The evolving financial landscape – Part 2

Key catalysts for the economy and markets

Overview

The objective of this report

Today, we are releasing Part 2 of a series of papers that delve into the themes that we think will have a pervasive influence on financial markets over the next several years. This report has 4 parts, with each instalment highlighting a different economic theme.

The 4 themes we have chosen are:

1. Geopolitics and a multipolar world – released in March 2025
2. Ageing populations and immigration
3. The energy transition
4. Technology and artificial intelligence.

The themes were chosen for their ubiquity and the potential magnitude of their impact. While these themes are presented as distinct ideas, there are common implications across them. Including:

- Increased global investment
- Higher levels of government debt in advanced economies
- More volatile inflation, and potentially a higher average inflation rate
- Higher government bond yields in advanced economies.

Our aim is to explore what could happen rather than assert what will happen, which is more in line with TCorp's mantra to "prepare not predict". By understanding the possible paths that lie ahead, we at TCorp can take a more informed approach in our decision making.

Demographics – Another day older and deeper in debt?

Demographics differ in different countries. Some countries in Africa and the Middle East have very young populations and are growing rapidly. But for most countries in Asia, Europe and the Americas, the key development is ageing populations, and the most affected countries will experience shrinking workforces. These developments will have important implications for global investors when thinking about which sectors and countries will deliver the best investment returns.

Even for Australia, where the working age population is expected to continue growing at a decent pace over the next couple of decades, an older population poses important challenges for policymakers. For example, Australia relies more on personal income tax for government revenue than most other OECD countries. An ageing population means that the ratio of working people to people not in the workforce will decline. And this means that without substantial tax reform, Australia would need to raise tax rates on income substantially or else cut spending on services such as health and aged care.

Of course, it's a good thing that more people are living longer, as it reflects tremendous advances in healthcare and living standards. But an older population can also create a range of challenges for economies, governments and society.

More generally:

- Government budget deficits could surge as spending on health and age care explodes. This could be reinforced as people move into retirement and the number of people paying income tax declines.
- Fewer workers could result in more skill shortages, pushing up wage growth and inflation.
- And as people move into retirement, they could go from adding to their savings to running down their savings.
- What would happen to equity markets if a large cohort of retirees shifted from net buyers of stocks to net sellers at the same time?
- Governments will find it more difficult to fund large deficits if households are also saving less, which means that interest rates could rise significantly, and that could lead to less business investment.

Obviously, these possibilities paint a bleak scenario for the economy if they all come to fruition. And it would be a very challenging environment for investors as well. But it is certainly not inevitable. Governments can take actions that will mitigate the adverse impact of ageing populations, such as delaying retirement ages. And some potential impacts that seem plausible – such as the risk that an older population will reduce saving – might not hold up to scrutiny. This means that predicting the economic and financial market impacts of ageing populations is not straightforward.

