VANISHING HUMAN CAPITAL:

The implications for global investment markets

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Veronique Riches-Flores, Economist, Founder and President of RichesFlores Research offers her insights into this topic as a guest writer for Advance.

The importance of human capital in driving investment markets and global economies has often been under-estimated, or even ignored by a majority of market participants. However, upon close scrutiny of market behaviour and bearing in mind the extraordinary expansion of the global population, human capital has most certainly had a positive impact on shaping the post WWII global economy. Recognising this influence and the rapidly changing demographic outlook for key countries of the world raises some significant concerns in respect of the potential impact this could have on global economies going forward.

The positive influence of demographic trends to date

In the past fifty years, we have seen unprecedented growth in production and innovation that has had follow-through benefits to life expectancies, health, increase in global trade and services and overall global growth. Business cycles have increased from historically being approximately five years each to being around seven to nine years in duration. Inflation in most Western countries has been generally subdued as have interest rates (even excepting the impact of the Global Financial Crisis).

During this period, the baby boomer generation came of age and the working age population (typically identified as those aged between 15-64 years) increased by three billion with an increase of 1.5 billion concentrated in the period between 1980 and 2000.

An increase in the working age population coincides with the rise of labour market participation with two stages of positive results, or demographic dividends.

The first stage of the demographic dividend reflects the changes that an increased labour force delivers in terms of the rapid growth of the productive base which in turn drives:

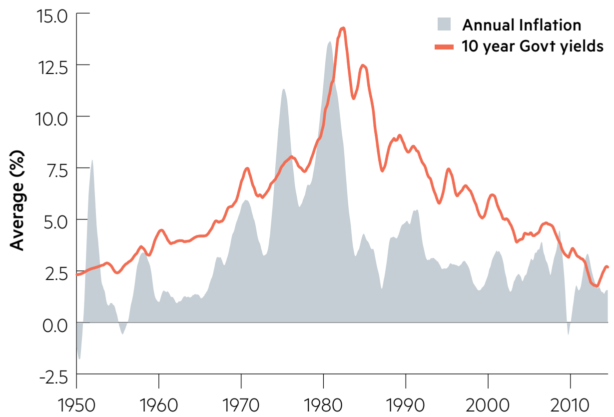
> A surge in productivity

> Hyper-competition

> An oversupply of goods and services (disinflationary)

These developments assist to dampen inflation and pressure interest rates lower as demonstrated in the chart below.

US inflation and 10 year Government yields



Sources: RichesFlores Research, Macrobond

Veronique Riches-Flores, Economist, Founder and President of RichesFlores Research, specialises in global macro analysis, thematic research and forecasts with a particular emphasis and interest in demographic research. She has more than 28 years of experience working as an economist across research and investment banking sectors, having worked at the Obseratoire Francais des Conjonctures Economiques, Societe Generale Corporate and Investment Banking along with others. Her interest in demographic research started in 1996 and she has published a number of research papers on this topic since then.

The second stage of the demographic dividend occurs when the working age population starts to increase their savings as they grow older and prepare for retirement from the workforce. This coincides with decreasing household spending due to factors such as children leaving the family home, children becoming self-sufficient adults, or the completion of mortgage payments along with the desire to save for a self-funded retirement. As both household savings increase and household expenses decrease, there is a decline in household risk appetite levels leading to the following:

> Decreased cost of capital due to readily available pools of household savings.

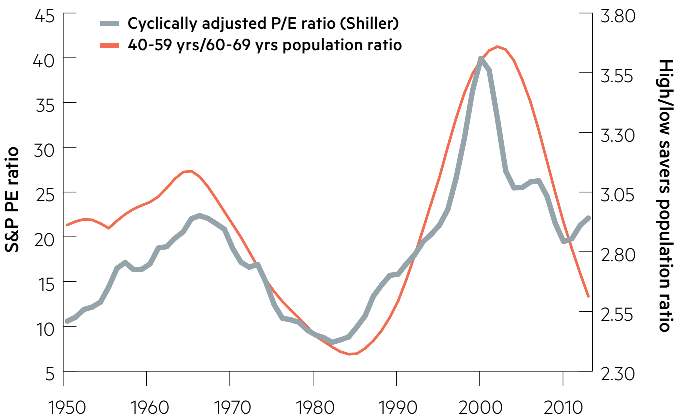
> A search for stable and less volatile financial assets and a steady income stream.

> Cheap capital encouraging business capital investment, business expansion and development.

These factors combine to bolster financial asset market prices and support rapid economic growth.

With regard to the baby boomer population, the period of 1990 to 2000 tends to reflect that stage of increasing savings and decreasing expenses. This period represented a growth of approximately 800 million savers. We can see the rapid growth ratio represented in the chart below.

US High/Lower Savers ratio and S&P PE Ratio



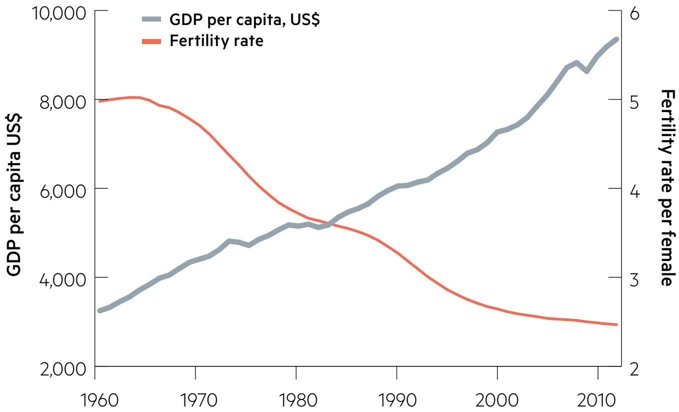
Sources: RichesFlores Research, Macrobond

The transition into retirement and demographic shifts of the future

While these forgoing combinations of factors had a positive impact in the past, the shift of this large demographic cohort into retirement is concerning for future global growth, savings patterns and financial asset market prices. There isn't the same volume of upcoming population to replace the space vacated by the baby boomer generation due to the growth rate of the world population declining (although in absolute numbers the world population will increase). The challenge for the existing workforce will be the need for them to deliver a higher level of productivity in order to mitigate the "dependency" ratio where there is likely to be fewer workers supporting an ever increasing aged population. Higher productivity though, tends to require a large share of young people in the workforce.

