MORNING BRIEFING
June 13, 2012

Demography Is Destiny
(1) Volatility is back. (2) Spain gets cut-rate loan as its yield soars to record high. (3) Sentiment is still quite bearish. (4) Merkel seeking to avoid bigger "disasters." (5) FSMI is down, but it should be up soon. (6) "Live long and prosper" doesn't work without more kids. (7) Socialism breeds infertility. (8) A labor shortage in China. (9) Europe may be demographically doomed. (10) From Baby Boom to Senior Boom in America. (11) The Theft of Generations.

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Strategy. Nice rally yesterday. The S&P 500 rose 15 points following Monday's drop of 17 points. It was obvious why stock prices fell on Monday. They were following the lead of Spanish bond prices. The 100 billion euro "line of credit" that Spanish Prime Minister Mariano Rajoy victoriously extorted from the EU over the weekend at below-market interest rates caused the market yield on 10-year Spanish government bonds to soar. That's because the loan increases Spain's sovereign debt by 10% and is senior to the outstanding debt of the government. The yield soared again yesterday to a new euro-era high of 6.86% (*Fig. 1*). It is at 6.61% this morning.

So why did stocks rally yesterday? For now, let's chalk it up to volatility. Also, there's already lots of bad news discounted in the market. Sentiment is very bearish, which is bullish. Investors Intelligence Bull-Bear Ratio edged up to 1.40 this week from 1.28 last week, which was the lowest in seven months (*Fig. 2*). The S&P 500 seems to have found support right at its 200-day moving average. While the technical picture may be bullish, the fundamentals remain challenging:

(1) *The Euro Mess is actually getting messier.* Yesterday, German Chancellor Angela Merkel said, "Germany--and I can say this for the whole country--is prepared to do more on integration but we cannot get involved in things which I am convinced will lead to an even bigger disaster than the situation we are in today." That was her way of once again saying "*nein*" to any plan that would oblige Germany to cover the cost of recapitalizing Spanish banks and picking up the tab for French men and women who retire at 60. There will be no banking union and no Eurobonds before there is fiscal union, with adult supervision from Berlin..

Austrian Finance Minister Maria Fekter made a prediction she then retracted that Italy may need "help payments." Italian Prime Minister Mario Monti said her comments were "inappropriate." Spanish Prime Minister Rajoy says he is ready for "the battle we have to wage in Europe." Apparently, the enemies are any European central bankers who object to the ECB buying Spanish bonds.

(2) *Our Fundamental Stock Market Indicator is still down.* Debbie reports that it fell for the eighth time in nine weeks during the week of June 2 (*Fig. 3*). One of the components of the FSMI is the CRB raw Industrials spot price index, which has yet to rebound from its recent swoon (*Fig. 4*). Another component is initial unemployment claims, which have stalled around 380,000 in recent weeks after falling late last year and early this year (*Fig. 5*). (See our regularly updated *Stock Market Indicators*.★)

Debbie and I expect that China's recent fiscal and monetary stimulus programs will revive commodity demand and prices soon. We are also encouraged by the jump in the percentage of small businesses reporting that they have one or more job openings to 20%, the highest since June 2008 (*Fig. 6*). And what about the Euro Mess? Have some Sangria.

Demography. Demography is destiny. If so, then the future will be challenging in many countries around the world where fertility rates have dropped below the replacement rate (*Fig. 7*). At the same time, people are living longer (*Fig. 8*). So dependency ratios are destined to soar.

Why have fertility rates fallen around the world? There are a few plausible explanations. One of them stands out, in my opinion: Socialism may breed infertility! In the past, people relied on their children to support them in their old age. Your children were your old-age insurance policy. Over the past few decades, people have come to depend increasingly on social security provided by their governments. So they are having fewer kids.

That's fine as long as the ratio of retirees to workers isn't so high that the burden of supporting our senior citizens crushes any incentive to work resulting from excessively high tax rates. The cost of increasingly generous and excessive entitlements has been soaring relative to taxable earned incomes even before dependency ratios are set to rise in many countries. Governments have chosen to borrow to finance social security and other entitlements, to avoid burdening workers with the extremely high tax rates that are necessary to balance entitlement-bloated budgets.

Bond markets may be starting to shut down for countries that have accumulated too much debt. That's creating a Debt Trap for debt-challenged governments. If they slash their spending and raise their tax rates, economic growth will tend to slow. If tax revenues fall faster than spending, their budget deficits will widen. There has recently been an outcry about the hopelessness of such "austerian" policies that perversely lead to higher, rather than lower, debt-to-GDP ratios. Let's examine some of the relevant demographic developments around the world:

(1) *Median ages are highest in advanced economies with large social welfare states.* The UN compiles all sorts of demographic data. Among the most interesting are median ages for the countries of the world. I asked Sailesh Radha, our consultant, to collect the data. He did so for 45 countries for 2010 (*Fig. 9*). Japan has the highest median age (44.7), while the Philippines has the lowest (22.2). Advanced economies tend to have higher median ages than emerging ones because they provide more social welfare, which boosts longevity and depresses fertility.

