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Proactive Investment Management & Financial Planning

Global Perspectives, February 2019: A World Starving for Growth

Almost three years ago, we put out a *Global Perspectives* article discussing the ongoing slowdown in the world's population growth, the resulting increase in average ages, and the implication of those trends for the world economy and financial markets (see "Investment Implications of Changing Demographics," April 2016, at www.wealthadv4u.com/insights). Slowing population growth and population aging continue to have a big impact on the markets, even if the impact is often obscured by short-term cyclical trends. What's different now is that the world may be facing a second major headwind from the maturing of the Chinese economy. Whatever the impact of changing demographics, we think the future challenges could be exacerbated by any potential slowdown in Chinese exports, imports, investment, and overall economic activity.

Slowing Birth Rates, Aging Populations

Our April 2016 article showed the current slowdown in global population growth stems mostly from falling birth rates. Death rates dropped sharply in the decades right after World War II, sparking a short-lived population boom, but birth rates only started to fall in earnest in the 1980s and 1990s. With birth rates falling into balance with death rates, the United Nations forecasts the world's population will essentially stop growing by 2200. In some major developed countries, such as Japan, birth rates have already fallen so far that their populations are declining (see Figure 1). Our April 2016 analysis showed that falling birth rates have also taken hold in the United States, but legal and illegal immigration have kept overall population growth from falling to dangerously low levels. All the same, a lower birth rate and the continued aging of the big post-WWII generation have combined to push the average age in the United States sharply higher. Because of the rise in the number of people who are retired, disabled, or caregiving, the U.S. "labor force participation rate" has fallen significantly. That is, the share of the adult, civilian, non-institutionalized population that is either working or looking for work has declined to its lowest level since the late 1970s.

Slowing population growth, population aging, and lower labor force participation have affected the economy in several ways. For example, these forces have reduced the supply of labor compared with what it otherwise would have been, which has probably contributed to a gradual slowdown in net hiring and weaker increases in productivity (the average value of output per hour worked). That alone would cut into national wealth. After all, the growth in a country's gross domestic product (GDP) boils down to the increase in its workforce plus the growth of its workers' productivity.

Just as important is the way these forces have affected workers in their role as consumers. Not only are workers aging, retiring, and otherwise dropping out of the labor market, but research shows that their consumption spending drops sharply as they prepare for and then enter into those situations (see Figure 2, next page). To the extent that this segment of the population slows its spending, we think businesses will sell, hire, and invest less. Indeed, the decrease in the labor supply mentioned above has been accompanied not by accelerating wage rates, as would be expected with widespread labor shortages, but by muted wage gains, which we suspect is evidence of slowing labor demand. Weaker consumer spending and softer capital investment have probably also contributed to the slowdown in price inflation in recent decades (along with factors like a strong dollar and disciplined monetary policy). Perhaps the biggest evolving threat from these changes is that they will probably lead to much higher government spending on Social Security and Medicare. That will likely require higher taxes, benefit cuts, and/or potentially destabilizing increases in government debt.

Figure 1.

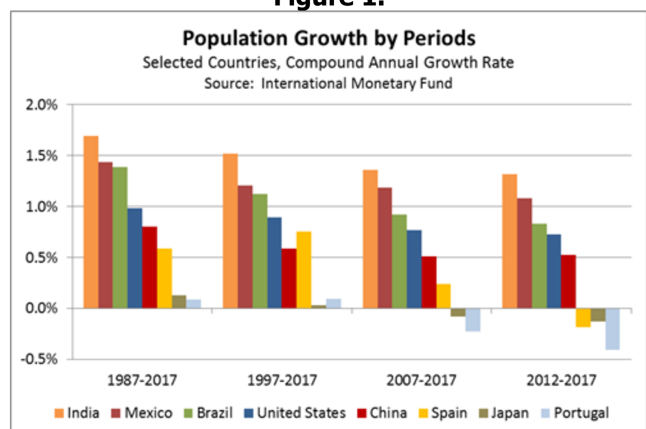

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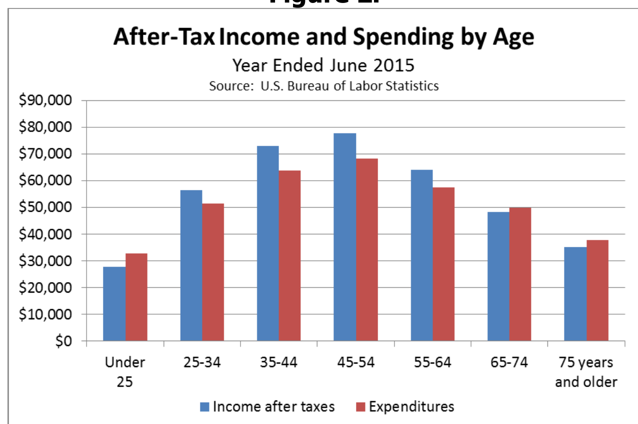
Figure 2.

