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WEEKLY REPORT

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Global Report

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Is demographics everything?

On 15th November, the United Nations reported that the world's population had reached 8 billion people. The news coincided with the 2022 UN Climate Change Conference, setting off alarm bells in environmentalist circles. Blame for global warming is levelled at insatiable consumer demand for more and more goods and services. Jacques Cousteau said, "Population growth is the primary source of environmental damage." Another naturalist, David Attenborough said, "We have a finite environment, the planet. Anyone who thinks that you can have infinite growth in a finite environment is either a madman or an economist."

Attenborough is correct to cite economists. As well as being an environmental problem demographics also pose a problem for long-term asset values and inflation. Finance professor Jeremy Siegel summarises the demographic challenge: "Two conflicting forces will impact the world economy over the coming decades. The first force, which gives rise to rising government budget deficits and strains private and public pension programmes, is the "age wave," or the unprecedented rise in the number of individuals in the developed world who will enter retirement. The age wave poses two fundamental questions. Who will produce the goods and services that the retirees will consume, and who will buy their assets that they plan on selling to finance their retirement?"

Population numbers have accelerated with technological innovation, reaching 1bn in 1804 and 4bn in 1974. It has only taken 11 years for the population to grow from 7bn to 8bn.The UN predicts the world's population will reach 9bn in 2037 but peak at 10.4bn in the 2080s. With the world's fertility rate steadily declining, now at just 2.3, population growth has become less about rising birth rates than about ageing. The fertility rate is well below 2 in most of the developed world, below 1.5 in many European countries and around 1.3 in Japan, South Korea, Taiwan, and China. Meanwhile, life expectancy is rising sharply due to accelerating medical advances. Between 1990 and 2019 global life expectancy increased by almost 9 years to 72.8 years. In developed economies, life expectancy is higher at 83 years compared with 65 years in low-income countries. Population ageing is the most significant demographic change of the century.

Population ageing has serious implications for the cost of production and inflation and for long-term financial market returns. Siegel wrote, "An increase in the number of retirees generates an excess of sellers over buyers, a situation that could depress asset prices substantially. Lower asset prices are the market's way of saying that the economy cannot accommodate retiree's expectations of early retirement and generous health and income benefits. As the value of their assets falls, baby boomers will have to work longer and retire later than they planned."

By 2060, the number of retirees for every 100 workers is expected to rise in the US to 56, to 75 in Europe and to 113 in Japan. Future demands from retirees will drive up inflation. There are solutions.

The key is for emerging markets, with their larger working age populations, to contribute increasingly to the global production engine. At the same time, savings and wealth accumulated from increased economic growth in emerging markets can fund the purchase of assets being sold by retirees in developed countries, enabling global financial markets to keep rising.

Another solution is for labour productivity, defined as the real economic output per labour hour, to grow fast enough to keep pace with the age wave. Productivity growth has been worryingly sluggish in developed economies over the past decade, unable to maintain its long-term average of around 2%. However, emerging market economies enjoy productivity growth of close to 5%, made possible by the rapid adoption of western technological innovations.

Emerging markets hold the key to stabilising inflation and maintaining long-term financial asset returns. Siegel references IMF and OECD forecasts on the distribution of world GDP that show the growing contribution from emerging markets. By the end of the century, contribution by the US to world GDP will have dropped to just 9% and Europe’s to 7%. Emerging economies will be contributing 77% of world GDP, with Africa equalling China’s contribution of 14%.

Risks to this outlook stem from increased geopolitical polarisation. The global exchange of goods and capital surged after Deng Xiaoping opened up China’s economy in 1980 and after the Berlin Wall came down in 1989. In the years that followed, China joined the World Trade Organisation in 2001 and Russia joined in 2011, promoting cross-border sharing of research and knowledge and increasing the ratio of trade to global GDP. Unfortunately, the era of globalisation and cooperation is making way for censorship, technology embargos and trade wars. As the threat of deglobalisation grows, geopolitics will be increasingly critical, not only to the long-term financial outlook but also to international cooperation on climate change.

Local Report

Gielie Fourie

Commodities super cycle

INTRODUCTION: In January 2022 Jeff Currie, the Global Head of Commodities Research at Goldman Sachs, was bullish on commodities. Since then, he became even more bullish. The Goldman Sachs Commodity Index (GSCI) reached a peak of 816 in June 2022. Then it took a breather. Currie expects stronger price increases over the next several months. Says Currie: “The commodities market is far more bullish than we could ever have envisioned. We have not hit maximum pain yet.”

