The Equus Report

—BY BARNABY LEVIN

DEMOGRAPHICS

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Demographics

Author Peter Bernstein says in the prologue to his book "Against the Gods":

> "The story I have to tell is marked by a persistent tension between those who assert that the best decisions are based on quantification and numbers, determined by the patterns of the past, and those who base their decisions on more subjective degrees of belief about the uncertain future. It boils down to one's view about the extent to which the past determines the future."[1]

This, of course, is what makes the future so exciting: it is the great unknown. And yet, I also believe there are certain insights that we as humans can and should apply and which, when we do, can help us more confidently make better informed decisions. In this article, it is my contention that, to a large degree, it is demographics and the human life cycle that determine how the economy will fare. And, given the current "lack of visibility" that seems to be plaguing so many of our best thinkers, I feel it is a good time to revisit some of the arguments so strongly championed by Harry Dent in his 1998 book "The Roaring 2000s."

Dent starts with three basic premises:

1) That "our economy is driven by the family spending cycles of each new generation of consumers and workers"
2) That the way in which the average family spends their money over time is predictable
3) That "the best leading indicator for our economy is birth rates" [2]

Consumption, he says, drives our economy, which reaches its height only when the greatest number of consumers reach their peak spending years. And – for other than (relatively) brief periods of time, brought about by unexpected dislocations like the outbreak of war – it is only then that the economy truly begins to decline until the next generation comes along and enters its spending cycle.

What about the past three years? I suggest we have been caught in an unprecedented series of painful but largely unrelated "dislocations," and that the underlying and considerably more powerful trend of a growing Gross Domestic Product is still intact.

To explain, the U.S. Bureau of Labor conducts annual Consumer Expenditure Surveys which, over time, have revealed the following statistics illustrated in Fig. 1.5 below: on average, "we enter the work force at age 19; get married at age 25.5; buy our first car, move into apartments and furnish them. This period of household formation represents the fastest rate in

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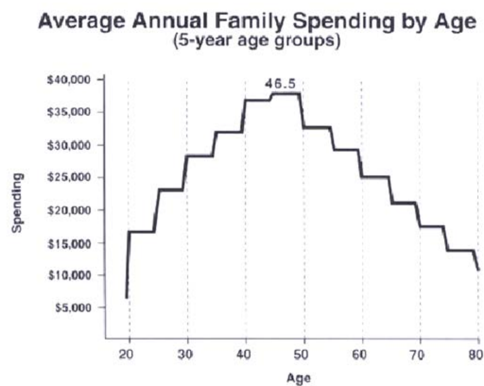
[1] "Against the Gods: The Remarkable Story of Risk," Peter L. Bernstein, John Wiley & Sons, Copyright 1996, page 1
[2] "The Roaring 2000s," Harry S. Dent, Jr., Bantam Books, 1998, pages 32-34

earnings and spending growth in the entire family life cycle. Two years later, at age 27.5, we have our average kid and, between age 33 and 34, buy our first home. By age 43, we trade up to the largest home we'll ever own, fully furnishing it by age 46.5, about which time our children, themselves, are leaving the nest at age 19. This makes 46.5 the peak spending age. And it is only after this that our variable spending costs quickly decline by as much as half at the very time we're typically at the top of our earnings cycle. This is when savings rates finally begin to accelerate up to and through the time of retirement."

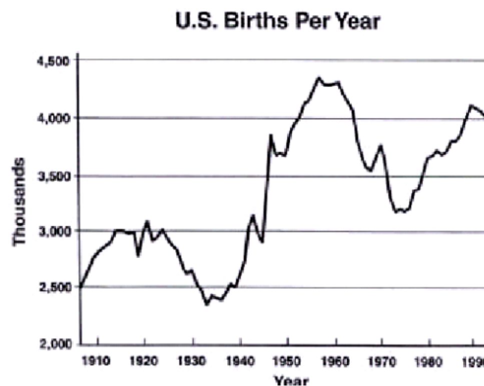
Fig 1.5[3]



© 1997 H.S. Dent Foundation, adapted from The Great Boom Ahead by Harry S. Dent, Jr.

