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INVESTOR DIGEST | 16 May 2022

# Short-term markets versus long-term demographics



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Even when markets are not performing well in the short term, it is crucial not to be caught like startled deer in headlights when thinking about long-term goals. This week, in addition to a summary of market performance, our Senior Bond Strategist Shilen Shah will offer some thoughts on how demographic trends, notably population growth, might affect future investment prospects. This is exceptionally long-term thinking, but is extremely important in guiding investors' opinions on, for example, how much they might realistically need to save for retirement.

### **What happened in the markets?**

While some media reporting of market events in the last week has been apocalyptic at times, the damage was not too severe at the aggregate level. A question lingers about the choice between the definite and indefinite article to describe the low point of trading for the S&P500 Index – was it the low or just a low. Comparisons with the trough reached on Christmas Eve 2018 are compelling. Then, the index also bottomed out just a few basis points away from falling 20% from January's peak – the level at which the drawdown can be labelled a "bear market" (even if it already feels like one). But the Fed has more inflation to fight this time around and valuations, in the US at least, are not as generous as they were then.

Even so, there is scope for a counter-trend rally, if only because sentiment is so poor and positioning is supportive. It has been interesting to note the shift in tone from some of our strategy research providers, a quick sweep across which always serves to remind one that opinion is never unanimous.

BCA Research (an independent house) switched its tactical stance last week from neutral to overweight on equities, citing a topping out of US inflation indices and a belief that the peak for US Federal Reserve (Fed) rate rise expectations is also past us now. JP Morgan, which never turned cautious in the first place, reiterated its positive stance. Goldman Sachs has become more constructive, pointing to a strong first quarter earnings season, healthy private sector balance sheets, reasonable valuations and negative sentiment. Citigroup is tempted to dip a toe or two, but with the caveat that growth or long-duration shares remain vulnerable to further derating.

Even Bank of America, the standout bear of recent months (at least among those whose views are not permanently set to "pessimistic"), can see the possibility of a rally, although would feel more comfortable with an entry point on the S&P500 in the 3600-3800 range, against Friday's close of 4023.

Having recommended taking more risk off the table in March, we are certainly considering when to put it back on again. However, any sustainable rally will probably need to be accompanied by a view that the Fed is going to back off from its tightening, either in terms of rate rises or balance sheet shrinkage (or both), and it has given absolutely no hint of that yet. In fact, last week's commentary from Fed Chair Jerome Powell remained resolutely hawkish in the face of a Consumer Price Index print that topped expectations (although it was lower than the previous month's on a year-on-year basis). And, unless inflation does fall back swiftly towards its 2% target, the Fed will only back off in the event of much more severe economic weakness, which itself could lead to more stress for equity and credit markets initially.

### **What is the role of demographics in financial markets?**

Long-term demographic trends are likely to have a significant impact on financial markets over the coming years. A good starting point is to look at the long-term population projections produced by the United Nations. We note that Africa's share of the global population is forecast to increase sharply over the coming decades, while the population share of North America and Europe is projected to drop

equally sharply as their population's age. At the same time, the median age is projected to increase globally. Notably, the age profile of the United States is forecast to rise less sharply than, for example, either Germany or Japan given the US's better demographic profile.

Importantly from a macro perspective, the ageing of societies is likely to increase the dependency ratio – the ratio of retirees to productive workers. In the UK, for example, the size of the UK's working age and children's population in 2045 is projected to remain stable relative to 2030. However, the pensionable age population is projected to increase by 28%. The high and increasing cost of social care and pensions will create a significant fiscal burden and this will affect most developed countries. The US is potentially a significant exception given the projected increase in its working age population over the next few decades.

As evidenced in the French presidential election, governments are attempting to increase state pension age as a way of reducing the burden on public sector finances. However, it is clearly politically difficult and extremely unpopular. The Macron government's proposal to increase the retirement age from 62 to 65 drew significant opposition, even if the proposed increase would only bring it in line with both the UK and Germany. However, those countries are already looking to increase their state pension age to 67.

Another possible solution was introduced in Japan as long ago as 2000. Rather than trying to reduce the liabilities by shortening the pensionable years, this raises funds by imposing a social welfare tax on the over-forties to pay for additional costs related to a higher dependency ratio.

