

Declining Consumer Populations Causing Extended Global Depression

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Global economic depression

We are slipping into a protracted global economic depression because the aggregate number of consumer households located throughout the world's major G7 economies has stopped increasing each year going forward and, instead, started decreasing each year going forward. This problem is neither fiscal nor monetary in nature. This problem is a secular decline in what economists call final demand. Simply put, as the number of consumer households located throughout the world's major economies declines with each passing year the global capacity to consume goods and services will decline.

Isn't this an obvious problem?

Can this seemingly obvious problem, a massive global decline in the number of consumers, have gone completely unnoticed by economists and government planners? In short, yes. Extended population declines are unnatural events and extremely rare. The essential nature of humankind is to steadily increase in number – not decrease. My research has confirmed only three past cases of extended consumer population declines. Being unnatural and rare events, it is understandable that major economic schools of thought (all those of which I am aware) do not even consider the possibility that the capacity for final demand can decline. All economic schools of thought share a common belief that final demand is infinitely-expandable. The three past cases of extended consumer populations declines include: the Dark Ages, the Great Depression and Japan from 1990 to 2005. Of the three, the Great Depression has the most in common with our present situation. I will describe those similarities a bit later on.

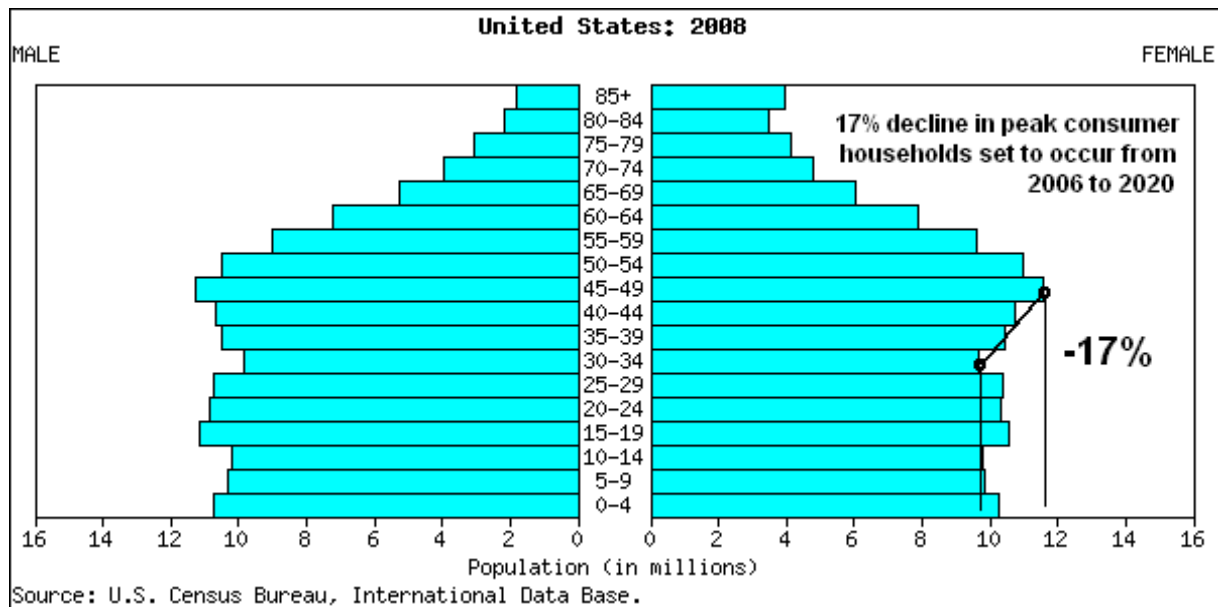
The first to fall

Our present consumption capacity decline kicked-off in the United States in 2007. The projection is for US consumption capacity to decline by about 1.2 percent each year over the next fifteen years to come. The first full year of US consumption capacity decline has already generated some predictable results including, for example, the dismal 2007 holiday retail sales. This is not a scenario where the average US household spends less money each year going forward. Whether the average US household spends more or less each year is a wavelike, cyclical phenomenon. The condition we are facing is more akin to a falling ocean tide. With each passing year the total number of key US consumer households will gradually decline. By the year 2012, four more of the world's largest economies will have

switched from no-growth, to steady declines among their own consumer populations.

