Confluence INVESTMENT MANAGEMENT

Weekly Geopolitical Report

By Patrick Fearon-Hernandez, CFA

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Investment Implications of Changing Demographics: Part II

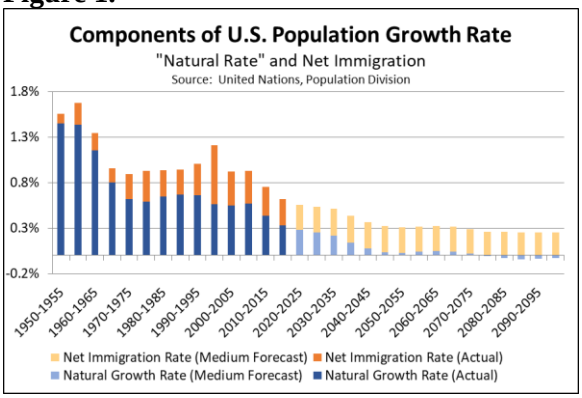
In Part I of this report, we looked at current key global population trends. The report showed how plunging birth rates have been weighing on population growth and boosting average ages all over the world, potentially having a huge impact on the distribution of geopolitical power, economic prospects and future investment returns. An important countertrend is that urbanization is accelerating, with city populations growing relatively faster while rural populations stagnate or decline. Part I noted that stronger innovation and productivity could help offset the negative impact of slowing population growth and population aging, but the world's education systems are not rising to the occasion so far.

This week, in Part II, we will show how these demographic trends are playing out for the world's sole superpower and most important economy: the United States. Part III will dive deeper into the economic impact of slowing population growth and population aging, and, as always, conclude with a discussion of the ramifications for investors.

U.S. Population Growth and Immigration

Consistent with global trends, U.S. population growth has slowed dramatically from an average rate of 1.6% per year in the period of 1950-1955 to a projected rate of 0.6% in 2015-2020. The U.S. death rate has changed little, edging down from 9.6 per 1,000 in the earlier period to 8.7 per 1,000 in the latter. However, the U.S. birth rate has been cut in half, from 24.1 per 1,000 to a projected 12.0 per 1,000. The small difference between the death rate and the birth rate – 3.3 per 1,000 – reflects a "natural" population increase of just 0.3% per year. The U.S. population would seem to be virtually stagnant. What accounts for the actual growth rate of 0.6% when the natural growth rate is only 0.3%? The answer, of course, is immigration.

Figure 1.



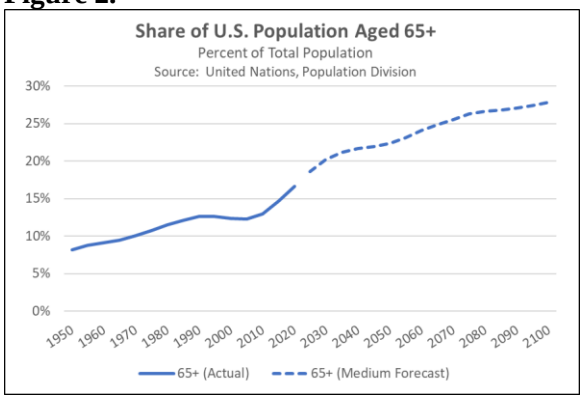
As shown in Figure 1, about half of U.S. population growth in recent decades has come from immigration, whether legal or illegal. If U.S. population trends play out as expected and natural growth rates eventually swing slightly negative, immigration would become the country's only source of population growth. This underscores how changing migration patterns can have a big impact on demographic changes in particular countries. In fact, the recent surge of Syrian refugees into Germany has actually reversed that country's population decline, at least temporarily. In contrast, Japan's falling population stems at least in

part from its continued inhospitable approach to immigration.