But it is only when this spending cycle is combined with a sufficient number of people to constitute a meaningful part of the population that it drives an economy up and down. Hence Dent's contention that birth rates may be "the best leading indicator."[4]

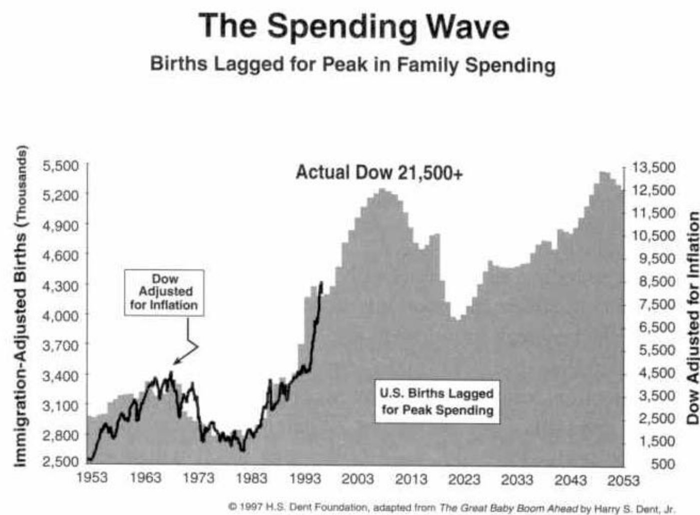
Fig. 1.2[5]



[3] *ibid.,* page 37
[4] *ibid.,* page 34
[5] *ibid.,* page 33, Figure 1.2: U.S. birth rates in the 20th century. "We can see that new generations emerge about every 40 years. The peak in the birth cycle of the baby-boom generation occurred in 1961, whereas the peak of the 'Bob Hope' generation occurred in 1921. The two peaks are exactly forty years apart."

Dent suggests that we can predict the health of our economy by simply lagging the birth index forward 46.5 years, again under the assumption that the economy peaks when the greatest number of people in each generation enters its point of highest spending. We know that, when people spend, the earnings of those companies whose products they buy – be it homes, cars or furniture – rise. And, setting aside for the moment any questions of P/Es or valuation, we also know that when earnings rise, so does the value of that company's stock. Since the NYSE was founded in 1871, one could say its' whole purpose has been to provide people with a way to legally bet on this premise. The stock market is based on the assumption that, at some future point in time, someone else will always be willing to pay more for a share of stock if that company's earnings continue to rise. But it is only when we look at Fig 1.6 below that we see how the correlation between demographics and the market over the past century has been nothing short of uncanny.

Fig. 1.6[6]



Again from author Peter Bernstein: "We cannot quantify the future, because it is an unknown, but we have learned how to use numbers to scrutinize what happened in the past."[7] And, by using these numbers, we can sometimes identify trends that have a high probability of occurring again.[8]

[6] "The Roaring 2000s," Harry S. Dent, Jr., Bantam Books, 1998, page 39. Figure 1.6: The Spending Wave "shows how our economy correlates very closely with the birth index adjusted for inflation, moved forward 46.5 years for peak spending of the average family in the U.S. It allows us to see when the economy and stock market will grow and declines almost five decades in advance." Dow Jones Industrial Average is a price-weighted index of the 30 largest, most widely held stocks traded on the New York Stock Exchange.

[7] "Against the Gods: The Remarkable Story of Risk," Peter L. Bernstein, John Wiley & Sons, Copyright 1996, page 7

[8] *ibid.,* page 329: as Leibniz said in 1703, "Nature has established patterns originating in the return of events, but only for the most part."

You see, it is not parallels to any given period that I am concerned with here. As I have said in other articles, it is my opinion that Globalization and the Internet have truly changed everything in a process (originally coined by Joseph Schumpeter in 1942) known as "creative destruction."[9] The mass acceptance of the Internet has changed the way that business is done, flattening organizational structures, and creating (as Steve Jobs said in a 1996 *Wired* article) "a direct producer-to-consumer distribution system." This technology, when combined with cross-border globalization, now allows ideas and processes to spread at the speed of light, leveling the playing field and destroying, possibly forever, any real or long-term pricing power for anything but truly new and novel ideas that can be patented. And even then, there are often opportunities to "design around," as we constantly see in the biotech and pharmaceutical industries. I suppose, for those with a nostalgic bent, there is still only one Mickey Mouse. But I firmly resist any temptation to seek comparisons with the past, simply because they seem to provide us with a convenient and comforting roadmap to the future.

