MORNING BRIEFING
November 3, 2016

Old Wide World

See the collection of the individual charts linked below.

(1) For economies, demography is destiny. (2) Demography's effects on growth not evenly distributed. (3) Advanced economies aging faster, led by Europe's. (4) Too little too late in China. (5) Japan a microcosm of graying growth. (6) Jackie interviews expert Ivy Zelman on housing demographics. (7) Millennials finally launch. (8) Bodes well for economy and housing-related industries.

Global Demography: As Time Goes By. Yesterday, Melissa and I discussed the demographic facts of life in the US that are weighing on economic growth. They aren't limited to the US, and the implications are universal. That's why we think that the global economy is likely to stay in a low-growth mode for a while. Around the world, populations are aging, though not uniformly across the major regions. Advanced economies are advancing faster in their aging. The story among the emerging economies is mixed. Let's take a cruise around the world's seas of humanity:

(1) *Advancing in age*. As a percent of the total population, the elderly population is rising across each of the G-7 countries. For the G-7 combined, the ratio was 17.9% during 2013, up from 8.8% from the start of data during 1956 (*Fig. 1*). An 8/11 FRB-SL note focused on age dependency ratios in G-7 countries, all of which have risen in recent years. It concluded: "The decrease in the young population may also pose problems for the economic future of countries, since it is likely going to contribute to a reduction in labor force participation in the long run. Indeed, fertility has been declining in all these countries. A decrease in the labor force due to demographic trends may result in a slowing down of economic growth. This could eventually spill over to developing economies."

The Census Bureau's March 2016 report titled "An Aging World" showed the percentage of populations over 65 by region in 2015 and projected them for 2050: Europe is the highest (17.4% in 2015, 27.8% in 2050), followed by North America (15.1, 21.4), Oceania (12.5, 19.5), Asia, (7.9, 18.8), and Latin America and the Caribbean (7.6, 18.6). Africa stands out with an exceptionally young population (3.5, 6.7).

(2) *Aging Asians.* Asia might not top the list above, but its elderly population is notable given its sheer size. More than half of the world's population aged 65 and older, i.e., 341.4 million people, lived in Asia as of 2015. That's projected to grow to two-thirds of the world's population of oldsters, or 975.3 million people, by 2050, reports the Census Bureau.

(3) *Old panda*. In particular, China's aging population is massive. The Census Bureau observes: "In 2015, the number of older people in China (136.9 million) exceeds Japan's total population (126.9 million). … By 2050, it will take the combined total populations of Japan, Egypt, Germany, and Australia (345.6 million) to match the older population in China (348.8 million)."

Last year, the Chinese government abandoned its one-child policy. The move was most likely too little too late, as China already faces a declining, graying population without the workers it needs for its vast economy. By 2050, the primary working-age population in China will represent less than half of the total population, below a peak of 61.6% during 2011, according to the Census Bureau's data.

(4) *World's oldest*. For direct evidence of the aging population's impact on economic growth, look no further than Japan. Among the G-7 countries, the demographic transition occurred in Japan first. Japan "is currently the oldest nation in the world and is projected to retain this position through at least 2050," notes the Census Bureau report. The FRB-SL note observed that Japan has experienced the largest increase in its age-dependency ratio of all the G-7 nations from 1990 to 2014.

As a result, Japan's workforce is shrinking, as discussed in an 8/9 Bloomberg article titled: "Japan's Plunging Jobless Rate Is All About Aging, not Abenomics." Japanese officials have struggled for a long time to revive economic growth through monetary and fiscal stimulus. So far, it hasn't worked. Demographics will continue to weigh on Japan's growth. And it could be a sign of what's to come for other nations that are also rapidly getting older.

Sector Focus: Housing's Demographics. Yesterday, Melissa and I reported some tentative evidence that the Millennials may be starting to hitch up. This could be a very big deal for the economy in general and the housing industry in particular. Millennials, a cohort that's almost as big as the Boomers, are starting to emerge from their parents' basements and strike out on their own. That's just one of the reasons why Ivy Zelman, CEO of Zelman & Associates, is optimistic that the entry-level segment of the housing industry should fare well over the next few years.