2008 Population Pyramid graph for the United States

This graph shows the key US consumer segment population declines that will occur over the years from 2007 to 2020.



Understanding consumption capacity

According to government and industry research households where the head-of-household is 48 years old, on average, spend the most money into the economy each year. Census data shows that the number of US peak consumers (ages 45-49) peaked in 2007. By the year 2012 Americans who currently make up the 40-44 age band will have moved up to inhabit the 45-49 peak-spending age band. Aggregate consumption capacity for the entire US population can be estimated by assigning a standard consumption capacity metric to each age band based on that age band's average per-household expenditures. This approach allows for a standardized estimate of each country's aggregate capacity to consume goods and services in any given year. My analysis shows that 2006 was likely the all-time peak of America's capacity for consumption of housing, goods, and services.

The US population pyramid graph above clearly shows that over the next fifteen years the number of peak consumers (ages 45-49) will decline by about 17%. What about immigration you might ask. The US census bureau makes a good effort to include legal and illegal immigrants in their data, but regardless of that, new immigrants don't have the level of income required to make up the difference. Even if efforts were made to increase immigration, it likely would not have a positive effect because research shows that during their first 15 years new immigrants are a net drain on GDP rather than a contributing factor.

Demand for US housing

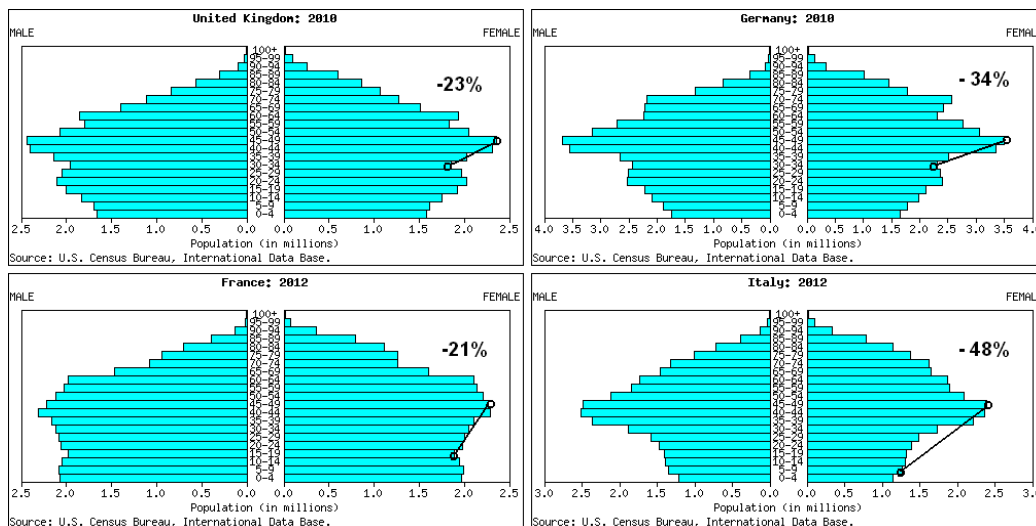
Over the past fifty years US homeowners have tended to acquire their first home when between the ages of 31 to 36 years old, and their largest home when between the ages of 43 to 48 years old. Looking at the graph above we can see just how strong the demographic demand for US housing has been over the past 50 years. Today, the demand for larger US houses is steadily declining each year going forward because the US population of 43-48 year-olds has commenced falling. Besides the steady drop-off in demand, there is also an increasing supply problem. It should surprise no one that millions of aging Americans have been, and still are, planning to sell their large homes and 'downsize' their lifestyles in order to finance their retirements. The US census graph above clearly shows that the number of Americans aged 65-69 will gradually double over the next twenty years. As that rising tide of new seniors attempts to sell their large homes into a shrinking population of 40-somethings, prices will fall even harder.