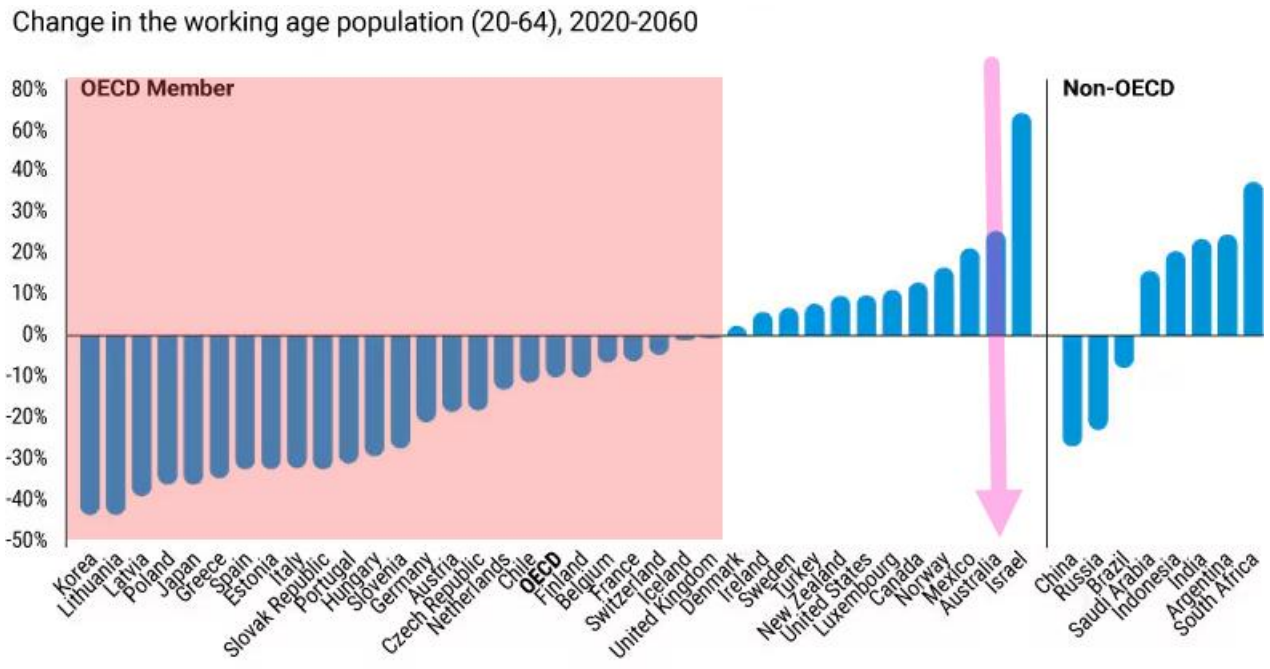
This piece aims to highlight what might happen and what factors will determine the outcomes. Again, rather than predicting what will happen (and when), we seek to understand what could happen and be prepared to quickly respond to developments as they occur.

Ageing populations and immigration

Populations are ageing in many economies and frequently are associated with declining working-age populations. This reflects a combination of falling birth rates and longer life expectancies, which are creating a unique set of economic, fiscal and social challenges. While the ageing of populations is well-known and anticipated, the impact on economies and financial markets is far from certain. This is because countries can enact policies that, at least partly, offset the impact of declining working-age populations. These include boosting immigration and taking measures to increase domestic labour market participation. Productivity improvements could also offset the adverse impact of a shrinking working-age population on a country's economic growth potential.

Although it is difficult to predict the net impact of demographic change, many countries are facing a stark challenge. As highlighted in Chart 1 below, many countries are projected to face a 10%-30% decline in their working age population out to 2060. While Australia's high immigration rate means its working-age population will continue to grow, it does have an ageing workforce. The average age of an Australian was 32 in 1981 and is expected to rise to 43 by 2060. And as we will see later, that may still have profound implications for the economy.

