

# UBS CIO Monthly Letter



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## *The immutable force of demographics*

There are two types of laws in this world: man-made laws that we *shouldn't* break, like the speed limit, and natural laws that we *can't* break, like gravity. Austrian daredevil Felix Baumgartner recently illustrated the latter when he jumped from a capsule 39km above the earth, becoming the first skydiver to break the sound barrier with nothing more than gravity propelling him at speeds exceeding 1,340 kmph.

Like gravity, demographics are a natural law. As a result of increased longevity, declining fertility, and the aging of the "baby boom" generation, the share of elderly in the global population is rising. This trend is most advanced in wealthy economies, but it is also a growing concern in emerging markets such as China. According to United Nations projections, the percentage of people over 60 years old will double by 2050, to 22% of the global population.

The implications for economies and public finances are profound. As populations age, pension and healthcare liabilities soar, placing additional pressure on already burdened public finances. Governments cannot halt the forces of demographics – any more than skydivers can defy the force of gravity – and aging populations will inevitably slow trend economic growth. But policymakers *can* take action to ensure that their liabilities stop growing at an unsustainable pace relative to their assets.

The necessary reforms will be very difficult because they strike at the heart of the "social contract," the implicit agreement that governs the mutual obligations of citizens and their governments. This contract has evolved differently in different regions. In Europe, it has been founded on a generous welfare state, in the US it has been supported by the

twin pillars of social security and Medicare, while in China, support for the ruling elite has been rewarded with state-sponsored growth that has helped lift hundreds of millions of people out of poverty. Many citizens view the man-made social contract as a rule that *shouldn't* be broken, but the contract can, and will have to, be renegotiated if governments are to remain solvent. As protests in numerous European peripheral countries illustrate, this is a brutally difficult process.

In this letter we review the current investment prospects for each of our key regional drivers. To do so effectively, we need to step back from the daily market swirl and consider how demographic changes not only affect the economy, but also impact the political debates and decisions of today and tomorrow – from controversy over the US fiscal cliff, to debt sustainability in the Euro-zone, to the future of China's economic growth model.

### **US – demographics raise stakes on fiscal reform**

The US is in the final stage of a great debate that will decide which party will lead the country for the next four years, and how the social contract will be rewritten in the future. The nation's finances are already on an unsustainable path, and with a demographic crunch looming, difficult decisions will have to be made about taxes and spending priorities.

Like other aging societies (see Figure 1), the US will have a dwindling number of workers to support each retiree drawing on benefits. In 1950, there were 16 workers paying payroll taxes for each retiree collecting Social Security benefits. Today, there are 3 workers supporting the Social Security and Medicare benefits of each retiree and in little over a decade, this ratio will be just 2 to 1.

The US has not run a budget surplus since 2001, and the accumulation of deficits since then has raised federal debt to more than 100% of GDP, the highest in over 60 years (see Figure 2). When the present value of social security and healthcare liabilities for the coming three decades is taken into account, analysts estimate the debt-to-GDP ratio will climb to more than 300%.

While a highly accommodative central bank and the safe-haven status of US government bonds are currently helping the government fund its deficit at historically low rates, such a benign environment will not last forever. Among other steps, it will be critical to reduce healthcare costs, since projected spending on Medicare makes up over half of the US government's future liabilities.

It is clear the US has to get its fiscal house in order.

However, there is a danger that excessive fiscal tightening in the near term could cause a recession. The most pressing issue for the newly elected Congress will be to resolve the "fiscal cliff." Without an agreement between Democrats and Republicans, USD 607 billion (3.7% of GDP) of spending cuts and tax increases will be triggered in January. We believe that the most likely outcome is a "fiscal pothole," rather than a plunge over the fiscal cliff, e.g. a deal to incrementally reduce the government deficit by c.0.7% of GDP. This would likely slow the economy, but not tip the US into recession.

If confidence is to return in a sustainable manner, politicians will need to pivot quickly to credible, longer-term deficit reduction plans in 2013. The choices made over how to redefine the social contract will have critical implications for the investment landscape.