Pre-emptive defensive actions

In mid-2005 it was against conventional wisdom to downsize. On the basis of my demographic research I beseeched my recently retired parents to sell their trophy house in Connecticut and buy a smaller house before market conditions deteriorated. My parent's real estate broker told them I was irrational. Prices were rising, and US capital gains taxes strongly favor leveraging-up to a bigger house. I was passionate and relentless. My parents eventually gave in. They grudgingly paid their capital gains taxes, and are now comfortably set for their rest of their lives. As frustrating and upsetting as my admittedly gloomy forecast may seem, if it helps to motivate informed defensive actions, then my efforts will have been rewarded.

Population Pyramids for the UK, Germany, France, and Italy

The graphs below show the key consumer segment declines that will occur in four of the major European economies starting from 2010 and 2012.



The unfortunate coincidence of debt securitization

The roots of today's monster credit bubble trace back to the 1990s when Central Banks and major investment houses shepherded-through regulatory reforms that allowed the securitization of mortgages and other forms of debt collateral. Prior to securitization, only banks were able to extend mortgages and they did so directly to homeowners. Each bank conducted its own credit checks and by law was required to retain 7% (later 5%) of outstanding mortgages on reserve against defaults. After securitization 'reforms' no banking capital reserves were required - zero. As a result, financial sector profits surged on the liberation of the formerly reserved capital. Thousands of independent mortgage brokers sprouted up across the modern landscape. The name list of those that founded and financed the so-called independent brokers reads like a who's who of the great investment banking houses. From a demographic perspective, the securitization credit bubble was created at precisely the worst possible moment in modern history.

The 'American' nightmare

Widespread mortgage-credit availability has caused systemic irregularities the likes of which have never been seen before. Prior to mortgage securitization the percentage of US homeowners had held steady for over 40 years at about 60 percent owners versus 40 percent renters. After mortgage securitization reforms, US home ownership rates shot up to peak at about 72 percent of households. Most of the new owners are ALT-A, Interest-only, and Sub-primers. The evidence suggests that as many as 12 percent of American homes are likely to be foreclosed on or sold at distressed market prices as the nation's home ownership ratio grinds its way back to the historical average. A similar scenario has transpired in Europe. As a result I remain highly confident in my forecast of steadily falling housing prices and consequent real GDP contractions over the next decade.

Three historical precedents

The earliest historical case study is the extended consumer population decline that coincides precisely with Europe's Dark Ages. Just prior to the Dark Ages, major European cultures experienced rapid 25 percent (or greater) population reductions due to the Bubonic plague. As these sudden demographic declines worked themselves through consumption lifecycles, the disruptions caused equally sudden declines to the level of commerce in goods and services.

The second case study is the Great Depression. From 1930 to 1938 there were near simultaneous consumer population declines in all of the world's major economies. Much like today, the 1930's demographic declines were immediately preceded by a period of easy mortgages and leveraged finance schemes. Many today would agree with the notion that the Great Depression was caused by the 1929 stock market crash, but in fact the Great Depression is more accurately defined as a massive

collapse in demand for real estate and, coincidentally, a collapse in valuations. A slowdown in the rate of consumption growth preceded the actual year-on-year consumption declines that commenced shortly after 1930. It is highly likely that the 1929 stock market collapse was a symptomatic reaction to the unexpected deceleration in the rate of real-economic growth.

The demographic and fiscal conditions we are facing today, in 2008, are very similar to those of the Great Depression. I suspect that our global stock markets reacted in the year 2000 to the unexpected initial deceleration in the rate of economic consumption capacity. By the year 2007, consumption capacity increases have completely shifted to consumption capacity declines and, once again, securities and credit markets are reacting.