Except, that is, when it comes to demographics and to my belief that, deep down, people are basically the same. We may have different religious or philosophical beliefs, different tastes, desires and motivations, from one person to the next. But as a species, we are all more or less the same. We simply want to love and to be loved. And to make a difference: to feel that, in the end, our lives somehow made a difference. The demographic argument, therefore, simply makes sense and, throughout my career, it has survived as the one, unshakeable cornerstone in my philosophical outlook. I return to it now because, in this time of upheaval – when the array of discontinuities, irregularities and volatility are expanding, not diminishing – I think it important to step back to see the bigger picture and to make sure everyone agrees we are generally headed in the right direction.

Clearly the timetable spelled out by Dent has to be taken with a grain of salt. According to him, the third wave of baby boomers should already have been "joined by the strong acceleration from the following generation's household formation cycle on or about 2002" and we should, therefore, be enjoying a strong market even as we speak.[10] Obviously we're not. And the reason, we now know, is that the very Bubble that took everyone by surprise from late 1998 through early 2000 on the upside, is taking longer than anyone expected to unravel. What may not be so obvious is that (painful as it has been) this unraveling has only taken us back to trend in a classic "reversion to the mean":

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[9] "Capitalism, Socialism and Democracy," Joseph Schumpeter, 1942: "Capitalism exists in a state of ferment marked by spurts of innovation destroying established enterprises and yielding new ones." Also see my article, "Creative Destruction," dated February 1, 2002

[10] "The Roaring 2000s," Harry S. Dent, Jr., Bantam Books, 1998, page 42

Fig. 12.4[11]

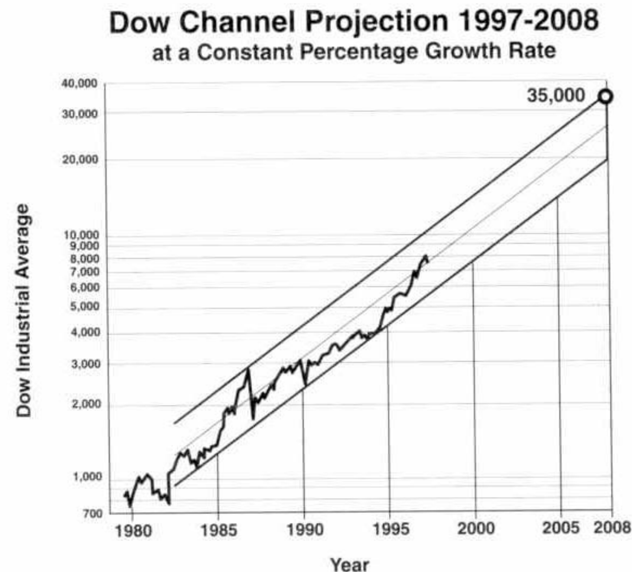

Figure 12.4: Dow Channel Projection 1997–2008.

Another point: as time goes on, people are living longer and starting families later. So, again, we may need to push Dent's timetable back a year or two.

But, as Smith Barney's Chief Investment Officer recently said: "The (current) slowdown didn't start because companies got into financial difficulties or because of tight money. It started because of over-investment."[12] Over-investment triggered by one of those periodic manias, which only come and go with a price. And yet, if over-investment did, indeed, trigger the current downturn, we can certainly say the opposite is true today. Companies are so focused on outsourcing, downsizing and slashing costs in general that they have all but curtailed capital spending to the point where the corporate sector has almost literally no need for new money.[13] Any money that has been raised has been used simply to pay down debt or to refinance longer-term debt at lower rates, even as individuals have been taking advantage of low interest rates to strengthen their personal balance sheets through record mortgage refinancing.[14]

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[11] *ibid.,* page 294

[12] "America at a Turning Point," Bill Helman, Chief Investment Officer, Smith Barney, Capital Markets Commentary, March 3, 2003: *Contact us for copy of full article*

[13] "TechStrat Barometer," Steven Milunovich, Merrill Lynch Global Securities, April 11, 2003. "A survey by the Business Roundtable found that CEOs are more concerned about economic weakness than six months ago. About 27% said they expect to reduce their investment spending the next six months while only 18% plan increases."

