



## Demographics and the New Normal

- Japan is often derided for its 'lost decade' (now two) of stagnant growth following the collapse of its real estate and stock bubbles in the early-1990s. Japan's cautionary tale of political, institutional and corporate sclerosis is well known. However, another salient takeaway for the US and other developed nations is from Japan's demographic transition – its population is getting older – since a country's long-run sustainable growth rate is a function of the growth of its working-age population (WAP) and productivity.
- Adjusted for demographics, Japan's performance can be judged more favorably. Daniel Gros, director of the Centre for European Policy Studies, writes: "When one looks at GDP/WAP (defined as population aged 20-60), one gets a surprising result: Japan has actually done better than the US or most European countries over the last decade. The reason is simple: although Japan's overall growth rates have been quite low, growth was achieved despite a rapidly shrinking working-age population."
- According to McKinsey Global Institute, US labor force growth will slow to 0.5% over the next decade from its historical average of 1.6% (see Weekly Chart), as detailed in a study recently highlighted by the *Wall Street Journal*. Given historical productivity growth of 1.7%, McKinsey suggests that US 'new normal' GDP growth will average about 2.2% annually, a full percentage point below the 1960 to 2008 average of 3.3%. We think McKinsey may be underestimating the degree to which baby boomers will postpone retirement, but we agree that growth will be lower than the past five decades. The *Wall Street Journal* gloomily notes that: "Slower growth would slow gains in living standards. It would make the US a less attractive place to invest — bad news for the dollar, for stocks and for bonds (and therefore interest rates). It would make the nation more prone to recession. And it would make the nation less able to care for those retiring boomers." While conceivable, in our view, none of this is inevitable — the US has excelled at applying technological breakthroughs and improvements to increase productivity, and due to still-significant net immigration the US remains better positioned demographically than most other developed nations.
- We have been concerned that falling unemployment was mostly reflecting a cyclical decline in labor force participation and that participation would rebound as the economy recovers. This would bring more people into the labor force and make further declines in the unemployment rate more difficult. One silver lining to a secular slowdown in labor force participation is that the current 9% unemployment rate, now below its September 2009 peak of 10.1%, is probably more accurate. Goldman Sachs recently found "that most of the drop in participation in recent years reflects changes in the underlying demographics... the overall labor force participation rate will edge up by ¼ to ½ percentage point over the next two years. If so, job growth will need to average 200,000 jobs per month to push the unemployment rate down to 8% by the end of 2012." We think these underlying demographic trends include the aforementioned aging of baby-boomers (offset somewhat with later retirement), the leveling off of female participation rates (currently about 75% versus 35% after WWII, compared to 89% for men from over 95%) and the extended education that is increasingly necessary for young workers before they enter the labor force (teen unemployment is currently 25%, but drops considerably with educational attainment).