A good analogy would be that of an economic airplane voyage. Passengers (market players) soon adjust themselves to increasing speed at takeoff and an upward climb (growth). Sometime after takeoff, the pilot will reduce the throttle (growth rate) and the passengers will experience a sudden dropping sensation even though the airplane is actually still climbing. Depending on the pilot's skill, the slowdown in the rate of the aircraft's climb (growth) can be smooth or somewhat startling. Once the passengers have looked around and confirmed that the plane is, in fact, not falling, but just climbing a bit slower, they will all settle back in their seats. The next shock to perception comes when the pilot suddenly lowers the throttle and the nose dips. This change causes another wave of concern until the passengers acclimatize themselves to the deceleration phase of the flight. The year 2000 was when our global economy first slowed its rate of climb and the market participants reacted. The year 2008 is when our global economy moves to actual deceleration and the consumption attitude shifts toward year on year reductions.

Japan's experience from 1990 to 2005

The most recent example of an extended consumer population decline is the data-rich case study of Japan between the years 1990 to 2005. Despite steady increases in its total population throughout the period, Japan's key consumer segments declined rapidly by about 20 percent from 1992 to 2004. Fortunately for Japan, the key consumer populations in the other six major economies continued to increase thus allowing Japan's net exports to help offset some of its GDP losses at home.

Similar to the US's 1929 stock market crash, I believe Japan's long 1990s economic recession began with its symptomatic 1990 stock market crash, a reaction to the sudden deceleration in Japan's rate of real economic growth increases. America's brief 1991 recession only added to the deceleration in Japan's aggregate consumption. Over the course of Japan's protracted actual consumption capacity declines from 1992 to 2004, Japan's urban real estate prices lost up to 55% of nominal values, and its suburban prices lost up to 75% of nominal values.

Ultimately Japan's combined real estate losses (including real estate related stock losses) dwarfed its combined real-economy stock and equity losses.

Japan provides a modern example of what can happen when a real estate bubble runs smack into an extended demographic buyer decline. Admittedly there are some key differences between Japan's case in the 90s and the situation today but no one should seek solace in the differences. First off, despite the widespread availability of Japanese no-money-down mortgages in the late 1980s, the Japanese ratio of home ownership never exceeded 57%. Second, Japanese households consistently maintained high per-household savings making foreclosures a rare event and, as a result, very little reclaimed stock was added to the available supply. Third, Japan was (and still is) a large creditor nation with huge foreign currency reserves. In stark contrast, American's today have little household savings and the United States is the world's leading debtor nation and one increasingly dependent on foreigners to finance its increasing deficits and prop-up the value of its currency.

Bear market strategies

There is no shortage of financial advisers with bear market strategies. Some plans are good; some are not. The main point I wish to convey here is that this is very likely not a cyclical US and European downturn. If my analysis is correct, there will not be a return to sustainable global GDP growth any time prior to 2020. The US, England, Germany, France, Italy, Russia, and even China are facing 10 to 15 year demographic consumption capacity declines and there is nothing that can be done in the near term, fiscal or otherwise, that will change those facts.

Profiting from negative growth

In March 2002 AGS published its first report stating that "... 2006 or 2007 a major ratings agency downgrade to an MBS portfolio will officially kick-off the global bust." AGS's classically hedged long-short investment portfolio has risen steadily since July 2007 when Moody's first downgraded mortgage-backed securities thus forcing the two, now infamous, Bear Stearns' hedge funds into bankruptcy. Today's extreme global credit bubble, coupled with firmly held beliefs that recessions are cyclical fiscal-monetary phenomena, will continue to offer up many opportunities to profit as global indexes stagger downward in real terms over the course of the next decade.