Chart 1: Working age population projections



Source: UN Population Prospects

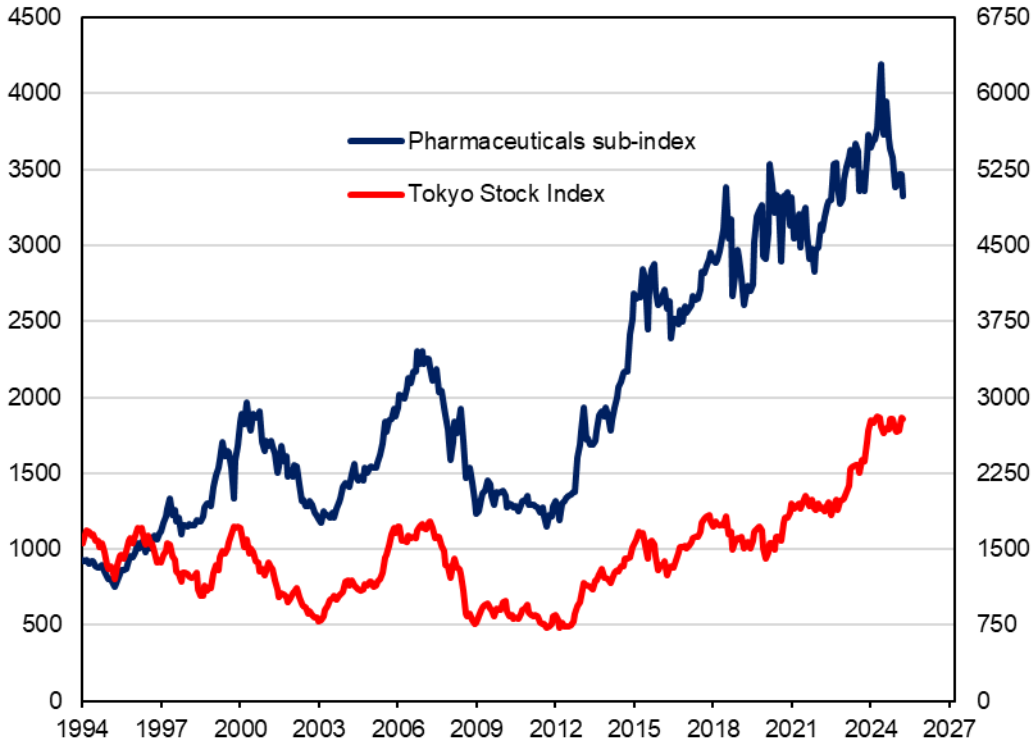
Consumer spending and investment

As spending patterns change throughout a person's life cycle, ageing populations will cause a shift in the demand for goods and services in the broader economy. For example, older individuals typically spend more on healthcare, pharmaceuticals and travel and reduce spending on durable goods like cars and household appliances. This has implications for business profitability in those sectors and the investment that would be undertaken, by both the private and public sectors. Conversely, some industries will face weaker demand as populations age. For example, older people typically spend less money on dining out, luxury goods and clothing, and technology.

Despite the changes in consumer spending behaviour being predictable as a population ages, financial markets tend to respond to these changes after they have occurred rather than anticipate them. For example, Japan's population started rapidly ageing in the mid-1990s (more quickly than in the preceding 2 decades) and this led to weak consumer spending and economic growth and a stagnant stock market. Indeed, the overall Japanese stock market was flat for 2 decades up to 2015.

Healthcare stocks, however, did benefit from Japan's ageing population as indicated in Chart 2. While the broader equity market index moved sideways over 20 years, those investors in Japanese health care stocks saw their investment rise by 250% over the same time. This suggests that the equity market was not forward-looking, as healthcare stocks did not outperform until after the population started rapidly ageing.

Chart 2: Japanese stock market title



Source: Bloomberg

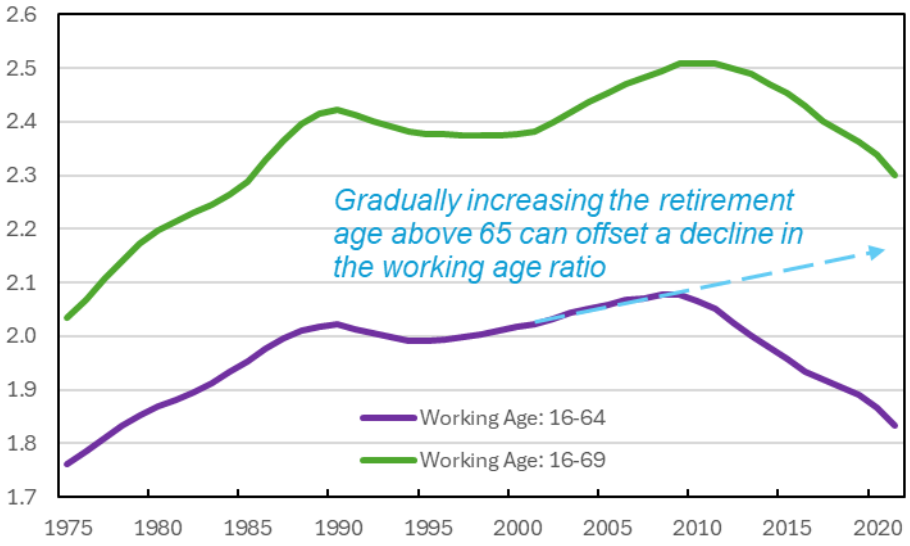
Government spending

Although governments could potentially offset the impact of ageing populations on the size of their workforce, an ageing population will inevitably add considerable pressure to government spending. Many economies are already facing rising healthcare and pension costs, which are expected to increase significantly over coming decades. For example, some estimates suggest that rising pension and healthcare spending could amount to an additional 2-3% of GDP in many advanced economies (and up to 5% of GDP in others, like Italy). Tax revenue would likely also fall if working-age populations decline. These factors would add considerable pressure to government budgets that are already strained in many economies. As mentioned earlier, while Australia's demographics are less worrisome than some other countries, the Australian Government's reliance on personal income tax to raise revenue is a particular vulnerability.

