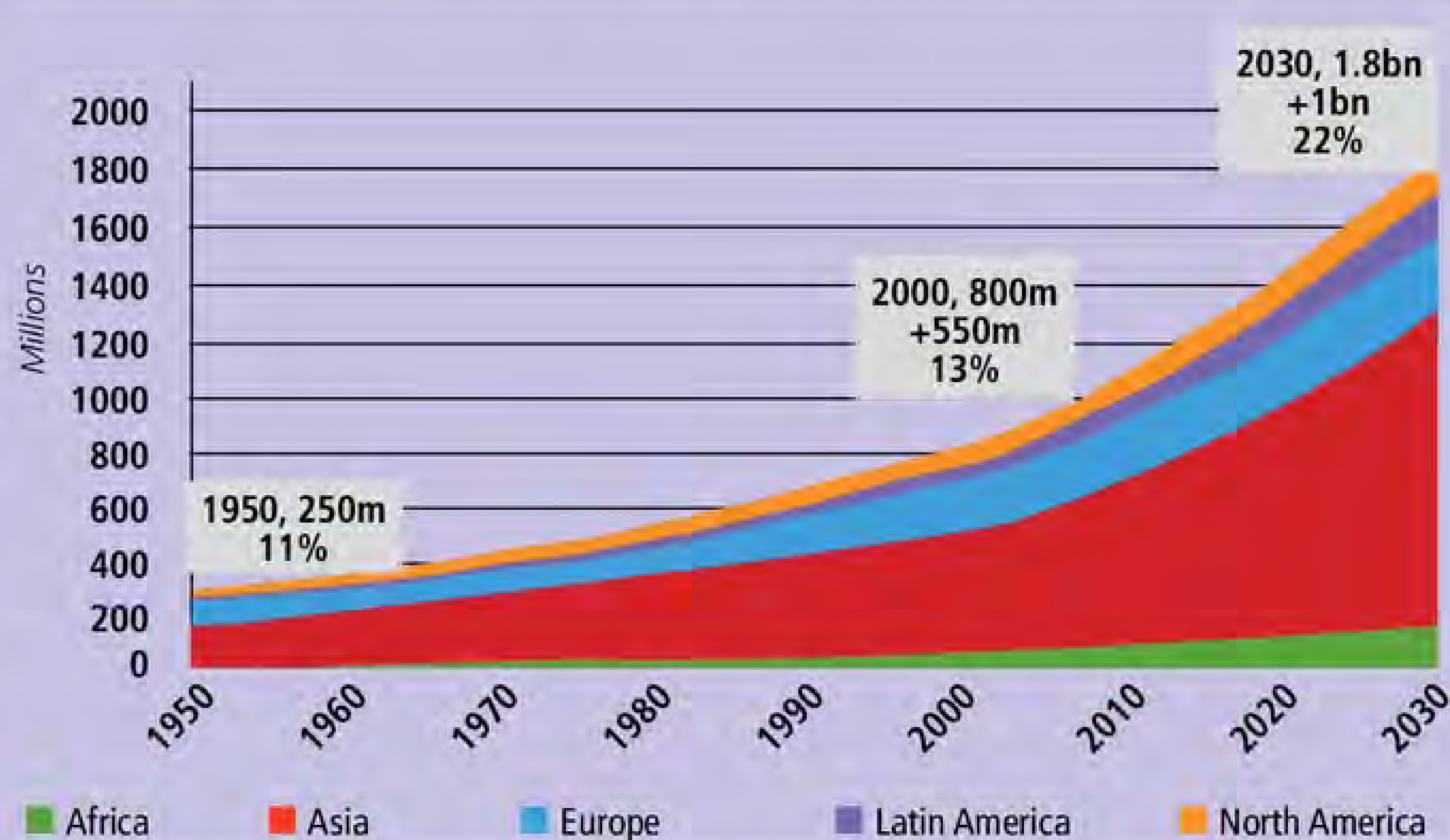
DEMOGRAPHICS

Slowly but surely, reality is returning to oil and feedstock markets. Brent oil prices have been supported recently by the weakness of the U.S. dollar. As always, this has prompted financial market traders to boost their ownership of commodities, in the belief these offer a "store of value" in dollar terms. But in the real world of oil market supply and demand, the collapse of the so-called OPEC/Russia price freeze discussions highlights the supply glut that exists across all major energy markets.