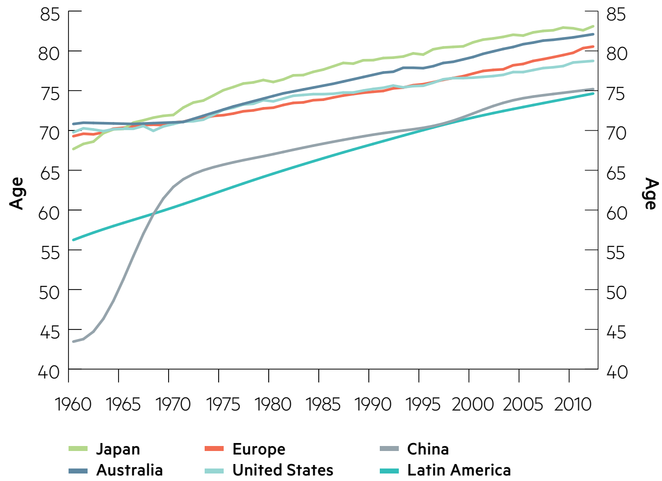
The UN expects that the global population will grow by around 2.5 billion by 2050, which seniors (aged over 65 years) are expected to comprise 40%. The working age population is expected to rise by 1.5 billion in this period with a growth rate reduced from 75% to 35% when compared with the past. However, the key challenge going forward is increased life expectancies coinciding with a substantial decrease in fertility rates as shown in the charts below.

Fertility rate and real GDP per capita



Sources: RichesFlores Research, UN & World Bank

Life expectancy at birth



Sources: RichesFlores Research, Macrobond

The ramification of this change in the composition of the working age population with low replacement includes the following:

> The retiring population starts to drawdown their savings and reduce the level of risky assets in their investment portfolios while searching for assets that deliver steady and stable returns with low volatility causing defensive assets prices to be well supported.

> The drawdown of savings results in less capital supporting business investment and financing and a higher base of cost of capital as the pool of household savings decline.

> Risk appetite decreases with age so there is less inclination to invest in growth or volatile assets causing the prices of these assets to decline.

> Slowdown in productivity due to fewer workers to support the global population compared with the past or an ageing population being forced to remain in the work force.

Aside from the obvious impact to economies, there is also an impact to the supply of goods and service where demand remains elevated but supply is constrained. The growth in overall population with a lesser working age population to support it might result in an undersupply of goods and services. In turn, this is likely to create demand for scarce resources that generates protectionist policies and geopolitical tensions as countries seek to secure and protect their resources and their national interests. To some extent, this could already be considered to be occurring in Russia and China.

Managing the changing dynamics of demographics

The lower levels of working age population cannot be addressed with an immediate fix and managing the impact globally of the aging population – along with overall population growth – resides with well thought out and carefully implemented policies to address specific challenges.

Global governments should consider:

> Policies that assist the private sector in securing capital and investing at a reasonable cost to help to close the gap left as retirees' drawdown their savings.

> Being ready for a change in demographic patterns and increases in life expectancy, for example, Australia has increased the retirement age.

> Investing in innovation and technology to manage the required increase in productivity to support an increased global population with a significant shift in the composition in the respective cohorts.

> Environmental policies to manage population growth and manage the decrease in the availability of physical and natural resources.

Unlike many countries, Australia's physical isolation and larger sources of natural resources may serve to protect it somewhat from the impact of the negative shift in demographics. Australia's working age population is also supported by immigration of 3-5% annually which is typically dominated by those of the working age.

What does this mean for investments?

The ageing of the population and transition from the working age population is likely to see:

> In aggregate, movement out of risky assets like equities is likely as risk appetite tends to decrease with an increase in age.

> However, given that Australian investors are reasonably familiar with and seek high dividend yielding shares that also offer franking credits, it is likely those investors who are not too concerned about marking their portfolios to market and instead rely on superior income streams, may favour such Australian shares.

> Increased investment into more conservative and liquid investments is also likely for retirees who need a steady income stream and the ability to drawdown capital. This will make products with low volatility and a high regular income distribution popular amongst this cohort.

> If we are to use the Japanese experience as a guide, it is likely that retirees will seek the relative safety of sovereign debt and other types of fixed income instruments, such as corporate credit, that are highly rated and less volatile to receive a steady and better income stream over cash and term deposits.

> As the price of capital moves higher because it becomes less freely available with retirees drawing down their household savings, the cost of borrowing for property is likely to move higher. In turn, this will push the cost on household rent higher making an income stream from investments in residential property attractive to this particular cohort.

Markets are likely to be more volatile during this period as governments seek to address the challenges caused by ageing populations through legislation and taxes. Under such conditions, taking a defensive approach to structuring investment portfolios for this cohort with a steady and less volatile income stream becomes a very high priority.

Changing demographics of the world with a particular reference to the baby boomer generation will undoubtedly shape financial asset market trends in the future as they have done in the past. The response of policy-makers in managing this change will be the key to determining the long-term outlook for the global economy, global geopolitics, and financial asset markets.

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