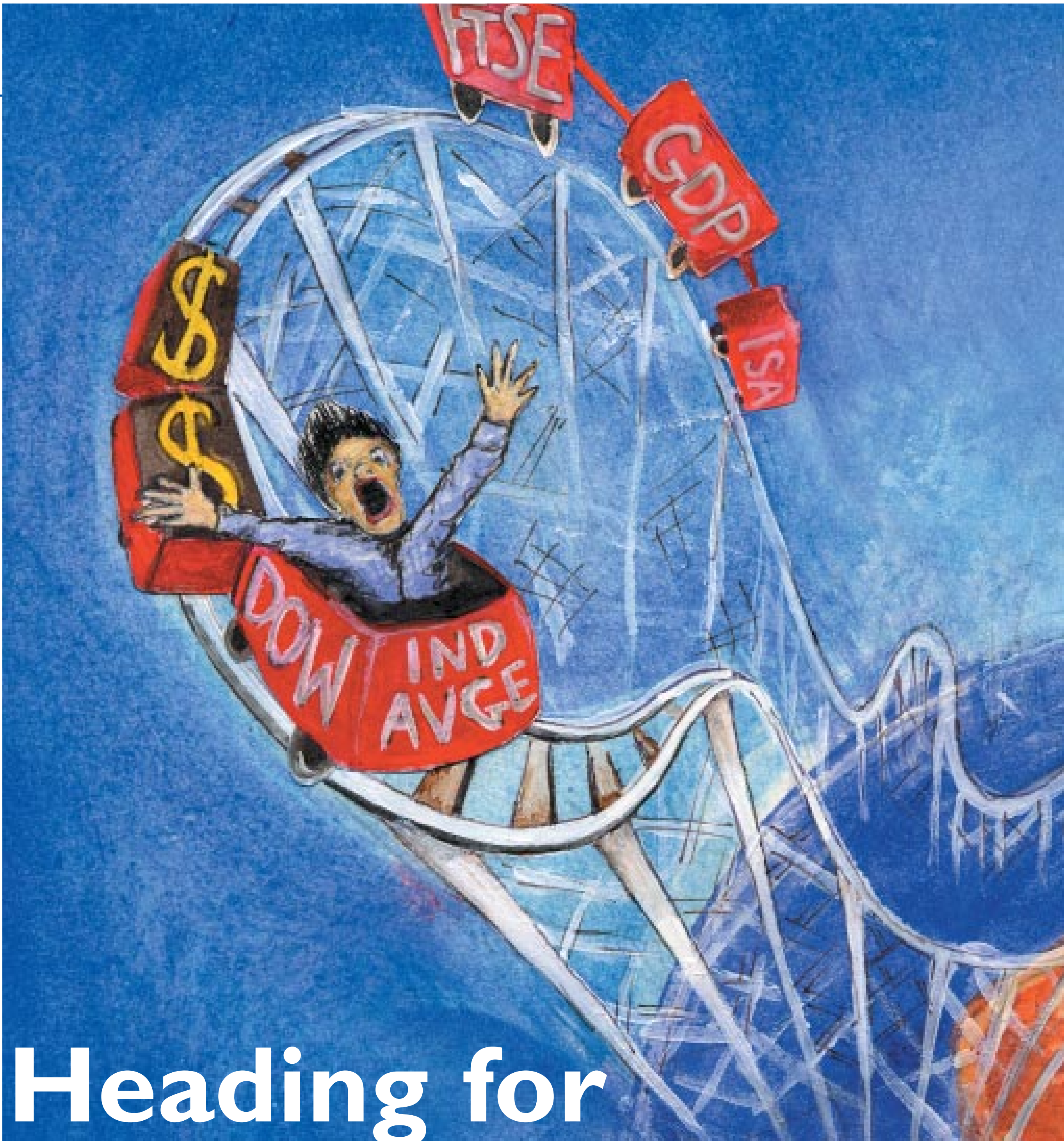


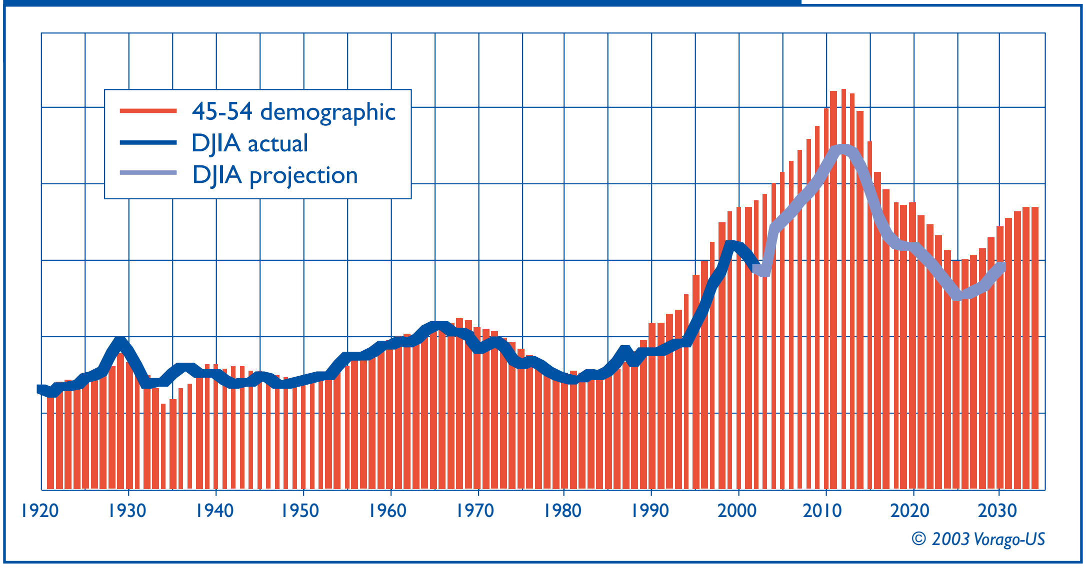
Illustration by Catriona Dickson

Heading for meltdown

Daniel Arnold explains why we should all be bracing ourselves for the biggest depression in history

What really controls the economy? Forget interest rates, deficits and taxes; forget Iraq and forget whichever party is in office. In fact, forget just about everything. The greatest force that has controlled the long-term trend of the economy for at least the last century doesn't give a fig about any of these sideshows. And just what is this "greatest force" now telling us in 2004? The same thing that it has been telling us for at least the last 20 years - that the onset of a catastrophic depression, unprecedented in history, has been marching silently and steadily towards us, and it is now just a few years away.

Chart 1: Inflation adjusted DJIA versus 45-54 demographic



It has long been suggested (and feared) that the 77 million or so baby boomers in the US will tank the economy big-time as they begin to pull their savings out of Wall Street when they start retiring around 2011. Well, 77 million is completely wrong. There are over 100 million American baby boomers, which means that whatever problems they might create just got 30% worse. Second, the hard evidence of nearly a century shows that people retiring has never been a force in the overall trend of the economy. Let's get back to basics to see why.

About 60%-70% of GDP is simply consumers spending their hard-earned income, and they do spend just about all of it. What many people don't know, or at least don't think about, is that it's more like 90%-plus when national and local government expenditures, first taken in from consumers as taxes of all kinds, are included. The bottom line is that the consumer is overwhelmingly the "greatest force" in the economy. This is a simple, hard economic fact.