[14] "Citigroup Leads J.P. Morgan in First Quarter Lending," George Stein, Bloomberg News, April 14, 2003. "Companies raised $3 in bonds for every $1 borrowed from banks in the first quarter, the highest ratio in four years, as they locked in interest rates as low as 5.18% for a 10-year investment-grade bond. Companies around the world sold $729.6 billion of bonds, 17% more than a year earlier. Companies benefit from selling bonds because they are able to lock in cheap financing at a time when interest rates are at 40-year lows."

But that's the problem, isn't it? People are asking: "When will spending begin again?" The answer, if we dare put down the newspapers and turn off the television, is that it may already have. With regard to my earlier comment about there being "no need for money," I said "almost literally." Rest assured, Venture Capital is still at work, although at a lesser pace than in recent past. One of the oldest most respected firms, Sequoia Capital, "is dipping its toes in the water as the first of the veteran VCs to raise a new fund since the tech bust."[15] It is raising $285 million and has plans to fund about 15 new startups per year. It may be halving the money it initially invests to $3 million but, given the fact that companies have become more deliberate again with regard to expenses and cash flow generation; have more realistic plans for future growth; and a firm focus on bottom line profitability, the lower investment may be enough. As partner Michael Moritz says, "We view 1999 and 2000 as aberrations. This is a more natural rate for us."[16] And, as the article explains, they "seem to be on the right track. Since Sequoia announced last November that it would begin raising money for its 11th fund, at least 200 institutions have sought a piece of the action. Indeed, the money committed to venture capital is expected to total about $25 billion this year, down from a high of $99.8 billion in 2000, (but) still one of the industry's best, putting it back at 1997 levels."[17]

When pundits talk about there not being an adequate pool of funds to drive future capital spending, it simply flies in the face of reality. It is true that business spending will only kick in after issues of liquidity, leverage and profitability have been properly addressed. But I suggest we are already in the 6th or 7th inning of doing so and that the current state of affairs is really more an issue of confidence. As John Goode of Davis Skaggs points out, there have only been "three times in the last 20 years when money market fund assets have reached or exceeded 15% of the Wilshire 5000. Currently, they total $2.4 trillion, or more than 28% (of the index), a record by a wide margin, even though interest rates are hovering below 1%. In a very real sense," he says, "investors are 'stuffing the mattress'."[18]

People are obviously feeling risk averse and are steadfastly sticking to the sidelines. Clearly, they are faced with multiple uncertainties and are ceding the equity markets to hedge funds and day traders. But no one can say there isn't plenty of money; nor that, at some point, this money won't readily be put back to work when things look better. It's almost like selling short – all that money sitting on the sidelines is ultimately a bullish indicator since the "short" position must, at some point, be covered as investors look for better returns.

In the meantime, we wait for Congress and for approval of the President's Stimulus Plan. Those opposed are concerned about the prospect of simultaneously reducing taxes and increasing selected spending and what that will do to the deficit, arguing that we are only borrowing from the future and are degrading the financial system. But, once again, I think this argument can easily be refuted. As Figure 2.5 shows, debt accelerated from 1980 to 1986 faster than at any time in recent U.S. history and yet, over the same period, inflation actually fell.