*What this means for an investor today:* A risk remains that politicians may be willing to push the US over the fiscal cliff, potentially using the debt ceiling as a bargaining chip, before negotiations reach an acceptable compromise. The markets are not pricing in this result and, to be clear, it is

not our baseline expectation. Still, given the binary nature of the risk and the fact that in an election year politicians can act less rationally than usual, it seems logical not to add risk at this point in time. Furthermore, after an extended period of inventory re-stocking, uncertainty over the US political situation and global growth has led businesses to manage stocks more tightly and limit capital investment. These factors could prove to be somewhat of a drag during the ongoing third quarter earnings season.

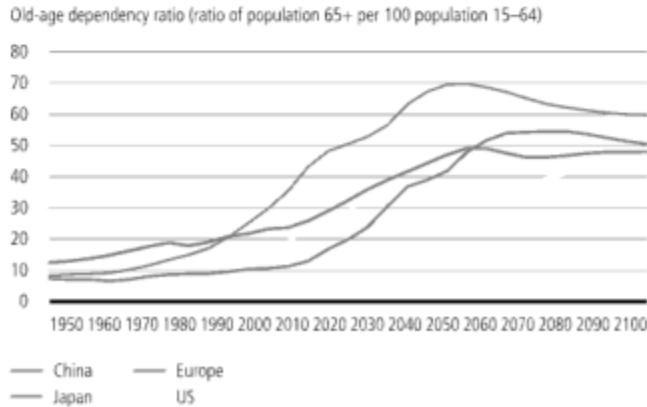
### Eurozone – debt only made worse by demographics

In Europe, looming demographic pressures are even more severe than in the US. For example, by 2050, 40% of Portugal's population will be over the age of 60, second only to Japan in its ratio of elderly citizens. Italy, Spain and Germany will be close behind at 38%, all among the oldest populations in the world. The rapid pace of aging raises the urgency of finding a sustainable solution to Europe's sovereign debt crisis.

There are essentially two ways to achieve debt sustainability: fiscal austerity, or higher GDP growth. Peripheral countries have been forced to emphasize the former. As a result, the news is full of headlines about budget cuts, tax hikes, pension and salary cuts for public workers, and increases in the retirement age. As continued violent street protests in Greece and Spain attest, the social contract is under threat. Also, over the past few months, a debate has intensified over whether fiscal austerity could actually be harming debt sustainability by undermining growth prospects. The International Monetary Fund recently stated that since the start of the great recession, fiscal austerity has been more contractionary than many had expected.

A huge gap in competitiveness between the core and the periphery is at the root of the Eurozone's problems. German labor costs rose by +18% in 2000–2009, significantly less than Italy's +35% and Spain's +50%. Our estimates suggest that Italy and Spain would require a -20% real exchange rate adjustment, while Portugal and Greece would need more than -30% to get labor costs back on an

**Figure 1: Dependency ratios are rising around the world**



Source: United Nations, as of 31 December 2011

**Figure 2: US debt-to-GDP ratio has risen above 100% (total gross central government debt/GDP)**



Source: IMF, World Bank and US Treasury, as of 31 December 2011

equal footing. This necessitates painful tradeoffs between deflation in the periphery and inflation in the core.

Structural reforms, too, will be needed. According to the World Bank's "Doing Business" rankings, it is easier to do business in Mongolia than it is in Italy. On this front, we are heartened by the announcement this year of a host of new reforms in Italy, including an overhaul of labor market laws and deregulation in a range of sectors from insurance to taxis.

*What this means for an investor today:* The key near-term financial markets driver in Europe remains the European Central Bank (ECB). The ECB is playing a crucial role in calming the markets long enough to allow politicians in Spain and other peripherals to hopefully implement reforms that restore competitiveness, growth, and address debt sustainability. At present, markets are stuck in a holding pattern waiting for Spain to apply for assistance – a move that could help lower its borrowing costs. In the longer term, however, demographics will have a big impact on trend growth and asset price returns. Without bold reforms to restore competitiveness and enhance productivity, Europe may be destined for a new paradigm of subpar growth.

