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# Demographic Dispatch: Get Ready for the Big Mortgage Paydown

One of the biggest fears in financial markets is about the dreaded "reversion to the mean." What happens if P/E ratios go back to their average level of the last 40 years? What happens if interest rates go back to their average level of the last 40 years?

These are two reasonable and closely related questions with very unpleasant answers. If interest rates were to suddenly skyrocket, and if stock valuations were to suddenly revert to historical averages, the potential loss of wealth would make the recent cyclical bear market seem modest in comparison.

We have always been skeptical of simple "reversion to the mean" predictions because it is not clear to us that the past is always the best guide to the future. For example, if interest rates were extremely high in recent decades because inflation was quite high, why would we expect interest rates to "revert to the mean" unless we could think of good reasons for inflation to take off again?

If investing requires us to think about the future, we would rather focus on data that give us clear insight into the future – and that is one reason we have always kept our eye on demographic data. In *Boomernomics*, we suggested that the surprise of this decade could be how low interest rates end up falling as a result of powerful demographic forces coinciding with prospects for low inflation resulting from intense global competition and the productivity-enhancing impact of the technology revolution.

In view of fears that the cyclical bear market could turn out to be the beginning of a nasty secular bear market, we thought it would be useful to update some of the demographic analysis that helps guide our investment policy. The good news from this demographic dispatch is that there is no reason to expect interest rates to move back to levels seen in the 1970s or 1980s any time soon. If anything, we still believe the surprise could be how low interest rates will go this decade based on demographic dynamics of the U.S., Canada and other rich industrial nations.

**Demography is Still Destiny**

The key demographic force in most wealthy industrial nations is still the aging of the baby boom generation. The boomers, who were born between 1946 and 1964, are huge in number relative to the preceding generation and the following "baby bust" generation. That means that the age wave has always had big economic effects whenever the baby boomers move into a different stage of life – raising the demand for whatever they need and lowering the demand for whatever they no longer need.

Our idea has always been fairly simple: If you can anticipate what the baby boomers will need in the future, or no longer need, then you should be able to anticipate some major economic trends.

If our take on the demographic data is correct, there is one fairly important financial product that the baby boomers won't be needing too much

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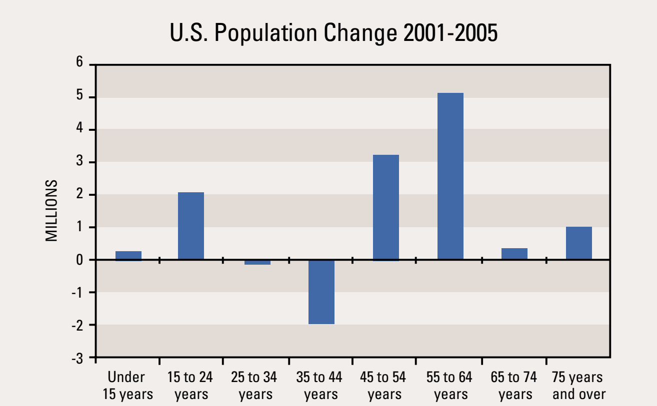
more of in the next five to 10 years – mortgages. And since mortgage debt is the 800-pound gorilla of our financial system, reduced demand for mortgage debt would tend to keep overall credit demand and interest rate pressures fairly subdued as well.

The demographic support for this argument is straightforward. As shown in Chart 1, aging baby boomers will account for the bulk of population growth by age group in the United States over the 2001 to 2005 time period. Reflecting the reproductive rhythms of more than half a century ago, the greatest growth will be in the 55-to-64-year age group, which will swell by more than five million over the five years to 2005. Next in line will be the 45-to-54-year age group, which will swell by roughly 3.25 million.

In contrast, there will be outright declines in the size of the 35-to-44 and 25-to-34-year age groups, reflecting the "baby bust" phenomenon associated with the introduction of the birth control pill in the mid-1960s. The 35-to-44-year group – the prime home-buying, debt-embracing folks – will decline by nearly two million in five years.

