



The RACE to ZERO

Economies and markets are facing a fundamental shift, according to demographic expert Richard Hokenson. In the past, “the shocks to the system were *inflationary* in nature,” he says. “Now, the shocks to the system are deflationary in nature, negative-demand shocks.”

BY JONATHAN BARNES

Mix falling birth rates with demographic insight and what do you get? Low-interest-rate environments and a new take on trends in currencies, according to Richard Hokenson, founder of demographic economic consulting firm Hokenson & Company. Previously director of demographic research at Credit Suisse First Boston, Hokenson was also chief economist at Donaldson, Lufkin & Jenrette, where, in 1978, he pioneered the application of demographics to economic and financial market forecasting. In an interview with CFA Magazine, Hokenson spoke about labor force as a trigger for rate changes, the strength of the U.S. population profile, and currency moves as a demographic effect.



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Is a demographic paradigm shift happening?

I think the fundamental paradigm shift is populations shrinking. We always had populations that grew, and now we confront the issue of population implosion because the majority of people on the earth are making the decision, voluntarily or involuntarily, not to replace themselves in the population pool. So, in my opinion, the global population, which is today roughly 6.9 billion, will probably never get to 8 billion before it begins to shrink. This is in contrast to the issues associated with population growth—congestion, pollution, etc. Depopulation (shrinking population) presents a whole new set of issues.

What are the investment implications of depopulation?

The most important implication is that the world is engaged in a race to zero interest rates. Japan is winning that race. It is not necessarily a race one wants to win. Very low interest rates are good news for people who borrow money, but it makes a more difficult environment for the CFA Institute audience, most of whom have the mandate to find good investment returns for their clientele. It's going to be a more complicated issue in terms of looking for better returns. It's more complicated because it is a world of lower average nominal returns resulting from the aging of the population, a lack of inflation, and countries that are saving for the retirement of their own populations.

What's the relationship between shrinking populations and low interest rates?

There is a very strong relationship between nominal long-term interest rates and nominal long-term GDP growth. I have seen studies that tracked this relationship back to the 1800s. If you do a supply-side decomposition of the GDP, in terms of population, labor force, and productivity, you end up with a very strong causal relationship between labor force and nominal GDP. And labor force growth is slowing—it is slowing worldwide. That will continue to pull down nominal GDP and nominal interest rates.

So labor force is the trigger for changes in long-term rates?

There is a book entitled *The Great Wave: Price Revolutions and the Rhythm of History* (1999) by David Hackett Fischer, a historian at Brandeis University. Essentially, Fischer looked at the last 800 years of prices in Europe and found that every eruption in the price index—inflation—was preceded by a rising birth rate. That makes sense, of course. Basically, what a rising birth rate would show—15 or 20 years later—is “I have an abundance of young people in the work force and they are young and inexperienced, but at the same time, they are making enormous demands on the markets in terms of places to live, places to work, places to shop, and so on.” You can't increase the real supply of goods and services fast enough. Markets still have to clear, so they are cleared with rising prices (i.e., inflation). In contrast, an aging population is fundamentally disinflationary.

How should investors adapt to a lower-interest-rate future?

In this sense, I am persona non grata with pension plans. Pension plans would love 6–7 percent Treasuries. If you look at what most pension plans hold, most of them are big holders of fixed income. The gap between what their portfolio yields and what they need to fund their long-term liability will get bigger over time, not smaller.

Everybody has to move toward holding more risky assets. In your productive years, you focus on growing capital, but as you approach retirement, you want to think about an income stream. If interest rates are low, either you need to work longer or you need to accumulate more assets. For example, there's the whole issue about stocks that pay dividends. In the 1980s and 1990s, who wanted to own stocks that paid dividends? You didn't care. You wanted something that was going to double this year. Now, dividends or things that look like dividends are appealing.

It's a question of “What return can you get and can you live on that?” If somebody has accumulated US\$2 million in assets, and the investment adviser gives an 8 percent total return, the client will have US\$160,000 a year to live on without touching capital. But at 4 percent, the client will have only US\$80,000, and I am willing to bet that it will be immaterial to the client that 4 percent is a high real rate of return [under the circumstances], because now there is a material difference in the standard of living. That is the issue that you face. Can you generate adequate returns? The issue is going to be generating adequate returns and trying to minimize the volatility.

