The View From The Outer

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EVANS & PARTNERS

Fifty Trades on Grey

Demographics played a major role in the era of higher growth, volatile inflation and rising asset prices in the 1980s and 1990s and will be heavily influential again over the next 20 years as baby boomers leave the workforce.

The grey economy

The negative effects of global ageing started around 2008 as the baby boomers began retiring. We expect many of the macro trends evident since the financial crisis could be driven by demographics rather than a crisis hangover. Changing demographics imply:

- Lower trend GDP as the labour pool and investment shrinks. Both of these are already in train but investment rates are probably still too high.
- Persistently lower inflation given reduced levels of demand, and supply that has not yet adjusted. This will keep interest rates lower and QE policies in place for longer.
- Asset prices will be affected although baby boomers will liquidate assets over a longer period than which they bought them, so this effect may occur later and be diluted.
- Government finances will deteriorate due to higher demands from pensions and healthcare spending. This could exacerbate the impact on GDP if governments are forced to increase taxes or cut spending.
- We see that Australia is better positioned than most countries because of our advanced pension system and our scope to use immigration to mitigate the ageing impact.

Trades on grey

The demographic effect will lower equity returns through weaker earnings and the effect of baby boomer selling on valuations. However, selling will occur over a long period and will be partially offset by the benefit from lower interest rates on valuations. For bonds, steady deflationary pressure will keep interest rates and bond returns lower for longer.

At the sector level we expect the major winners will be:

- Global healthcare companies that have better pure exposure to ageing than most Australian companies.
- Financials particularly asset managers that will assist retirees manage their finances.
- High yielding companies. Low interest rates will support valuations and mean that baby boomers will prefer high-yielding equities rather than bonds to finance their retirements.

We identify fifty Australian stocks that are trades on grey. Within EAP coverage the major beneficiaries are:

- **Ramsay Healthcare** (RHC - EAP: Positive). Hospital stocks are the main beneficiary as demand rises and as the government supports private hospitals to reduce the burden on the public purse.
- **Cochlear** (COH - EAP: Neutral). Hearing loss from the elderly could be the next wave of growth.
- **Challenger** (CGF - EAP: Positive) will benefit from the growth in post-retirement financial products.

Other companies that we expect to be beneficiaries of demographic trends include:

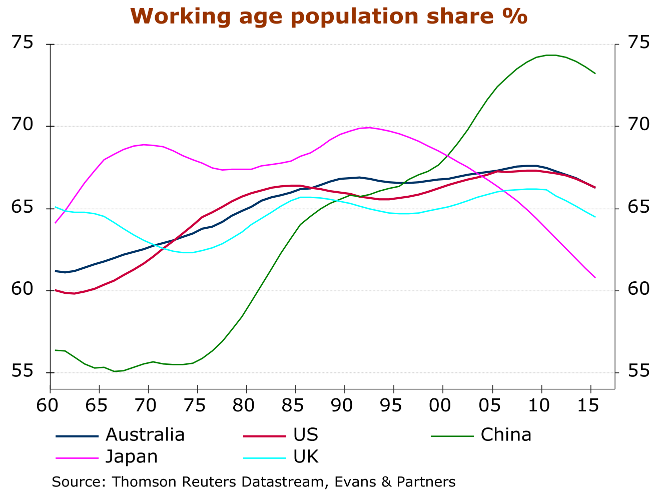
- **Lifestyle Communities** (LIC - not EAP rated) is well positioned as demand for affordable aged-care accommodation rises. However, here is some short term regulatory risk given recent media exposure on the sector.
- **Invocare** (IVC - not EAP rated) will benefit from higher death rates, industry consolidation and more personalised funerals.
- **Flight Centre** (FLT - not EAP rated) will benefit from grey nomad travel. Baby boomers are travelling more, using travel agents and willing to spend more on tours and adventures.

While these stocks are beneficiaries of demographic changes, other issues also need to be taken into account when making an investment decision. Our comments are not intended as investment recommendations. Contact your adviser to discuss the implications for your portfolio.