Ivy has been following the housing industry for nearly 25 years and was kind enough to share some of her insights with Jackie, who joined our firm last fall after a long career at *Barron's*. Here are some of the highlights from their conversation:

(1) *Time to fly.* Millennials--folks who are 14 to 32 years old--number 75 million strong. That's about 15% larger than Generation X, making Millennials only slightly smaller than the Baby Boomers at 76 million. For a while, we poked fun at this generation's inability to launch. But now, with the Great Recession a fading memory, unemployment among 20- to 34-year-olds has dropped below 6% from north of 13% during the recession. And as all generations have done before them, Millennials have begun to flap their wings. The yearly change in the number of households formed rose to 1.2 million in Q3, up from a low of 100,000 in Q4-2008 (*Fig. 2*).

The trend should accelerate as the generation starts having children and rents continue to rise. Since 2007, the number of owner-occupied households has fallen slightly, while the number of renters has increased sharply (*Fig. 3*). "I always joke it's hard enough to stay married. Imagine adding a few kids in 900 square feet? Rents are, as a percent of gross income, well above average and we continue to see more rent inflation," said Ivy. Toddlers running around a small apartment that's costing more to rent should continue to be just what it takes to push Millennials into the suburbs.

Meanwhile, homes remain affordable. The monthly payment as a percentage of gross income is 32% today, even after home price inflation is accounted for. That's below 42%, where it stood in the 1990s. Mortgage rates would have to rise to 6% for home affordability to return to historical levels of affordability. As a nation, we're about 20% better off owning rather than renting even after the recent appreciation in home prices.

(2) *A good deficit.* There's a very strong argument that the entry-level housing market should remain strong for a few more years because there's a lack of inventory. The same can't be said for the high-end housing market or the multi-family market.

"If you ask agents in every city in this country to rate the demand for affordable housing from 0 to 10, with 10 being the best and 0 being the worst, everybody says demand is at a 10. There is absolutely no inventory," explained Ivy. "They have a three-month supply of entry-level inventory. That is in comparison to the luxury market, which has about 11 months of inventory." We have a 30-year low in available inventory in the US. It's as bad as it has been since after World War II (*Fig. 4* and *Fig. 5*).

Because there's a 30% deficit in single-family shelter, orders for new homes should continue to increase in the low double digits over an elongated housing cycle, Ivy predicts. The entry-level, affordable housing market is still at a very early point in its cycle, maybe the second inning, to use a baseball analogy. Meanwhile, the higher-priced, new construction market for those moving up from their first house may be in the seventh inning, and the luxury housing market may be beyond the ninth inning, especially in cities that have benefitted from significant foreign buyer demand.

(3) *Turning a profit.* Despite strong demand and limited supply, housing stocks have been a disappointment this year. The S&P 500 Homebuilding stock price index has fallen 8.9% ytd (*Fig. 6*). One concern has been the industry's margins. Higher wages, higher land costs, and increasing fees levied by municipalities all have weighed on builders' profitability. Despite rising revenues in the industry, profit margins as calculated by Thomson Reuters I/B/E/S have been, and are expected to remain, flat at around the 2015 level of 7.2% (*Fig. 7* and *Fig. 8*). Ivy estimates the industry's average operating margin has remained relatively flat around 11.8%.

Municipalities charge homebuilders fees that vary sharply by geographic area, but not by the size of the house. So the builder of a large house in San Francisco pays roughly the same municipal fee as a builder building a small house. As a result, the small home homebuilder's margins get squeezed.

Wage pressures haven't gotten better, but they may not be getting worse either. For a long time after the recession, the industry wasn't actively recruiting workers, hamstrung by uncertainty about the strength of the recovery. "Interestingly, in the last year, year and a half, you've seen a concerted effort by contractors and builders to recruit at military bases, trade schools, and even at prisons or high schools. They hadn't been doing that," Ivy said. "The industry was turned off, arrested, in terms of its ability to grow, and wasn't investing the way they needed to."

(4) *Rate anxiety.* Fears about higher interest rates also are weighing on homebuilder stocks. But rates would have to rise significantly to deter married couples from looking for larger living spaces as their families grow. Ivy considers any dislocations in the stocks buying opportunities.

