FUNDAMENTALS

Retirement anxiety, rate depression, populism… and what to do about it

With global interest rates remaining near all-time lows, and **$15 trillion** of debt providing investors a negative yield, bond-market bears are in danger of becoming extinct. But could today's ageing society finally provide the trigger for a sustained bond-market selloff?

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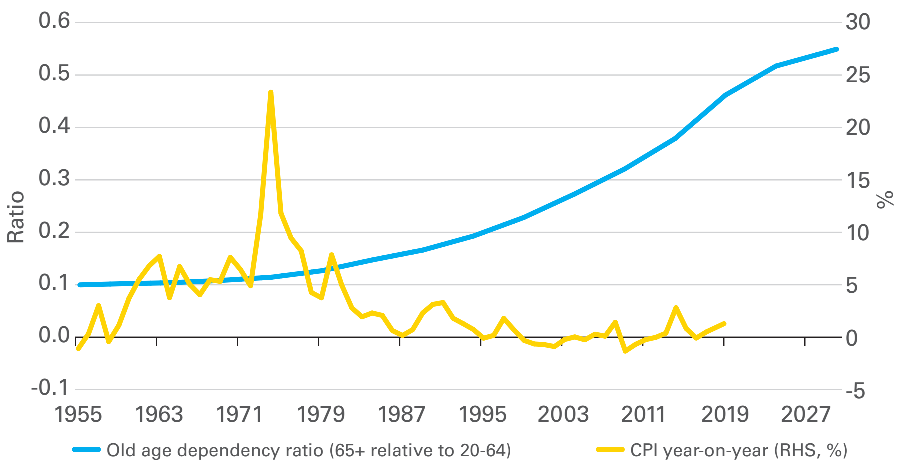
The life-cycle hypothesis in economics suggests that people save in middle age and then consume when they retire, as described by our economist James Carrick in his blog **'The ant and the grasshopper'**. This shift from saving to consumption suggests that the impact of an ageing population is inflationary, which should go hand in hand with rising yields. But does the evidence back the theory?

Japan is the bellwether for an ageing society and so can provide valuable insights for answering this question. Among OECD countries, **Japan has both the highest life expectancy** and the highest old-age dependency ratio: in 2015, the most recent year for which data are available, there were **46 people older than 65 for every 100 of working age**. This was just 13 in 1975 and 27 in 2000.

Figure 1: Falling inflation despite rising old-age dependency ratio in Japan



Source: OECD (historical and projected values), Macrobond

Despite all this, as Figure 1 shows, there has been little evidence of accelerating inflation in Japan – indeed, quite the opposite.

The reasons behind this are far from straightforward, but they can help us consider what may happen to the rest of the world if it ages in a similar fashion.

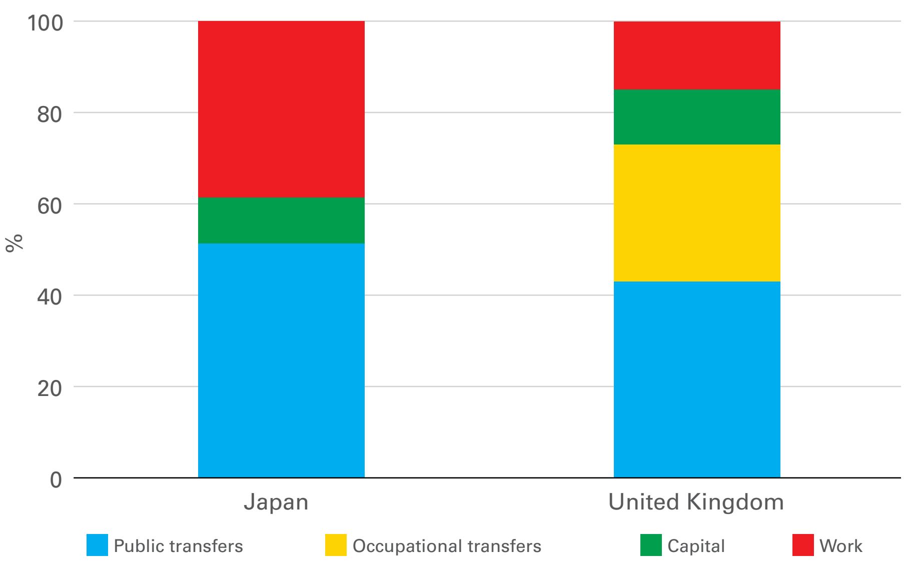
WORKING LONGER...

The first factor in this puzzling lack of inflation is that Japanese people are working for longer. There are numerous motivations for this, from a greater ability to work later into life thanks to improving health to the desire to supplement income in old age (see Figure 2). Importantly, there's little reason why people in other places shouldn't also work more as they age; indeed, many countries are enacting legislation to delay the age at which citizens become eligible for state pensions, which will encourage this trend of deferring retirement.

And as people work longer, there is a greater supply of labour, which should be disinflationary for wages. In addition, there is a reduced need to dip into savings, which also lowers the inflationary impact of ageing.

This is particularly the case when combined with the second factor to consider: reduced consumption.

