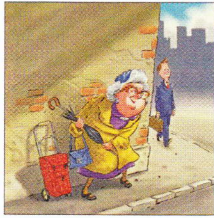
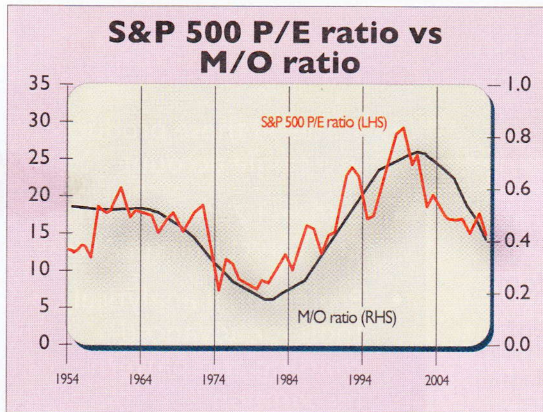
Why America's pensioners will hand



The baby boomers drove a stock boom. Now they're selling up to fund their retirement. That means a bust is on the way, says David Stevenson.

What the stockmarket will do in the next few weeks is anyone's guess. Yes, several business and consumer confidence surveys suggest that much of the global economy could soon return to recession, which would be bad news for share prices. But central banks could spice things up with another round of quantitative easing (QE) – in other words, buying bonds to push cash into the system (see page 44 for more). Asset prices could be buoyed in the short term, meaning the recent volatility may well continue.

But let's look beyond this. Let's assume that the world does see another slowdown (at the very least) next year, and that this is accompanied by a steady fall in equity values. It might not be ideal for current investors, but surely it would be a great buying opportunity? Wouldn't the slump set the scene for the next big rally, as economies and stocks recover in tandem?



Beware the 'inverse baby boom'

It might not be that simple. Another huge factor, which could inflict plenty of damage on stock valuations, is about to come into play: the 'inverse baby boom' effect. What's this all about? It stems from the post-World War II baby boom. Take the United States. From the end of World War I, and in particular through the Great Depression years, America's birth rate fell steadily. But when World War II ended, the baby boom lifted the number of births for each 1,000 of the population from just above 20 in 1945, to over 26 by 1947. That took the birth rate back to early 1920s levels. The rate stayed in similar territory for the next decade, before slipping again through the 1960s.

Long-term demographic trends like this may seem too abstruse to influence share prices today. But history shows a strong link between the age distribution of the US population and the performance of its stock exchange. In turn the latter, being the world's largest equity market, is a major driver of global share returns.

The generation born between 1946 and 1964 has already had a huge impact on America. For starters, as they've moved into positions of influence – and affluence – within the economy, they've snapped up lots of shares. A study by Gurdip Bakshi and Zhiwu Chen published in The Journal of Business in 1994 pinned the sustained stockmarket booms of the 1980s and 1990s on baby boomers moving into middle age, the prime time for accumulating financial assets.

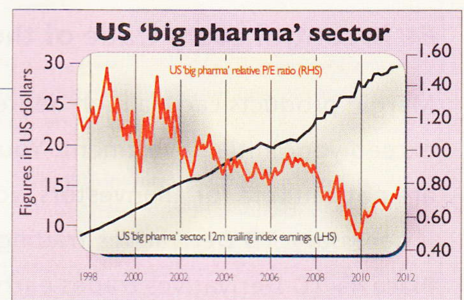
That's why stocks are heading for trouble, because these same baby boomers are fast nearing retirement age. Americans born in 1947, for example, will be 65 by next year. To fund retirement and all that goes with it – increased leisure time and rising medical and healthcare bills – they're now likely to sell a chunk of the assets they've piled up. The most risky shares in their portfolios will be first in line for disposal.

This isn't a new fear, but now it's on the verge of materialising. While many baby boomers will already have readied their portfolios to meet their needs

Big pharma will ride the boomer bust

Mention retirement and golden images of limitless leisure time spring to mind. Hopefully that will be how it works out for most new retirees. But with the average age of the world's population rising, there's one sector that's bound to see plenty of business. As Lombard Odier points out, with more than two billion people worldwide likely to be aged 60 or over by 2050, healthcare is almost certain to be one of their top requirements. While longer-term prospects for global stockmarket valuations look gloomy, as we explain above, this sector should buck the trend.