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What's more important is the magnitude of the change and the effect on the consumer psyche. Certainly, if rates backed up sharply and the economy fell into recession resulting in job losses, then sales in the housing market would slow and prices could fall. But If rates only rise modestly and unemployment stays low, it's likely the consumer will still buy a home. That would certainly be true if credit remains available, as it is today. Lenders do offer high loan-to-value loans with 3.0%-3.5% down payments through Fannie, Freddie, and FHA at FICO scores as low as 580-620. But less than half of the consumers Ivy surveyed believe they can get approved for a mortgage.

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After encouraging investors to consider their risk tolerance and ability to tolerate volatility and illiquidity, Ivy recommends buying the stocks of a few homebuilders. Also on her buying list are mortgage insurers and the home improvement centers. "Our stock of homes in the United States is getting old," she explained. "People are going to have to put money into their homes, especially if they can't find another house to buy. Ninety percent of home improvement dollars come from people that don't move even though they spend half as much as the person who moves." Some of the building products companies also are attractive.

So yes, the housing industry could have some rocky times in the next few months if it looks increasingly like the Fed will raise rates in December. But if the rate increase is modest and the economy continues to grow, homebuilders focused on entry-level buyers should do well. As Ivy's grandmother Ruth would say, "You got to have a little chutzpah."

CALENDARS

US. **Thurs:** Jobless Claims 255k, Productivity & Unit Labor Costs 2.2%/1.4%, Factory Orders 0.2%, ISM NM-PMI 56.1, Challenger Job-Cut Report, Weekly Consumer Comfort Index. **Fri:** Total & Private Nonfarm Payroll Employment Changer 178k/170k, Unemployment Rate 4.9%, Average Hourly Earnings 0.3%, Average Workweek 34.4hrs, Merchandise Trade Balance -$38.9b, Baker-Hughes Rig Count, Fischer. (Bloomberg estimates)

Global. **Thurs:** Eurozone Unemployment Rate 10.0%, UK Composite & NM-PMIs 53.5/52.5, Japan NM-PMI, Australia Retail Sales 0.4%, BOE Rate Decision & Asset Purchase Target 0.25%/435b, BOE

Inflation Report, ECB Publishes Economic Bulletin, RBA Statement of Monetary Policy. **Fri:** Eurozone, Germany, France, and Italy Composite PMIs 53.7/55/1/52.2/51.5, Eurozone, Germany, France, and Italy NM-PMIs 53.5/54.1/52.1/51.5, Canada Employment Change & Unemployment Rate -15k/7.0%. (DailyFX estimates)

STRATEGY INDICATORS

Stock Market Sentiment Indicators (*link*): The Investors Intelligence Bull/Bear Ratio (BBR) moved back below 2.00 again this week--fluctuating around that level for the past five weeks. The BBR fell to 1.72 this week after rising from 1.80 to 2.04 last week. Bullish sentiment sank 5.4ppts to 41.7% (the fewest bulls since the end of June) after rebounding 4.2 ppts last week to 47.1%. Most of the bulls fled to the correction camp, with its count jumping from 29.8% to 34.0% this week--10.9ppts above mid-August's reading of 23.1%. Bearish sentiment rose slightly from 23.1% to 24.3%; recent readings are only slightly higher than in mid-August, when bearish sentiment hit a multi-year low of 20.0%. The AAII Bull Ratio rose to 42.1% last week after sliding the prior two weeks from 50.8% to 38.6%. Bullish sentiment rose from 23.7% to 24.8%, while bearish sentiment fell from 37.8% to 34.1%.

S&P 500 Earnings, Revenues & Valuation (*link*): S&P 500 consensus forward revenues and earnings rose to record highs last week. The forward profit margin forecast was steady at 10.6%, which is little changed from an eight-month high of 10.7% in mid-September and the record high of 10.9% in September 2015, but is up from its 24-month low of 10.4% in late March. Forward revenue growth for the S&P 500 edged down to 5.3% from a four-year high of 5.4%, up from a seven-month low of 2.7% in late February. Forward earnings growth dropped to 10.5% from 11.0%, which compares to a 24-month high of 11.2% in early October and an 11-month low of 4.8% in late February. Valuation fell to a 17-week low of 16.6 last week, which compares to February 2015's 12-year high of 17.4 and a 15-month low of 14.9 in January 2016. Despite the collapse in Energy sector forecasts beginning in early 2015 and currency translation headwinds, S&P 500 forward revenues and forward earnings both have held up well. Ex-Energy, the forward revenue and earnings growth rates are 4.2% and 8.4%, respectively. Ex-Energy, the forward profit margin is 11.3%, down from 11.5% in September 2015.