While Australia's working age population is projected to keep growing due to immigration, the population is nevertheless ageing. And when thinking about the potential impacts we need not only be concerned if the absolute number of workers is declining, but also if the workers are declining as a share of the population.

Chart 3 shows that the ratio of the working-age population to the non-working age population has fallen by around 10% since 2010. The implication is that if the government wanted to maintain the level of services provided to the non-working age population, then taxes paid by workers would need to have increased by 10%. In fact, income tax as a share of household income increased by more than 10% since 2010, a period which also coincided with persistently weak consumer spending. Also note that whereas Australia's real GDP growth averaged 3.3% from 1975 to 1990 and 3.2% from 1990 to 2010 – periods when the dependency ratio was stable or improving – real GDP growth has averaged just 1.8% since 2010 which coincides with the falling ratio of working to non-working age people.

Chart 3: Australia's working-age population to non-working age population ratio



Source: ABS

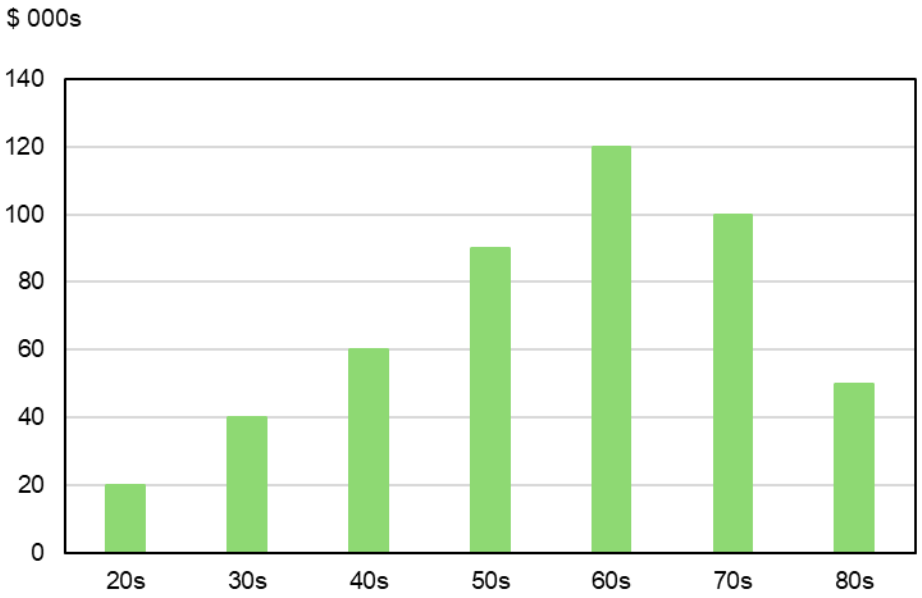
Of course, correlation is not causation. And it's worth noting that there are simple but powerful policy tweaks that can change the path of the dependency ratio. The chart below also shows what the dependency ratio would look like if we defined the working age population to include people up to 70 years rather than 65, and the blue dotted line shows what the implied dependency ratio would be if the country transitioned to a higher retirement age. As highlighted, the impact is significant. Of course, Australia has already got rid of a compulsory retirement age for most occupations while the government has increased the eligibility age for the aged pension from 65 to 67. Denmark recently increased its retirement age to 70 for people born after 1970. Thus, while demographics are crucial, policy is also very important for determining the ultimate impact on the economy.

Saving and financial markets

Ageing populations could have important implications on the stock of global savings (investable funds). The argument is often made that savings will fall as a rising share of the population enters retirement, because retirees usually draw down on their savings to fund their retirement. While it is true that people often dis-save in retirement, this does not necessarily imply that the *stock* of savings in an economy will be lower. This is an example of the fallacy of composition.