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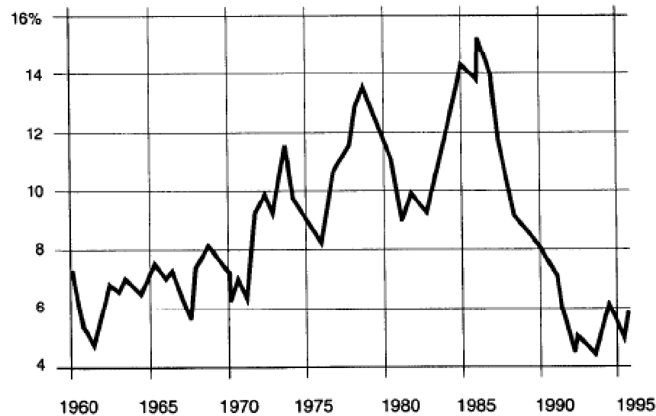
[15] "Venture Capital Catches a Smaller Wave," Linda Himelstein, BusinessWeek, March 3, 2003. p. 114
[16] *ibid.,* page 114
[17] *ibid.,* page 114
[18] "Stuffing the Mattress," John G. Goode, Davis Skaggs Investment Management, March 7, 2003

Fig. 2.5[19]



Indeed, the rate of inflation coincides more closely to growth in the labor force than it does to increasing debt. Labor forces only grow during times of radical new technologies, or with the advent of new generations who bring those technologies into the workforce to begin with. It is during these times that massive investment is needed at the very time that savings rates are lowest, thereby creating a fierce competition for money. It all comes down to Supply and Demand: inflation only takes place during times of increasing Demand and limited Supply, neither of which is the case today.

There are, on the other hand, numerous positives to stimulus. According to Tobias Levkovich, Smith Barney's Senior Institutional Equity Strategist:

"By accelerating the tax cuts or the child tax credit, it is hard to argue that these are not stimulative to some degree. I believe the dividend tax relief is really corporate tax reform somewhat disguised as dividend tax relief, although there is a benefit to dividends. My view is that you almost have to think of it as a net dividend increase to the investor.[20] Indirectly this acts as a benefit since people tend to look at the stock market as a gauge or a barometer of the economic health of the nation. With respect to savings, we all go back to Benjamin Franklin and the notion that a penny saved is a penny earned, yet most people would agree that the solution to a deficit would be a growing economy and a better stock market so you can get those capital tax receipts. Since 1960, if my numbers are right, there have only been four years of budget surplus. Three of these occurred between 1998 and 2000 and were helped in no small measure by capital gains receipts. Therefore, I view as somewhat illusory this notion of the surplus being the ultimate panacea. For those who

[19] "The Roaring 2000s," Harry S. Dent, Jr., Bantam Books, 1998, page 77
[20] see my article, "Boston Tea Party," dated January 8, 2003

argue that raising revenues is a code name for raising taxes, we are not Japan and we are not Germany. Raising taxes does not seem to be a solution to provide for a better economy and stock market and ultimately higher revenues. It is difficult to tax a nation into prosperity."[21]

When was the last time that inflation truly ran rampant? It was during the 1970's, as those of us working back then can well remember. And what was taking place at about that point in time? 76 million children born between 1946 and 1964, now known as "Baby Boomers," were just entering the workforce. As Ken Dychtwald points out in "Age Wave":

"When life returned to normal after the Second World War, births rose dramatically in many parts of the world. The phenomenon was due partly to the soaring economy and the widespread feeling of hope brought by the war's ending, and partly to the fact that when the boys returned home, couples made up for lost time for romance. In most countries, this birth spurt lasted for three to six years. But in the United States, Canada, Australia and New Zealand...the boom lasted for nearly two decades."[22]

The difference, when compared to prior generations, is that the Boomers comprise one third of the U.S. population. This alone is extraordinary. But add in the up tick in immigration that was taking place from 1978 to 1991 – of the people entering this country at average age 30 and who, themselves, were born beginning in 1948 – and you have a population – not three – but four times the size of the preceding generation. This is shown graphically in Figures 1.3 and 1.4 below.