S&P 500 Sectors Earnings, Revenues & Valuation (*link*): Consensus forward revenue forecasts rose last week for 4/11 sectors (Discretionary, Energy, Materials, and Tech), and forward earnings rose for 4/11 (Energy, Financials, Materials, and Tech). Forward revenues and earnings are at or around record highs for 5/11 sectors: Consumer Discretionary, Consumer Staples, Health Care, Industrials, and Tech. Forward P/S ratios rose w/w for 4/11 sectors and the forward P/E rose for 6/11, with both measures rising only for Staples, Financials, Tech, and Utilities. Health Care's P/E of 14.3 and P/S of 1.55 remain well below their 2015 highs of 17.9 and 1.88, respectively. With Energy's forward revenues and earnings improving, its valuation is beginning to come back to Earth; its P/S ratio of 1.40 compares to a record high of 1.56 in early May, and its P/E of 34.9 is down from a record high of 57.5 then. Higher y/y margins are expected for only 6/11 sectors in 2016: Consumer Discretionary (to 7.4% from 7.1%), Consumer Staples (6.6, 6.5), Health Care (10.5, 10.4), Real Estate (21.5, 20.6), Tech (19.1, 18.8), and Utilities (10.9, 10.7). Margins are expected to remain flat for Industrials (8.9) and Materials (8.9), and to deteriorate for Energy (1.2, 4.6), Financials (14.8, 14.9), and Telecom (10.9, 11.3).

S&P 500 Q3 Earnings Season Monitor (*link*): With nearly 70% of S&P 500 companies finished reporting Q3-2016 results, earnings surprise metrics are encouraging while the revenue surprise is weaker than expected. However, Q3 results do suggest that Q2 was the bottom for y/y revenue and earnings comparisons. Of the 348 companies in the S&P 500 that have reported, 71% exceeded industry analysts' earnings estimates by an average of 6.3%; they have averaged a y/y earnings gain of 1.5%. At the same time period in Q2-2016, a slightly higher percentage of companies (72%) in the S&P 500 beat consensus earnings estimates by a smaller 5.1% and earnings were down 2.3% y/y. On the revenue side, 53% beat sales estimates so far, with results meeting the forecast and 1.5% higher than a year earlier. At the same point during Q2, a higher 56% was above forecast, exceeding estimates by a greater 0.4%, but results were up only 0.2% y/y. Q3 earnings results are higher y/y for 70% of companies versus 62% at the same point in Q2, and revenues are higher for 66% versus 59%. Aggregate earnings continues to benefit from a reduced share count, but about the same as during Q2--shares outstanding is down 1.1% y/y in Q3 compared to a 1.1% decline at the same point in Q2. These figures will change markedly as the remaining 30% of companies report Q3 results during the coming weeks.

US ECONOMIC INDICATORS

ADP Employment (*link*): Private industries added 147,000 to October payrolls (the second smallest gain since April 2013), after an upward revision to payrolls in September (to 202,000 from 154,000) and a downward revision in August (162,000 from 175,000)--overall showing a 35,000 increase over the two-month period. October's advance was driven entirely by a 165,000 increase in service-providing jobs; goods-producing companies cut payrolls by 18,000. According to the report, "Job growth appears to be shifting from small to large companies due to the lessening impact the global economic environment had on large companies earlier in the year. … This is also true because large companies often have the resources to attract workers with better pay and benefit packages." Large companies--usually at the bottom of the list--was at the top for the third consecutive month, adding 64,000 jobs, almost all service-providing (58,000). However, goods-producing firms added 6,000 to payrolls last month and 23,000 the past two months after cutting jobs by 15,000 the first eight months of the year. Medium-sized companies (48,000) remained at the number-two spot in October, adding 59,000 service-providing jobs and cutting 11,000 goods-producing ones. Small businesses (34,000) provided the fewest jobs in October, growing at less than half the average 80,000 gain recorded the prior four months. Service-providing companies expanded payrolls by 48,000, while goods-producing companies cut payrolls for the second time in three months by 13,000 m/m and 21,000 over the period.

