DEMOGRAPHICS: THE FUTURE IS NOW

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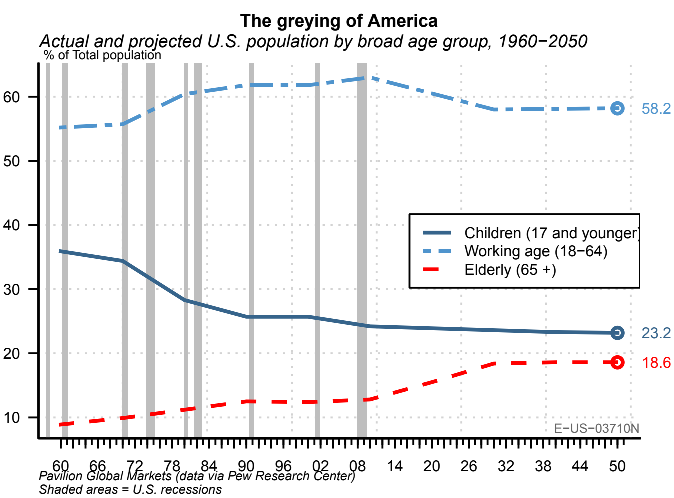
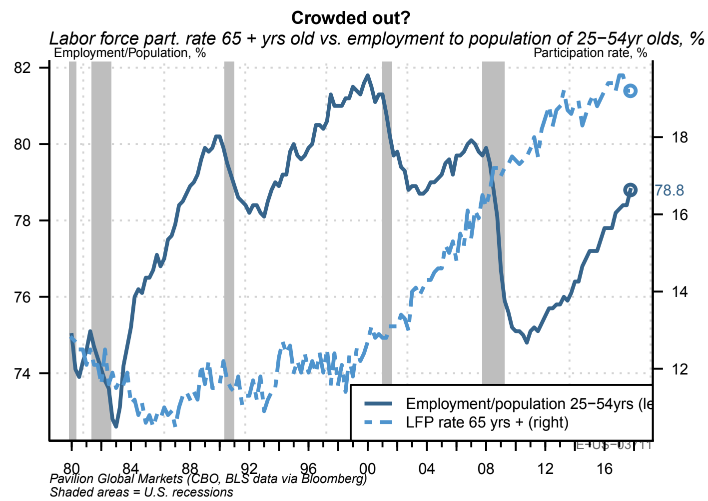
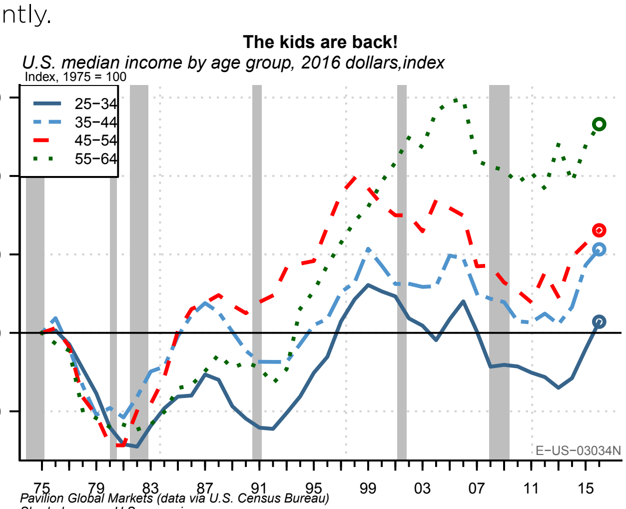
Demographics are often thought of as long-term trends, or developments that can be put off or worried about later on. The problem for most advanced economies is that demographic changes are not a long-term issue any more, they are happening now! For example, on average, 10,000 people turn 65 years old every day in the United States. This has important implications for the economy and equity markets. The percentage of the U.S. population of working age peaked in 2010 at 63%. Over the next few decades, this group will fall as a proportion of the overall population to 58% by 2060, while the proportion of Americans 65 years or older will rise to about 19%.



