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**DEMOGRAPHICS – AMERICA’S LONG-TERM ADVANTAGE**

There is one thing we know for certain about stock market returns: You can’t get them over the long term without economic growth. And economic growth doesn’t happen without either a growing labor force or improving productivity. At a time of positive but sluggish economic progress in the U.S. and recession in much of the developed world, it seems opportune to investigate whether the very long-term demographic underpinnings of our economy remain sound.

Fortunately, the U.S. possesses a substantial advantage relative to much of the world in the critical area of potential labor force growth, which is a function not only of the fertility rate, but also of the immigration rate and the propensity to work. While this nation clearly has obstacles to overcome, such as the maturation of the baby-boom generation, massive deficit spending, and sub-optimal immigration policies, productivity will continue to grow and we believe America remains the best place in the developed world to invest for the long term.

**Baby Bust: the Price of Success**

Although many people would point to the rapidly growing global population and bemoan its impact on the environment or worry about the ability to feed so many people, the reality according to the U.N. is that demographic trends are pointing to a likely peak in global population at around 10 billion toward the end of the century, from 7 billion currently, with the expectation of real declines thereafter. The reason is falling fertility rates worldwide. Though fertility rates remain high in many parts of Africa and the Middle East, they are nonetheless coming down, and the rate of decline is extremely fast in certain regions. According to the Central Intelligence Agency’s World Factbook, the current global fertility rate is just below 2.47 children per woman, and the U.N. now estimates that half of the world’s population lives in countries with fertility rates lower than the rate required to maintain a stable population, which is 2.1.

It is well known that China has long had a one child policy, but what is less well known is that between the numerous exemptions allowed and people simply choosing to pay a fine for having more children, the fertility rate in China is actually 1.55 children per woman. More surprisingly, this figure is about equivalent to the European Union’s fertility rate. How is it possible that wealthy, unhindered Europeans would choose to have as few children as a relatively poor people whose family planning decisions are artificially restricted? Because, in general, the greater the level of economic development and success people enjoy, the less
likely they are to have children. It may seem counter-intuitive, but in a subsistence economy, the cost of an extra mouth to feed is viewed as being more than offset by the benefit of an extra pair of productive hands. Conversely, in a highly developed economy that is more focused on intellectual than physical activity, raising and educating a child to become a productive adult takes much longer and costs a lot more.

There are plenty of other reasons fertility rates are falling, such as urbanization, education, and increasing participation by women in the workforce. The highly developed economies in Europe, North America, and Japan also tend to have well-established social safety nets that reduce reliance on the next generation for retirement security. Finally, outstanding health care and the availability of reliable birth control free a woman from the burden of giving birth to more children than she absolutely wants to have.

If all nations appear to experience this trend, and it seems to get worse as development matures, one might wonder why we are so bullish about America’s long-term prospects. After all, ours is arguably the world’s most advanced economy. The primary reason is that unlike most other developed economies, the current fertility rate in the U.S. has stabilized at approximately 2 children per woman, not too far off the replacement rate. This is good enough in absolute terms, but also is well in excess of the 1.58 rate for the European Union as a whole, 1.39 for Japan and, surprisingly, only 1.82 for Brazil. A country’s “natural” growth rate, however, is not the only factor to consider when looking at the potential long-term growth of the labor force.

“They’re Coming to America”

A country with a low birth rate can supplement its population through welcoming immigration policies, and with a positive 3.62 net migrants per 1,000 residents, the U.S. ranks fairly high globally, in this respect. The only large, developed countries with higher net immigration rates than the U.S. are Australia, Canada, Spain, and Italy, all of which, incidentally, have such low fertility rates that they need all the newcomers they can get.

More importantly, the U.S. remains the destination of choice, where people have such a choice. The Gallup organization spent three years polling nearly half a million people over the age of 15 in 151 countries, asking whether they would like to emigrate and, if so, to where. Projecting the answers to the global population implies that more than 600 million people would like to leave their native lands permanently, and nearly a quarter of those want to come to America. It appears that despite our political dysfunction and lackluster economic growth, plenty of people still see the U.S. as the land of opportunity, and they’re not wrong to do so.