(2) *China is aging quickly.* Among emerging economies, China has one of the highest median ages at 34.5, up from a low of 19.7 during 1970 (*Fig. 10*). The country's fertility rate plunged from a high of 5.9 births per woman during 1966 to a replacement rate of 2.1 during 1992. It has been below this rate ever since then, falling to a record low of 1.6 during 2009 (*Fig. 11*).

The UN's population projections show that the cohort of 15- to 24-year-olds rose from 98 million in 1950 to a peak of 249.8 million during 1990. It is projected to fall back down to 124.2 million by 2050 (*Fig. 12*). Of course, China's demographic profile is a consequence of the one-child policy imposed by the government during 1979. Now anecdotal evidence suggests that China's labor force growth is already slowing along with the supply of new entrants. This is why the country's growth rate is slowing.

(3) *Europe is old and infertile.* The median age in Germany was 44.3 in 2010. It was 43.2 in Italy, 40.1 in Spain, 39.9 in France, and 39.8 in the UK (*Fig. 13*). UN population projections show a plunge in the 15- to 24-year-old age group exceeding 20 million over the next two decades in Europe (*Fig. 14*). That's because fertility rates dropped below the replacement rate in most European countries during the late 1970s and early 1980s (*Fig. 15*, *Fig. 16*, *Fig. 17*, and *Fig. 18*).

(4) *Americans are still reproducing, and the Baby Boomers are living longer.* China's problem is that the one-child policy distorted the country's demographic balance, leading to too many old people relative to young ones to support them. The US has a similar problem. However, the fertility rate remains around the replacement rate in the US (*Fig. 19*).

The problem is the aging of the huge Baby Boom generation. They exceed 70 million people, and they are currently 48-64 years old. Life expectancy at birth rose to a record high of 78.5 years in 2009, up from 70.5 years in 1969 (*Fig. 20*). The median age is up from 28.2 during 1970 to a record 36.9 (*Fig. 21*). That's relatively young compared to other advanced countries around the world. However, the dependency ratio is already rising in the US (*Fig. 22*).

People around the world are awfully inconsiderate. They are lingering into their 80s and 90s. Some of them believe that they are entitled to retire in their late 50s and early 60s even though they are living longer. Yet, they didn't have enough children to support them either directly (out-of-pocket) or indirectly (through taxation). Instead, they expect that their governments will support them. So governments have had to borrow more to fund retirement benefits. That debt is mounting fast and will be a great burden for our children. The result can only be described as the Theft of Generations.

CALENDARS

US. **Wed:** MBA Purchase Applications, Headline & Core PPI -0.6%/0.2% m/m, Retail Sales Headline, Ex Autos, and Ex Autos & Gas -0.2%/-0.1%/0.4%, Business Inventories 0.3%. **Thurs:** Headline & Core CPI -0.2%/0.2% m/m, Jobless Claims 375k, Current Account Balance -$132.3b, Bloomberg Consumer Comfort Index. (Bloomberg estimates)
Global. **Wed:** German CPI & German CPI EU Harmonized 1.9%/2.1% y/y, Euro Zone Industrial Production -2.7% y/y. **Thurs:** Japan Industrial Production, Headline & Core EU CPI 2.4%/1.6% y/y, Swiss National Bank rate decision, ECB June Monthly Report, Bank of Canada Financial System Review. (DailyFX estimates)

STRATEGY INDICATORS

Fundamental Stock Market Indicator (*link*): The FSMI--a good coincident indicator that can confirm or raise doubts about stock market swings--fell for the eighth time in nine weeks, down 0.4% during the week of June 2 and 7.8% over the nine-week period. Our FSMI is the average of our Boom-Bust Barometer (BBB) and Bloomberg's Weekly Consumer Comfort Index (WCCI). The BBB lost 3.9% during the latest two weeks, more than reversing the 3.2% gain the previous three weeks. Jobless claims--a BBB component--increased to 377,500 (4-wa) from 370,750 two weeks ago, though weekly claims fell from 389,000 to 377,000. The CRB raw industrials spot price index, another component, is volatile around recent lows. The WCCI increased for the third straight week, heading back toward its cyclical high seven weeks ago.

S&P 500 Cyclical vs. Stable Sectors (*link*): How are the S&P 500's Cyclical and Stable sectors performing? Cyclical's market cap is up 4.1% ytd and is slightly ahead of the 3.8% rise for Stable sectors. However, Cyclical is down sharply from its peak gain of 16.2% ytd on March 26. The forward P/E for Cyclical fell to 11.3 in May from 12.2, but Stable's was steady at a four-year high of 13.8. The P/E for Cyclical sector is down from an 11-month high of 12.6 in March.