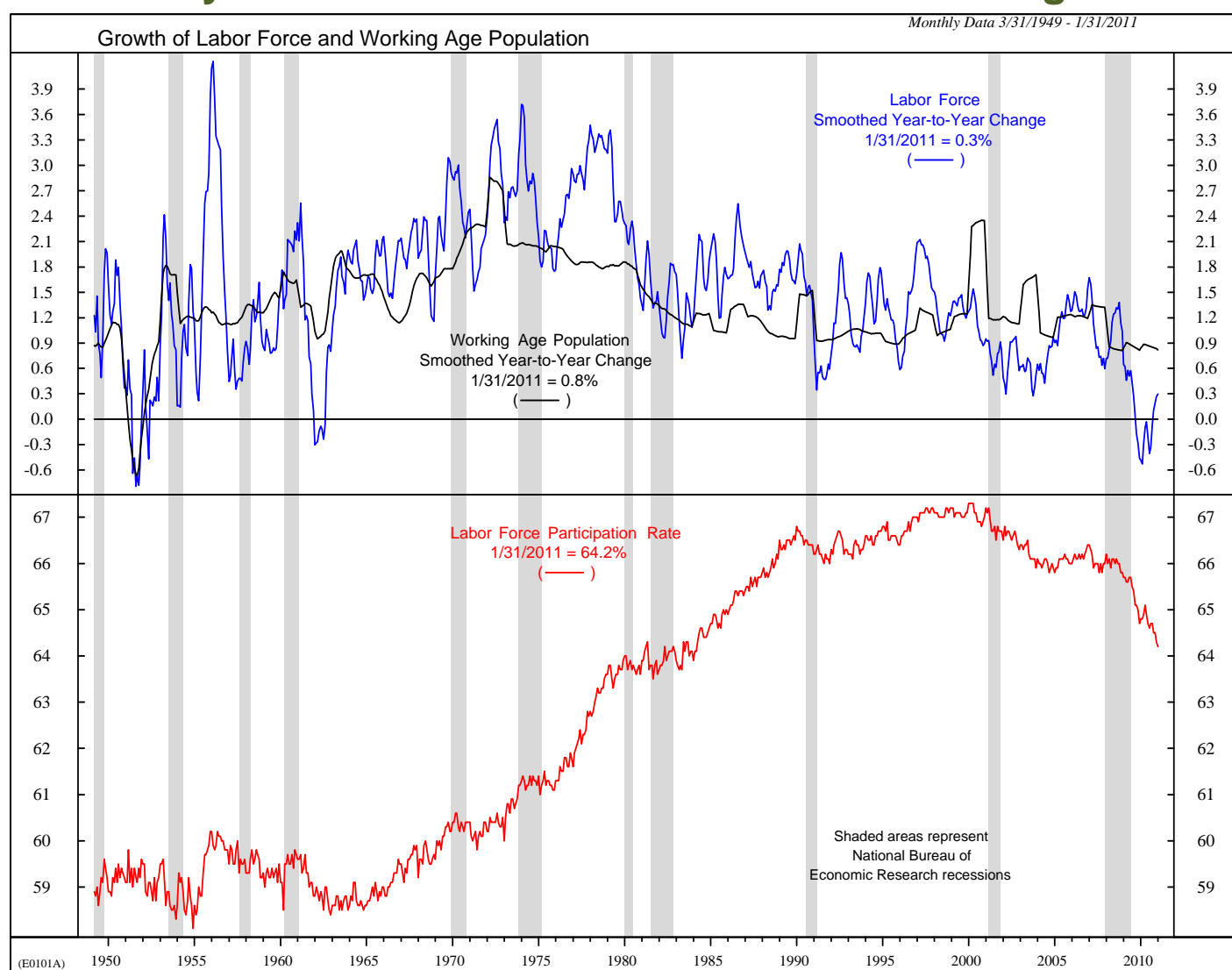
### Oil and the Middle East

The price for a barrel of West Texas Intermediate (WTI) oil briefly traded over \$100 last week while Brent crude (which we think better reflects international supply-demand concerns) approached \$120. Both retreated after Saudi Arabia offered assurances that it would cover any production shortfalls resulting from civil unrest in North Africa and the Middle East. Moreover, Saudi King Abdullah returned from a three-month medical leave abroad to help quell any instability that might arise, particularly from a restive Shi'ite minority in the kingdom's eastern province (where most of Saudi's oil is) that also neighbors Bahrain, which has seen significant protests but has remained relatively calm in recent days. Meanwhile, to the south, Yemen is increasingly becoming politically destabilized and also poses risks to the Saudi

Kingdom. In response, Abdullah announced 'reforms' amounting to \$36 billion (about \$1400 for each Saudi citizen) that we think should allow the regime to escape the turmoil that has engulfed the region.

We think Mohamed El-Erian, the Egyptian-born CEO of bond fund manager PIMCO, summed up the risk of further oil disruptions on oil-importing economies well: "First, higher oil prices will increase production costs and act as a tax on consumers. Second, greater precautionary stockpiling around the world will intensify pressures on commodities as a whole, aggravating the impact of demand-supply imbalances and large injections of liquidity. Third, the region will be a smaller market for other countries' exports." WTI's retreat from last Thursday's brief foray over \$100 was received well by financial markets, but we fear this may only be temporary. If oil prices continue to rise, so do risks to financial markets, in our view. Currently, our portfolios are positioned neutrally in risk assets, since we do not believe last week's pause in the stock market's uptrend is over. In the context of the stock market rally that started last summer, a typical, shallow pullback for the S&P 500 would find initial support around 1275 and then 1225. We still expect upside to 1440 for the S&P 500 at some point this year. Our portfolios are therefore not positioned for a substantial spike in oil prices.

## The Weekly Chart: Secular downtrend in labor force growth



©Copyright 2011 Ned Davis Research, Inc. Further distribution prohibited without prior permission. All Rights Reserved  
See NDR Disclaimer at [www.ndr.com/copyright.html](http://www.ndr.com/copyright.html). For data vendor disclaimers refer to [www.ndr.com/vendorinfo/](http://www.ndr.com/vendorinfo/).

Rod Smyth, Bill Ryder, CFA, CMT & Ken Liu • 804-549-4800 • [www.riverfrontig.com](http://www.riverfrontig.com)  
Riverfront Investment Group, 9011 Arboretum Parkway, Suite 110, Richmond, VA 23236

Information provided in this report is for educational and illustrative purposes only and should not be construed as individualized investment advice. The investment or strategy discussed may not be suitable for all investors. The Standard & Poor's (S&P) 500 Index measures the performance of 500 large cap stocks, which together represent about 75% of the total US equities market. It is not possible to invest directly in an index.