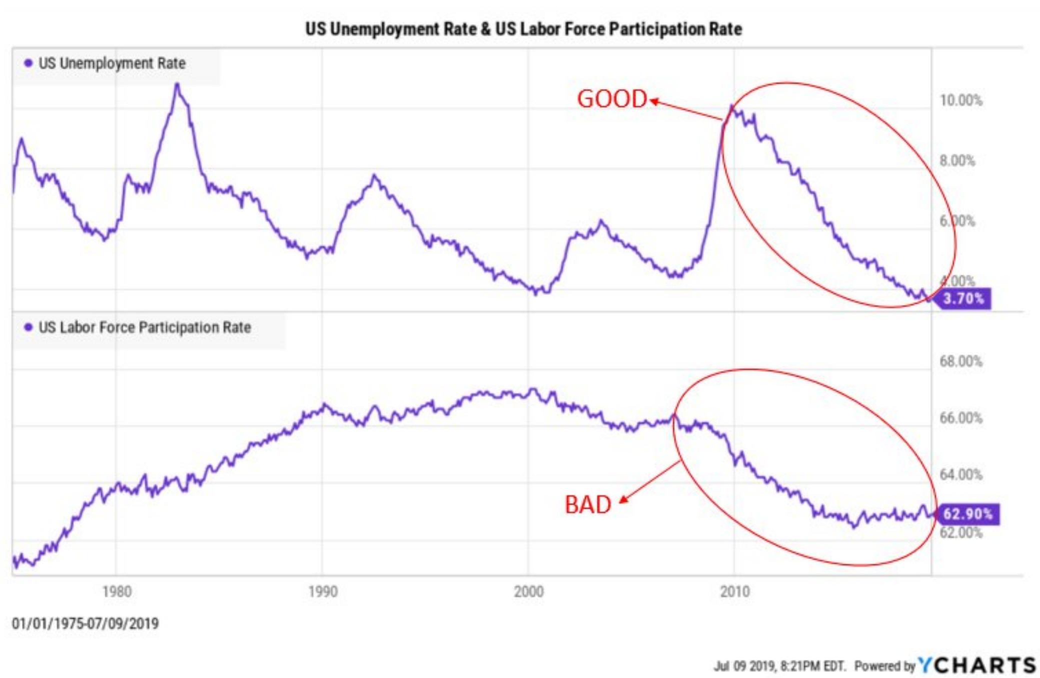
Shifting Demographics and its Potential Affects on Long Term Market Growth

July 2019 – Q2 Exploration

The closely watched US Jobs report comes out on a monthly basis. How many people were hired? How low is the unemployment rate? These headline numbers move markets. A statistic typically revealed closer to the bottom of the news article is the labor force participation rate. We find this number provides more insight and meaning for longer term market trends - (though, as a longer-term metric, it is seemingly not sexy enough for the news to highlight). The participation rate measures how much of the population 16 years and older are part of the labor force. While the unemployment rate is near 50-year lows (a positive), the participation rate has dropped dramatically since 2008 and are at levels not seen since the late 1970's (a negative). What gives?



