Confluence INVESTMENT MANAGEMENT

Weekly
Geopolitical Report
By Patrick Fearon-Hernandez, CFA

March 2, 2020

Investment Implications of Changing Demographics: Part III

In Part I of this report, we looked at current key global population trends. The report discussed how plunging birth rates have been weighing on population growth and boosting average ages all over the world, with a potentially huge impact on the distribution of geopolitical power, economic prospects and future investment returns. In Part II, we showed how these demographic trends are playing out for the world's sole superpower and most important economy: the United States.

This week, in the final segment of this report, we'll dive deeper into the economic implications of slowing population growth and an aging population. Our analysis will show that these demographic trends are likely to weigh heavily on future economic growth and inflation. The trends may well impact standards of living and constrain monetary and fiscal policy in important ways. We'll conclude with a discussion of the long-term ramifications for investors, although it's important to remember that many other forces can have a greater impact on investment returns in the short term.

Economic Impact

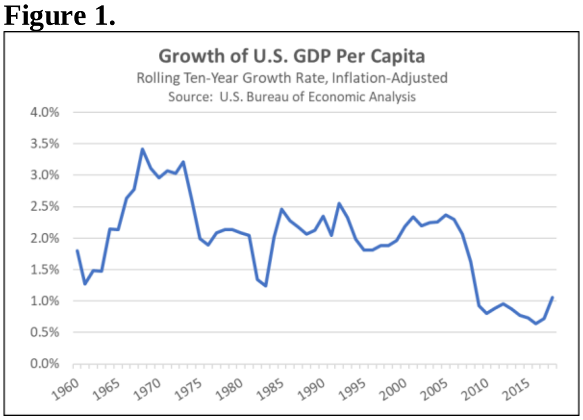
Tracing the impact of slower population growth, changing immigration rates and aging populations is difficult, given that these trends are playing out over a long period of time and a lot of other things can happen that will affect how things develop. All the same, we expect the following outcomes.

Weaker Economic Growth. Most analysts seem to agree that slowing population growth will retard the economy in the coming decades. Ignoring international trade, the growth in a country's gross domestic product (GDP) essentially consists of the increase in its workforce plus any increase in the average value of output per hour worked, i.e., productivity. If the workforce stops growing, productivity gains become the only source of overall economic growth as well as the only source of the per-capita GDP growth that leads to higher standards of living. Our recent WGR on Japan suggests that a U.S. economic slowdown induced by population aging might be especially insidious if debt levels remain high or increase further.

- As noted in Part I, student test scores suggest academic achievement has long been stagnant both overseas and here at home. ***That factor alone may undermine hope for a boost in innovation or productivity that could offset today's demographic headwinds.*** Another problem is that slower population growth may hold back productivity. Since people spend less as they move toward retirement, the gradual increase in the average age means consumer demand should rise at a slower pace. On the supply side of the economy, it's important to remember that relatively younger workers show the greatest propensity for entrepreneurship and the strongest ability to rapidly boost output as they learn new skills. Having a smaller proportion of the workforce in the younger age categories therefore could also hold down productivity growth and innovation. Meanwhile, retirees and disabled people leaving the workforce could spark labor shortages and higher wages in at least some occupations.

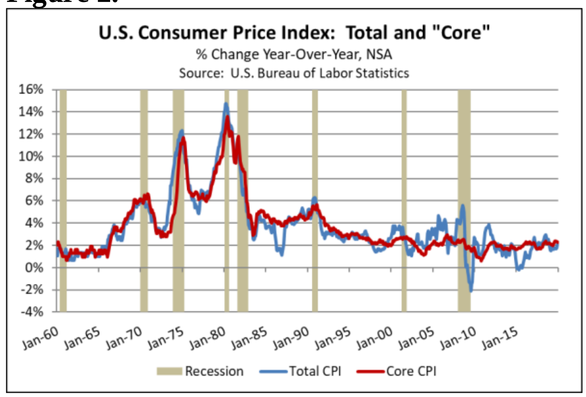
- Among the economists who have modeled these dynamics closely, Robert D. Arnott and Denis B. Chaves have been especially prescient. In an analysis from 2012, they predicted that the aging U.S. workforce would reduce the country's per-capita GDP growth during 2011-2020 by about 1.0% versus its long-term average. As it turns out, U.S. ***inflation-adjusted, per-capita GDP has only grown at a rate of 1.5% in the decade through 2019*** compared with an average rate of 2.1% over the previous five decades (see Figure 1). Just as economic theory would suggest, slowing population growth and population aging seem to be producing a U.S. economy that is much less dynamic and innovative than in the past.

Figure 1.



Weaker Inflation. We believe price inflation is determined primarily by the strength of aggregate demand in the economy versus aggregate supply. The tepid spending by older people therefore suggests demand is already being reduced as average ages rise. The resulting downward pressure on prices is probably exacerbating the impact of other longstanding trends on the supply side of the economy, like the revolution in information technology, deregulation and globalization. Along with improved monetary policy by the world's central banks, these trends help explain why inflation has slowed so much in recent decades (see Figure 2).