Firstly, healthcare is defensive. These companies don't need rampant growth to make money – good news given the state of the global economy. Secondly, investors have ignored them for ages. Take America's 'big pharma' stocks. The red line on the chart (right) shows their average p/e compared with the overall market valuation since 1997. Note that the sector used to be valued at a significant premium (ie, more than 1.00) to the S&P 500 index. Yet despite a small pick-up since the start of 2010, it's been de-rated and so far in the last decade it's still trading at a discount.



In other words, big pharma has already been through the de-rating now facing the wider market. Why has this happened? Many former blockbuster drugs have either lost, or will soon lose, their patent protection, the so-called 'patent cliff'. That means these medicines can be copied by 'generic' rivals and

bag the world's biggest stockmarket

following retirement, the asset selling process is likely to continue for at least the next ten years as more retire. This switch from buying to selling is set to be a major depressive influence on the stockmarket during that time.

How bad will the damage be?

But can we quantify just how damaging this could be? There have been several studies on this subject in recent years. The latest comes from Zheng Liu and Mark M Spiegel of the Economic Research Department of the Federal Reserve Bank of San Francisco. They looked at the effect on the price/earnings (p/e) ratio of the S&P 500 index – the US benchmark index – of changing age distribution across the US.

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America's stockmarket is in for a rocky ride once baby boomers start selling off their stocks

Their start point is the year-end p/e ratio of the S&P 500 – ie, the valuation of the market. They adjust both the level of the index, and the earnings generated by the companies within it, for inflation over the past 12 months. They measure age distribution using the ratio of the 'middle-age cohort' of the American population (defined as aged between 40 and 49) to the 'old-age cohort', aged between 60 and 69. This has been christened the 'M/O' ratio. The higher it is, the bigger the number of middle-aged Americans compared with old-aged ones. Anyone younger than 40 has been excluded from the analysis. That's because they don't save much and if they do, it's "primarily for housing rather than for investment in the stockmarket".

So how has this all played out over the last 50-plus years? The chart on page 24 shows the S&P 500 p/e ratio compared

Continued on next page

sold cheap, so they'll be less profitable. Yet so far, such fears haven't stopped big pharma firms producing solid profits. The black line on the chart shows the sector's relentless ability to produce higher earnings year after year.

Now these companies are evolving their business plans to focus on more niche diseases and tie up with generics players to market copycat big drugs. They're also trying to launch more big-ticket medicines. While some firms could see a small profit dip next year, these strategies should help to power continued long-term earnings growth as the needs of retirees steadily grow. Meanwhile, all this historic investor dislike has left several stocks in the sector selling at bargain prices.

Global pharmaceutical giant **Eli Lilly (US: LLY)** specialises in anti-infectives, cardio, endocrinology, neuroscience, oncology and animal health. Potential blockbuster drug Solanezumab is expected to complete its current phase results in 2012. The current year p/e is just 8.4, while the prospective yield is 5.4%.

Merck (US: MRK) also focuses on human and animal healthcare: bone treatment, cardio, derma, diabetes, immunology, obesity and respiratory problems are its main areas. Following its merger with Schering-Plough, Merck aims to make cost savings of more than $4.0bn. Revenue growth should continue on the back of a battery of product launches. The company has many medicines in late-stage trials, including treatments for acute heart failure, cancer and osteoporosis. On a 2011 p/e of 8.6 and a 4.9% prospective yield, this stock is great value.

London-listed **AstraZeneca (LSE: AZN)** is the world's seventh-largest drug company and a key player in the areas of cancer, cardiovascular, central nervous system, gastrointestinal and pain management. It gets 23% of its revenues from Asia and other emerging markets. Astra has just got the nod from the US Food and Drug Administration – the key drug approval body – for its potential acute coronary syndrome blockbuster Brilinta. Though next year's profits are expected to dip by 15%, the 2012 forecast p/e is just 7.3, while the prospective yield is 6.2%.

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with the M/O ratio between 1954 and last year. Clearly, the p/e has been more volatile. That's because earnings, and in particular share prices, have oscillated more than the M/O ratio. But the overall trend is very clear: the two ratios have moved quite closely together. "We estimate the M/O ratio explains about 61% of the movement in the p/e ratio during the period," say Liu and Spiegel.

As post-World War II baby boomers reached their peak working and saving ages between 1981 and 2000, the M/O ratio increased from about 0.18 to around 0.74. During the same period, the p/e ratio tripled from about eight to 24. Yet during the last decade, as the frontrunners of the American baby boomer generation began moving towards retirement, both M/O and p/e ratios turned down markedly.