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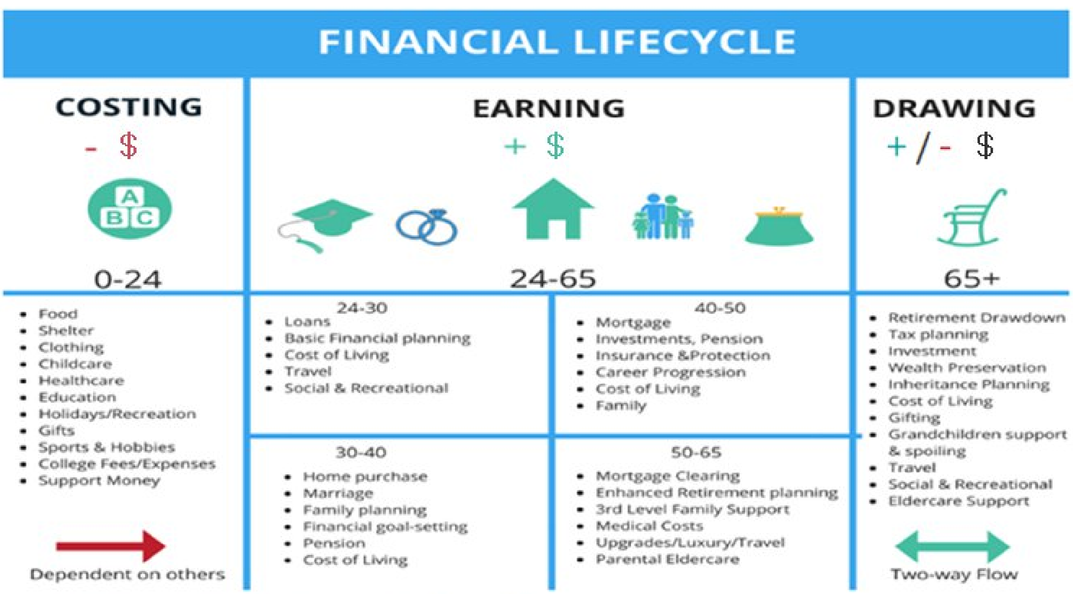
We are confident in the ability to commiserate with our readers that we are all getting older (We are factually 3 months older from the last Insights). In the financial cycle of life, one is (hopefully) (1) first supported until working age, (2) then may support a few dependents while building up a retirement nest egg ,(3) prior to either being dependent on that nest-egg - which may or may not be supplemented by government and possibly others. At optimal points financially in one's life that means contributing to the world market through productivity and investing. At other points in one's life they are receiving and therefore deducting from the world market.

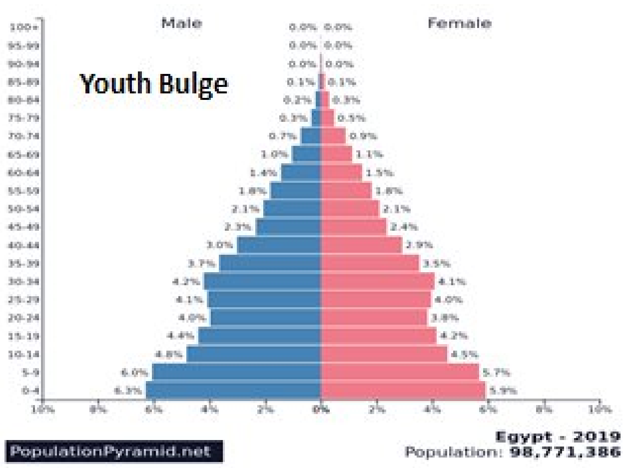


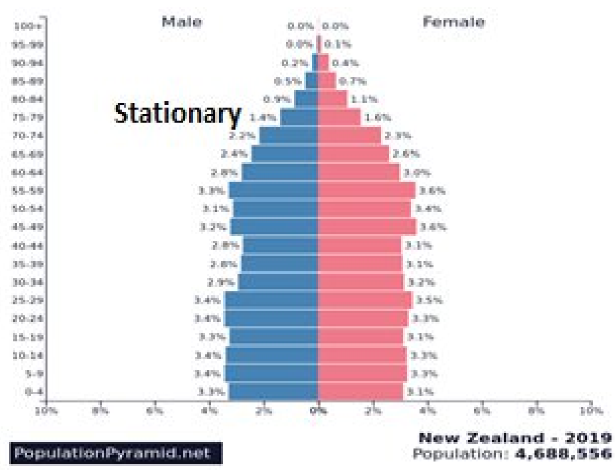
https://employeefinancialwellness.ie/2018/05/30/employee-financial-wellness-lifecycle-planning-chart/

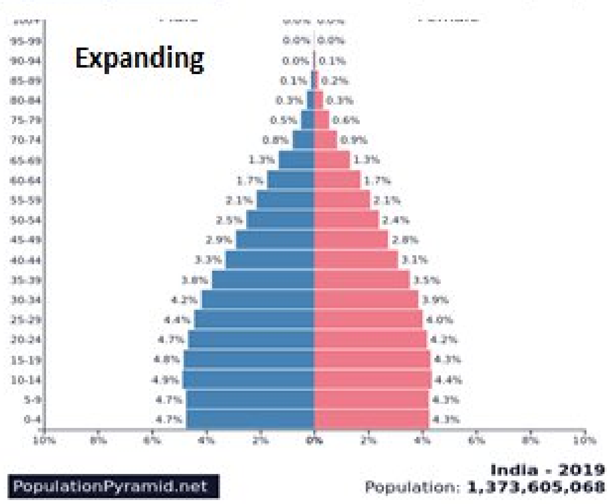
Widening out the scope a bit from singular to society, demographics play an important role in the health of financial markets. If a singular age group overwhelms others within a market (e.g., baby boomers) it can overwhelm in different eras positively or negatively. The following charts are termed population pyramids. There are four general shapes for population pyramids:

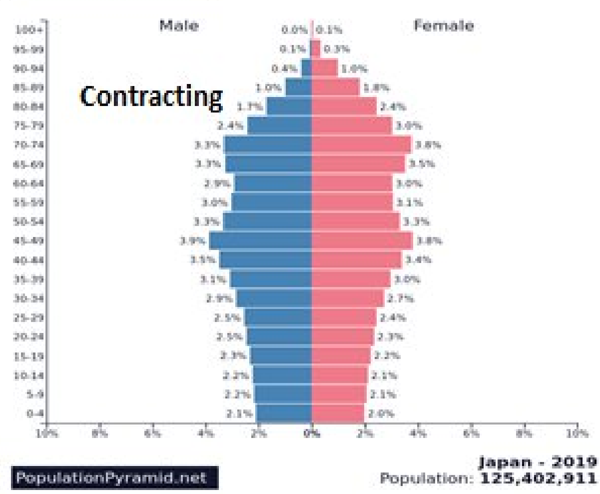
- **Youth Bulge**: High birth rate and shorter life expectancy, typical of frontier and lower economic regions

- **Expanding**: Still high birth rates but with a growing middle class and slightly longer life expectancy, typical of frontier and some emerging markets
- **Stationary**: A population that is neither growing nor contracting where the populace is growing at a fair replacement rate, more typical of developed markets
- **Contracting**: Low birth and death rate, more typical of developed markets though China may be an exception here due their one child policy









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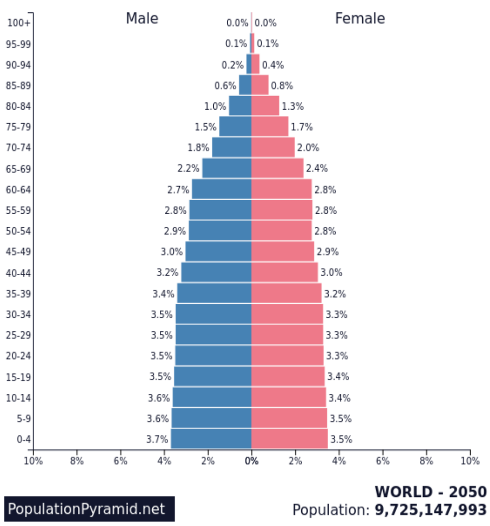
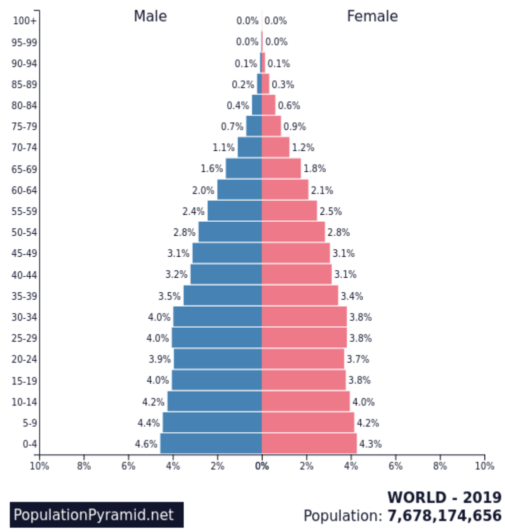
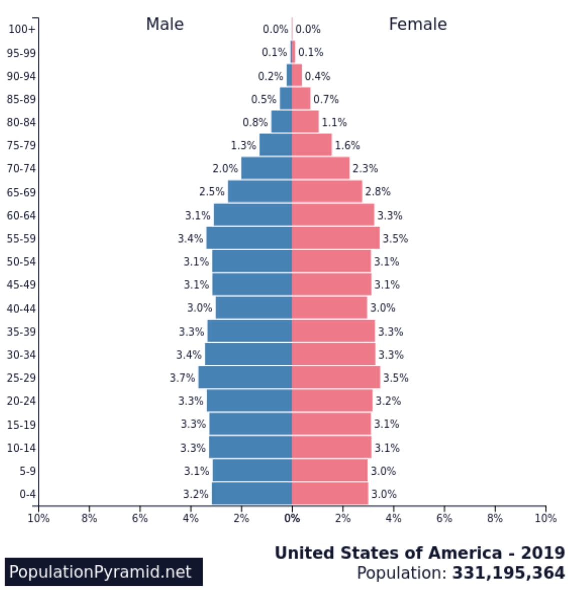
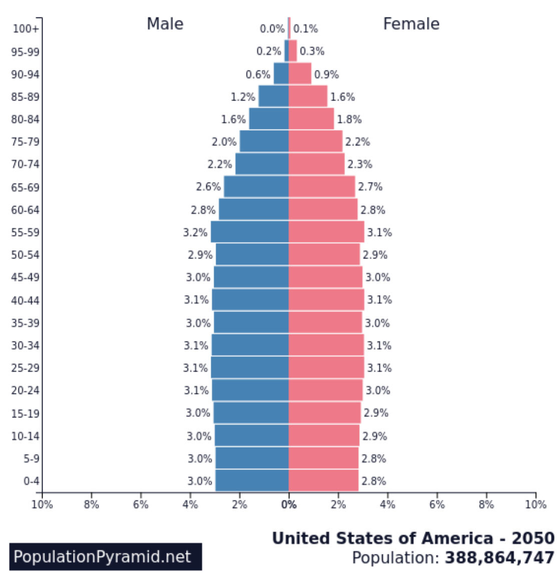
Below are the current demographic charts for the World, US, China and Europe. As can be seen, the US is in relatively good shape while the effects of low birth rates (artificially created in the case of China due their past one child policy) can be seen in both China and Europe. It is helpful for us to see given our US colored glasses that the World is still in an expanding state though expectations are for that to moderate over the next 30 years (though we all know a lot can happen over that time period).