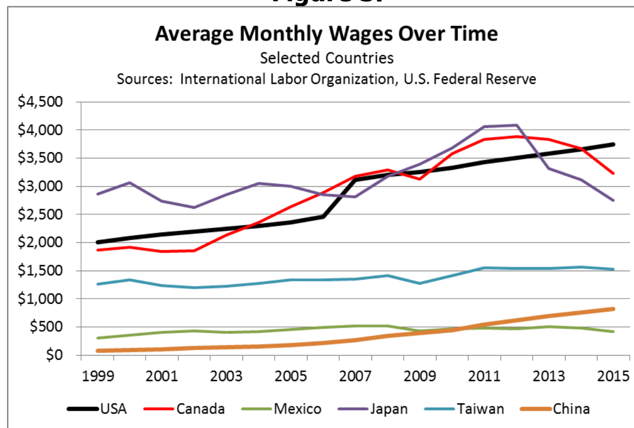


The End of the Chinese Economic Shock?

Over the last few decades, even as people gradually became aware of the demographic challenges discussed above, the world was grappling with a more sudden, immediate shock to the system. As early as 1979, the Chinese government began implementing a series of reforms aimed at opening the country's economy to market forces, international investment, and trade. Given China's enormous population of relatively competent, inexpensive workers (see Figure 3), it should probably be no surprise that the reforms sparked booming investment in modern, efficient manufacturing facilities and public infrastructure, which quickly transformed China into the "factory floor to the world." Chinese workers grabbed market share from more expensive workers all around the globe. Chinese exports surged, factories were relocated to China, and workers in the developed countries suddenly lost their jobs or had their pay reduced. To add insult to injury, China's rise has made it the biggest source of new demand for many kinds of commodities – such as crude oil, copper, and soybeans. China's enormous investment in new infrastructure and its surging demand for raw materials, manufacturing inputs, and consumer goods have often helped boost global prices, especially in the years right before the Global Financial Crisis of 2008-2009.

While that was bad enough, China has also agitated other countries with its over-the-top efforts to grab even more market share and re-establish itself as a central player on the world stage (see our *Global Perspectives* article "Our Approach to Investing in China," published in April 2018). China has attempted to accelerate its development through industrial spying, pressuring foreign companies to share their intellectual property with Chinese partners, and subsidizing state-owned companies in an effort to make them into powerful "national champions" that can dominate their global markets. Even though the Chinese government committed to fair trade practices when the country was admitted to the World Trade Organization in 2001, it has continually dragged its feet on making the needed changes to its trade rules. Under the leadership of nationalist President Xi Jinping, it has even reversed course and stacked the deck further in favor of domestic Chinese enterprises.

Figure 3.



What's different now is that there are signs that Chinese economic growth may be coming back down to earth, and that the era of its disruptive integration into the world economy may be coming to an end:

Slowing Economic Growth. Chinese economic statistics are simply too stable to be believed. At a minimum, the high-level figures are manipulated to support the Communist Party. Nevertheless, we suspect the trends in the official data are roughly indicative of what's really going on in the economy, especially when they're scrutinized and adjusted by analysts at the major multilateral organizations, such as the International Monetary Fund (IMF). Those figures show a continued slowdown in China's economic growth ever since 2007 (see Figure 4, next page). There is also reason to believe Chinese economic growth will continue to slow in the coming years. For one thing, outsized economic growth naturally gets harder as the economy gets bigger and more of the available high-payoff investment projects get completed. That's a big reason why Japan and South Korea naturally slowed from their boom periods, to the point where their GDP growth now is typically as low or lower than that of the United States. In addition, after the Chinese government staved off the worst of the Global Financial Crisis with a massive program of fiscal and monetary stimulus, the economy has been left saddled with an enormous load of debt and other serious imbalances. Even with the economic slowdown of recent years, the government is hesitating to pump new stimulus into the economy for fear that the problems with debt and unproductive investment will worsen. The reluctance to adopt new stimulus, and the need to work

