FUNDAMENTALS

End of the baby boom

The retirement of baby boomers is having a negative impact on economic growth. This is bad news for the return on risky assets and applies downward pressure on interest rates.

The old proverb states that it's better to teach a man to fish, so he can eat for life, than to give him a fish, where he can only eat for a day. This relates to how companies and the economy as a whole works. To boost fish production, we can either employ more fishermen, give them more equipment (e.g. nets) or invent and build new and better equipment (e.g. boats). A fisherman without a net is unproductive, as is a boat without a crew. Growth might be understood as being driven by the number of people, the amount of equipment and their technological progress.

A GLOBAL PROBLEM

Investors should therefore be concerned by the riveting sea change that's occurring in global demographics: the retirement of the post-WW2 'baby boomers'. Globally, the 'working-age population' (15-64 year olds) is currently growing by just 1% instead of the previous average of 2% in recent decades. But some workers are more productive than others. Adjusting for this, we estimate the global workforce is almost stagnant; growing by just 0.25% as opposed to the 1% of decades past. This is very important, feeding directly into potential economic growth, as well as the solvency of public finances.

REGIONAL DIFFERENCES

There are three potential solutions: delay retirement, increase immigration or implement economic reforms in poorer countries. But different countries face different problems.

For example, birth rates are paradoxically highest in countries with the lowest 'human development' - whereas they have fallen furthest in high productivity economies. As German Chancellor Angela Merkel put so succinctly, Europe has 7% of the world's population, 25% of its income yet 50% of its social spending.

How is a new-born baby in sub-Saharan Africa going to pay for a retired European baby-boomer's pension? Immigration is very important, but ultimately a politically fractious topic. So delaying retirement is an alternative way to boost the workforce.

The UK, for example, has had some success here. It has gradually raised the female retirement age from 60 to 65, in line with men and is set to increase the joint retirement age to 66 by 2020 and 67 by 2028. This has encouraged a 10 percentage point increase in the share of women 55-64 'participating' in the labour force (willing and able to work) over the past decade and smaller increases in the share of elderly men participating too.

The net effect of delayed retirement has been to boost the UK's labour force by 0.25% per year. If we extrapolate these participation trends and combine it with population projections, we estimate that the UK's productivity-adjusted labour force (we take into account that elderly workers earn less than middle-aged ones) should grow by around 0.3% over the next decade, somewhat worse than the 0.7% growth seen in previous decades. Without delayed retirement, UK labour force growth would be zero (Figure 1).

However these population projections assume continued net immigration of 190,000 per year. Without this, the UK's productivity-adjusted labour force would be stagnant, even with delayed retirement. In other words, if Brexit leads to a significant decline in immigration, it could completely offset the demographic effects of delayed retirement.

Legal & General
INVESTMENT MANAGEMENT

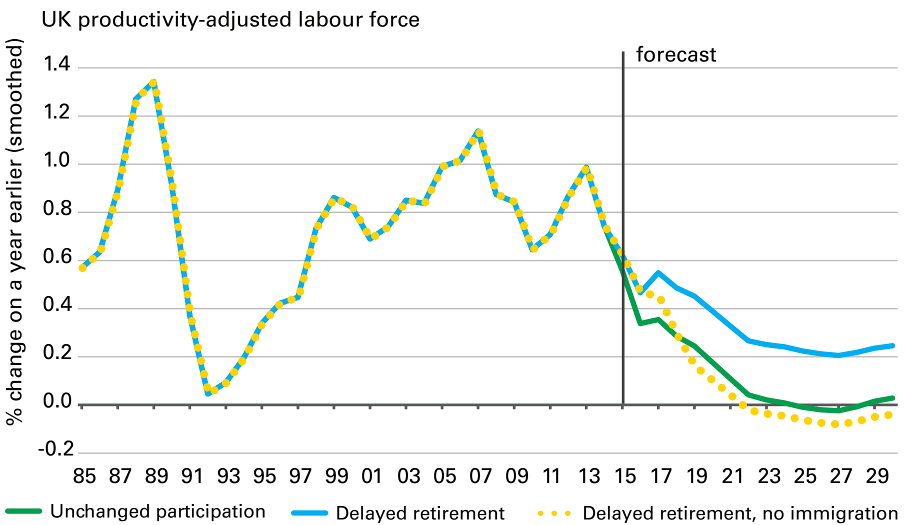
Immigration is also an issue in the US, with President Trump promising to "build a wall" on the southern border and an "America first" approach to jobs. As with the UK, we find immigration has made a significant boost to the labour force of around 0.4% per year. But unlike the UK, there has been no increase in the participation rate of elderly workers because the US doesn't have a formal retirement age. We estimate that the US productivity-adjusted labour force is set to be stagnant (+/- 0.25% depending on immigration) instead of average growth of around 1.25% in recent decades. In other words, US demographics are expected to deteriorate by at least 1% per year and contribute nothing to economic growth (Figure 2).