Fig. 1.3[23]

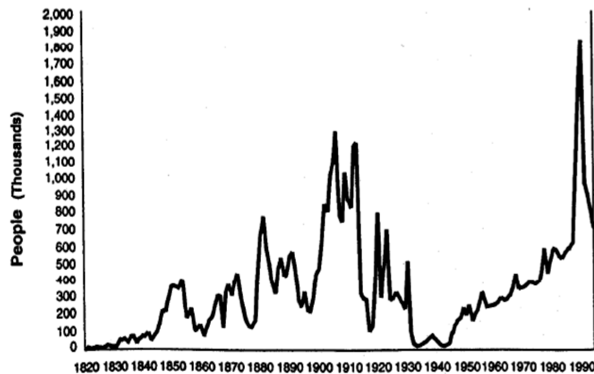
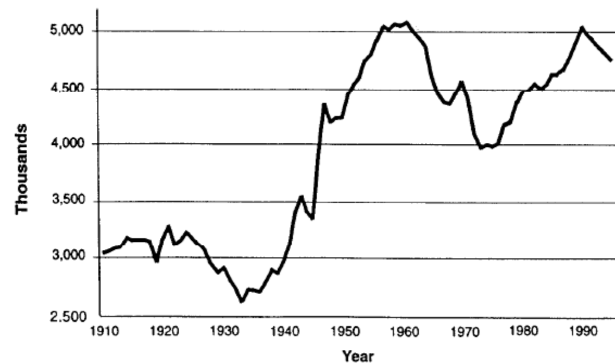


Fig. 1.4[24]



[21] "America at a Turning Point: a Roundtable Discussion on Government, the Economy and the Financial Markets," Tobias M. Levkovich, Capital Markets Commentary, Salomon Smith Barney, March 3, 2003: *Contact us for copy of full article*
[22] "Age Wave: The Challenge and Opportunities of an Aging America," Ken Dychtwald, Bantam Books, 1990, page 13
[23] "The Roaring 2000s," Harry S. Dent, Jr., Bantam Books, 1998, page 34. Figure 1.3: United States Immigration, 1820-1995. "Immigration was the driving factor behind growth and generation cycles before the early 1900s. The steepest spike from 1898 to 1914 caused the Roaring Twenties on a lag. The next large surge in immigration occurred from 1978 to 1991."
[24] *Ibid,* page 34. Figure 1.4: Immigration-Adjusted Birth Index. "The average peak immigrant in 1991 would have been born in 1961, which coincides with the peak in the baby-boom births. Therefore, this recent immigration wave has even further exaggerated the enormous size of the baby-boom generation."

It is this generational mass which has dominated American culture for nearly five decades and which will continue to do so for decades to come. Not because we're any better or any different than our parents or their parents before them. It is simply because, when you take this mass of people, all more or less going through the same stage in life at the same point in time, it is virtuously impossible for them not to have a dramatic impact on their economy.[25]

Again, it is increasing consumption, tied to growth in the workforce, and to the subsequent competition for funding at a time when funds are scarce, that drives inflation higher. Given the predictable spending pattern of the average American family and the statistical fact that spending peaks at age 46.5, the spending wave for the Baby Boomers should peak sometime around 2010 (see Figure 1.6 on page 4). This is when that "third wave" transitions from Spending to Saving. And it is also when the U.S. economy is most likely to enter a truly prolonged downturn, possibly for as long as six or seven years, similar to that of the 70's and 30's, one and two generations ago.

The bottom line is I think we're wasting time and that we need the President's stimulus package to help get us back on track, sooner not later. The clock is ticking and we're wasting what's left of our precious demographic dividend. The bond market – as indicated by the recent collapse in corporate yields – is telling us 1) that, with a few exceptions, investor's may have overplayed the corporate default risk last year; and 2) that the risk of inflation going forward remains low. As I demonstrated, one cannot conclude that a rising deficit necessarily leads to rising rates and that a resumption in economic growth is more important now than any concerns regarding the impact it may or may not have on inflation or borrowing from the future. We are the future, but we must dare to embrace it.

I am in no way trying to minimize or ignore the many issues facing us today. It is simply my hope that we not ignore the undertow of demographics, nor the family spending cycle, both of which are quietly, inexorably at work under everything else going on in the world. As I said in the beginning, to risk is to dare. And, at the moment, I think it is becoming more important than ever to begin distinguishing between shorter- and longer-term risks. It is the actions we dare take today in the face of such looming obstacles that will define us and determine our prosperity for many years to come.

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[25] "The Roaring 2000s," Harry S. Dent, Jr., Bantam Books, 1998, page 40

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