This 'greying' of America, and indeed of the developed world, has long been known. However, this trend has been complicated by an unseen development: the global financial crisis. As financial turmoil and global uncertainty buffeted markets, younger generations were hit particularly hard. In Europe, for example, youth unemployment reached 40% in some countries. In the U.S., fewer younger workers were able to find jobs, in part because older workers delayed retirement. Currently, the employment-to-population ratio of prime working-age Americans (those aged 25-54) is below the two previous cyclical peaks. Over the same period, the labor force participation rate (those working or looking for work) of Americans aged 65 years or older has marched steadily higher.



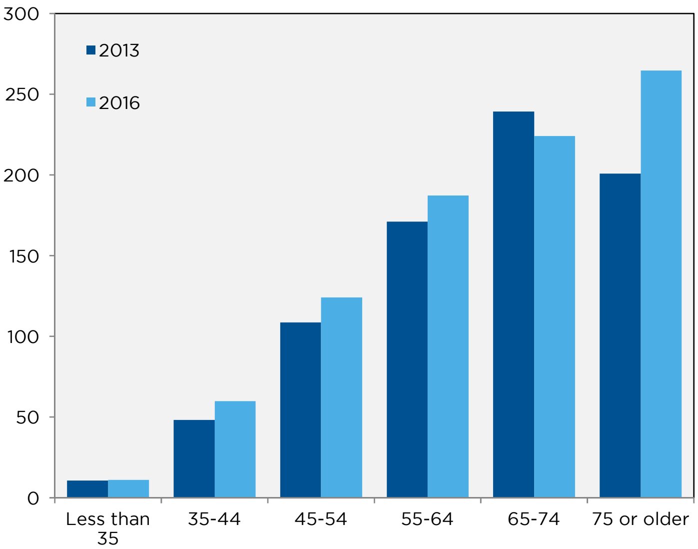
These trends are having meaningful impacts on the U.S. economy. For example, while incomes recovered quickly for most workers following the financial crisis, they remained depressed for workers aged 25-34 until very recently.



Not surprising then, net-worth has tended to rise the most for older Americans. Younger generations, burdened by onerous student loans and lackluster employment prospects, and scarred by the memory of the financial crisis have found it more difficult to build wealth.

Chart 1: Accrued returns

USD - Family median net worth, by age of head of household, thousands of 2016 dollars



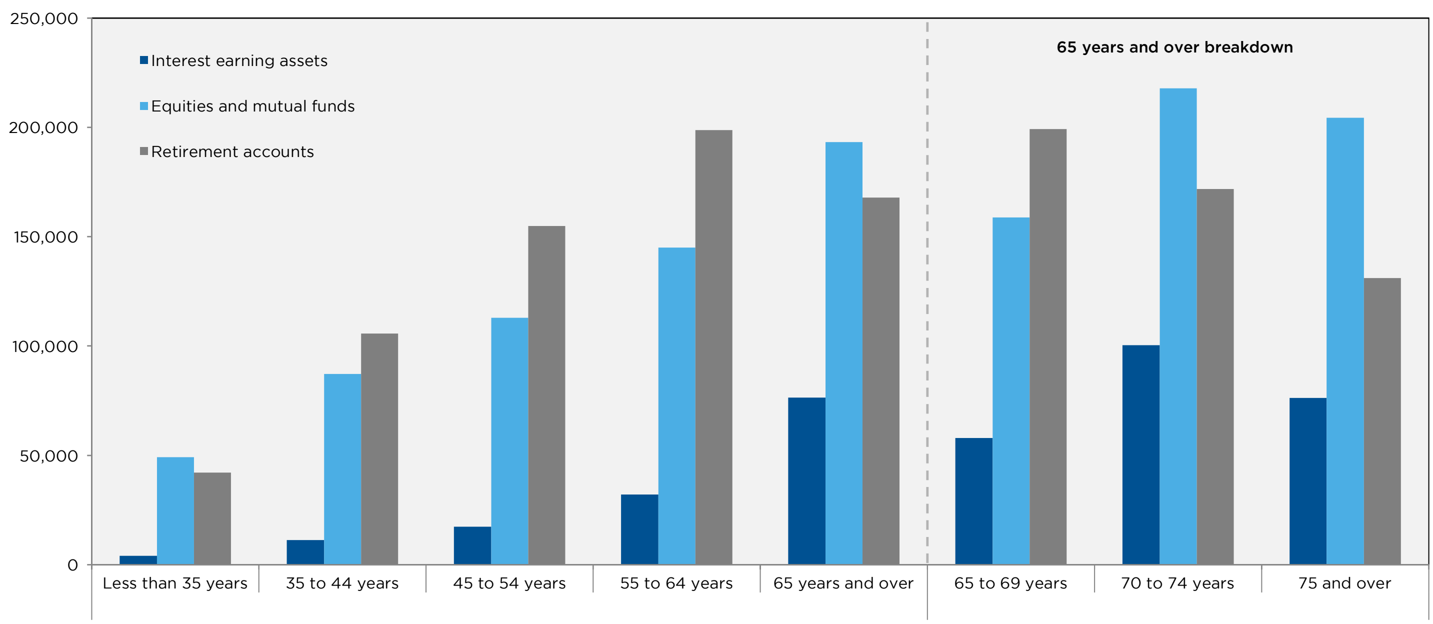
Pavilion Global Markets (data via Federal Reserve)