The central banks may still claim that their policies are just about to return the global economy to long-term growth. But for those who believe demand is created by people, rather than by economic models, it is clear that a paradigm shift is underway in terms of demand patterns. The critical issue is that for the first time in history, domestic demand growth in most countries is being driven by the needs of the lower-earning, lower-spending New Old 55+ generation.

2020

New Old 55+ Population by Major Continent, 1950-2030



Source: pH Report, UN Population Division

Who Are the New Old?

As the chart shows, across the world, 1 billion people are now moving into the New Old 55+ age group, where their spending and incomes start to decline quite sharply. These New Olders already own most of what they need, and their incomes are dropping as they move into retirement.

By 2030, this demographic will represent more than one in five of the global population, nearly twice the ratio seen during the Supercycle. The period from 1983 to 2007 saw a span of 25 years with only 16 months of U.S. recession – something never seen before, and probably unlikely to be seen ever again.

Consensus wisdom has thus failed us, yet again. The next few years are, therefore, likely to prove very uncomfortable for many companies. Boards who have sanctioned major expansion projects are going to have to consider whether to proceed or cut their losses. They face binary decisions, with no middle ground.

Are they really clear about the potential drivers for this demand in the future? As the *Financial Times* summarized new U.S. research from the Pew Foundation, "Companies struggle to adapt to an over-60s group that is set to drive half of all U.S. spending growth." (See "Middle class meltdown," *Financial Times*, 10 December 2015.)

Essentially, what we are witnessing is a Great Unwinding of policymaker stimulus. Over the past decade, the world's major central banks have deliberately pumped up prices for financial assets via ever-increasing amounts of stimulus and quantitative easing. Their aim was explained by then U.S. Federal Reserve Chairman Ben Bernanke in the *Washington Post* on 3 November 2010. "Higher stock prices will boost consumer wealth and help increase confidence, which can also spur spending. Increased spending will lead to higher incomes and profits that, in a virtuous circle, will further support economic expansion."

Their economic models assured them, despite all evidence to the contrary from the real world, that stimulus could somehow return us to the demand levels seen during the Baby Boomer-led Supercycle. They believed they had become modern "Masters of the Universe," able to control a global economy of 7.3 billion people with just the touch of a money-printing machine.

Now, the hollowness of this claim is being exposed, as markets return to being based on the fundamentals of supply and demand, rather than tidal waves of central bank liquidity. The end-result is that companies face chaos in both feedstock and product markets.

This chaos could take a long time to resolve itself. Five critical questions will therefore likely dominate every company's agenda over the next few months:

1. Can businesses still plan ahead for demand by simply using a relevant multiple for each product in relation to an International Monetary Fund GDP growth forecast?
2. How will Saudi Arabia's new "Vision 2030" impact oil prices? They seem likely to be much lower, for much longer, than consensus wisdom had suggested.
3. Do China's New Normal policies mark a complete change of direction from its previous role as the manufacturing capital of the world?
4. Will today's globally aging population maintain the same levels of demand for autos, housing, electronics, etc. as in the past?
5. How can companies develop a more service-led business model, which emphasizes the value created by the product, rather than simply focusing on the product itself?

My key concern is that this chaos will create winners and losers. There will be no middle ground. Winning companies will accept that the world is moving into a New Normal that will be quite different from previous experience. Losers will cling vainly