It is therefore only common sense that the long-term trend of the economy must be controlled somehow by this absolutely massive consumer-spending component. In the short term (one to three years) many factors, such as war, terrorism and corporate scandal can seriously affect the economy, but they are always sideshows to the much bigger "hidden" picture.

The ability to spend

To understand what is happening in this hidden picture we must look at who we (the consumers) are, regarding our ability to spend. Obviously, a thousand middle-aged men or women earning and spending $40,000 a year are going to have a vastly different effect on the economy (GDP) than a thousand 15-year-old teenagers spending an allowance of $1,000 a year. According to data published by the US Bureau of Labor Statistics the group with the biggest spending power by far is the 45 to 54-year-olds. This makes total sense. They are at their peak earnings, with huge matching expenditures to support teenage/college kids, their biggest mortgage, their best car etc.

If the number of 45 to 54-year-olds in the US population is plotted against the Dow Jones Industrial Average (DJIA), adjusted for inflation using the Consumer Price Index (CPI) issued by the US government, a breathtaking, glove-fit correlation covering the best part of a century is revealed (*see Chart 1*).

Chart 1 is not just approximately right. In detail, it is correct right down to the beginning and end dates of every major economic event of the 20th century, and everything in between. The roaring twenties; the 1929-32 crash; the second world war impact 1939-1945; the Vietnam war impact 1966-75; the rolling recessions of the 1970s; the massive boom of the 1990s; and the current flat economy from 2000 to 2003.