Breaking down household wealth by asset type, we see that the value of equity portfolios tends to increase with age. This is due to the proclivity of older Americans to save as well as strong equity market returns since the financial crisis. Additionally, the retirement accounts of Americans peak around retirement age and begin to decline as retirees draw down savings (see Chart 2).

One challenge for equity markets is the fact that as Americans age, they typically sell equities in favor of ‘safer’ fixed income. Compounding this problem are tax rules that force retirees to begin drawing down some registered retirement accounts (i.e. 401(k), 403(b), 457(b) and traditional IRA plans) beginning in the year they turn 70.5 years of age. According to the SEC, the minimum required drawdown for an investor with a $200,000 portfolio would be about $7,300 per year (actual drawdowns are likely to be higher). What this means is that the largest holders of equities will be sellers of stocks over the next five years. Put another way, one driver of the massive outperformance of risky assets and equities in particular, relative to other asset classes will be less potent.

Chart 2: Riding the equity returns... but for how long?

USD - Mean asset values of households, by age



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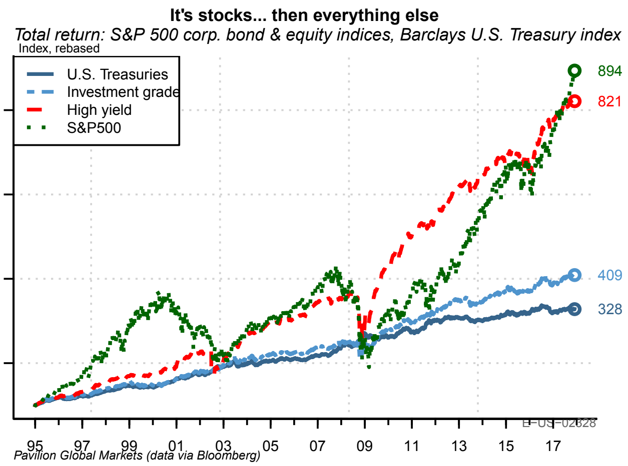
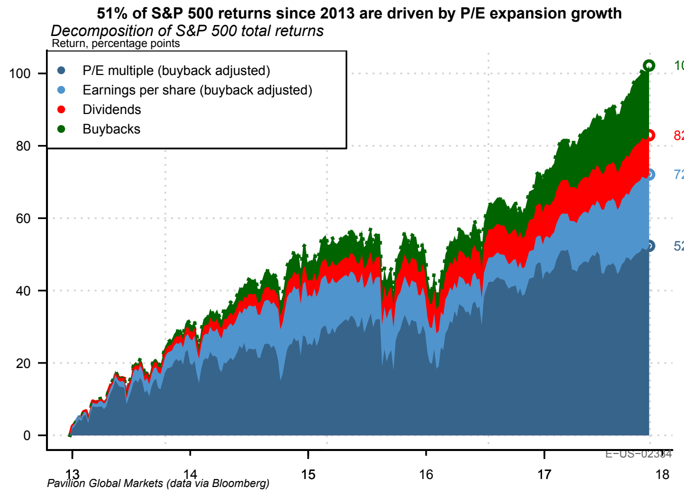
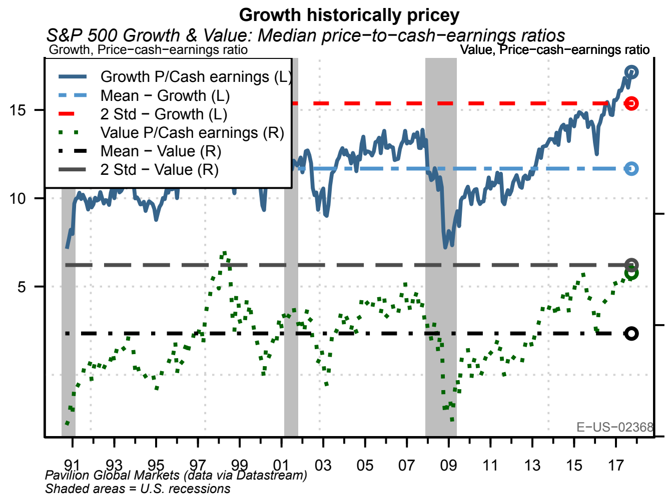