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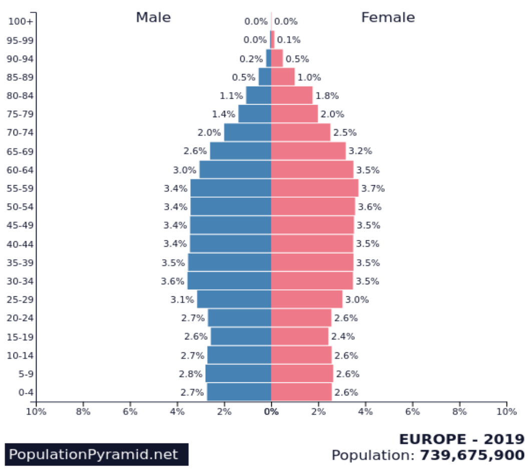

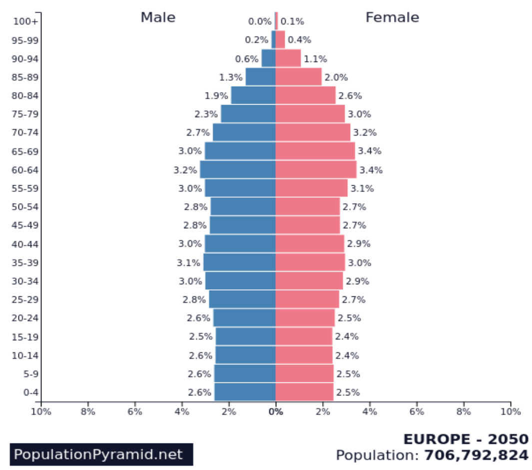

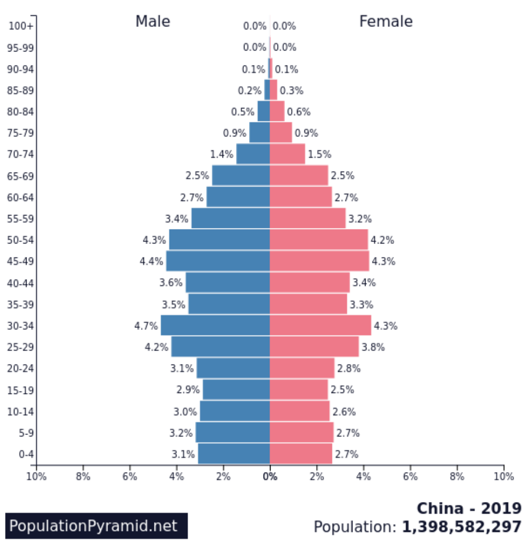

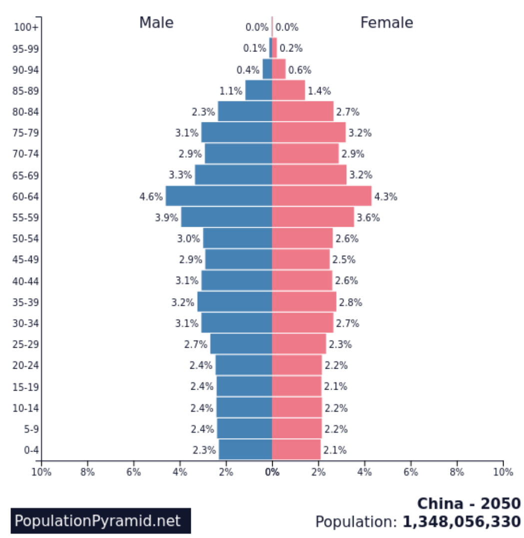

As can be seen from the population pyramids above and the following graphs, populations in certain regions are becoming