Investment Insights

UBS Asset Management
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In this month's Investment Insights we take a fresh look at the potential impact on macroeconomic variables and markets of some well-known demographic trends.

In particular, we challenge some widespread misconceptions about the impact of ageing populations and the imminent retirement of the so-called 'Baby Boomer' generation in developed countries.

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Human capital: power to the people

Jonathan Davies, Dan Heron

It is all too easy to ignore demographics in modern markets. Real time news and daily macroeconomic data demand investors' attention at every turn. So what role should plodding structural population trends play in investors' analytical armoury when shorter-term market sentiment seems to offer the key to performance?

According to the United Nations' latest population forecasts, the number of over 65s globally will grow by just under one billion people between 2015 and 2050. Perhaps more importantly, the ratio of over 65s to the working population is forecast to double globally to 32% by 2050.

In developed nations the demographic challenge of increasing longevity and falling fertility rates is particularly acute. In aggregate, the ratio of over 65s to the working population is forecast to exceed 50% by 2050, or 1 retiree for every two workers. In Japan, the UN forecasts that there will be 9 retirees for every 10 workers by 2050.

For longer term investors we believe these figures are important. In particular, the ageing of the so-called Baby Boomer generation and the dramatic increase in retirees relative to the rest of the population across the developed world is likely to have major long-term implications for savings and consumption, growth, inflation, monetary policy, and on demand for asset classes.

Lower for longer growth

Few would argue that the most obvious takeaway from the stark UN population projections is that demographic forces are likely to act as a material downward force on economic growth in the developed world. After all, basic economic theory says a smaller workforce, all else being equal reduces potential output. The idea of "secular stagnation" for the developed world driven by demographics is therefore hardly new and in 2016 the US Federal Reserve described the impact of demographics on the US economy as driving a "new normal".

We believe that ageing populations will continue to act as a drag on economic growth in the developed world. Principally, we expect this to be driven by a continued reduction in the labor force both in absolute terms and relative to both old and young dependents.

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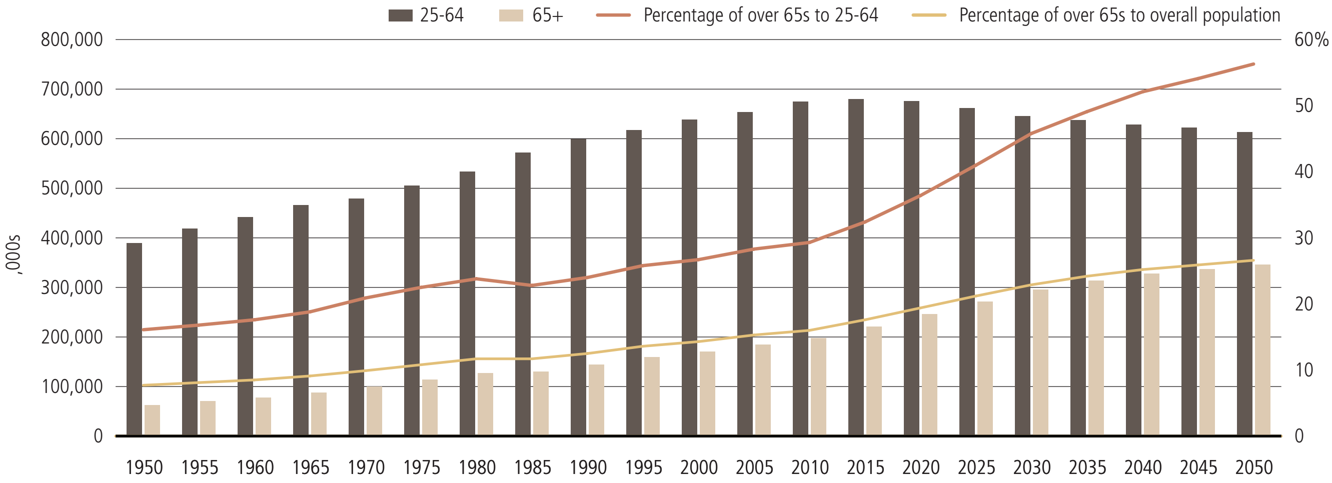
Developed World Retirees (over 65s) to Working Age (25-64) Population (UN Estimates post 2015)