From a valuation perspective, the ability of U.S. equities to continue posting stellar returns appears challenged. Since 2013, multiple expansion has driven about 51% of the S&P 500's total return. Easy monetary policy has contributed another 30% via debt-fueled share buybacks and dividends. Earnings growth, on the other hand, has been less stellar. Weaker wage growth and employment prospects among younger generations—that tend to consume more—are somewhat responsible, so too are cyclical factors, such as the tepid economic growth that has plagued most of the global economy for the last decade.

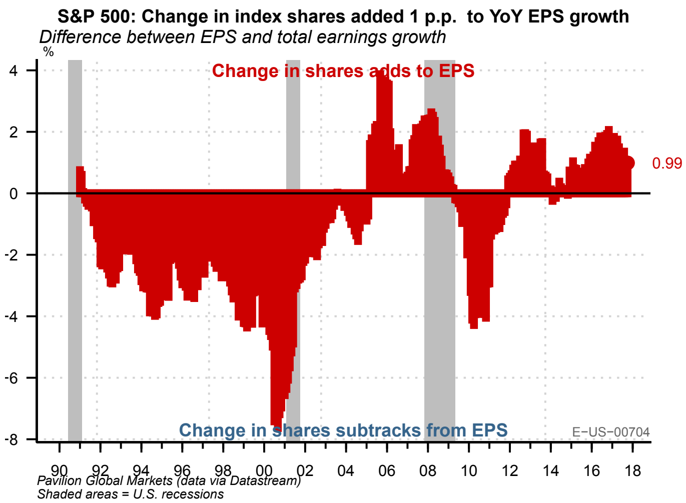


As a result, valuations look stretched. The median price-to-cash-earnings ratio for Growth stocks (i.e. tech) are more than two-standard deviations above their historical average. It is a similar picture for so-called Value stocks, which tend to be more reasonably priced. As the Federal Reserve and other developed-world central banks consider tighter interest rate policies that coax valuations toward more normal levels, equity returns likely will weaken.



However, the outlook isn't totally bleak. One of economy's most serious afflictions since the financial crisis has been weak productivity growth. There have been a number of explanations—albeit incomplete ones—for this, ranging from the popularity of social media to measurement errors. Productivity growth is picking up again, which should be a boon for wages, profit margins and economic growth.

One possible reason for the comeback of productivity is that interest rates are rising. As this occurs fixed investment becomes a more worthwhile use of corporate funds than either share buybacks or dividends. Indeed, the contribution of share buybacks to EPS growth has peaked, and is declining as rates rise.



So far, workers have not benefitted much from the nascent improvement in productivity. However, as retiring baby-boomers exacerbate labor market tightness, wage growth for younger workers likely will improve. This should help offset some demographic impacts on equity markets and the economy more generally.

Demographic changes, most notably the 'greying' of America, are no longer just a long-term issue, they are happening now! The aging and retirement of the baby-boomers, the most affluent segment of America, poses some serious challenges to the U.S. economy and equity markets. However, there is a silver lining. A rebound in productivity and tighter labor markets should help younger generations of Americans escape the lingering fetters of the financial crisis and improve wage growth. This may help offset the sizable gap left by the boomers, as they retire from the labor force and retreat from riskier financial assets.

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