U.S. Population Aging

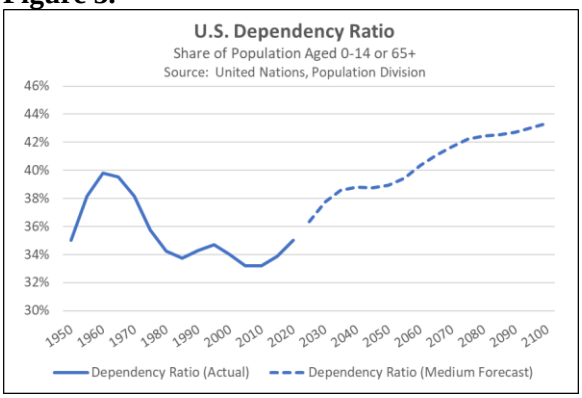
All over the world, millions of people born during the period of high birth rates after World War II are getting older as birth rates are falling. The average age is therefore rising in many countries, and older people are making up a larger and larger share of the population. In the United States, the huge "Baby Boom" generation born between 1946 and 1964 is now aged 56 to 74. That has pushed the median age (the age at which half the population is older and half is younger) to 38.3 compared with 30.2 in 1950. The share of the U.S. population aged 65 and over has more than doubled over that period, from 8.2% to 16.6%, and it is projected to almost double again to 27.8% by the end of the century (Figure 2).

Figure 2.



Another important demographic gauge is the "dependency ratio," which tries to capture the entire share of the population that must be supported by the country's working-age adults, i.e., those aged 65 and older plus children aged 0-14. Like the share of the population aged 65 and over, the broad dependency ratio suggests that each working-age adult will be supporting more and more people in the coming years, potentially creating difficult fiscal challenges and social tensions (Figure 3).

Figure 3.

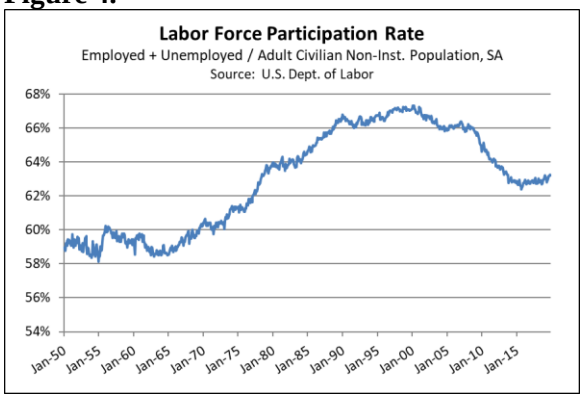


Working and Not Working

As in virtually all modern societies, only a limited share of the U.S. population is in the labor force at any given time. For example, even as the U.S. unemployment rate plunged to 50-year lows in 2019, the Labor Department's monthly household survey indicated that only about 47.8% of the total population had a job. The reasons for not working are as varied as the population itself. Those who aren't working include young children, youths in school, people serving in the military, people in prison or psychiatric institutions, the unemployed, the retired, the disabled and other categories.

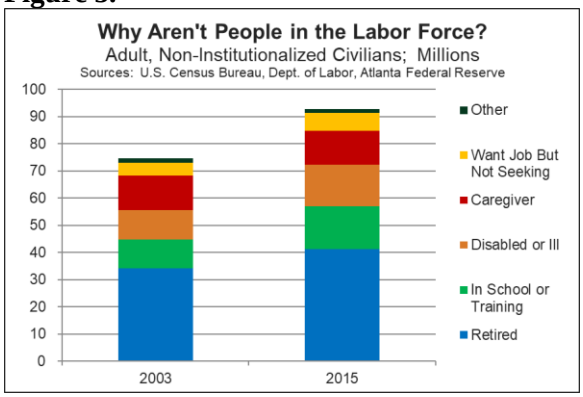
Because many of the non-working cohort wouldn't be expected to work, economists generally focus on the "civilian participation rate," i.e., the number of people employed or looking for work divided by the total adult, civilian, non-institutionalized population. Many people are concerned that the participation rate fell from its all-time peak of 67.3% in early 2000 to just 62.4% in September 2015 (see Figure 4). The participation rate rebounded back to 63.3% by late 2019, slightly surpassing its average rate since 1950, but the slide over the last two decades has people worried that there are not enough working people for the economy to grow, and that each worker is having to support too many idle people.