Fifty Trades on Grey

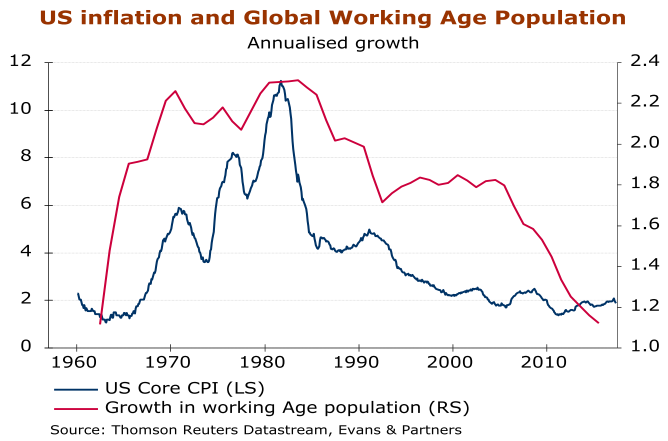
Demographics have had a significant impact on the global economy for decades. The most significant demographic event continues to be the progression of the baby-boomers through their life cycle. This has had major impacts on the global economy since the baby boomers started entering the work force in the mid-1960s. It is becoming clearer that the retirement of the baby-boomers from the work force, which began a few years ago, is having just as big an impact on economies and markets.

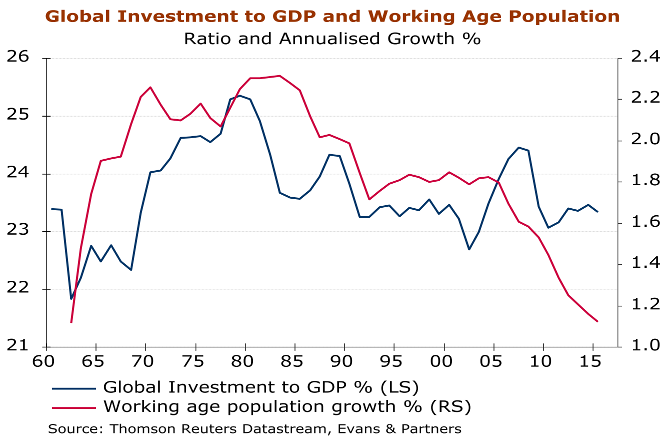
The chart below shows the working age share of the population for a range of countries. The demographic profiles of most major western countries are remarkably similar and show working age populations that started rising in the 1960s and peaked around 2008. Japan's working age population peaked earlier in 1992 and is falling rapidly. China's working age population is peaking at the same time as the west but has a more severe profile due to the one-child policy.



Baby boomers explain the 1970s boom

Demographics played a major role in the dramatic economic events of the 1970s and 1980s. This was when the bulk of the baby boomers entered the workforce. Inflation spiked since demand was greater than supply and remained elevated until supply had responded through higher levels of investment in the 1970s and 1980s. Higher consumption and much greater investment resulted in higher levels of trend GDP through the 1970s and 1980s and higher levels of inflation. While there were certainly other factors at play, such as the oil crises in the 1970s, demographics was the underlying force behind these trends.





Baby boomers and bust

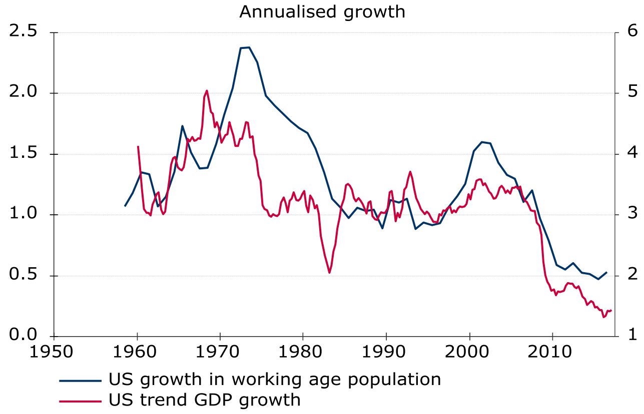
The baby boomer effect turned negative in most western countries around 2008 and the effects will now work in reverse until around 2028. The coincidence of the financial crisis has masked some of these initial effects; much of the deflationary pressure and weaker growth since 2008 is likely to be due to demographics but it is hard to disentangle crisis and demographic influences. One important difference though is that the reverse effects will probably be more drawn out because retirement ages and deaths will be less aligned than were birth and work-commencement dates.

The major changes to macro trends we expect over the next couple of decades are:

- Trend GDP growth will fall due to lower growth in the working age population. The effect will be more acute in the short term as investment rates must adjust to a lower level of demand. Trend GDP growth is already in decline however the major fall in investment is yet to occur. Investment is running at a similar share of GDP as to that pre-crisis even though consumption as a % of GDP has stepped down. Excessive investment partly explains the lack of pricing power that is keeping inflation very low in this cycle.

