POPULATION AGING CREATES CAPITAL REPAYMENT RISK FOR GOVERNMENT BONDS

Good news for all of us as individuals is now potentially bad news for those who invest in government bonds. The reason is the dramatic rise in the percentage of people in the 'New Old' 55+ generation.

By Paul Hodges

The good news is that life expectancy has increased by 50% since 1950, to around 70 years. Thus today there are already 1 billion 'New Olders,' compared with just 300 million in 1950. And the UN Population Division forecasts they will number 1.8 billion by 2030.

The bad news is that fertility rates have also fallen by 50%, with each woman now having an average of just 2.5 children. Until 2000, the post-World War II baby boom disguised the problem this created for investors, as the proportion of New Old in the adult population remained constant at around one in five. But since then, it has been rising very rapidly, such that the proportion of New Old will be almost one in three people by 2030.

"Where's the problem with this?" you might well respond. Life expectancy 200 years ago, after all, was only around 36 years old in the developed world and 24 elsewhere. And even when Otto von Bismarck and David Lloyd George introduced the world's first state pension schemes in 1888 and 1909 respectively, Western life expectancy was less than 50 years. Yet today, US residents aged 65 still have on average a quarter of their lives ahead of them.

RETHINKING PENSIONS

The problem is that our thinking about work and pensions has not caught yet up with these developments. Bismarck and Lloyd George saw pensions as being means-tested social insurance and set pension age at 20 years above life expectancy. A pension was meant to be a small amount of money paid to a small number of people for a small period of time. Thus only 600,000 of the UK's 40 million population were initially eligible to receive a pension in 1909.

Lively for much longer: the New-Old adult population

Yet today, pensions are a universal entitlement, with 13 million receiving a UK pension. And instead of pension age being 20 years above life expectancy (or around 100), it is instead now below the 1909 level.

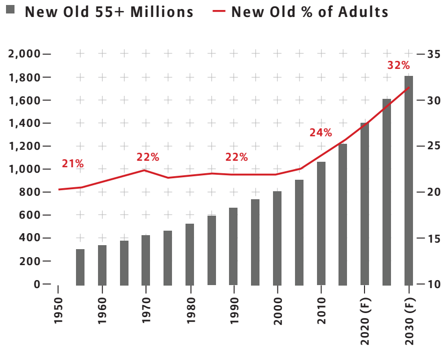
Until recently, this paradigm shift created a benign environment for bond investors, as people realized they needed to increase their savings and spend less, in order to finance their unexpectedly long life. They naturally favored 'safe' Western government bonds, given stock market uncertainties. In addition, of course, the shift from spending to saving helped to reduce inflation and created a more deflationary environment.

Japan is the obvious model for this shift. Its baby boom took place earlier than in the rest of the G7, meaning that its

By 2030, almost one in three of the global population will be 'New Olders,' creating problems for governments previously in denial.

THE DEVELOPMENT OF A GLOBAL AGING POPULATION

New Old 55+ population, & percentage of adults worldwide, 1950-2030 (F)



Source: United Nations Population Division

society's proportion of New Old rose from a benign 20% of the adult population in 1970 to 32% by 1990, and 47% today. In turn, its government bond yields fell from 8% in 1990 to current levels of 1%. Other G7 countries have seen the same phenomenon in more recent years, as Germany and Italy's New Old percentage has risen to 43%, and the US and UK's to 36%.

» MODERN GENETICS HAS NOT YET FOUND A WAY OF TURNING 55-YEAR-OLDS BACK INTO WEALTH-CREATING 35-YEAR-OLDS. «

But this virtuous cycle is now in danger of turning vicious, as doubts increase about governments' ability to repay today's historically high levels of borrowing when growth remains anemic at best.

The problem is twofold: first, aging populations inevitably reduce economic growth. Official data for household spending confirms the common-sense conclusion that spending peaks by the age of 55 once the kids leave home. Older people essentially represent a replacement economy, as they already own most of what they need, while their incomes reduce as they approach retirement. And, given that household consumption is 60% of GDP, this means the economy will slow as the New-Old percentage rises.

Second, policy-makers ignore this issue at their peril. They have been too cowardly to propose meaningful increases in pension age, or even to warn that the 'demographic dividend' had turned to 'demographic deficit.' Instead they have tried to restore growth by following the failed Japanese playbook of major stimulus spending and massive increases in government debt.

IGNORED WARNINGS

They have thus chosen to ignore last year's warning by former Bank of Japan governor Masaaki Shirakawa: "most Japanese people, along with economists, did not grasp the gravity of population aging coupled with a low birth rate for Japan's economy." China has made the same mistake: its one-child policy, in force since 1978, will cause its New-Old population, currently at a moderate 20%, to double by 2030.

Today, therefore, the main question now facing government bond investors is when to jump ship. They have profited hugely over the past two decades from the increase in saving and low inflation rates caused by the rise of the New-Old generation. But now they face the risk of a 'Custer's Last Stand,' with policy-makers continuing to believe they can somehow kick-start growth by adding yet more debt.

Contrary to expectations, this debt will not be inflated away as in the 1970s. Back then, the rapid rise of the boomers created a vast increase in demand at a time when the small interwar generation was totally unable to provide the necessary supply. But today, the supply-demand balance is instead moving steadily in the opposite direction. Rising proportions of New Old inevitably create a deflationary rather than inflationary environment, as the various consumer price indices are increasingly confirming.

Thus the old adage of 'don't fight the Fed' will progressively face the reality that modern genetics has not yet found a way of turning 55-year-olds back into wealth-creating 35-year-olds. Western government bonds will carry increasing capital repayment risk until policy-makers finally agree to recognize the true economic consequences of today's aging populations.

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