What Chart 1 is telling us is quite mind-boggling. It is telling us that the massive spending power of the 45 to 54-year-olds in the population is so powerful it controls the long-term trend of the economy at all times. Even major wars are only able to sideswipe the trend modestly and temporarily. The "greatest force" in the economy is indisputably

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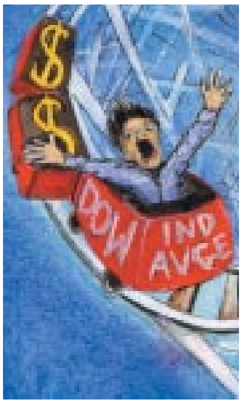


The massive spending power of the 45 to 54-year-olds in the population is so powerful it controls the long-term trend of the economy at all times

consumer demographics, and within that the demographic of 45 to 54-year-olds is just as clearly all-powerful. Such things as interest rates, deficits, who is elected, and inflation are "followers or consequences" of the economy - not the makers of it. The Federal Reserve and the Bank of England raise or lower rates because the economy tells them to. Stock market crashes don't cause recessions or depressions. It is the other way around. With similar demographics, the DJIA and FTSE are simply following the 45 to 54-year-olds demographic down and reflecting the new lower value of stocks. For easy to understand, fundamental reasons the economy has followed the 45 to 54-year-olds demographic for nearly a century. Chart 1 tells us unequivocally that it's simply a fact of economic life.

Demographic ramp-up

I said earlier that there are more than 100 million US baby boomers, not the much lower number of about 77 million you hear quoted. They are the huge demographic ramp-up shown in Chart 1 beginning about 1986 and continuing to 2012. When backed off to their birth years we get 1936 to 1962. If you add up these births (and include immigrant-derived boomers), it is over 100 million. To put this in perspective, this approaches in size the entire population of Japan. It is unprecedented in history (and downright scary).

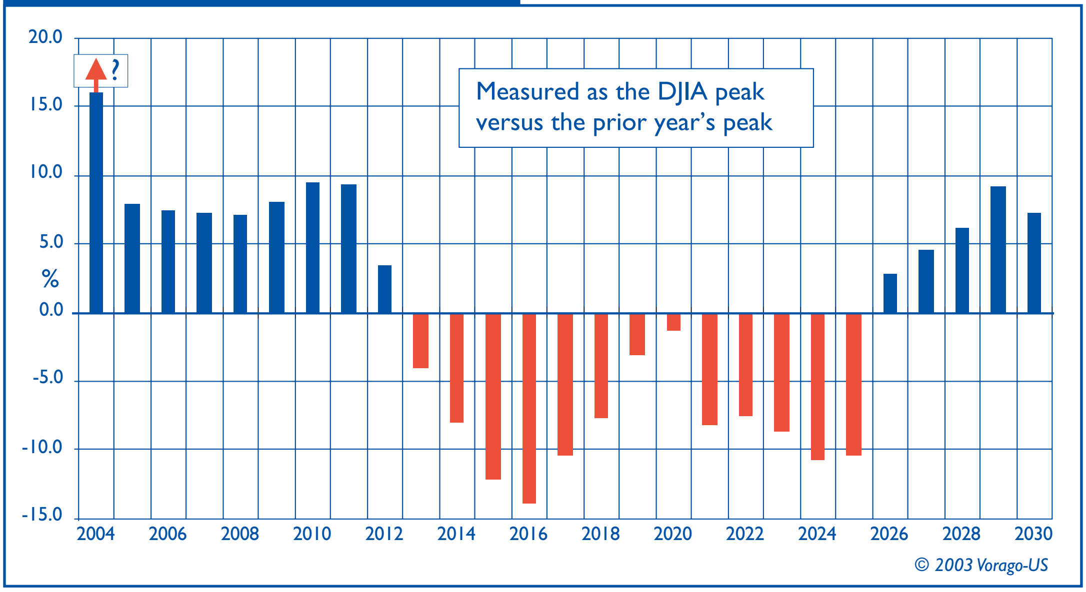
Traditionally, baby boomers are identified as those born between 1946 and 1962-64. Economically this is incorrect. It is pure coincidence that the arbitrarily defined baby-boomer group just happens to start to retire in 2011, which is close to when the number of 45 to 54-year-olds goes off a cliff. Chart 1 shows that the economy always declines when the number of big-spending 45 to 54-year-olds in the population declines, a full 11 to 20 years *before* they retire. As can be seen in Chart 1, this happened rapidly in the early 1930s, slowly (thank goodness) in the 1970s, and will happen again from 2013 to 2025, rapidly, relentlessly and catastrophically.