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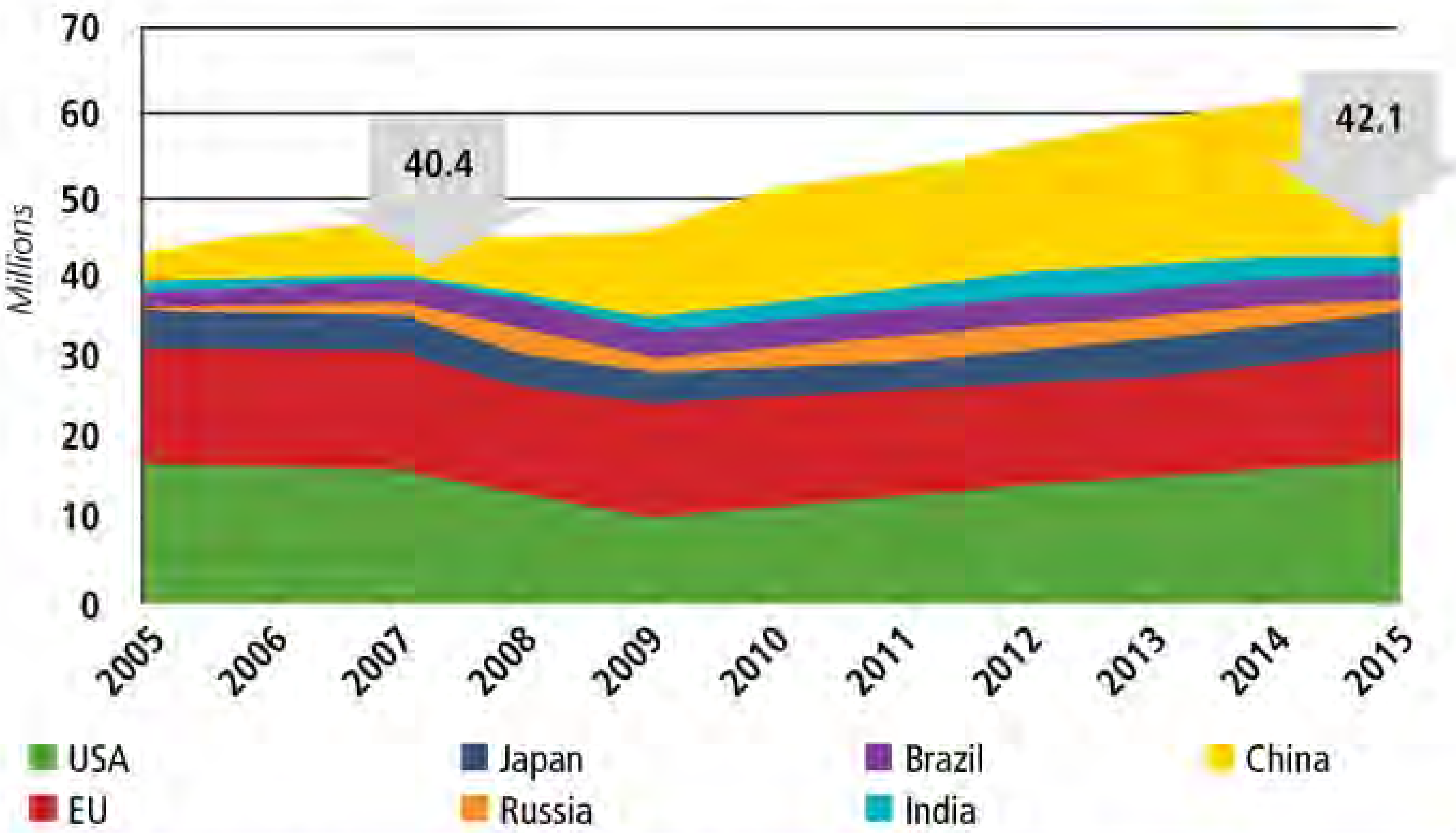
Passenger Car Sales in the Seven Major Markets



Source: IeC analysis, National Auto Manufacturer Organizations

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to the hope that change is not inevitable, and that the world will eventually return to the comfortable Old Normal, where constant demand and robust profits were the norm.

The New Normal

Auto markets are a good example of the paradigm shift now underway. General Motors President, Dan Ammann, put it well earlier this year when he warned, "We think there's going to be more change in the world of mobility in the next five years than there has been in the last 50 years."

His use of the word "mobility" was also significant. People around the world will still need mobility, but will they need to own cars to achieve it? Probably not, if they live in cities, which most people now do in the wealthy developed economies. As Ammann also noted in June 2015, "It's [buying a car] the last thing you should do because you buy this asset, it depreciates fairly rapidly, you use it 3 percent of the time, and you pay a vast amount of money to park it for the other 97 percent of the time."

Ammann's insights highlight the fact that previously successful business models, based on the supply-driven principle, no longer work. Instead, companies now need to adopt demand-led strategies if they want to maintain revenue and profit growth, due to the transformations now underway in consumer markets.