The fact remains that even as some tail risk recedes in Europe, the continent is in recession and a robust economic recovery is unlikely for some time. Thus, an investor looking for growth needs to look beyond the region; quality Western blue-chip companies that benefit from exposure to faster-growing emerging market economies are one way to address this challenge. An alternative way is to focus on high-quality dividend stocks – in a low-growth environment the contribution of dividends to total equity returns should increase.

### **China – growth model must change**

China's social contract has relied almost entirely upon the maintenance of high GDP growth, which has helped lift approximately 600 million people out of poverty. This growth has been fueled by fixed asset investment, the mobilization of a huge pool of labor from the agricultural sector into the industrial sector, and growth in the labor force-to-population ratio facilitated by the "one child policy."

The one child policy led to working parents supporting a single child. However, as the parents age, this dynamic will reverse and, within families, one working adult will have to support two elderly parents. A weak social safety net in China makes this adjustment particularly difficult. Chinese households need to save more for healthcare and retirement, which helps explain their exceptionally high savings rate of almost 40%. As a result, it has proved difficult to boost private consumption, which accounts for just 35% of GDP, compared with roughly 70% for Americans and 57% for Europeans.

China's leadership needs to shift the composition of growth from an excessive reliance upon investment towards greater consumption, and this economic transformation will inevitably impact the social contract. One way of promoting such a shift would be increased public spending on healthcare and pensions – establishing a safety net would likely help bring the household savings rate down. Another way would be to boost the purchasing power of consumers by allowing a greater appreciation of China's currency. The CNY hit a 19-year high in October, but markets do not expect the rise to continue, and are currently pricing in a depreciation of 1.7% over the next 12 months.

*What this means for an investor today:* Demographics and the political imperative of maintaining high levels of growth are pulling China's policy in opposite directions. The pace of the Chinese economic recovery and its global impact will depend on whether China's new leadership continues to stimulate fixed asset investment, or if it pursues rebalancing. The former would likely be positive from a short-term, tactical perspective, leading to improved global economic data and a more positive view on risk. The latter path, however, would ultimately be the more sustainable one – even if it involves some short-term pain.

Recent data shows no signs of a rebalancing towards private consumption, with exports storming ahead at +9.9% y/y (prior +2.7%) in September, and fixed asset investment at +20.5% y/y. Overall, we expect infrastructure investment and other stimulus measures to support a "cyclical" upturn of China's economic momentum this quarter. Hence, China remains a preferred market within emerging market equities, but we are carefully watching to see if its policymakers make the right longer-term decisions.

### **A note about Japan**

No discussion of the impact of demographics on investing would be complete without an observation about Japan. Japan is the fastest-aging society on earth, its population is expected to shrink by 30% in the next 50 years and by 2050, 42% of citizens will be over 60 years old. Japan also has the highest debt-to-GDP ratio in the world, which it has been able to sustain due its high private sector savings ratio. Unfortunately, as Japan's population ages the savings ratio will inevitably drop as people finance their retirement, and this makes its debt more difficult to sustain. Should Japan try to inflate its way out of this debt, this would destroy the fixed income savings of its increasingly elderly population. The falling savings ratio should support economic growth, but it remains to be seen if this will be enough to avert an eventual debt crisis. Japan continues to serve as a poignant reminder of what can happen to even the strongest of economies when debt and demographics collide.

### **Asset allocation**

Overall, the fiscal challenges posed by aging societies constitute a demographic-driven, new investment paradigm

that is likely to slow global growth and will be one of the key trends of our lifetimes. A return to sustainable global economic growth will require policymakers around the world to confront these challenges head-on, in creative and effective ways.

In the meantime, aggressive action by central banks has greatly reduced tail risks and global growth is showing signs of improvement, thereby supporting our "middle ground" strategy of focusing on corporate credit, and in particular, US high yield.