It seems to us that, with a rational immigration policy, America has an opportunity to lock in productive population growth for an indefinite period. There is, of course, plenty of anti-immigrant rhetoric here, as many people believe immigration causes lower wage rates and strains the social safety net. Research has not found much evidence of that, and we would argue that runaway medical spending by the overall population is what is really
endangering U.S. entitlements. Our fundamental belief—and history appears to confirm it—is that people come here to work, not to get handouts. Therefore, immigration has always been and will continue to be a net positive influence on the U.S. economy. Furthermore, it seems pretty clear that if we were to increase the annual number of highly-specialized guest workers allowed and did not restrict the length of their stay here, our economy could absorb permanently into its labor force some of the best and brightest immigrants.

**The Elder Burden**

So we have a relatively high birth rate and the means to attract immigrants. That’s all good, but we still have to consider the impact of the “graying of America” on our economy. It is well known that the first of the baby boomers turned 65 in 2011. That means that they have, on average, passed their peak spending years. It also means that there is now a natural downward pressure on labor force participation rates, putting labor force growth at risk. If the number of workers were to shrink while the population grew, it would be a clear negative for the economy. Not enough people would be working, paying taxes, and spending at a time when so many would be retiring, drawing on Social Security, and generally cutting back on spending. *Businessweek* reported that in 2011 Japan’s largest diaper manufacturer sold more diapers for adults than for babies, a simultaneously amusing and horrifying statistic. As investors, we would want to know if that is also our country’s fate.

To assess that risk, we look at a figure the U.N. projects, called the “elderly dependence ratio,” which is the anticipated number of retirees in a country (defined as people aged 65 or older) compared to the number of workers (people aged 15-64). The chart below assumes constant birth rates and shows the number of workers expected to be supporting each retiree for the countries or regions we believe should be of primary interest to U.S.-based investors.

**Workers per Retiree**

![Chart showing workers per retiree for different regions: U.S., Brazil, China, Europe, Japan, with data points for 2010, 2040, 2070.](chart)

Source: United Nations
Several things are apparent from the chart. First, every country or region noted has a weakening demographic profile. Second – and more positively for the U.S. – after an initial shock caused by retirement of the boomers, the U.S. has a fairly stable profile that is superior not only to the other developed regions, but also to China and Brazil, each of which seems likely to hit a demographic brick wall in coming decades. Third, Japan already has a worker/retiree ratio that is only slightly better than the level the U.S. is projected to hit in 2070.

Of course, the trends shown in this chart could be changed by a meaningfully increasing fertility rate which we find highly unlikely, by increasing global migration which would certainly work to the advantage of the U.S., or through increasing labor force participation rates. Many of this nation’s baby boomers were forced to change their retirement plans due to insufficient savings, and the stock market and housing crashes since 2000. As a result, there has, in fact, been a marked increase in labor force participation rates among both men and women aged 62-69 since the mid-1990s. Finally, it is normal and natural for an advanced economy, where high educational levels are prevalent, careers start later, and life expectancy has been increasing, to expect people to work longer. Ultimately, this benefits our economy, and we expect this positive trend to be bolstered further by the inevitable increase in the Social Security retirement age.

A Note on Productivity

Thus far, we have focused on potential labor force growth, but before we rest our case that America is still a land of strong potential economic growth, we must briefly address the other element in determining the degree of that growth: worker productivity. American workers are among the most productive in the world. In terms of GDP per employee, the Eurozone is about 25% and Japan 30% less productive, while Chinese and Brazilian workers are approximately 80% less productive.