Auto Sales (*link*): Motor vehicle sales rose for the second month in October to a high for this year of 18.0mu (saar), from 17.0mu in August, near last fall's cyclical high of 18.2mu. Domestic light truck sales remain on an uptrend, climbing to a new cyclical high of 9.2mu (saar) last month--the highest since July 2005. Domestic cars sales continue to lack momentum, ticking down from 5.3mu in September to 5.1mu (saar) last month, not far from August's 4.9mu, which was the weakest sales pace since May 2012. Import sales returned to their cyclical high of 3.7mu (saar).

Construction Spending (*link*): Construction spending remained volatile around record highs in September. Total investment was down 0.4%--rather than up 0.4% as expected--but August's decline (to -0.5% from -0.7%) was less negative and July's (0.5 from -0.3) was revised to a gain. Private construction spending fell 0.6% the past two months, while public construction spending dropped six of the past seven months, by 0.9% in September and 9.8% over the period. Within private construction, spending on residential investment rose for the fourth time in five months, by 0.5% in September and 2.1% over the period, while nonresidential spending slipped 1.0% following a four-month spurt of 5.2% to a new record high. A 2.0% jump in multi-family construction--to a new record high--led September's gain in residential investment; home improvement (0.6) and single-family (0.1) spending also moved higher. Within nonresidential investment, spending on amusement & recreation, lodging, and commercial structures remained on steep uptrends, while manufacturing was stalled around recent highs.

GLOBAL ECONOMIC INDICATORS

Global Manufacturing PMI (*link*): Global manufacturing activity expanded at its fastest pace in two years in October. The J.P. Morgan/Markit M-PMI advanced for the fourth time in five months from 50.1 in May to 52.0 last month--the highest reading since October 2014. Last month, output (to 53.6 from 51.9), new orders (52.8 from 51.3), new exports (51.0 from 50.7), and employment (50.7 from 50.2) all accelerated--output and orders more notably. According to the report, 22 of the 31 nations for which October data were available posted improved operating conditions. Growth accelerated at a 33-month high in the Eurozone and a one-year high in the US, while rates in China, India, and Japan were at 27-, 22-, and nine-month highs, respectively. Also registering improvements were Russia, Taiwan, and Canada, while the UK decelerated a tad from September's 27-month high. Among the nine nations recording contractions, almost all--South Korea, Indonesia, Malaysia, Thailand, Singapore, and Myanmar--were in Asia; Brazil, Turkey, and Greece also contracted.

Eurozone Manufacturing PMI (*link*): Manufacturing activity in the Eurozone gained momentum in October, expanding at its fastest rate in 33 months. The M-PMI advanced for the second month from 51.7 in August to 53.5 in October--the best since January 2015. Production, new orders, new export orders, and employment all accelerated during the month, while price pressures showed further signs of increasing. Regionally, the Netherlands (55.7, 15-month high) and Germany (55.0, 33-month high) were the top performers, followed by Austria (53.9, four-month high), Spain (53.3, six-month high), and Ireland (52.1, four-month high). France's (to 51.8 from 49.7) manufacturing sector moved from contraction to expansion, posting its strongest growth in 31 months, while growth in Italy (50.9, two-month low) moved closer to the breakeven point of 50.0; manufacturing activity in Greece (48.6, five-month low) contracted for the second month.

Japan Consumer Confidence (*link*): Consumer confidence took a step back in October after climbing to a three-year high in September. The consumer confidence index dipped to 42.3 after rising four of the prior five months from 40.8 in April to 43.0 in September. Consumers were less optimistic about all four key aspects that affect sentiment. Employment posted the biggest setback, falling to 44.8 after climbing to a 13-month high of 46.2 in September. The rest of the components show overall livelihood (to 41.4 from 42.0) remained close to September's three-year high, while willingness to buy durable goods (41.9 from 42.5) also held near its cyclical high. Income growth (41.0 from 41.1) remained in a volatile flat trend.

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