What does this mean for career opportunities?

There are great career opportunities here. It will matter in terms of the asset selection that people make within portfolios, and it will matter what securities you buy within various asset classes. I think this is a very positive environment for active money managers and for people who make decisions, as opposed to index managers.

What is your view of currency as a demographic phenomenon?

All of the non-petrodollar sovereign wealth funds are Asia based—Temasek Holdings, the Government of Singapore, China Investment Corporation (CIC), etc. Essentially, these countries are saving for retirement. What does it mean for a country to retire? It means that at some point in the future many people will be retired and no longer producing, so they will not have enough producers. These countries are going to have to import from the rest of the world. They are building current account surpluses, saving for that day. In the process of saving, their currencies appreciate versus countries that are younger than they are (e.g., the United States). So, the euro appreciates versus the U.S. dollar and the yen appreciates versus the U.S. dollar and, in time, the renminbi will appreciate versus the U.S. dollar.

At some stage, of course, you get to the tipping point when aging countries start to use the money. Then their currencies will depreciate. That's the basic idea. In that sense, I have a very different opinion on what people call the global imbalance in terms of current account deficits in North America and current account surpluses in Asia. The standard diagnosis is, "Well the United States is profligate, debt crazy, consumer crazy, so we need to really cool the U.S. consumer, we need very restrictive monetary and fiscal policy to halt the growth in consumption, slow down the growth of imports, and reduce the current account deficit. Asia, on the other hand, then needs to stimulate domestic consumption." In my opinion, that is a recipe for disaster, because when Asia retires, it will have no money, and the United States is being "punished" for being young.

What do you expect in terms of currency movements?

As long as a country is still in the asset-accumulation phase, its currency should appreciate (unless you are Japan, where you manage the currency). That is a mistake on the part of countries in that phase. When they start to actually use the accumulated assets, their currencies will start to depreciate versus the U.S. dollar. That tipping point is probably 15 or 20 years away.

You don't view a weak U.S. dollar as a reflection of U.S. policy?

You can flip it and, instead of saying "a weaker dollar," say "stronger yen or stronger euro." That's the mirror image. I mean, 99.99 percent of the discussion in the press about foreign exchange is always about a weak dollar. Well, all you have to do is flip it and say strong yen or strong euro, and it's a different take on the same story. It is not a policy issue. It is just a natural consequence of the differences in age structures of populations.

How is the labor force affecting global growth?

The United States is the only major developed country with a replacement-level birth rate—2.1 children per woman.

The United States is also very open to immigration, both legally and illegally. I have a very contrary view, in the sense that I am bullish on the long-term prospects of the United States. It has a growing population. I live in Europe, and some of the companies I deal with here are looking at insourcing to America. We all hear about outsourcing, like the American jobs that go to China or India, but there has actually been an increase in insourcing from operations of non-U.S. companies. Some European companies are actively thinking about expanding existing U.S. operations or initiating them because the United States has the workers.

I work with a private equity firm in New York, and one of the portfolio companies that this firm owns has now moved production from China back to Michigan. Michigan now becomes the low-cost producer. It is the total cost of production. You are paying more per hour to the workers, but also you are getting higher output, higher productivity.

What other regions are benefiting from growing labor forces?

Mexico, Brazil—basically, the Americas. Within Asia, there are several countries—the Philippines, Malaysia, Indonesia. It is not true of China anymore, and it is not true of South Korea or Taiwan or Singapore, because those populations are aging much faster.

If you look at Africa, that's the region in the world where population growth is slowing the least—a continent with nearly one billion people. When I started doing this work a long time ago, there was no interest in Africa other than maybe South Africa. Now, in Nigeria, Ethiopia, Egypt, and the Congo alone, you have more than 350 million people.

Do we need more CFA charterholders looking into Africa?

Yes, absolutely. It is the last unchartered area, the last source of labor. As people become more aware of the demographic issues, they'll realize that everybody has to import labor. Where do you import from? In countries that depend heavily on immigration, it's going to become the reality that "Hey, it is not so easy to attract people anymore." The pool of candidates is not growing so fast, so where do we look? There is only one place left to look, and that is going to be Africa.

What other demographic trends are affecting investment choices?

There is a big investment shift from goods consumption toward experiences. In that sense, it's no real surprise that the global financial crisis had such a big impact on manufactured consumer goods. Aside from the United States, the global demand is pretty weak. People are perhaps underestimating, especially in the case of China, the demand for experiences, which include things like cruises and air travel.