Picture this: the great American economy is an ocean whose total depth is made up overwhelmingly of the combined spending of all the various age groups. The heaving waves on the surface of this deep ocean are always the big spending of the 45 to 54-year-olds group. These waves produce the peaks and troughs of the economy - the long-term booms and busts. They can and have both raised and sunk ships. We will soon have to man the lifeboats as the greatest wave in history crashes down with a thunderous roar. Like the great Titanic, there will not be enough time or enough lifeboats onboard, and only very limited rescue available.

Chart 1 begs four questions:

1. Why did the DJIA bottom in 1932 instead of following the demographic down to 1934? The answer is simple. In 1932 the US government under Roosevelt created the New Deal. Massive public works programmes were begun - roads, the Tennessee Valley Authority (TVA), the Golden Gate and Bay Bridges and the Hoover Dam. It boosted the economy somewhat in the primarily manual labour environment of the day. In time of course, the DJIA was forced back to the demographic line just as the second world war began. Again, Chart 1 is spot-on.
2. Why doesn't the impact of the 1950-53 Korean war show? The answer is visible in Chart 1. The Korean war occurred in a period of economic (demographic) growth, while the second world and Vietnam wars were in periods of significant economic (demographic) decline. The booming 1950s consumer economy simply absorbed it.
3. Why didn't the DJIA tightly follow the demographic from 1990 onwards like it did from 1920 to 1990? The answer is NASDAQ. In the 1990s the NASDAQ exploded, sucking money away from the traditional large cap stocks of the DJIA, and into (typically) technology stocks. In exactly the same way that money going into stocks draws money away from bonds and depresses bond prices, this depressed the stocks of the DJIA. The DJIA stocks, although also surging, were actually being held back by NASDAQ, as shown in Chart 1. While the NASDAQ was unquestionably full of "irrational exuberance", Chart 1 shows that the DJIA was not.
4. What happened in 1987? As can be seen, the DJIA was simply getting a little ahead of itself. It had no choice but to snap back to the demographic. 1987 was simply an unavoidable correction, not a crash. At times it may feel like the DJIA is leading, but it is only doing so like a dog straining on its leash and being jerked back into line. It never controls where the walk is really going.

Chart 2: Projected % DJIA annual return



The future - 2004 to 2025

The US has just a few more years left of solid economic growth with an accompanying rise in the DJIA. After that, starting no later than 2012-13, an economic decline of terrible proportions begins and lasts until about 2025. Unlike their parents, baby boomers everywhere are truly not going to have a pleasant retirement. In Chart 1, compare the drop in the demographic curve in the 1930-35 period of the Great Depression to the monstrous drop coming in 2013-2025. I will quantify its impact shortly. Fasten your seat belt.

2004 to 2012

Starting no later than 2003-2004, the economy will resume its march upwards accompanied by the matching rise in the DJIA. The peak it rises to will be easily quantified shortly. Chart 1 shows that the next several years represents the last chance for a very long time to make any money by traditionally investing in stocks. There is a big caveat though. The returns are not going to be anything like the 1990s. Why would this be? The slope of the demographic curve looks almost as steep as the 1990s. It is, but let me explain it this way.

Imagine the demographic curve from 1992 to 2012 is a 20-foot ladder and you are now standing about half way up at the year 2002. When you were standing on the first rung in 1992 you were one foot above the ground. You are now 10 feet off the ground (2002). Your height increased a whopping 900%. When you go from the tenth rung that you are on (2002) to the top 20-foot rung (2012), you will only increase your height from 10 to 20 feet, a mere 100%. In other words the big returns were on the early rungs of the ladder in the 1990s. The second half of the rungs is going to give modest returns even though the slope is similar.

What will those returns be? The first step is to project where the DJIA is going. Take a look at Chart 1. The yellow line is a conservative projected path for the DJIA through 2030. It is high school arithmetic to convert any projected DJIA path in Chart 1 to actual DJIA numbers. The projected DJIA path peaks at about 26,000. A path chosen to follow the demographic tightly would peak at about 32,000. Regardless of the path used, the percentage magnitude of the subsequent decline from 2013 to 2025 hardly changes. Arithmetically, inflation does affect the peak and valley DJIA numbers, but does not change the magnitude of what is coming in any significant way. Again, simple arithmetic enables the DJIA peak to be forecast for each future year. This in turn enables the annual returns to be easily determined on a peak versus peak basis.