older. This trend is expected to continue resulting in some regions having over 35% of their populations above the age of 65 in the next few decades.

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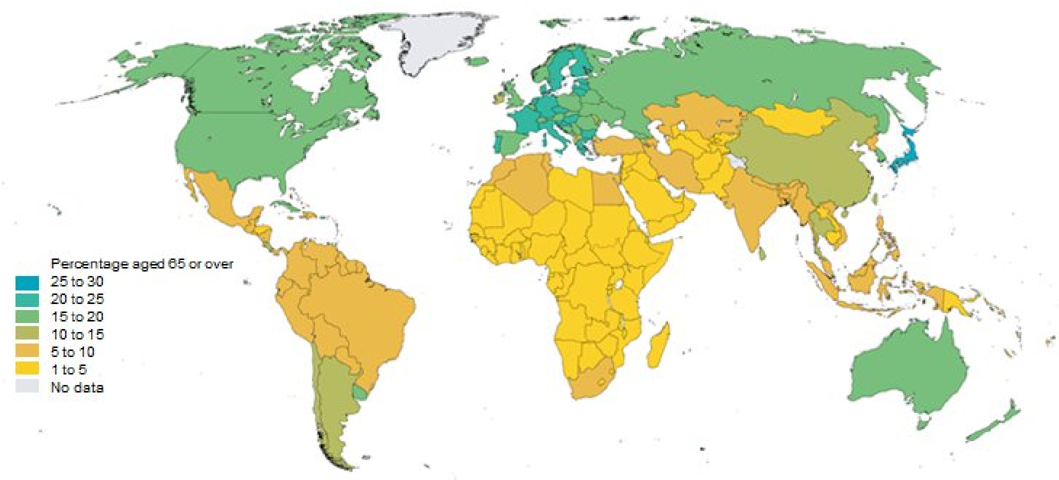
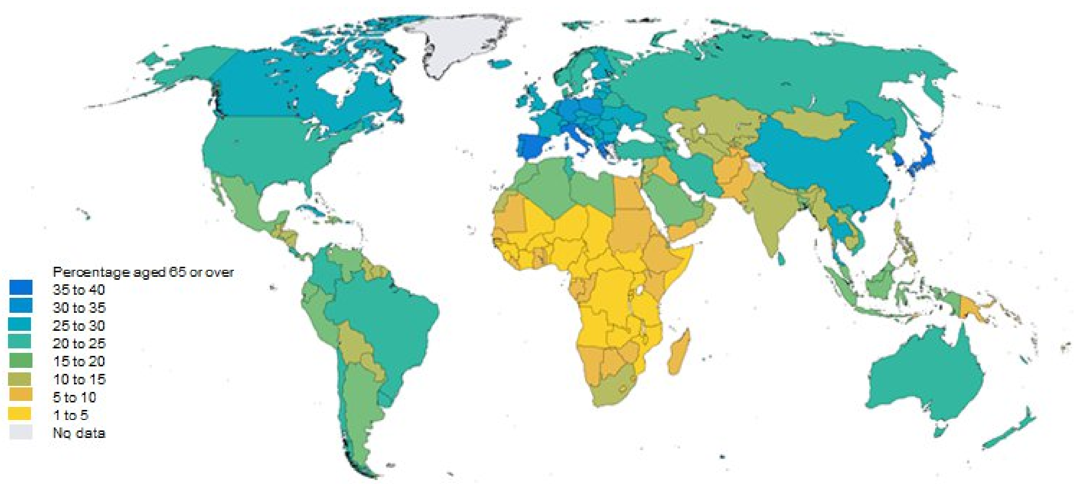
Percentage of population aged 65 or over, 2020