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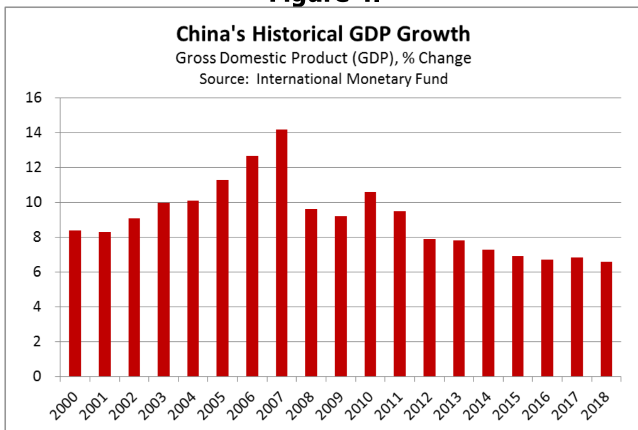
through the imbalances caused by past stimulus, seem sure to hold down Chinese economic growth in the coming years. We also think slowing population growth and population aging will probably impede the Chinese economy at least as much as the developed economies in the coming years, owing to China's policy of limiting couples to just one child up to 2017.

New Trade Restrictions. On top of the natural slowdown in its maturing economy, China is now facing the prospect that investment and trade restrictions will be imposed by the United States and other big, developed countries. President Donald Trump has been at the forefront of the effort to roll back Chinese exports and stop its unfair trading practices, especially with his imposition of punitive tariffs on hundreds of billions of dollars of Chinese exports. Other countries have often bristled at the Trump administration's brinksmanship and bull-in-a-china-shop approach, but that shouldn't obscure the fact that they often agree it's time to protect their workers from unbridled Chinese competition and push back against the Chinese effort to get ahead unfairly. Even if the Trump administration ultimately agrees to just a watered down agreement in its current trade talks with Beijing, we believe the developed countries' pushback against China will remain and further pressure on China could come again in the future. In a word, we think China will find it harder and harder to grow its exports, even though its economy may not yet be mature and reformed enough to support growth through its own private consumption and investment.

Figure 4.

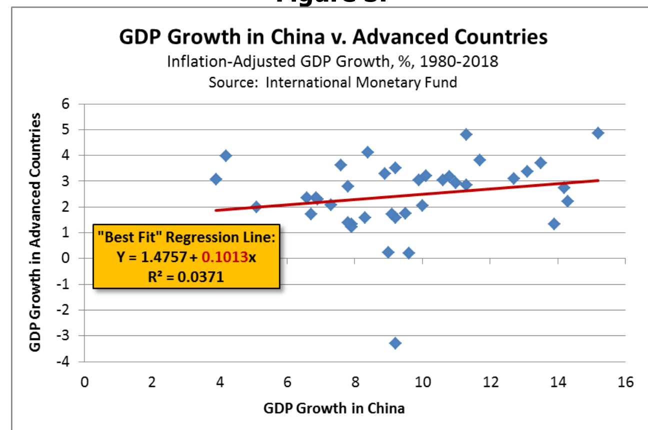


Is Slower Chinese Growth a Problem?

If slowing population growth, population aging, and lower labor force participation rates are indeed about to be exacerbated by slowing Chinese economic growth and reduced Chinese trade, what will the impact be for the global economy and financial markets? At the very highest level, we think the question is this: Is slower Chinese economic growth a good thing or a bad thing?

Classic economic theory argues that free trade and the introduction of more international competition should produce net gains for all involved. The theory says free trade and international competition will, over time, force each country to specialize in producing those goods and services where it has an advantage, while leaving other countries to produce the goods and services that they're better suited for. With each country concentrating on what it does best, each should become richer. A full, deep analysis of the Chinese experience is beyond the scope of this article, but we note that high-level analysis does support the idea that, on balance, the integration of China into the world economy has been positive for both the Chinese and the residents of the advanced countries. As shown in Figure 5, for example, our analysis shows that in the period 1980 to 2018, every 1.0% rise in Chinese GDP was associated with a 0.1013% increase in the cumulative GDP of the advanced countries (although, admittedly, the results are not necessarily significant from a statistical standpoint). The apparently positive impact of Chinese integration is probably not so clear to those workers who have suffered the "concentrated pain" of losing their jobs and seeing their factories moved to Asia, but those ills have apparently been more than offset by the "diffuse gains" of lower prices and opportunities to sell into the Chinese market.