The US high yield sector has gained 14% year-to-date, but the key question for investors is whether this rally will last. We expect prices to rise further as yield spreads tighten from their current level of around 5.4% towards our target of 4.75%. While US corporate balance sheets have been repaired through deleveraging and cautious business activity, the yield spread is still far from its pre-crisis low of 2.4%.

Low refinancing needs, ongoing US growth, and a healthy US banking sector are also supportive of US high yield bonds. In addition, we expect default rates to remain below the historical average (see Figure 3).

Our research shows that over the longer term, the total returns of high yield corporate bonds are mainly driven by two factors: the "fixed" coupon component and the default rate (see Figure 4). Since 1990, 115% of the total return can be attributed to coupons, -30% to default losses and the remaining 15% to the decline in the Treasury yield. Consequently, as long as high yield bonds provide a decent coupon, aggressive spread tightening is not needed from current levels to still earn a reasonable return.

Why are we not overweight equities in the current environment? Global equities have rallied substantially since June, but for this rally to be sustained, we would need to see clarity around the US fiscal cliff, a re-acceleration of

corporate earnings, and further strength in business fundamentals.

Within equities, our preference remains with the US and emerging markets (EM). Inflows into EM economies have started to pick up over the past month, supported by signs of economic recovery in key regions, most notably China and Brazil. In addition, stronger commodity prices are likely to support EM earnings, given the high tilt towards the energy and materials sectors in many developing nations. And lastly, the traditional scare factor for EM equities, namely inflation, appears under control, which leaves room for further central bank support. In our view, these factors all justify an overweight in EM equities.

For investors seeking EM exposure with a somewhat lower level of volatility, we continue to highlight the attractive yields offered by EM corporate bonds.

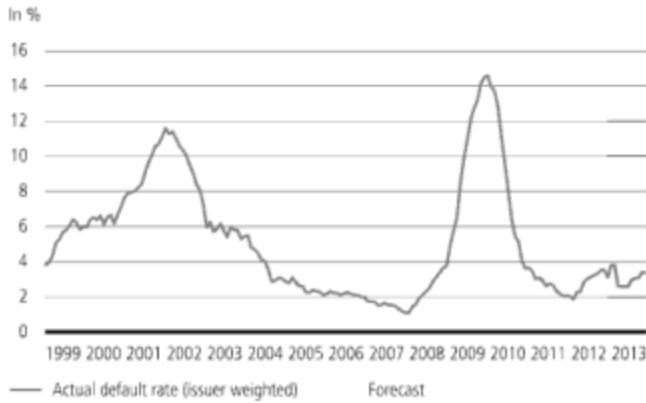
In major currencies, we are maintaining our recommendation to underweight the Japanese yen. The Japanese economy continues to weaken against its peers, raising pressure on the Bank of Japan to engage in further quantitative easing. We have also closed our preference for the Canadian dollar, which is less attractively valued after solid gains against the US dollar in recent months. And finally, we have closed our remaining short position in the Swiss franc.

Kind regards,

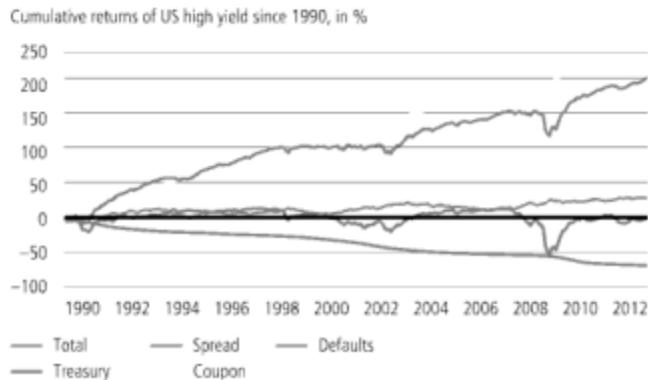


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**Figure 3: US high yield default rates to stay low**



**Figure 4: Coupon accounts for bulk of high yield bond returns**



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