Source: United Nations Population Division, as of June 2017

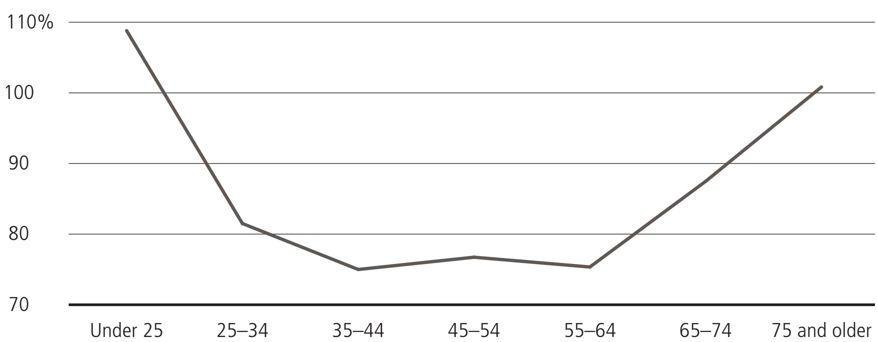
Low interest rates
While the impact of ageing populations on demand seems relatively straightforward in the main, the likely impact on interest rates of the Baby Boomers' inevitable progress from working age saving to retirement consumption—and of the timing of the so-called "demographic cliff"—is more complex.

The abundance of capital globally has been driven in the main by the Baby Boomers' savings, by wealth effects and by strong capital creation in China and oil-producing emerging countries. According to the US Federal Reserve, this savings glut relative to labor has suppressed global interest rates by depressing the return on capital and causing aggregate investment to decline.

But with the Baby Boomers shifting to spending not saving and capital flows from these emerging market sources now reversing, are the downward pressures on global interest rates now lifting? The increasing scarcity of labor and the increased propensity of ageing populations to consume would logically, all else equal, exert upward pressure on wage growth, inflation and therefore on long bond yields.

It is worth noting that consumption by age cohort varies significantly between economies and that the consumption curve looks much flatter in emerging markets—where access to debt capital is limited in youth and retirees do not go on the spending spree that those in developed economies (the US in particular) appear to enjoy.

Lifecycle hypothesis in practice: US consumption as a percentage of income by age bracket



Source: US Bureau of Labor Statistics, 2013

The policy balancing act

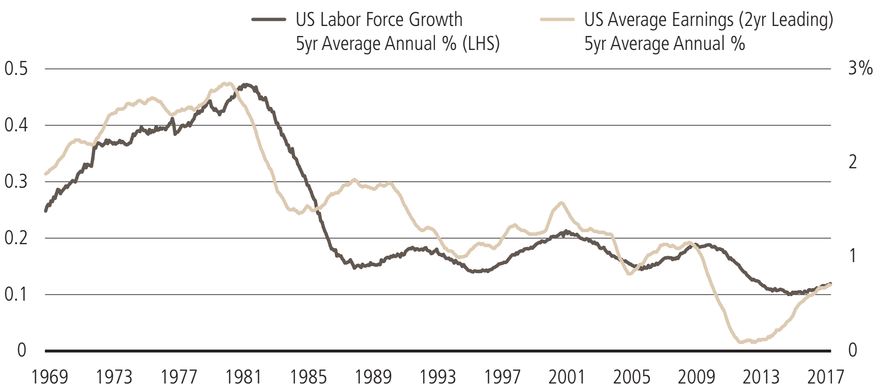
The pressure on public finances due to higher pension costs as the ratio of dependents to productive tax payers diminishes is likely to be material across the developed world. In the absence of an unexpected spike in economic growth, it seems very hard to believe that these can be addressed without reducing welfare payments, higher taxes and/or a sustained large increase in borrowing.

Developed world governments therefore face a delicate fiscal and political balancing act in appeasing the increasingly large proportion of the population that over 65s represent versus the harsh budgetary realities and the needs of the young.