Chart 2 shows that historically normal 7-8% average returns will occur through 2012. As Chart 1 shows, the one piece of bright news is that the DJIA has been driven too low in the current decline due to the NASDAQ bubble bursting, terrorism and corporate scandals. The DJIA snap-back to the demographic line that must happen, probably by the end of 2004, will be to at least 13,000, and the FTSE in the UK to at least 6,000. It is a one time "big" opportunity. Whenever this occurs, the return for that year(s) will be inflated substantially beyond the 7-8% average.

Money is just a commodity and, as demand for it falls, its price (interest rate) drops, just like prices for TVs, cars or hotel rooms

2013 to 2025

The show is well and truly over. No amount of stimulation or any form of economic mouth-to-mouth will make any difference. As Chart 1 shows, from 2013 to 2025 the big-spending 45 to 54-year-olds that dominate the economy are only there in relentlessly declining numbers. It is almost sad to think that the baby boomers' retirement years were economically set in concrete half a century ago.

Just how big is this catastrophic depression going to be financially? In the US stock market crash from 1929 to 1932, the value of stocks dropped approximately $90 billion. When expressed in year 2000 dollars and adjusted to match the size of the population now versus then (284 million v 123 million), this is a drop of about $2.6 trillion. It directly affected the less than 5% of the US population who owned stocks at the time. The population at large was affected by job loss and the ensuing poverty. When the 2013 to 2025 decline of the DJIA, shown in Chart 1, is converted with simple arithmetic to the loss in the value of all stocks in the same, year-2000 dollars, it is a staggering $18 trillion. This is seven times as bad as 1929 to 1932. The actual loss at the time will be more like $24 trillion.

This is all bad enough, but now there is a terrible difference. This time the loss directly affects the more than 50% of the US that now own stocks either directly, or in mutual funds, pension plans, IRA or 401K type plans (ISAs and TESSAs etc. in the UK). It will be a financial holocaust. This will be just the beginning. In the depths of the depression of the 1930s, US and UK unemployment reached 25%. With a depression that is financially about seven times as deep as the 1930s, what will unemployment reach this time? As in the 1930s, home values will also plummet, destroying much of the homeowners' equity, or all of it for those who buy homes in the years leading up to 2012-13.

This is the calm before the storm. Between now and 2012 full advantage must be taken of the last few years of the 45 to 54-year-olds baby boomer-driven growth economy. Stocks are the place to be, but you must not get too close to the edge. There may be some substantial market ups and downs along the way to 2012. The temporary effects of a 9/11, war, corporate scandals and other unforeseen events cannot be removed. Remember, all the facts presented are long-term trend related. In any one to three years' short-term part of the next 10 years, serious disruptions could happen. Such disruptions may cause the depression to begin as early as 2009-10.

In times of economic depression interest rates always inevitably fall. Few want to risk borrowing money to buy houses, build businesses or invest in whatever. Money is just a commodity and, as demand for it falls, its price (interest rate) drops, just like prices for TVs, cars or hotel rooms. So, the place to be is bonds. Why bonds? As interest rates fall, the value of an existing bond goes up because the higher interest rate it is paying to its owner makes it more valuable in the eyes of others. Intermediate and long-term bonds will increase in value the most. You must obviously get into bonds before interest rates drop - ie, before the crash. There is a huge risk, perhaps even a certainty, that corporate and individual state issued bonds will default in this depression. Only go for the best quality. This means federal government bonds. Much more sophisticated survival strategies are, of course, possible.

Plan for the inevitable

This depression will happen. Our immutable demographics make it absolutely inevitable. It's nobody's fault. It cannot be fixed or wished away. The federal and state governments cannot prevent it. It's just as unstoppable as a tidal wave. We have to accept the reality that it is coming, and plan for it as best we can. Use the knowledge that is provided to you in this article and the book *The Great Bust Ahead*, which also reviews the social impact, to plan for this catastrophic depression. Imagine it is 1922 and you know with certainty that the crash of 1929-32 and the depression of the 1930s are coming.

What will you do? The precious few years that are left before this coming 2013-2025 depression, which will dwarf the 1930s, must be used to their fullest starting immediately. It still won't be enough time for many, but at least forewarned is forearmed. ■

After a 17-year management and consulting career with The General Electric Company in the US, Dan Arnold ran a successful manufacturing company in Santa Clara County (Silicon Valley) California for 10 years. After being bought out by a larger company he focused on investment and understanding the economy's long-term trends. His book, The Great Bust Ahead (www.thegreatbustahead.com), ISBN 159196153X is available only through amazon.com with worldwide shipping.
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