Figure 2: Income sources of people aged over 65



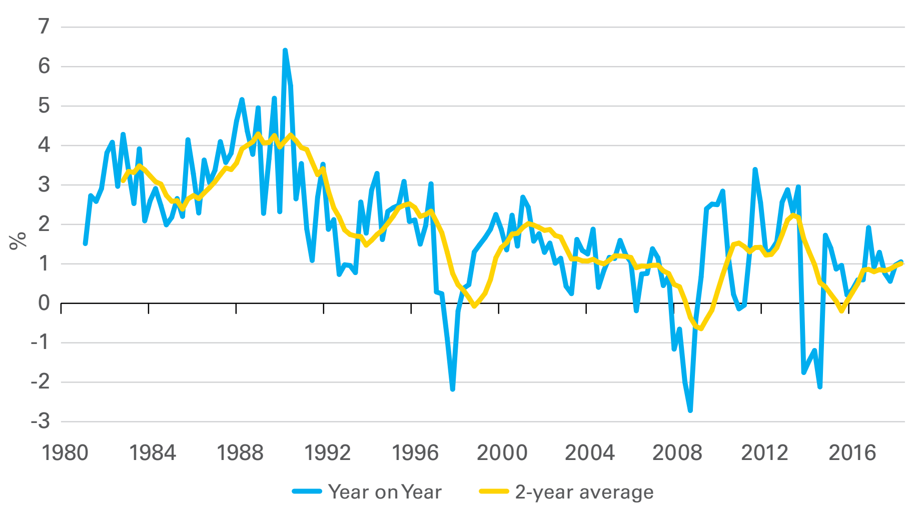
Source: OECD Income Distribution Database; **www.oecd.org/social/income-distribution-database.htm**, Japan data for 2012, UK for 2015

...AND CONSUMING LESS

As can be seen in Figure 3, Japanese consumption has been on a declining trajectory over an extended period of time despite a rapidly ageing population. Of course, this might simply be a function of a weak economy, with the global financial crisis leaving a permanent impression.

However, this phenomenon has been observed in other countries. For example, **Deutsche Bank** observed that elderly German households increase their saving rate in the second half of their retirement period, i.e. when they are aged 75 years or older. The **CPB Netherlands Bureau for Economic Policy Analysis** also found no evidence for wealth decumulation during retirement across a sample of two million Dutch households despite their gross income being roughly half the income of their working contemporaries.

Figure 3: Japanese consumption (private and government) per capita, constant prices



Source: Macrobond

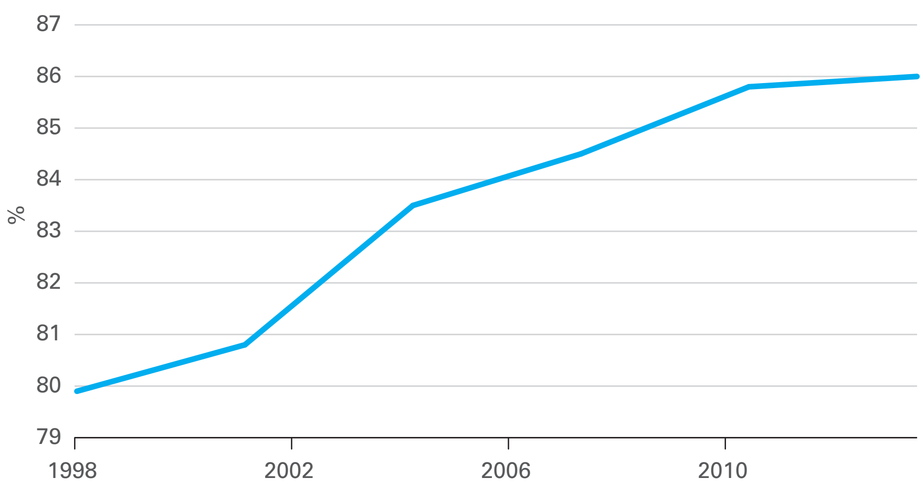
Why would this be the case? One possibility is a bequest motive, with people reducing consumption in order to pass on money to their surviving children. However, in the Dutch analysis, there was little difference in behaviour between couples with or without children.

So perhaps there is a psychological reason behind this relative frugality: anxiety. Again, the Japanese experience is enlightening.

PENSIONER ANXIETY

Japanese anxiety about retirement has clearly been increasing in recent years, as Figure 4 indicates.

Figure 4: Proportion of Japanese respondents who expressed anxieties about life after retirement



Source: JILI, Goldman Sachs

One explanation could simply be increasing concern about how people will pay for retirement. As Figure 5 shows, the relative poverty of people aged over 65 in Japan is high, despite older people working longer and consuming less. This is partly a function of a relatively low state pension, as well as rising public-pension contribution and health-insurance premium rates.

The social impact of such poverty can be extreme, with reports of Japanese pensioners choosing to be sent to prison for food and shelter rather than live a life of freedom and poverty.

Despite such problems, the Japanese government does not throw money at the issue. Japan has famously run huge deficits, but in recent years has managed to reduce its gaping fiscal hole, resulting in an extended period of austerity which has arguably weighed on general economic growth as well as put pressure on the population.