**THE PIG IN THE PYTHON**




Source: U.S. Census Bureau

*Chart 1. Population growth by age group over the 2001-2005 period will be dominated by aging baby boomers in their mid-40s to mid-60s. The next most important growth segment will be echo boomers in their mid-teens to mid-20s.*

What about the "echo boomers," the children of the baby boomers who are just now beginning to grow up and enter the housing market? That group will eventually become very important to the overall housing and credit markets. However, as can be seen in Chart 1, this generation's growth over the 2001-2005 period will be concentrated primarily in the 15-to-24-year age group, which is characterized by low incomes and low rates of home ownership.

Now consider some data on how economic and family circumstances differ rather markedly depending on the age group. As shown in Table A, the groups that are growing most rapidly – those between 45 and 64 years – are characterized by higher-than-average incomes and declining family sizes. For example, the average annual income of those in their mid-40s to mid-60s is around $55,000, compared to a national average of $37,000. The "empty nest" trend is also evident for older families since the average number of children under the age of 18 in the household is only 0.2 for the 55-to-64-year group, compared with 1.3 for households in the 35-to-44-year group.

So for the U.S. the picture is quite clear – the bulk of population growth by age group over the next five years will be concentrated among middle-aged to advanced middle-aged baby boomers who currently have relatively high incomes. These people still have anywhere from five to 20 years of work ahead of them, but they are at a stage of life when they need to be preparing actively for retirement and when the children are helping out by growing up and leaving home. This basic trend is nearly identical for Canada and quite similar in other rich industrial nations as well.

### A Muted Mortgage Market?

Against this demographic backdrop, it would not be surprising to see a relatively muted demand for mortgages over the next five years or so as baby boomer couples decide to prepare for retirement

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by increasing their savings and paying off debt. According to the U.S. Bureau of Labor Statistics, the number of families without any mortgage obligation increases significantly as the head of household advances in age.

For example, while 80% of families in the mid-50s to mid-60s group own their own home, fully half of those families are able to own a home without having a mortgage. In contrast, only about 20% of families in the mid-30s to mid-40s group are able to own their own home without having a mortgage. So if past patterns are any guide to future behaviour, as more people enter their immediate pre-retirement years they are likely to curtail their demand for mortgages as they focus on preparing financially for retirement. The fact that they are also being freed from significant financial responsibilities as their children grow up may also contribute to their ability to be relatively debt-free as retirement approaches.

But wait a minute – won't those grown-up children jump-start the demand for mortgages as they enter the housing market themselves? Eventually, the echo boomers should become a major factor in the housing market. But for the next five years or so, we think the mortgage paydown by their parents is likely by far to be the most dominant factor. In the first place, the growth in the group of people in their mid-40s to mid-60s of more than eight million swamps the growth in the 15-to-24-year group of only about two million.

Also, as seen in the table, households headed by young people under the age of 25 overwhelmingly tend to rent rather than own their homes. And not only do fully 87% of the youngest households rent their homes rather than own them, but they also have annual incomes that are on average only about one third of the incomes of those in their mid-40s to mid-50s ($18,000 versus $55,000).

**U.S. DEMOGRAPHIC SNAPSHOT:**
**CONSUMER SPENDING PATTERNS BY AGE OF HEAD OF HOUSEHOLD, 1999**

| ITEM | All consumer units | Under 25 years | 25-34 years | 35-44 years | 45-54 years | 55-64 years | 65-74 years | 75 years and over |
|---|---|---|---|---|---|---|---|---|
| *Income before taxes* | $43,951 | $18,276 | $42,470 | $53,579 | $59,822 | $49,436 | $28,928 | $23,937 |
| *Average number per household:* | | | | | | | | |
| Persons | 2.5 | 1.8 | 2.9 | 3.2 | 2.7 | 2.2 | 1.9 | 1.5 |
| Children under 18 | 0.7 | 0.4 | 1.1 | 1.3 | 0.6 | 0.2 | 0.1 | 0.0 |
| Earners | 1.3 | 1.3 | 1.5 | 1.7 | 1.8 | 1.3 | 0.6 | 0.2 |
| Vehicles | 1.9 | 1.1 | 1.7 | 2.1 | 2.5 | 2.2 | 1.8 | 1.2 |
| *Percent distribution:* | | | | | | | | |
| Male | 55 | 46 | 56 | 58 | 59 | 58 | 54 | 43 |
| Female | 45 | 54 | 44 | 42 | 41 | 42 | 46 | 57 |
| Homeowner | 65 | 13 | 45 | 67 | 77 | 80 | 82 | 77 |
| With mortgage | 38 | 7 | 37 | 54 | 54 | 40 | 22 | 9 |
| Without mortgage | 27 | 6 | 8 | 13 | 22 | 40 | 60 | 68 |
| Renter | 35 | 87 | 55 | 33 | 23 | 20 | 18 | 23 |
| At least one vehicle owned or leased | 87 | 70 | 87 | 91 | 92 | 90 | 87 | 76 |
| *Average annual expenditures* | $37,027 | $21,725 | $36,181 | $42,836 | $46,538 | $39,427 | $29,911 | $22,900 |
| *Average annual savings* | $6,924 | -$3,449 | $6,289 | $10,743 | $13,284 | $10,009 | -$983 | $1,037 |