THE COMPOUNDING EFFECT OF UNRELATED EVENTS: Currie says the compounding effect of unrelated events disrupts demand. When disrupted demand causes high increases in demand, the result is a commodity super-cycle. Something happening at the port of Los Angeles can disrupt demand and trigger a chain of events that end up propelling commodity and energy prices higher. Another example: The transition to cleaner energy resulted in years of underinvestment in fossil fuels. We are now suffering the consequences of that underinvesting. We do not have enough renewable energy to satisfy demand. In Europe nuclear energy has been aggressively phased down. Now increased demand for natural gas causes prices to soar. The ESG lobby does not favour natural gas, now they are talking of reclassifying nuclear as ESG friendly.

Consumer Price Inflation (CPI) also drives commodity prices higher. CPI in the US reached a high of 9.1% in June. In response the Federal Reserve has raised interest rates several times. The market was concerned about higher inflation and interest rates before the commodities bull run started in October 2022. Bloomberg reported European zinc smelters cutting production by as much as 50% because of higher energy costs. On the other side of the globe, major Chinese coal and iron mines were hit by floods causing deaths and major damage in September and October. The Chinese government ended its intervention in the coal market which is unusual. It liberated the entire market and drove commodity prices to new levels. Once again, we see unrelated events in different parts of the world, all happening at the same time.

Global consumption of oil is around 100 million barrels per day (bpd). Currie says at the end of September we were running at a deficit of 4.5 million bpd – nearly 5% of the market is in deficit. This is such a large hole (deficit) that nobody, not even OPEC or the US Administration, can fix it. The same is true for copper, where inventories are dropping 8% to 10% week after week. Currie continues: “It is like the train is off the track and you are watching it in slow motion. These are numbers I have never envisioned, or seen, before.” It is like a perfect storm with several unrelated Black Swan events occurring simultaneously when we least expect it.

Problems in one market often flow over to other markets and create problems there. Currie explains: “First it was coal in China (the flooding of mines), then it became gas in Europe. Then it became aluminum in China (aluminum smelters in China's Sichuan province have been forced to halt production due to the power crunch, pushing prices to a 13-year high), which then impacted copper elsewhere in the world. It keeps this chain of events going and each one of their markets get tighter and tighter. Aluminum is a unique commodity – you need it to solve climate change.

You now have oil being used in lieu of both coal and gas because of shortages in coal and gas. The bottom line is, we see a lot of upside risk from present price levels, which is far greater than the price levels we were forecasting nine months ago. The underlying picture is far more bullish than we expected in January 2022. The drivers (of the price increases) are pretty much exactly what we thought, just in a significantly larger degrees than what we could ever have envisioned.”

THE REVENGE OF THE OLD ECONOMY: Currie explains: “The “revenge of the old economy” is a term used for poor returns in the old economy that saw capital redirected towards the new economy. Basically capital was taken from the Exxons of the world and given to the Netflixes of the world. As a result, you starved the old economy of the capital base it needed to grow production and hence (we created) the problems we have today. So whether it is trucking in the US or chipmanufacturers for vehicles, energy and gas in Europe, or coal in China, which are all old economy, they are all the same story. These (old economy) companies have failed to deliver good returns over the last five to ten years. A lot of wealth was destroyed and investors have had enough. We got investors back in the old economy space, but this time they were hammered by volatility (in oil prices). They left. There is something inhererent about the investments in (oil) that makes it difficult to attract capital.”

BOTTOM LINE: Currie thinks we are in the early stages of a commodity supercycle, rather than a commodity bull market. Every supercycle is caused “by something hitting all commodity markets simultaneously, as well as by a bout of inflation.” Currie’s view for the next nine months is that we will experience scarcity (of supply) across oil and metals. When the system is so strained, like it is right now, it just takes a small little problem to create a big upward movement in prices. For example, when the wind stopped blowing in Europe earlier this year, the market had to replace wind power generation with natural gas. There was no gas at the time, and a small Black Swan event like the wind quitting blowing unexpectly, created a massive spike in oil prices. Currie expects the real upside risk to occur in the first quarter of 2023. Currie's final thought: "Maximum pain is coming in the next three months, if not sooner."

Source: Bloomberg

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