Data source: United Nations, DESA, Population Division. *World Population Prospects 2019*. http://population.un.org/wpp/

The designations employed and the presentation of material on this map do not imply the expression of any opinion whatsoever on the part of the Secretariat of the United Nations concerning the legal status of any country, territory, city or area or of its authorities, or concerning the delimitation of its frontiers or boundaries. Dotted line represents approximately the Line of Control in Jammu and Kashmir agreed upon by India and Pakistan. The final status of Jammu and Kashmir has not yet been agreed upon by the parties. Final boundary between the Republic of Sudan and the Republic of South Sudan has not yet been determined. A dispute exists between the Governments of Argentina and the United Kingdom of Great Britain and Northern Ireland concerning sovereignty over the Falkland Islands (Malvinas).

Percentage of population aged 65 or over, 2050 (medium-variant projection)



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We care so much about demographics and the labor force participation rate for the following reasons:

- From demographics, one can calculate a "dependency ratio" which is defined as the ratio of the population below 15 and above 65 to the total population between those ages[1]. In countries like China and Europe, it is reasonable to believe that the labor force participation rate will decline over the next few years which can truly stress a population. How will the government react and assist on social issues such as retirement and child support? Does this mean increased borrowing? What kind of stresses on society can we expect simply from the age mix of our population?

- It also provides insights into expected flows of capital. If a bulge in a population pyramid is at prime working age in a functioning economy (think developed market or growing emerging market with proper characteristics such as governance) then one can expect inflows into capital markets. Conversely, as that bulge retires, outflows can be expected.

In our Q1 Insights we anticipated further and quicker world innovations translating into productivity and wealth. Innovation may indeed result in us humans attaining increasing longevity which may put further pressure on these population pyramids. Demographics are not quite as rosy for the future economy though a slow-down in world population growth does not seem an entirely terrible idea long-term for the planet. Financially, contracting population pyramids places stress on governments and regions and it is an area we analyze when thinking through our general allocations.

Biases in favor of the US continue; lowering credit risk

Our general approach to investing on your behalf is to take a top-down approach in creating diversification of risks and returns in one's portfolio. Let's unpack that. A top-down approach means we start by viewing the high-level investing opportunities. Equities vs. Fixed Income exposure first. Then within equities, US, Developed Markets (e.g., Europe & Japan), and Emerging Markets (e.g., less- developed markets like China & India) and so forth. We continue on this path to actual strategy and manager selection. Diversification of risks and returns means we invest in multiple exposures on your behalf in order to increase the likelihood we'll have varied return streams as well as risk streams. Since we do not know with certainty (nor does anyone

[1] *The case can be made to expand both sides of the equation: Developed nations tend to nurture their youth well beyond the age of 15 with the cutoff of age 24 illustrated on the financial lifecycle graphic more reasonable. Meanwhile, due medical innovation and better knowledge, the age of 65 does not really indicate the need for one to retire and indeed the general retirement age continues to creep up.*