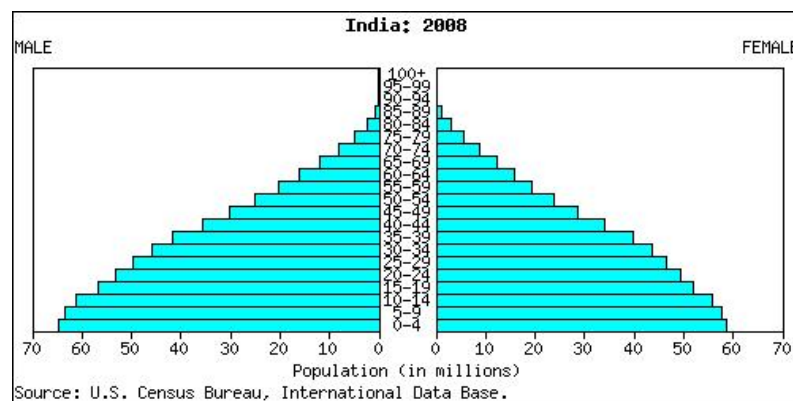
Bear market rallies will begin each time investors attempt to time a US recovery based on the Federal Reserve Bank's missives and rate cuts. Experience in Japan tells me that even negative real interest rates and massive deficit spending will not lead to a sustainable economic recovery. Only demographic shifts that augur year-on-year steady increases to aggregate consumption capacity can lead to real and sustainable economic growth.

Old habits die hard, but even so, by the end of 2008, I expect a decoupling of the US and Japanese currency and stock markets to have taken place. The unwinding of the yen carry trade will likely have two powerful collateral effects. It will drive the yen higher relative to other currencies, and the significant increase in repatriated capital will lead to certain classes of domestic asset inflation. Once realized, these two trends will lead to increase global investor interest in Japan.

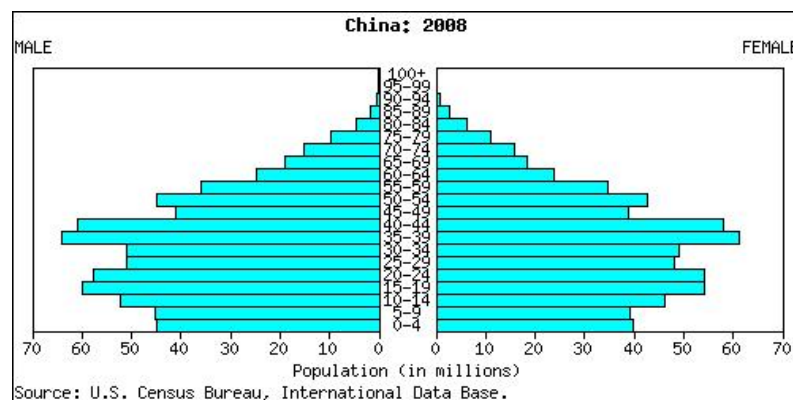
Despite the coming aggregate consumption declines in the west, there will still be large pockets of growth within specific age ranges in the major economies. There will also be aggregate consumption capacity increases in a few select large economies, notably India and Japan. There are also some interesting internal imbalances that I believe can be traded.

2008 Population Pyramid for India

Beyond its graceful symmetry and steady overall growth, there is also an interesting anomaly hidden in India's 2008 population pyramid graph. This same anomaly can be found in China's slightly less attractive 2008 graph. See if you can find it.



2008 Population Pyramid for China



The anomaly that the two countries share is an unnatural imbalance favoring males. For social and political reasons a majority of Indian and Chinese couples prefer to have male children. The distortions first began to appear about 30 years ago when scientific advances provided women with access to sonograms and selective abortions. The steadily increasing male/female imbalances are already causing social upheaval in those countries, and creating some investment opportunities as well.

My recommendation is that investors seek to buy long opportunities that will benefit from pockets of persistent demographic growth, and sell short the issues that are facing persistent declines. Developing such an understanding will provide the investor with an edge to help capture and retain profits despite the coming secular global consumption declines.

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