Source: U.S. Bureau of Labor Statistics, Consumer Expenditure Survey, 1999

*Table A. Consumer surveys show that people in the mid-40s to mid-60s have higher than average incomes and rates of home ownership. But those in their mid-50s and up have significantly less need for mortgage debt than other home-owning age groups.*

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There may well be a boom in the demand for low-rent apartments in the next few years as the echo boomers move away from home. But the demand for mortgages is likely to be highly restrained since the average mortgage debt service of the under-25 group is only about $304 per year, or less than one-tenth of the $3,984 per year in mortgage service paid by debt-embracing families in their mid-30s to mid-40s.

How will mortgage lenders cope with a likely drop in demand for their product based on unfavourable demographics? One trend that we have seen in recent years is that some lenders have become extremely aggressive in terms of taking on risk by catering to less credit-worthy customers or offering very lenient financing terms such as nothing-down loans. Other lenders may target niche markets with better growth prospects such as loans on vacation properties. Still others may diversify overseas by targeting customers in emerging markets where demographic trends are more favourable to lenders.

That said, such strategies are unlikely to reverse the expected demographically driven slowdown in mortgage-related credit demand over the next five years or so. Making riskier loans can easily come back to haunt lenders, and other markets, such as mortgages on second homes, are unlikely to make up the difference in lost demand for first home mortgages. In the U.S., only about one in seven households ever purchases a second home.

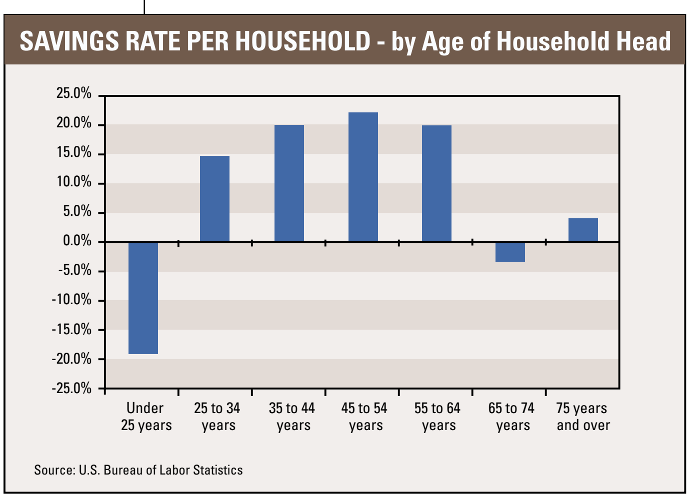


*Chart 2. Middle-aged and pre-retirement households tend to have the highest savings rates out of current income.*

If we are correct, the big impact of reduced demand for mortgage debt in coming years will come in the form of lower long-term real interest rates in the rich industrial nations. We suspect that this could be part of a larger demographically driven trend toward higher savings rates as baby boomers are forced to prepare seriously for their looming retirement. As shown in Chart 2, consumer surveys show a distinct increase in savings rates among middle-age and pre-retirement cohorts.

If we are also correct to expect that inflation will remain low based on sensible central banking, intense global competition and ongoing technological progress, then there is no reason to believe that interest rates or stock valuations such as P/E ratios will "revert to the mean" any time soon. If anything, we still believe that interest rates could fall to surprisingly low levels during this decade, which implies the continuation of fairly rich valuation levels in equity markets.

It may be that we are missing something since financial markets can be endlessly complex. On balance, however, when it comes to the "reversion to the mean" debate, we are still inclined to go with the opinion of a great American philosopher. "The future," according to Yogi Berra, "ain't what it used to be."

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