What are the implications for financial markets? If we look at the traditional life-cycle model, the savings profile is shaped like an inverted "U", with limited saving by both the young and old. From an economic perspective, savings are a source of funds for investments. As societies age, the supply of savings decreases which should (according to economic theory) lead to an increase in interest rates to attract additional savings. However, evidence from Japan suggests this is wrong, with an alternative theory suggesting that while an ageing society will run down its savings, there is also a reduced demand for investments due to a lower rate of underlying economic growth. If that is the case, then over the long run the downward pressure on interest rates owing to demographic forces is unlikely to be reversed as countries age. (Arguments about cyclical inflationary influences on rates such as we are currently witnessing are a separate part of the debate)

Looking at individual asset classes, the broad consensus is that as societies age, equity exposure is reduced relative to fixed income. Therefore, we would expect younger investors with a longer investment horizon to continue to put savings to work in equity markets while older investors will be a source of supply. The ratio between the size of the two groups is seen as a good indicator for the long-term marginal demand for equities. As populations age, the ratio of young to old will drop, suggesting a potential similar fall in the price/earnings ratio, at least based upon past experience. However, as we have seen in recent years, when growth is scarce investors are prepared to pay a premium for what growth they can find, and so market-average valuation projections might be misleading when it comes to the relative performance of individual sectors and stocks.

A final key caveat worth highlighting is that equity investors are increasingly investing on a global rather than domestic basis. Therefore, global equity markets are potentially less sensitive to domestic demographic factors than they were in the past. On that basis it will be interesting to see whether investors in countries benefitting from better long-term demographics (such as, for example, India) direct their investment flows into their domestic equity market or whether a significant portion will be allocated to international equity markets.

# Economic Commentary

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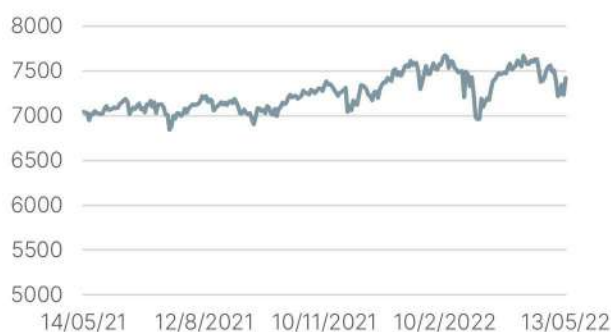
## FTSE 100 weekly winners

Coca-Cola HBC AG	14.1%
Compass Group PLC	9.6%
Next plc	8.9%
Kingfisher Plc	7.7%
Phoenix Group Holdings plc	6.9%
JD Sports Fashion Plc	6.4%
Ferguson Plc	5.8%

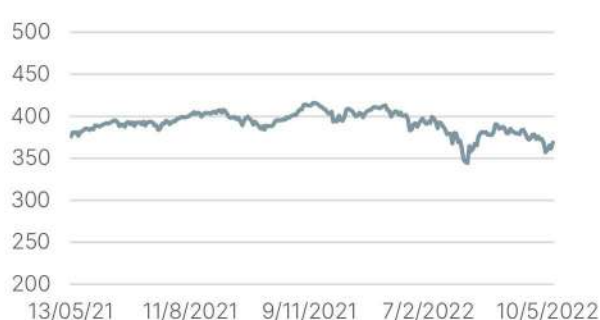
## FTSE 100 weekly losers

Antofagasta plc	-7.4%
Avast Plc	-6.6%
Fresnillo PLC	-6.5%
International Consolidated Airlines Group SA	-6.3%
Polymetal International Plc	-5.6%
Glencore plc	-5.4%
Anglo American plc	-5.3%

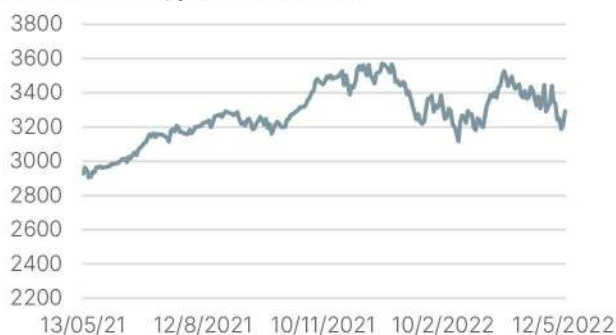
## FTSE 100 index, past 12 months



## EuroStoxx 600 index, past 12 months



## S&P 500 index, past 12 months



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