First, young people's attitude toward cars is undergoing major change in the developed world. They often see car ownership as unaffordable, while the advent of social media and greater environmental awareness reduce its perceived benefits. Thus, in the U.S., only four out of five young Americans aged 20 to 29 held a driver's license in 2010.

Second, demand for cars is also weakening at the other end of the age spectrum. Parents drive less once their children leave home, and their mileage reduces still further on retirement. German data shows almost a 50 percent reduction in annual mileage between the ages of 30 and 70 years. The U.S. shows similar patterns.

Taken together, these developments make it almost certain that we have reached peak car sales in the West. Median age is already past 40 years in most countries, and the aging Baby Boomers in the U.S. are now reversing their earlier flight to the suburbs, which had vastly increased demand for new homes and cars. In Japan, the case study for aging populations, annual car sales peaked as long ago as 1990.

Contrary to popular belief, it is also most unlikely that demand in the emerging economies will some-

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Evolution of China's Passenger Car Market

Source: pH Report Analysis of data from China Automotive Association, Ministry of Public Security

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how pick up the slack. China's new leadership has recently highlighted how their predecessors' stimulus spending resulted in U.S. $6.8 trillion of "wasted investment" between 2009 and 2013. They are unlikely to repeat this mistake by introducing similar stimulus in future.

Without China, there would have been no overall increase in global car sales in recent years. And in formerly high-flying Brazil and Russia, for example, auto sales are down more than 40 percent in 2015 vs. 2013 levels. Yesterday's promises that these economies would inevitably see major growth now seem more like wishful thinking.

Even more important is that China's auto market, the engine of growth since 2009, is now poised for a major slowdown. Its sales growth has been focused on new cars, which were affordable due to the stimulus-induced property bubble. But today's volumes are increasing only because of the time-limited 50 percent tax cut on sales of smaller cars (those with engines smaller than 1.6 liters).

When this tax-break ends later this year, growth will instead be led by the used car sector. This market hardly existed in 2008, due to the poor quality of domestic production. But China's State Council is now actively boosting the sector, which seems poised for rapid growth.

A key factor is the introduction of Western technology in recent years, which has dramatically increased the average age of the car parc. Used car sales were just one-half the size of the new car market last year, but they are forecast to reach parity by 2020, inevitably cannibalizing potential new car sales.

Peering over the Cliff

These paradigm shifts require a complete change of mindset. Company boards can no longer assume that product demand will grow at an agreed multiple of an IMF GDP forecast for the global economy. This business model was successful during the Baby Boomer-led economic Supercycle, when the U.S. economy suffered just 16 months of recession between 1983 and 2007. But today, this model is broken.

The Boomers are now moving out of the Wealth Creator 25-54 age group, when spending and incomes tend to rise exponentially as people move forward in their careers and often settle down and have children. They were then the largest and richest generation in history, but their key characteristic today is that they also have the longest life expectancy. On average, a 65-year old Western Boomer can hope to live for 20 years – a century ago, total life expectancy was only 50 years.

At the same time, global fertility rates have collapsed, halving to just 2.5 babies per woman since 1950. This is dramatically reducing the relative size of today's Wealth Creator generation. As a result, the world has reached a demographic cliff, which is creating a demand cliff for the global economy.

"The debt financed growth model has reached its limits. It is even causing new problems, raising debt, causing bubbles and excessive risk taking, zombifying the economy....and may have laid the foundation for the next crisis."

This means we can no longer rely on the "build it and they will come" supply-driven business model that proved so profitable until recently. Anyone opening new capacity today may have to wait a very long time before demand catches up with the new supply.

This is why we argue that winners in this New Normal world now need to abandon their hopes that stimulus programs will restore former demand patterns. As German Finance Minister Wolfgang Schäuble warned earlier this year at the G20 finance ministers' meeting, "The debt financed growth model has reached its limits. It is even causing new problems, raising debt, causing bubbles and excessive risk taking, zombifying the economy....and may have laid the foundation for the next crisis."

Instead, companies need to return to the demand-led business models that proved so successful before the Supercycle. The core message of paradigm shift will be critical to future profitability for every company over the next 5 to 10 years, wherever it operates in the value chains. Difficult times clearly lie ahead. But as we highlight each month in *The pH Report*, the good news for potential winners is that the New Normal world is now open for business. □

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