Figure 2.



- At the same time, ***slowing population growth and population aging are probably also having a negative impact on the supply side***. For example, firms faced with the prospect of weaker demand seem to be holding back on new investment in facilities, equipment and software. Instead, many are returning capital to their investors via stock buybacks and dividend increases. The lethargic growth in productivity mentioned above means production is also less efficient and more costly than it otherwise would be. Finally, policies like higher minimum wages and trade protectionism will probably offset some of the downward pressure on inflation coming from demographics.

- Nevertheless, supply discipline is hard to achieve when easy financing terms, accommodative tax policies and new technologies are still providing incentives to invest. Since the late

1990s, ***industrial firms have failed to keep their facility expansions in line with their slowing sales growth***. Capacity utilization rates have gradually fallen, discouraging price hikes (see Figures 3 and 4). Thus, we think weaker demand and excess supply will keep weighing on inflation in the near term, in spite of low productivity growth and more populist economic policies.

Figure 3.

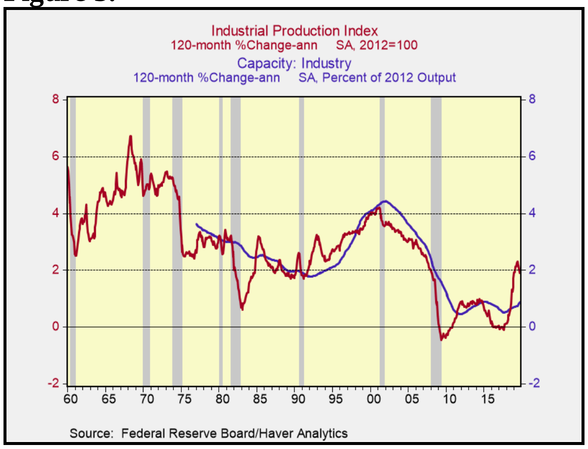
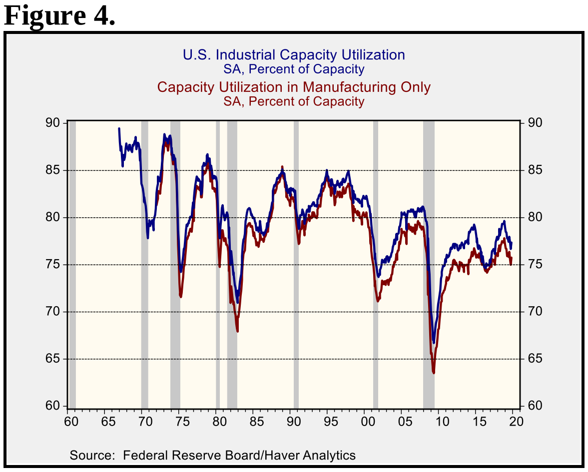


Figure 4.



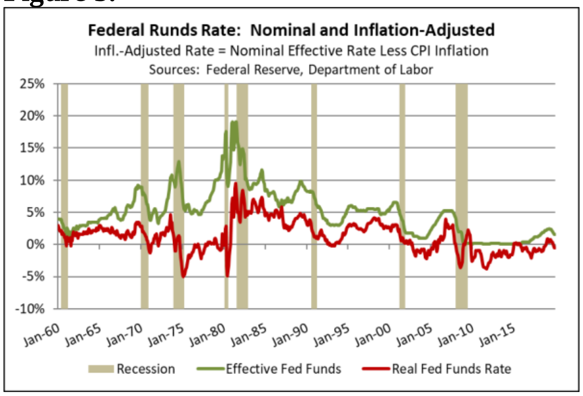
Looser Monetary Policy. Low inflation in the United States and other countries has encouraged major central banks to loosen monetary policy. Many central banks have an inflation target of about 2.0%, but persistent failure to reach that target has convinced many to cut their benchmark interest rates and buy up assets in an effort to push inflation higher. Many foreign central banks have even pushed their benchmark rates into negative territory. With population aging continuing and intensifying, there is a high likelihood that global interest rates will remain historically low for some time to come.

- ***Some of the fall in interest rates is the direct result of lower inflation.*** In the U.S., for example, inflation as measured by the year-over-year change in the consumer price index (CPI) peaked at 14.8% in early 1980, but it then began a long slide downward to just 1.7% at the end of 2019. At times during and after the Great Recession of 2008-2009, inflation in the U.S. was actually negative. That is, prices were generally falling on an annual basis. The long slide in inflation and expected inflation has drastically cut the inflation premium embedded in market interest rates.

- ***However, some of the decline in interest rates also reflects real monetary easing to combat slowing economic growth.*** When U.S. inflation peaked in early 1980, the Federal Reserve's benchmark "Fed funds" rate was approximately 17.2%. Stripping out inflation, the "real" rate stood at 2.4%. As the Fed worked to bring down the high inflation, it eventually boosted the real rate to almost 10.0%. Now, the world looks quite different. Faced with weak demand and tepid investment since the Great Recession, the Fed has kept the real rate negative for most of the last decade (see Figure 5).

