DEMOGRAPHICS & LONG-TERM FORECASTS

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There have been numerous studies, books and articles addressing the issue of demographics and the financial markets, with particular focus on the Baby Boom generation. Most of the analysis is the same. The supply and demand forces of the Baby Boomers are enormous and will continue to be a pivotal force behind higher equity and real estate prices at least until 2010 when the first group of Boomers begin to retire. The period from 2010 until 2030 has been labeled the "Big Chill" by William Sterling and Stephen Waite (*Boomernomics*) and the "Next Great Depression" by Harry Dent (*The Roaring 2000's*). As this significant group retires, mass liquidations of equities and real estate will begin to occur, outpacing the demand for such assets. Sterling and Waite predict a period of rising inflation due to heavy government borrowing while Dent suggests widespread deflation. The question is not whether investors should take these forecasts at face value, but rather how can demographic information be used to better predict capital market trends.

Demographic statistics can be useful in making longer-term capital allocation decisions as well as strategic business decisions. Unfortunately, demographics alone are not enough to determine where long-term stock or bond prices are headed. Supply and demand certainly impact the price of securities, but there are several other factors that contribute to the long-term trend in prices for stocks, bonds and real estate. For US stocks, history indicates that the three most important components of future return have been dividend yield, nominal earnings growth and change in valuation. Bond returns are a function of starting yields and change in interest rates. Real estate prices are a function of several variables such as location, the level of interest rates and supply/demand issues.

While I agree with Sterling, Waite and Dent on some of their assumptions, I do not believe long-term asset allocation decisions should be based on demographics alone. The argument for the "Big Chill" or the "Next Great Depression" beginning around 2010 is based solely on the assumption that mass liquidations will take place in stocks and that residential real estate purchases will dry up. It is likely that there will be downward pressure on real estate prices in the post-2010 world as the first-time and trade-up buyers' markets slow to a trickle. Stock prices will also face downward pressure from retirement fund liquidations. However, there are also a number of forces that will most likely stem the flow of expected liquidations in these markets. Global integration and productivity gains from technological advances will still provide a flow of capital into stocks and real estate. In addition, the effect of aging populations in the US, Japan and Europe, is likely to be offset by large potential market forces, such as China, that will provide the global capital needed to help sustain gains in stocks, bonds and real estate.

Making economic and market forecasts is difficult — whether the timeframe is one year, 10 or 20. It has been our experience that supply and demand forces do impact the price of any asset. However, at the end of the day, the most reliable and useful approach is to understand the underlying fundamentals of investment markets and the factors that drive long-term prices higher. In the US stock market, yield, nominal earnings growth and change in valuation have explained nearly all of the market's return from 1940 to present — even at times when demographics were changing.

In making long-term stock market forecasts, the operative assumption of the demographers is that investors will continue to retire at age 65, after which point the pace of investment portfolio liquidations will rise. In making long-term weather forecasts, some meteorologists assume that the ozone layer will continue to deteriorate, resulting in global warming and warmer weather patterns. In both scenarios, the projections are only as good as the assumptions on which they are based. The best advice I can give to investors with respect to long-term market forecasts is that: 1) market forecasts beyond 10 years are not only unreliable, but nearly impossible to make; 2) history indicates that the best predictors of return for stocks are the three factors of yield, nominal earnings growth and change in p/e multiple; and 3) long-term market forecasts based solely on demographics are dangerously similar to long-term weather forecasts.