So what will happen to the American market valuation over the next ten years or more? Based on the last 12 months reported earnings, the S&P index is on a p/e of around 14. Excluding the madcap 'dotcom' boom at the turn of the millennium, when valuations went haywire, that's about the average level for the last 50 years.

But here's where future demographic trends (which are largely predictable) will really create a huge impact. The forecast fall in the M/O ratio until 2025 is set to place a big strain on the index p/e. In other words, the valuation of the S&P 500 could well plunge towards the single-digit depths last seen in the 1970s, possibly 'de-rating' to as a low as eight or nine by 2025, on baby boomer selling. To put that into context, if the market p/e dropped to that level now, the S&P 500 would plunge by around 40%.

There's another key aspect to the overall level of the index. Earnings growth – or maybe the lack of it. At the moment, the average analyst still expects American firms' net profits to rise by 12% over the next year, which would underpin stock prices. But with company profit margins around their highest levels for 40 years, and a return to recession looming, that's starting to look hopelessly bullish. Even excluding one-off items, the last recession in 2008/2009 slashed US annual profits by 25%-30%. Unless the S&P falls further, a repeat of that earnings drop this time round – caused by both lower sales and smaller profit margins – would drive the p/e up to more than 18. Even if company

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Vietnam will profit from a 'youth bulge'

> "Real US stock prices could trend downward until 2021"

profits later recovered, a developing de-rating on the lines we mentioned earlier could inflict more damage on stock prices.

On a longer-term view, there seems little reason to get too excited about American companies' profit prospects. Between 1954 and 2010, US real (ie, inflation-adjusted) corporate earnings grew by an average of 3.42%. With profit margins already so high – meaning they're more likely to fall rather than rise – even maintaining this growth could prove tough over the next 15 years. Throw in that demographically driven p/e de-rating and real US stock prices could trend downward until 2021, not returning to their 2010 level until 2027. Not exactly a great prospect for new investors.

It's not just America's problem

What's more, much of the rest of the developed world is in a similar boat, with some countries even worse off. Japan has been the classic case in point. The number of workers as a percentage of the total population – which itself has been in decline – has been falling for years (see page 46). As retirees have sold their stocks, shares have been progressively de-rated (ie, the amount investors are happy to pay for a given level of earnings has fallen), leading to a near-80% drop in the Nikkei index since its 1990 peak.

Other developed countries have still to feel the effects of an ageing population on their markets. Germany hasn't peaked yet in working population terms, but is set to see its workforce decline inexorably over the next three decades, according to UN forecasts. It's a similar story for France, where about 200,000 centenarians are expected to be living by 2060. That's 13 times more than today. Even China, mainly due to the legacy of its 'one-child' policy that restricts the family sizes of over a third of its households, is likely to go the same way – seeing its working population decline within the next ten years. Of the major countries, only Britain looks likely to escape relatively unscathed, with just a modest dip in its working population expected.

A single statistic sums it all up. In 2000, people aged over 60 made up 10% of the world's total population. By 2050, that percentage is likely to have increased to between 20% and 25%.

So to recap: the US inverse baby boomer effect is likely to be replicated across the planet. Yes, the impact on individual markets from adverse demographics will differ area by area, but stockmarkets worldwide still tend to move in lockstep. As an ageing global population cashes in its equity assets, global share valuations are set to suffer long-term damage.

Not everywhere will be hit, though. A crescent of countries stretching from the Andean region of Latin America across sub-Saharan Africa, the Middle East and the Caucasus, through to the northern parts of south Asia is nearing 'youth bulges' – youthful age structures and rapidly growing populations. As these youth bulges mature into 'worker bulges' over the next 15 years, new economic 'tigers' – fast-growing economies – could emerge. This demographic bonus will come into its own when a country also offers an educated work force and a business-friendly environment.

For now, the likes of Algeria, Chile, Colombia, Costa Rica, Indonesia, Iran, Lebanon, Malaysia, Morocco, Turkey, and Vietnam look to be among the prime candidates to benefit. These could one day present some great investment opportunities. Meanwhile, despite the gloomy overall outlook for stockmarket valuations, there are some individual stocks that should benefit from future demographic trends. In the box on page 24, we spotlight one sector that for ages has been right out of favour with investors, but now it's set to cash in on an ageing population.