Looser Fiscal Policy? Since loose monetary policy hasn't been enough to push inflation back up to historic norms, there is a growing sense that looser fiscal policy may be necessary. Many governments around the world are starting to become more comfortable with the idea of boosting outlays.[1] If that spending is focused on high-payoff public spending that has been starved for funds in recent decades (such as repairing, expanding or modernizing roads and bridges), the investment could help boost productivity growth and would therefore be healthy. However, if the increased spending is poorly targeted, it might do little more than increase debt and create economic drag in the future.

Figure 5.



Investment Ramifications

Below are some thoughts on how current demographic trends might play out for investors.

Stocks. As early as the mid-1990s, economists such as Harry Dent warned that the stock market would face strong headwinds once the Baby Boom generation starts to retire *en masse*. More recently, Arnott and Chaves surmised in their analysis that stocks and bonds would both face headwinds as aging Boomers sell off their assets to fund their retirement. Assuming they sell their riskiest assets first, Arnott and Chaves expect stock prices will be the first to suffer.

- ***Fortunately, however, the Arnott and Chaves analysis suggests U.S. aging has not yet reached that point***. They expect stock returns this decade to essentially match their long-run average. We think stock market dynamics could remain encouraging for some time to come. ***Tepid economic growth and muted inflation are likely to keep interest rates low (see discussion of inflation above), so equity valuations could remain rich.*** In addition, the stock buybacks mentioned above could help support stock prices if they continue. Even though corporate earnings have been flat-to-down recently, the smaller number of shares means that earnings per share have been buoyed, helping stock prices rise.

- Since aging Boomers will likely hike their spending on some types of goods and services, such as healthcare, ***stocks in those sectors may potentially do even better.*** Real estate investment trusts (REITs) may be especially well-positioned for the future, given their competitive yields and the fact that most REIT assets are located in or near cities (which means they should benefit from accelerating urbanization). Finally, while slowing revenue growth has put a premium on "growth" stocks recently, the less-volatile, dividend-paying "value" stocks could become more attractive to aging investors and may be less susceptible to retiree-driven selloffs in future years.

Bonds. In 2012, Arnott and Chaves suggested that investors nearing retirement would buy more and more bonds, leading to above-average returns in fixed income. As it turns out, aggressive bond-buying by central banks and the global hunt for yield have contributed to increasing global bond prices and reducing yields. The problem is

[1] Usually, major policy changes require some sort of revolutionary narrative. Modern Monetary Theory could provide a theoretical construct to aggressively lift fiscal spending. See our four-part WGR series for our analysis of this theory, Modern Monetary Theory: Part I, Part II, Part III and Part IV.

that bond prices may not be able to rise and yields may not be able to fall much further. Prices have been bid up so far that trillions of dollars of bonds around the world now have negative yields, and many central bankers are itching to normalize their balance sheets. The reward/risk ratio for bonds does not look favorable going forward.

As global populations age, there is also a risk that surging public retirement benefits and health spending could push government budget deficits too high. That could potentially scare people out of the bond market, driving down prices and boosting interest rates. Against this fear, U.S. policymakers might raise taxes before debt levels cause permanent damage. Japan also offers hope as it has seen a massive increase in government debt but no resulting inflation or any evidence of a loss of investor confidence. In fact, "shorting" Japanese bonds has been dubbed the "widowmaker trade" by investors.

Another traditional risk for bonds is that inflation could erode the value of their fixed payments. However, as discussed above, we think weaker demand from slower population growth and an aging population is already holding down consumer prices around the world. If higher taxes also weigh on the economy, prices could stay low even longer. Even if inflation accelerates from its current low level in the near term, we think any rebound will likely be contained.

Commodities. Fast-growing populations can put stress on existing natural resources, creating shortages and driving up prices. Historically, firms have responded by finding ways to bring new supplies to market, driving prices down again ("fracking" and horizontal drilling in the energy industry are prime examples). In the slow-growth world of the future, we think overall commodity demand will probably be muted. That's especially likely as Chinese economic growth finally moderates and as some governments work to roll back globalization. That's leaving firms with less incentive to explore and develop new resources, so supply shortfalls and price rebounds in particular commodities could appear at various points in the future. Still, from the perspective of demographics, we suspect that the overall outlook for commodities is uninspiring. At the same time, in the medium term, the path of commodity prices may be affected more by the uncertainty surrounding U.S. hegemony.

Although we cannot predict the future, as investment managers we have to think through these trends and try to develop a reasonable strategy to navigate around them.

Patrick Fearon-Hernandez, CFA
March 2, 2020

This report was prepared by Patrick Fearon-Hernandez of Confluence Investment Management LLC and reflects the current opinion of the author. It is based upon sources and data believed to be accurate and reliable. Opinions and forward-looking statements expressed are subject to change without notice. This information does not constitute a solicitation or an offer to buy or sell any security.

Confluence Investment Management LLC

Confluence Investment Management LLC is an independent, 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.