Not only are Americans more productive, but their productivity continues to grow. Bureau of Labor Statistics figures going back to 1948 show that productivity growth averaged 2.2% over that 65-year period. Nay-sayers will claim that this is likely to weaken permanently, that the productivity benefits from the Internet are tapped out, and that there’s no reason to assume another groundbreaking technology will ever come along to change that. We disagree. Research and development go on, at both the government and private levels. If you happen to be one of the people who thinks there’s nothing extraordinary left for scientists to discover, then we would suggest you Google the word “graphene,” read what you find, and see if that changes your mind.

Conclusion

Global fertility rates are plummeting. The negative economic impact of simultaneously aging populations and shrinking labor forces will be felt strongly throughout much of the developed world and even parts of the developing world. But it won’t be felt here, at least
not to nearly the same degree. America remains the land of opportunity, not only for immigrants, but also for native workers and investors. We are one of the world’s most advanced economies, but our growth potential is far from being exhausted. While Japan and Germany have seen their population peak already, China and Brazil are expected to peak in the next 15-30 years, with India surpassing China as the world’s most populous nation within a decade. Meanwhile, the U.S. population, already the third-largest, should stay on a steady growth path to 470 million people by 2100, likely still trailing at that point only China and India, both of which will be shrinking. Our relatively high and stable birth rate, if coupled with rational immigration and retirement policies, should allow U.S. labor force growth to continue.

Meanwhile, if productivity merely follows its historical trend, reasonable economic growth should be assured. As we’ve noted in previous Investment Strategy Updates, this country boasts an outsized portion of the world’s fresh water and arable land, which are available to support a much larger population. We also have some of the richest deposits of oil and natural gas, the production of which will reduce energy costs and help the U.S. move towards self-sufficiency. Perhaps the coming few years won’t see the fastest growth in our history, but it should be respectable, and perhaps more important, it should be far better than any other country in the developed world. What’s more, over the very long term, U.S. economic growth should remain strong enough to surpass even some currently fast-growing “developing” economies.

We remain bullish on America.

A Market Comment

The stock market has risen some 130% since the bottom in March of 2009, but until recently, large numbers of investors have doubted the merits of equity investing. At last, interest in stock ownership seems to be rising once again, but many now wonder, “Is it too late to join the party?” After all, the stock market is close to its all-time highs – levels that were first reached more than a decade ago and revisited briefly in 2007.

Our simple answer is “No.” In inflation-adjusted terms, stock prices are still some 23% below their 2000 peak. Furthermore, the corporate earnings on which those stock prices are based are expected to be more than twice as high this year as they were in 2000. In other words, stock market valuations are about half today what they were back then, and are close to their long-term average. With interest rates at near-record lows, one could argue that valuations have significant room to rise from here.

Do we still have problems? Sure, there is too much government debt, continuing European fiscal difficulties, a dysfunctional U.S. political system, and widespread geopolitical flash points. But while few of the issues that arose in the past decade have been resolved, there is a general trend of overall improvement. For instance, even with our current fiscal drag, the U.S. economy appears likely to average 2% real (inflation-adjusted) growth in 2013, a respectable if uninspiring performance.
There is an old stock market adage that says “Don’t fight the Fed.” That adage can now be applied globally, as central banks around the world are aggressively stimulating – determined to boost their economies by keeping interest rates low and driving up asset prices (i.e. stocks and real estate). We believe that this broad based liquidity support lessens some of the potential economic “tail risk.”

We have long held the opinion that the stock market trading range that has been in place since 2000 would likely persist for a few more years. However, we now believe that the combination of abundant liquidity, very low interest rates, growing corporate earnings and dividends, and the distinct lack of available investment alternatives will likely continue to drive stock market valuations and prices higher – at least until rising inflationary expectations cause the Fed to begin to normalize interest rates, and that event may still be a year or two further out in time.

The current trend of rising stock prices will surely be interrupted by periodic setbacks, one of which may be near, but we believe the upward trend will continue, nonetheless. Thus, we are bullish for now, preferring diversified portfolios, dominated by quality stocks with growing dividends.

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