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The current departure rate (the percentage of a population that travels outside a country for business or personal reasons) out of China is 1 percent, and in Taiwan, it is 13 percent. I think China will end up catching Taiwan faster than people think. Relative to current expectations, people are underestimating the rate of growth of demand for intra-Asia travel, hotels, and so on. If you look at who is buying the planes, they’re not American carriers or European carriers, they’re Asian carriers and Middle Eastern carriers. They are the ones buying the new Airbus A380s and the Boeing 787s.

What’s the biggest demographic story investment-wise?

If you think about one of the most important things somebody who manages money has to make a decision about, it’s the outlook for inflation. If you get that wrong, you are going to have a big negative impact on your performance. In the 1960s and 1970s, people underestimated inflation and got burned. But for much of the past 30 years, it has been the other way around. People have underestimated the structural disinflation. Otherwise, in 1981, you would have bought the 14¾ U.S. 30-year Treasury bond.

In 1981, there were no buyers. And as interest rates were falling, there were still no buyers. Those people said, “They are declining, but they will start rising again,” and that has been part of the issue for the past 20 years. I have talked for 20 years about low interest rates, and people look at me and say, “You went to too many Grateful Dead concerts and inhaled too heavily.”

If you look in the press, everybody believes in inflation—that [Federal Reserve Chairman] Bernanke is going to reflate us, that inflation is going to be back next year or a year after, and that interest rates will be higher.

Why don’t you think there will be inflation?

If you have very low interest rates and you have an age structure where people don’t borrow money (aging populations), it doesn’t matter what the price of money is. You can push out money, but it doesn’t go anywhere. So that’s the question—is inflation caused by money supply or money demand? If it is money supply, then it is a central bank issue and the Central Bank is going to control it. But if it’s money demand, then it is a demographic issue. I think it’s a demographic issue. The age structure of the population matters in terms of whether you can reflate. And since the population of the world is aging, reflation becomes less and less likely.

How does this factor into portfolio selection?

If you invest in companies, it’s important to invest in companies that recognize they are operating in a world that is disinflationary. Twenty years ago, Jack Welch came to the conclusion—in part based on demographics—that

it would be increasingly difficult for General Electric to pass on higher costs and raise prices. What can I do with General Electric if I can’t raise prices? That led to the whole six-sigma strategy [of improved quality control]. You need to be number one or number two in your market, and if you’re anything less, you’ll just get clobbered.

If somebody came to him and said, “Well, I missed my target because I couldn’t raise prices,” they got fired, because Welch said, “No, you have to be thinking about it from the point of view of you can’t raise prices.” Then you have companies like Procter & Gamble or Colgate-Palmolive or Unilever—they think they can just raise prices. If they have to pay higher costs, they just raise prices, and then they get clobbered. That is an important issue—that company managements recognize the disinflationary world they are in.

It all hinges on the outlook for inflation. I am a structural disinflationist, and if inflation is going to surprise, it will surprise on the downside. Which means it is always going to be STRIPS [separate trading of registered interest and principal securities] not TIPS (Treasury inflation protected securities). TIPS are the inflation-protected bonds, and STRIPS will always outperform in a disinflationary environment.

What other factors signal a disinflationary environment?

Shocks to the system have been deflationary in nature, negative-demand shocks. When the baby boom was young and creating inflationary pressures, the shocks to the system were *inflationary* in nature. Now the shocks are deflationary.

Where are the opportunities in negative-demand shocks?

It’s a question of a company’s ability to withstand shocks. What is their debt structure? What is their capital structure? After 9/11, two-thirds of U.S. hotels couldn’t make scheduled debt repayments in 2002 because the economy got clobbered. What did the equity market do? It shocked the entire group. But that also gave you opportunities. If you were an active money manager, you could sift through and say, “There are some really good companies that have been unduly punished because they have a ‘hotel’ in their name.” You could double and triple your bets, and when the market came to its senses, you made a lot of money. The unexpected surprises are deflationary in nature, and they are negative-demand shocks. But that also creates opportunities, which means that equity analysts need to pay more attention to balance sheets, not just the income statement. Companies with strong balance sheets are in much better positions to withstand deflationary negative-demand shocks. //

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