US Working Age population and Trend GDP

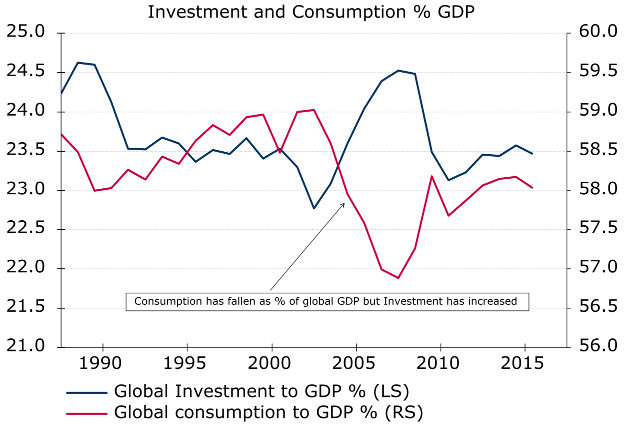
Annualised growth



Source: Thomson Reuters Datastream, Evans & Partners

Global Supply and Demand

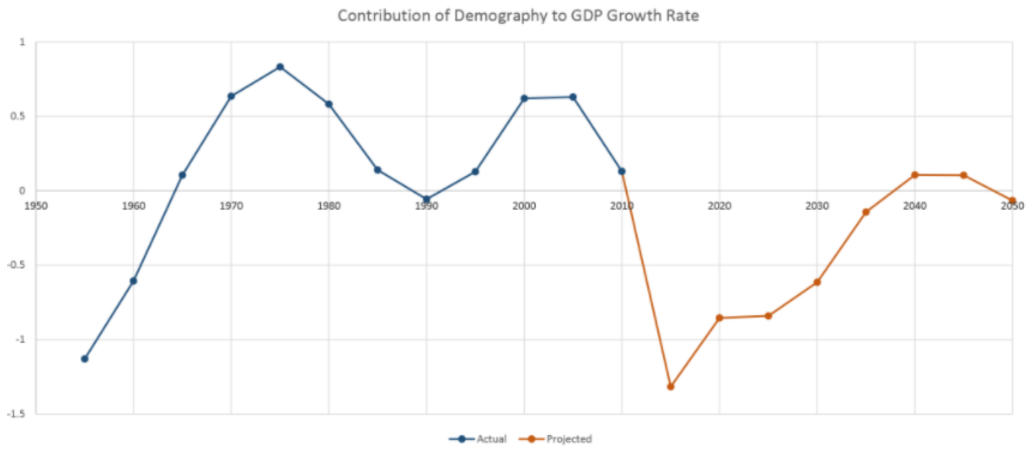
Investment and Consumption % GDP



Source: Thomson Reuters Datastream, Evans & Partners

The Federal Reserve recently prepared a paper estimating the impact on US GDP. Their estimate is that demographics will detract around 1% from GDP out past 2030 compared with a 0.5% positive contribution during the first decade of the 2000s. This is consistent with a decline in trend growth from around 3.3% to about 1.8%.

US Fed estimates of Demographics on the US economy

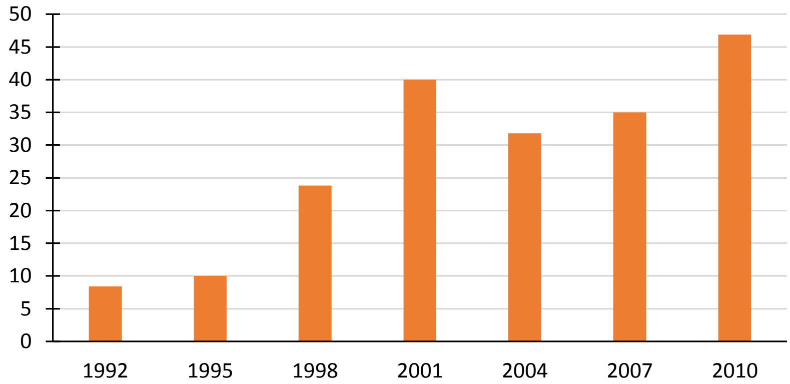


Source: The Effects of Demographic Change on GDP Growth in OECD Economies, US Federal Reserve, 2016

- Low inflation could be persistent given low levels of demand and too much supply. This has a range of implications for interest rates and monetary policy. Central banks will have an ongoing battle with weak inflation and will keep rates at or near zero for longer, and QE policies could remain in place. Bond yields may stay near record low levels.

- Baby boomers will eventually start to sell assets although it is most likely that they will liquidate assets over a longer period than which they bought them. Stock sales will probably occur before housing sales as boomers seek to fund their retirements. Boomers currently own about 46% of US stocks so this will be meaningful. This process may accelerate now that the first baby boomers are older than 70½; this is the age that mandatory minimum drawdown rules for retirement plans force investors to withdraw at least 5% of the value of the plan each year.