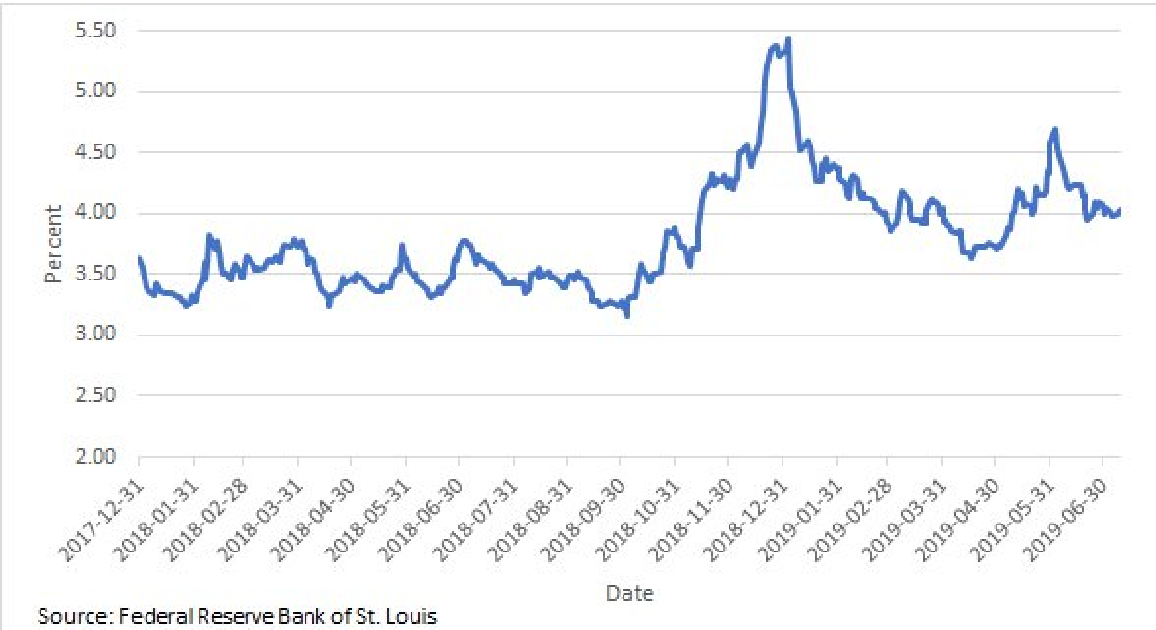
else to our knowledge) what investment will do best, we attempt to smooth out the experience. We do have biases though.

The demographic data shared above aligns with our bias in favor of the US. It is worth noting though that we are closely watching the widening premium between the valuations of the US vs other developed and emerging markets.

We also continue to remain a bit shorter in duration in our fixed income holdings. One is typically paid a premium to take on more risk. Holding a bond that pays back principal in five years is inherently riskier than holding a bond from the same issuer who will pay back principal in two years. In today's environment, both are paying a similar coupon. So, we are slightly biased in favor of shorter duration as we believe it provides us more flexibility.

Lastly, we are modestly lowering credit risk in some of our more growth-oriented portfolios as global central banks see some softness while at the same time credit spreads are relatively tight. Credit spreads being relatively tight means that the premium received for purchasing a Junk bond in place of a US Government bond is on the low side historically. Trade jitters due to misunderstandings (perhaps) and threats in May illustrated how quickly these spreads could widen. Similar to our approach on having a slightly shorter duration, we believe it prudent to lower this risk modestly.

High Yield spread (premium) above US Government Yields



Concerns: A Scarier World Awash in Debt

Note that given our longer-term focus, these concerns will not change dramatically from quarter to quarter. As such, when content does adjust, we will make sure to point it out. Demographics play a strong role in all three. For example, senior citizens tend to show up to vote in the US. As that cohort becomes larger, how will that affect policy - more services for seniors equates potentially to more government spending and perhaps other groups becoming irate as this unfolds resulting in volatility. This quarter, we adjusted the language on the second two points though the primary concerns remain the same.

- **Geopolitical climate**: Over the last century it seemed that the world had come to the conclusion that Communism and Fascism did not work; That the way forward was the American way: Liberalism and Capitalism. Country after country, though, seems to be re-examining that conclusion with strong men being elected too frequently (note South American and Eastern European countries). America itself is turning inward and away from the ideals of NATO post-World War II, where we basically agreed to keep peace in return for global commerce. We are concerned for the upheaval that may follow and its effects on world economies.

- **Artificial market support by governments**: Given the demographics shared above, it is hard to envision governments not ***expanding*** their holdings. The world now has a number of governments that are lending at *negative* rates. In many ways it feels like the credit environment can go on for quite a while though at what future cost?

- **Shorter-term volatility and risks**: The geopolitical climate (note first point) should result in an increased potential for volatile moves in the market. A good example was the weekend in which our government squeezed Mexico via trade threats in return for further border controls.