S&P 500 LargeCap vs. SMidCap (*link*): Which Russell and S&P market cap indexes are leading in 2012? All the indexes are up so far, but SmallCaps are trailing LargeCaps and MidCaps. Here's the ytd score: S&P 500 LargeCap (5.3%), S&P 400 MidCap (4.3), Russell LargeCap (4.1), Russell MidCap

(3.0), S&P 600 SmallCap (2.6), and Russell 2000 SmallCap (1.4). P/Es rose for all three indexes last week from a six-month low: LargeCap's advanced to 11.9 from 11.5, MidCap's to 13.6 from 13.1, and SmallCap's to 14.4 from 13.9. LargeCap and MidCap forward earnings are down from record highs last week for the first time in nine weeks and 12 weeks, respectively. SmallCap's rose, and now is less than 0.1% below its mid-May record high.

S&P 500 Growth vs. Value (*link*): Will Growth beat Value in 2012? Growth is clearly ahead so far with a gain of 6.2% versus a 4.2% rise for Value. Annual earnings is expected to rise 11.0% for Growth in 2012, ahead of the 6.9% expected for Value. Growth's forward earnings stood at a record high in May, but Value's at only a cyclical high (and 5.6% below its September 2007 record high). The forward P/E ratio for Growth fell to 13.2 in May from 13.9 in April, while Value's forward P/E fell to 10.7 from 11.4. Growth's PEG ratio slipped to 1.05 in May from 1.09, Value's to 1.15 from 1.23. For most of 1999-2006, the Growth PEG exceeded the Value PEG; since then, it's been the other way around.

Stock Market Sentiment Indicators (*link*): The Investors Intelligence Bull/Bear Ratio climbed to 1.40 this week after dropping to a seven-month low of 1.28 last week. Bullish sentiment increased to 37.2% from 34.0% (the lowest since September 2010). Bearish sentiment was unchanged at 26.6%. Those calling for a correction fell to 36.2% after advancing from 35.1% to 39.4% the prior two weeks. The AAII Bull Ratio declined for the second straight week to 37.5% during the week of June 6 from 44.1% two weeks ago. Bullish sentiment decreased from 30.5% to 27.5% over the two-week period; bearish sentiment increased from 38.7% to 45.8%. The S&P 500 Put-Call Ratio was little changed at 2.01 during the week of June 8, after increasing the prior three weeks from 1.67 to 2.02, based on four-week average.

S&P 500 Technical Indicators (*link*): The S&P 500's technical picture brightened over the past week. The price index rose back above its 200-dma, up from its first negative reading since December. At yesterday's close of 1324.18, it's 2.0% below its 50-dma (up from -6.4% on June 1) and 2.4% above its 200-dma (up from 0.9% below on June 4). The S&P 500 is down 6.7% from its five-year high on April 2, up from a low of down 9.9% last Thursday. Its 200-dma has been rising since Valentine's Day, but the 50-dma started falling on May 8 for the first time since November 30. Three sectors trade above their 50-dmas, and two have rising 50-dmas. Eight sectors trade above their 200-dmas; all 10 have rising 200-dmas.

US ECONOMIC INDICATORS

NFIB Small Business Survey (*link*): Business owners remain cautious, the result of what is--and isn't--happening in Washington. The Small Business Optimism Index (SBOI) ticked down to 94.4 from a cyclical high of 94.5 in April. The index remains historically low, consistent with sub-par GDP and employment growth. Individual indicators were mixed. Sales expectations posted the biggest decline, losing 4pps to a net 2%, capping a 10-point loss since February. The percent of owners reporting hard-to-fill job openings climbed another 3pps to 20% (highest since June 2008). Job creation plans remained anemic, with a net 6% of owners expecting to expand payrolls. Earnings trends held relatively stable (down 3pps to -15%), maintaining most of April's 11pps jump to its best reading since September 2006. Capital spending plans also held around recent highs.

US Federal Budget (*link*): The federal budget deficit should narrow this fiscal year, but remain above $1 trillion once again. The US ran a $124.6 billion deficit in May, steeper than the $57.6 billion shortfall last May (reflecting a shift in timing for some payments and credits related to TARP that artificially lowered May 2011 gap). Eight months into the current fiscal year, the cumulative deficit stands at $844.5 billion, $83 billion below the $927.5 billion gap over the comparable period a year ago. Fiscal ytd, total receipts were 5.4% higher (with individual income tax revenue up 4.2%, and corporate tax receipts up 39.2%); expenditures were little changed. The CBO projects a FY 2012 deficit of $1.17 trillion, slightly lower than FY 2011's $1.30 trillion.

GLOBAL ECONOMIC INDICATORS

Japan Key Machinery Orders (*link*): Japan's core machinery orders--a leading indicator of capital spending--rose a larger-than-expected 5.7% in April, the third gain in four months. These orders are up 9.1% y/y, driven by rebuilding from last year's earthquake. This data underscore the BOJ's assessment that solid domestic demand will keep Japan's economy afloat; however, the economy faces headwinds from a strong yen, slowing Chinese growth, and Europe's debt crisis.

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