Figure 5.



If the process of Chinese integration has been a modest positive for the United States and other advanced countries, we fear that slower Chinese economic growth and an end to its integration will be a negative. In recent months, several U.S. firms have already reported weakening financial results that they pinned largely on slower sales in China. U.S. information technology companies such as Apple seem to be particularly at risk, since they are facing the both the secular slowdown in Chinese demand and possible Chinese retaliation for U.S.

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tariff hikes. With China accounting for so much of the world's demand for basic commodities, companies in the natural resources sector are also at heightened risk. Already, the ebb and flow of Chinese growth has proven to be a major determinant of global prices for oil, copper, and other basic materials. Finally, it's important to remember that slowing growth will likely discourage future Chinese investment in infrastructure, housing, and new production facilities. Given China's huge trade surpluses and the boom in Chinese corporate profits to date, China has shipped trillions of dollars of excess capital abroad over the last few decades, contributing to severe financial distortions in the advanced countries. Now, with growth slowing further and domestic investment opportunities becoming even more scarce, the advanced countries could see more disruptive capital flows from China.

Implications of a World Starving for Growth

If we're right that global population aging is about to be exacerbated by a long-term slowdown in Chinese growth and trade, we think the problems we identified in our April 2016 article could potentially be even worse than anticipated. China's weakening demand and decreased competiveness could result in the United States and other advanced economies becoming even slower growing and less dynamic then they otherwise would have been. In a word, there is a possibility that the world will gradually become more and more starved for growth. That could have major implications for international relations, national security, social stability, and economic opportunity, even if there could be some benefit from Chinese economic growth potentially becoming more balanced and sustainable. In the financial markets, we see the following implications:

Stocks. We think aging people in the rich, advanced economies will generally fund their retirement by selling their riskier assets first, so we think stocks will eventually face headwinds. However, the day of reckoning may be pushed off somewhat as firms shift funds from capital investment toward stock buybacks that help boost prices. If fast sales growth and outsized profit gains become rarer, we suspect there will also be at least an initial period of high investor demand and outsized returns for "growthier" stocks, i.e., the stocks of companies that are able to reliably boost their sales and profits. Later on, however, we think aging investors focused on income and stability may shift back toward less-volatile, dividend-paying "value" stocks. Of course, some economic sectors (such as healthcare) are likely to benefit from the evolving trends, and they could provide attractive returns throughout the coming period.

Bonds. From a historical standpoint, today's bond prices seem extraordinarily high, and yields seem exceedingly low. Using a common rule of thumb that future returns are approximated by today's yield, a ten-year Treasury note bought today might only return a paltry 2.6% per year over the coming decade. If we're right that global investors may now be facing a future of relatively muted economic growth, the outlook for bonds may be better than commonly perceived. For one thing, U.S. bonds could retain their value as they are bought up by foreign investors facing even bleaker opportunities abroad, and by domestic investors who are initially focused on selling equities. Those sources of demand seem likely to cushion any negative impact from rising U.S. Treasury debt. In addition, slowing economic growth around the world will likely hold down inflation, long the bane of fixed-income investors.

Alternatives. As long as the U.S. population is merely growing slower and not yet declining, we think real estate properties can keep growing their rents. Coupled with the prospect for relatively low interest rates, that would seem to bode well for publicly-traded real estate trusts (REITs). However, slowing demand around the world seems likely to weigh on commodity prices. It is true that low prices in recent years have led firms to spend less on exploration and development of new mines and oil fields, potentially setting the stage for a near-term rebound in prices. All the same, we think the longer-term trend could well be for muted prices and reduced returns from most physical commodities.

In conclusion, we believe the world may be entering a period of slower growth, especially since the population aging and Chinese maturation described above could be further exacerbated by other challenges. For instance, the economic gains from information technology may start to wane, while increased monopolization seems to be on the rise. Government and corporate debt loads are also increasing, while income equality is prompting disruptive, populist economic policies. In this environment, we still think market forces will promote innovation and profit growth, but we may need to look harder for the pockets of opportunity and the areas of particular risk that will shape the future investment landscape.

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Lead Portfolio Manager

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