Figure 4.



The fall in the participation rate is at least partly a result of the demographic trends discussed here. This can be seen by comparing the rate at its nadir in 2015 to its level in 2003 – two years in which the unemployment rate was approximately 6.0%, suggesting they were at about the same place in the labor market cycle. Data from the Atlanta Federal Reserve show that the fall in the participation rate between those two years can be ascribed almost equally to increases in three categories of non-workers: those in school full time, those who are retired and those who are disabled (Figure 5). Those increases are consistent with the high return on education in today's knowledge-based economy and the impact of population aging.

Figure 5.

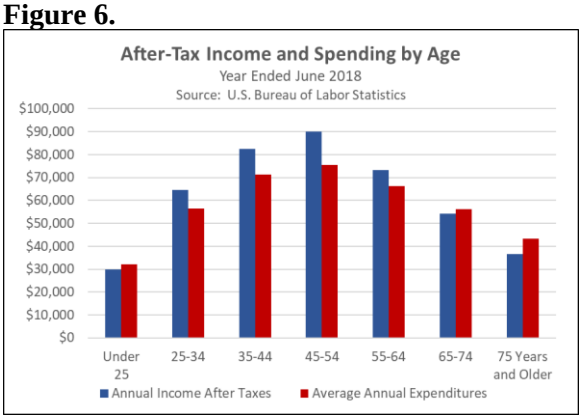


Changing Spending Patterns

A final major implication of the aging of the U.S. population is that the pattern of consumer spending is likely to change over time. Data from the U.S. Census Bureau indicate that people in the United States typically reach their peak income and spending rate when they are 45 to 54 years old. After that, average annual spending declines up to and into retirement age. The average person aged 65 to 74 spends only about 74.6% of what they spent when they were 45 to 54 (Figure 6). Spending drops even more precipitously after age 75.

Based on those spending patterns, we can estimate the economic impact of the continued decline in the number of U.S. residents in the high-spending cohort aged 45 to 54. We calculate that the average annual decline in this cohort is reducing total personal consumption expenditures by about $35.7 billion per year, all else being equal. The fall in the number of people aged 55 to 64 is cutting consumer spending by perhaps another $20.8 billion per year. We estimate those declines are only barely being offset by the growth in the lower-spending cohorts aged 65 and above. These demographic trends would suggest that, as a group, the total population aged 45 and above is boosting its annual spending only slightly.

Figure 6.



Of course, some types of spending actually increase when people get older. For example, the data suggest that annual

spending on miscellaneous entertainment equipment, products and services is 83.1% greater for people aged 65 to 74 than it is for people aged 45 to 54. That means people in the older cohort spend some $550 more each year on that category of goods and services than people in the younger cohort. The data show that for people aged 65 to 74, spending on drugs is 53.2% greater than for people aged 45 to 54, equal to $261 per year. For most consumer goods and services, however, demand falls off. For instance, spending on automobile fuel and motor oil for the older cohort is only about two-thirds as much as for the younger cohort ($1,741 per year versus $2,651 per year).

Part III

As investment managers responsible for safeguarding and growing our clients' assets, we have to think through these trends and try to develop a reasonable strategy to navigate around them. In the third and final part of this report next week, we'll look closer at the economic impact of these trends and examine their ramifications for investors.

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Confluence Investment Management LLC

Confluence Investment Management LLC is an independent, SEC Registered Investment Advisor located in St. Louis, Missouri. The firm provides professional portfolio management and advisory services to institutional and individual clients. Confluence's investment philosophy is based upon independent, fundamental research that integrates the firm's evaluation of market cycles, macroeconomics and geopolitical analysis with a value-driven, fundamental company-specific approach. The firm's portfolio management philosophy begins by assessing risk, and follows through by positioning client portfolios to achieve stated income and growth objectives. The Confluence team is comprised of experienced investment professionals who are dedicated to an exceptional level of client service and communication.