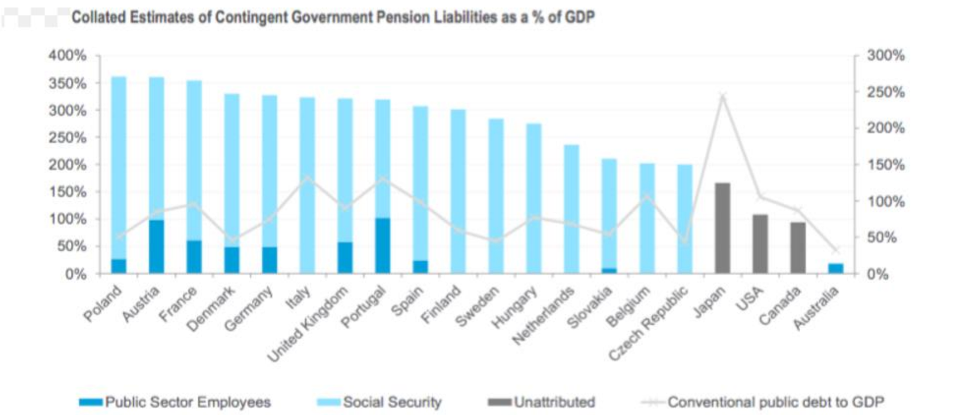
US equity held by boomers %



Source: Datastream, Evans & Partners

- The major impact on house prices seems likely to be spread out and delayed. Baby boomers are not downsizing in any significant numbers and still hold 39% of all dwellings and 43% of detached houses in the US. The major impact may not occur until death rates pick up in another 10 years or so.
- Government finances will deteriorate due to higher demands from pensions and healthcare spending. This could exacerbate the impact on GDP if governments are forced to increase taxes or cut spending to cover any shortfall. Some countries are much better placed than others as shown by OECD estimates of contingent government pension liabilities. Australia is best positioned due to the establishment of the Future Fund, the introduction of compulsory superannuation and the switch to defined contribution schemes in 1992.

OECD estimates of pension shortfalls by country



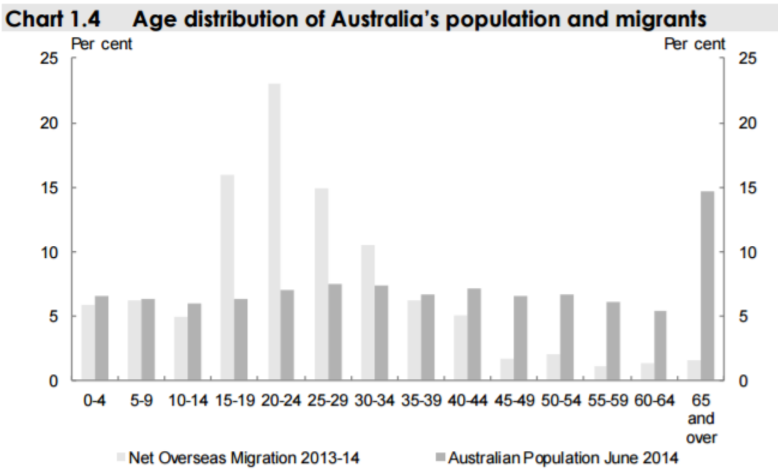
Note: Most data based on 'Freiburg' model calculated on 2006 data; UK, Australia and Spain based on National calculations based on 2010 data; US, Japan and Canada based on 1996 data estimated by Chand and Jaeger.
Source: Kaier and Muller (Freiburg University), DNB, OECD, Citi Research

Australia better positioned than most

The preceding analysis has generally focussed on US effects given the magnitude of US influence on the global economy and markets. The effects will be broadly similar for most western countries. Australia will be affected in a broadly similar way; Australian demographics are also deteriorating, weaker global growth and inflation will affect the Australian economy, and Australian interest rates will stay low if global rates stay low.

However one important difference for Australia might be that immigration may mitigate the effects. Immigrants tend to be younger than the existing population with the majority of immigrants aged between 15 and 34. An acceleration in immigration is one option that Australia can use to relieve the demographic pressure on government finances in particular, provided it is politically viable to do so. Countries with much larger populations like the US will find it harder to increase immigration materially enough to offset the effects of demographics.

Immigration as a solution for Australia



Source: Treasury Intergeneration Report

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