To be clear, there are and always will be concerns in the market and in the world. We explore them to obviously give us the best chance to navigate them effectively. It is worth noting though that the reason we diversify both risks and returns is that the future is simply unknown.

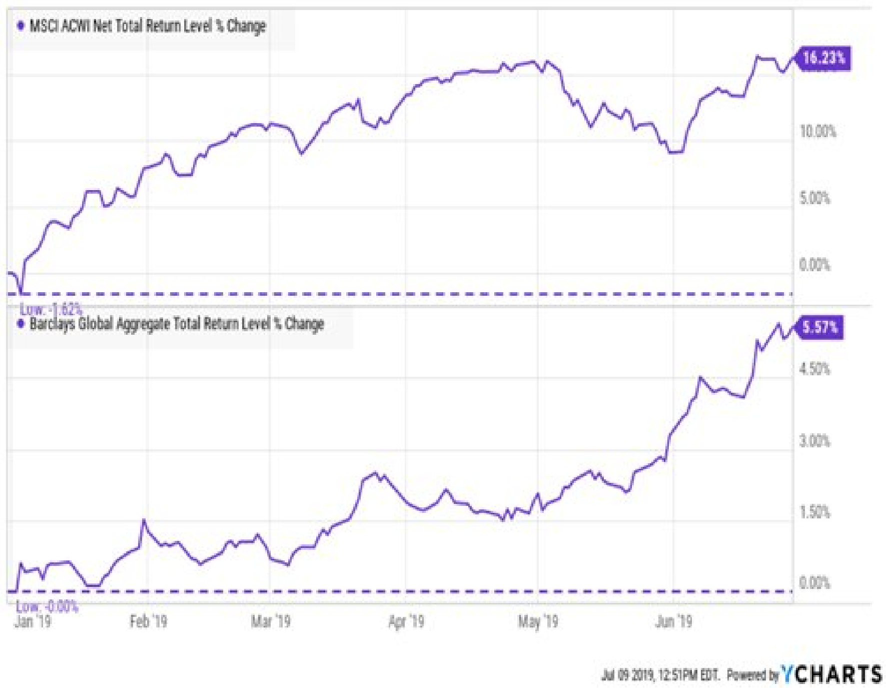
General Market Review: A Goldilocks Environment

Trade war headlines have primarily been positive, earnings continue to hum along fine and, under intense, immense pressure, the Fed is playing along. The blue dotted line on the following chart is the yield curve from a year ago while the green dotted line is as of the end of Q2 2019. The yield curve illustrates current interest rates out into the future (in this case, out 30 years). The blue line, reflecting a year ago, is relatively flat historically but is still an upward trending line which is the norm. The circled part of the green line is not normal. Though, it is simply the markets not accepting current fed rates and believing they will come down by at least 50 bps if not more in the short term. If the Fed does not comply and barring a tremendous upside global surprise, the markets will react rather poorly (an understatement) which would in affect prove the Fed wrong. In other words, the Fed does not have much choice in the matter. We expect them to comply and make any excuse necessary to justify it. *(footnote: This does not mean we do not believe it it justified, we are not in a position to expertly weigh in here, it just means we do not believe the Fed has much choice in the matter.)*

FOUNTAINHEAD INSIGHTS

Global markets have rallied roughly 16% this year through the end of Q2. The month-long equity market pullback in May (top chart) was primarily due to US - China trade negotiations hitting some snags and a weekend of threatening Mexico in regards our shared border. While we have had a strong rally to date, most if not all of the gains were simply recapturing losses from Q4 2018. A case for potential further upside can be made given modest corporate earnings expectations and potential for a China deal. The Fed, of course, is expected to also continue assisting with their easing policy which benefits equity markets.

Meanwhile, fixed income is also having a banner year. Gains made in the beginning of the year were primarily due to the reversal of Fed communications in regards policy (and perhaps policy itself depending on how one wants to interpret Fed action & communications). However, as equity markets seemed to catch their footing and trade war concerns reduced, there was enough softness to continue the fixed income rally. Finally, jitters in May in regard to trade wars and the resulting risk of global economic weakness resulted in a large leg up over the last month and a half.



In closing, we continue to monitor markets closely and look for opportunity on your behalf.

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