The announcement in July from the UK government that it is to bring forward by seven years an increase in the state pension age is symptomatic of these pressures. According to David Gauke, the UK Work and Pensions Secretary, the purpose of the change is to “maintain fairness between generations in line with continuing increases in life expectancy”.

Given the severity of these demographic forces, it is highly unlikely that this will be the last increase in the state retirement age across the developed world.

Does labor supply have the opposite impact on the price of labor to the one most economists assume?



Source: Datastream, UBS Asset Management as at August 2017

Between 2020 and 2050 the UN expects the number of working age people in China to fall by around 160 million, almost exactly the same number that has joined the workforce since 2000.

However, this has categorically not been the experience to date in Japan, where the proportion of over 65s to working age population is already well advanced. Wage growth and inflation in other developed economies also remains muted despite very low unemployment rates, a shrinking workforce and the prospect of further reductions in the workforce.

Improved health, the elimination of compulsory retirement and low annuity rates all mean that people are likely to work longer in developed economies and save more—softening to an extent the “demographic cliff” of the Baby Boomers’ retirement.

But a key implication from Japan’s experience to date is that it is changes to the size of the labor force rather than changes to savings that play the key role in driving investment in developed economies. We believe that smaller workforces are keeping investment low in the developed world, low investment is keeping economic growth low, and it is low economic growth that is likely to keep interest rates low.

With the UN forecasting further reductions in working age populations across the developed world we believe that ageing populations increase the likelihood that official policy rates and longer-dated market interest rate measures in developed markets will stay low for a protracted period in an historical context.

These pressures may be exacerbated by demographic developments elsewhere, most notably in China. Between 2020 and 2050 the UN expects the number of working age people in China to fall by around 160 million, almost exactly the same number that has joined the workforce since 2000. In light of its size, and judging from the experience of Japan, this suggests that population dynamics in China may also exert a downward pressure on global interest rates over coming decades.

Emerging nations and the demographic dividend

Given the diversity of the emerging markets economic universe it should come as little surprise that the demographic profiles within the developing world are similarly disparate. In Africa, fertility rates are extremely high in a global context. In Asia, China looks very much like a developed economy from a demographic perspective—with a fast ageing population resulting from its one child policy. According to the UN forecasts, the population of India will surpass that of China in just seven years.

We believe that the principal driver to the Chinese authorities' attempts to refocus its economy away from low skill manufacturing and towards a higher skill consumer services economy is the desire for increased productivity to counter the negative impact of its ageing population on economic growth.

But in general, emerging market countries enjoy much more favorable demographic trends than their developed counterparts, with higher fertility rates and continued growth in the labor force likely to support productivity and demand growth. This is part of the broader secular argument for emerging market asset classes and what economists refer to as the "demographic dividend". But the ability to reap that dividend is reliant on a number of factors including the availability of education, job creation and the structure of the workforce.