To understand why what may be true for most people in isolation is not true for the Australian population as a whole, consider Chart 4. It shows the expected decline in savings as Australians move into retirement. The important point to note, however, is that the age cohort with the highest level of savings are people in their 60s. Moreover, people in the 70s are likely to have more saved than people in the 50s or 40s. As a result, it is distinctly possible that with an ageing population and more Australian's in their 60s and 70s, overall savings could rise rather than decline.

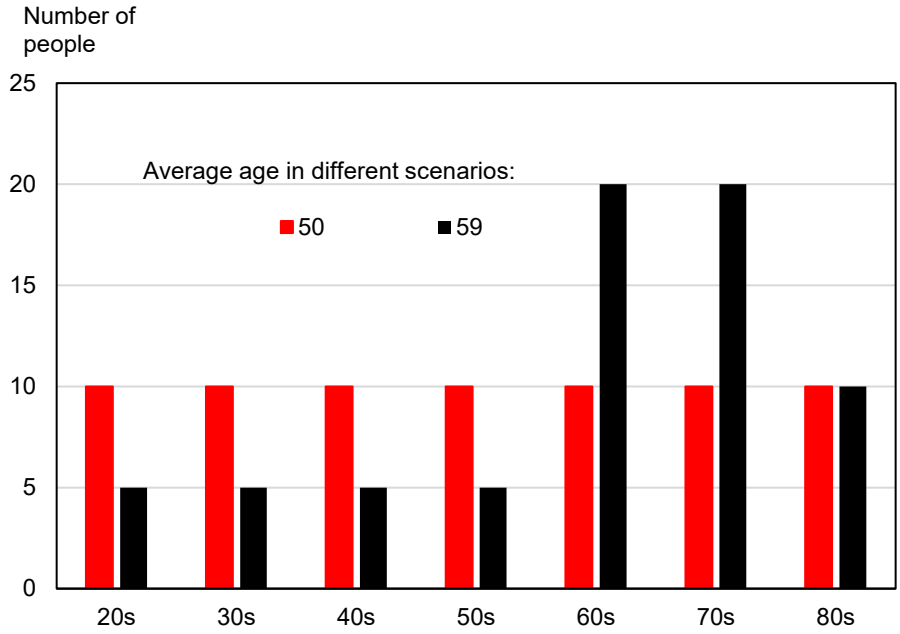
Chart 4: Indicative life-time savings profile



Source: TCorp

In Chart 5, the scenario shows the population is evenly distributed across age groups (the red columns). This results in an average age of 50. And if we multiply the number of people in each age cohort by the average saving level for that group in Chart 4, we can arrive at total savings for the economy. In Chart 5 the scenario results in average personal savings of $69,000.

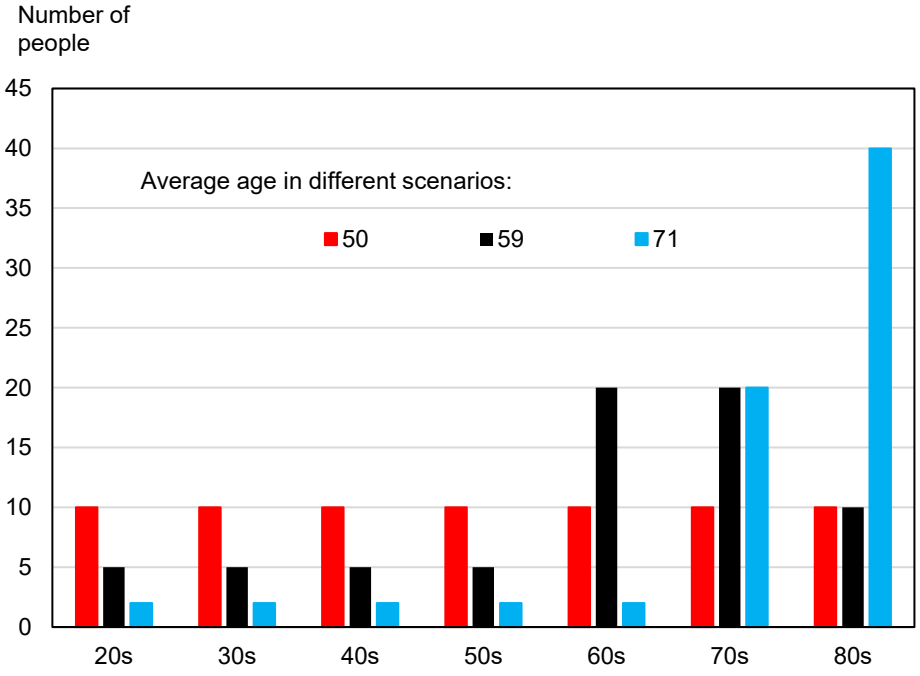
Chart 5: Population distribution scenarios