ECONOMIC REFORM ACROSS EMERGING MARKETS

What about investing in countries with stronger demographics, such as India or Nigeria? In theory, this would boost returns for investors. But as previously discussed, it's not just the number of fishermen that matters, but also whether they have the right equipment. A high birth rate is often driven by economic insecurity, which in turn deters corporate investment. However, a combination of strong demographics and economic reforms should provide better long-term returns.

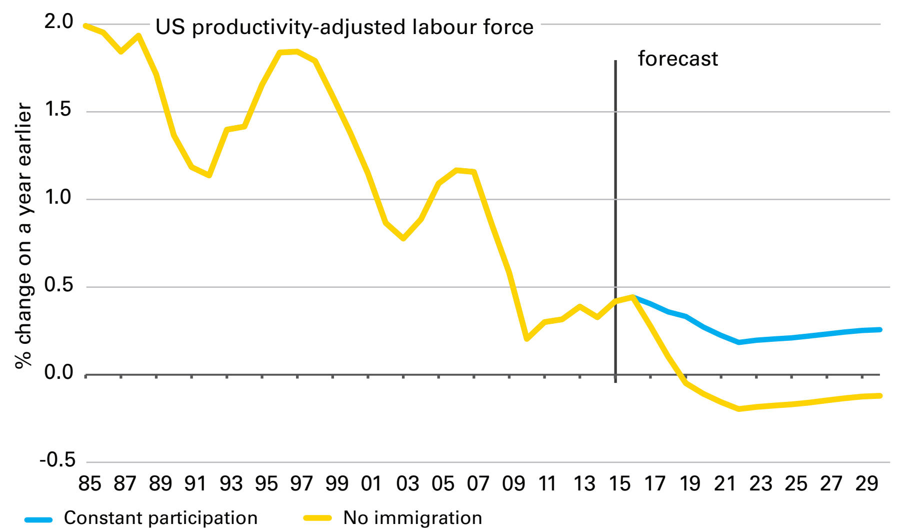
We are already seeing positive signs out of India for example under Prime Minister Modi: promoting infrastructure development, opening up some state-owned industries and removing barriers for foreign investment. But this will be a long and winding road.

Figure 1 – Delayed retirement is boosting the UK labour force, but this could be offset by reduced immigration



Source: OECD, UN, Macrobond, LGIM estimates

Figure 2 – US labour force is slowing sharply as baby boomers retire, particularly if Trump reduces immigration



Source: OECD, UN, Macrobond, LGIM estimates

BOTTOM LINE

While policies towards immigration, retirement and economic reform vary by region and country, the overall conclusion is very clear: global trend growth is likely to be significantly lower than in the past, notably in the US. In turn, this has negative implications for expected returns on risky assets such as equities. Lower growth also means that interest rates don't have to increase as much as previously thought so cash interest rates are unlikely to 'normalise' to levels seen previously. The inflation implications are more nuanced and ones which we will explore further in future articles on this topic.

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