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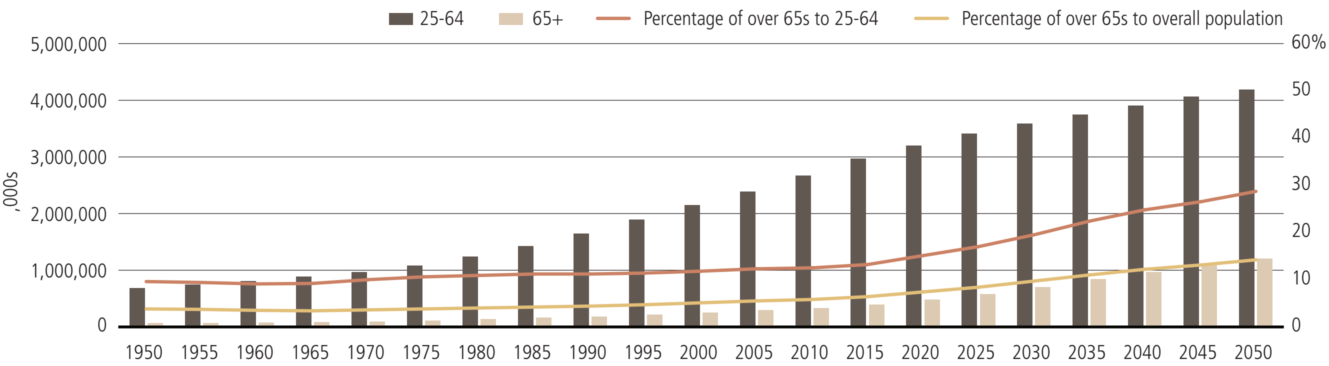
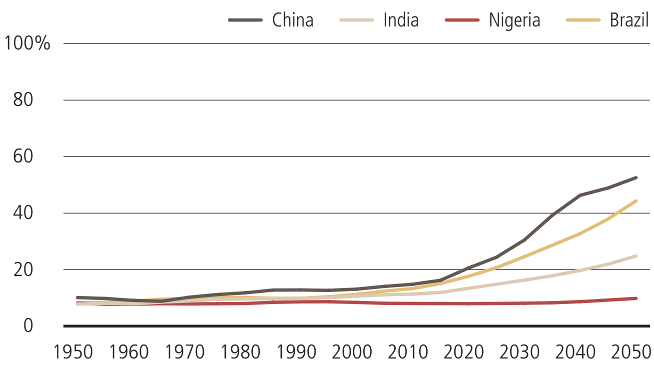


Source: United Nations Population Division, as of June 2017

Selected Developing Countries Retirees (Over 65s) as % of Working Age (25-64) Population (UN Estimates post 2015)



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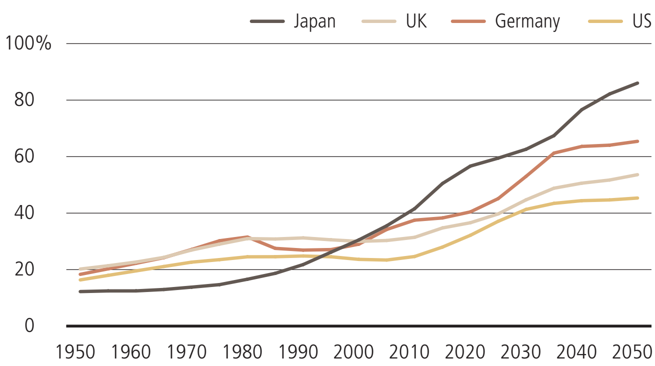

Source: United Nations Population Division, as of June 2017

Market impact

Some of the potential implications of demographic trends are well known and well established. While in emerging markets the demographics story is diverse and nuanced, positive demographic trends in aggregate have been a fundamental part of the long-term emerging market investment case at a top down level for a number of years. These trends also offer, we believe, attractive long-term opportunities on a bottom-up basis.

Our emerging market equity team has written extensively on the opportunities arising from demographic trends in their universe, most recently at the country level in *Moving Forward—opportunities in emerging markets*, and in *Riding a new wave—Emerging markets: The new normal*.

We focus here on the impact on from an asset allocation perspective. For equities, lower growth potential driven by demographics clearly equals lower profits growth potential, a potential negative that is offset by the benefit of a lower cost of capital. We believe the major impact is likely to come from the demand for asset classes.

In particular, we believe that Baby Boomer retirement savings have played a key role in supporting equity prices over the past two decades. As they retire and seek to draw down their accrued wealth in line with observed practice, it seems only logical that Baby Boomers will reduce their equity holdings in favour of cash and quasi–cash instruments and that equity risk premiums should rise.

For the same reasons we see continued downward pressure on bond risk premia relative to equities and see the forces of low growth and low investment prevailing in the long-term over any upward pressure on government bond yields due to scarce labor as the balance between capital and labor in the economy is gradually realigned.

The concepts of secular stagnation and lower for longer driven by ageing populations are hardly new, but we see demographics as still having a major role across economies and markets for the foreseeable future.

In short, demographics may be an age-old problem, but that does not make it old news for markets.

Further reading

If you would like to read more about demographics and its portfolio implications across the asset classes, please contact your UBS Asset Management representative or visit our website at **www.ubs.com/am.**

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