Source: TCorp

In Chart 5, we simply shift the population distribution so that there are more old people and fewer young people (the black columns). This results in an average age of 59. Undertaking the same calculations, this results in average personal savings of $85,000.

Chart 6: Population distribution scenarios



Source: TCorp

To be sure, if we shift the population distribution enough then savings will eventually fall. In Chart 6, the scenario shows the population is very skewed to older people. In this scenario, the average age is 71 and average savings per person falls to $64,000.

The impact on global interest rates will depend on how the balance between global saving and investment evolves. It is well known that 'the global savings glut' contributed to falling interest rates after the Asian Financial Crisis and was reinforced after the Global Financial Crisis. After the COVID pandemic, however, many countries have seemingly abandoned fiscal discipline and it is possible that global savings are more valued.

Ageing populations could also change the demand for different asset classes as retirees typically have lower risk tolerances and a greater need for stable income streams. This could, for example, see increased demand for fixed income products and dividend-paying stocks.

Immigration and housing demand

One way for countries to mitigate the effects of a falling working-age population is to increase immigration. While Japan or South Korea have not used immigration to combat rapidly declining working-age populations, high levels of immigration have been a key factor to limit (or postpone) declining work forces in Australia and Canada.

Although immigration can stem some of the adverse impacts of a declining working-age population, it should be carefully managed to avoid other problems and imbalances from arising. Australia's recent experience with the housing market is a good example, whereby rapid immigration after the COVID pandemic contributed to a sharp rise in house prices and rents. Infrastructure and public services must also keep pace with a rapidly growing population, which would require additional government spending.

Interaction with AI

AI has the potential to mitigate the impacts of a declining working-age population on an economy. At a high level, AI could improve productivity and boost an economy's growth potential, offsetting any drag from a shrinking labour force. This is important because productivity growth is the main driver of long-term economic growth and therefore the driver of improvements in living standards.

More simply, some people fear the potential impact of AI as it could mean that people lose their jobs. At the same time, one of the concerns with ageing populations is that there won't be enough young people to replace workers as they move into retirement. While it's not inevitable that these 2 trends will completely offset each other, one should at least mitigate the other.

AI can also address more specific challenges posed by ageing populations. For example, AI could improve efficiency in the healthcare sector. It could assist in the early diagnosis of medical conditions and so prevent the need for prolonged and expensive treatment down the track. It could also allow for more personalised health management for individuals which again would reduce the cost of life-time health care. This could, in turn, allow older workers to remain in the workforce for longer. Finally, it could reduce the time and cost of developing new medicines and treatments as it allows researchers to quickly hone in on the most promising candidates for new drugs.

In short, technology could:

- Reduce demand for healthcare (by keeping people healthier for longer)
- Increase the working age population (as people are able to keep working longer)
- Reduce the cost of treatment for those people that need it
- Result in more effective treatments of more conditions.

As noted earlier, it could also help alleviate labour shortages in the sector in the face of rising demand. In Japan, for example, Reuters reports that it will need 28% more nurses by 2040 to cater for its ageing population. Currently, however, there is only one applicant for every 4 nursing vacancies. While it may be tempting to imagine a fleet of robotic nurses running around a hospital ward like a scene from *The Jetsons*, the reality may be less dramatic but equally effective. For example, Japan is using sleep sensors which are placed under patients' mattresses to monitor their sleeping. This means that there doesn't need to be as many human nurses doing the rounds at night.

The French philosopher, Augustine Comte, declared that "demographics are destiny". And while there is a lot of truth in that statement, economic history highlights that countries can adapt and respond to underlying trends, often in unexpected and surprising ways. The demographic trends that we have highlighted here will have a significant impact on the investment landscape over the decades ahead. But just as important for investors, will be how individuals, companies and policymakers respond to those trends.

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