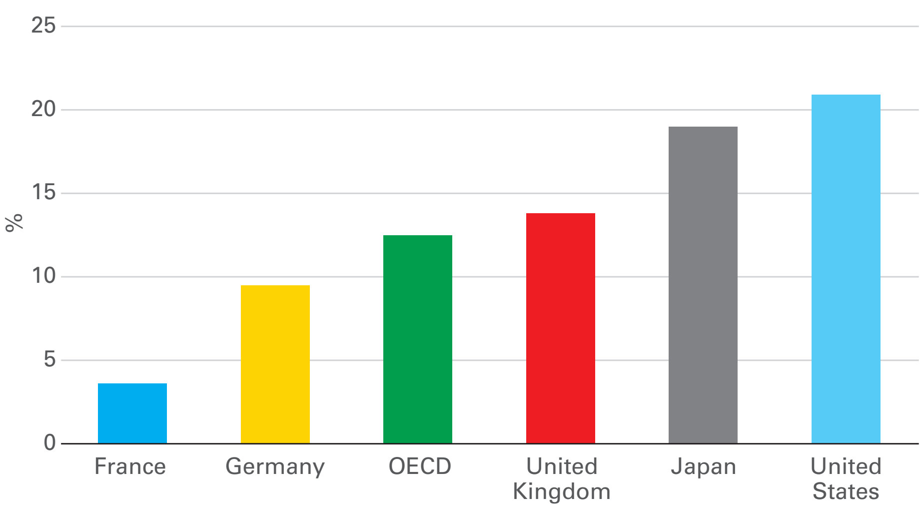
LESSONS FOR OTHER COUNTRIES

The Japanese experience, as well as early indications from countries less advanced along their own ageing track, suggests little evidence for the life-cycle hypothesis. Indeed, Japan's ageing population has actually coincided with a deflationary trend.

While working longer and consuming less could be applied to other countries with aging populations, it is this last point regarding fiscal restraint that raises most questions for other countries.

A significant driver of old-age consumption is public spending on health and social care. Indeed, if pensioners felt secure that both would be adequately provided, they could be less anxious and therefore consume more.

Figure 5: Percentage of population with incomes less than 50% of median household disposable income



Source: OECD Income Distribution Database, www.oecd.org/social/income-distribution-database.htm, 2014 or latest available data

Japan has arguably been shackled by a belief that the government should be more fiscally responsible. However, we are seeing changes to this mentality across the globe and the political spectrum: from the 2018 tax cuts of Donald Trump and the UK's Conservatives looking at giveaways, to more extreme parties' embrace of Modern Monetary Theory. This latter movement – the idea that governments which issue debt in their own currency can never have a financing problem – can be interpreted as allowing governments to use fiscal policy to achieve full employment.

The question is how far such policies will be allowed to run. As we wrote in **"Unconventional policy in the next downturn",** some countries are more constrained legally and philosophically than others. For inflation to develop, we would need to see policymakers be willing and able to unleash significant spending to offset the disinflationary forces described earlier.

It's possible that reckless government actions could unnerve populations, particularly if they lead to accelerating inflation and weaker currencies. This could even result in higher private saving rates, but a fully motivated government should ultimately be able to win out – as long as it remains in power.

LIFE-CYCLE PATH

The Japanese ageing experience does not suggest an end to low interest rates and subdued inflation. However, investors might want to take advantage of low interest rates and inflation expectations to protect portfolios from a sudden political shift that breaks all the old rules and unleashes weaker currencies and soaring inflation.

As we have experienced in recent years, politics is very unstable and it makes sense to prepare rather than predict.

FROM EMERGING TO AGEING

What about countries with small welfare states? For many, the issue is less relevant thanks to populations that are still growing – such as Nigeria – so dependency ratios are low and children are able to look after their parents.

China is a glaring exception. Over the medium term, we'd expect the Chinese welfare state to grow, but in the meantime China is an excellent opportunity for the savings industry. China's fast economic growth coupled with a high savings rate is generating a 'great wall of Chinese capital'.

Given there are limited state-backed safety nets, Chinese savers must look to the private sector to provide retirement solutions. Assets under management in **China's investment industry are expected to triple by 2025**, according to Boston Consulting Group, which will make it the second-largest market after the US.

This is a vast greenfield opportunity for asset managers, insurance companies, and pension providers, particularly as wealth in China is currently disproportionately concentrated in property, cash, and yield-enhanced structured products produced by the shadow banking industry. The government's recent drive to curb shadow banking as well as potential tax reforms encouraging saving into private pensions may lead Chinese savers to increase the weight of investment funds and insurance in their asset mix.

International insurance providers like AIA are well positioned as they have trusted brands and strong distribution capabilities within China. Global asset managers also stand to benefit given that Chinese savers are likely to increase allocations to overseas investments from a low base, in order to diversify away from risks in the domestic economy. **BlackRock recently stated** that it sees China as one of its largest future growth opportunities. We would expect most global asset managers to have similar ambitions.

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