Does Decumulation Spell Doom?

By Editor Test *Wed, Aug 24, 2011*

Economists at the San Francisco Fed suggest that P/E ratios are bound to suffer as the Boomer cohort gets older and liquidates its assets.

This question won't seem to go away: As the Boomers switch from accumulation to decumulation and liquidate their securities, will the sell-off undermine the prices of equities and bonds?

Since as far back as 1994, asset managers and academics have debated this question. Financial fundamentalists say that stock prices are determined by expectations of corporate earnings, not by demographics. A landmark 2004 study by MIT's James Poterba scoffed at the threat. A 2006 GAO report offered the "inequality" argument: the deep concentration of equity ownership among the wealthy makes a broad wave of liquidations unlikely.

But, barring lots of immigration or foreign buying on Wall Street, common sense suggests that sellers will outnumber buyers in the future. Which is never a good omen for prices. So the question continues to nag.

Among the most recent pessimistics are Zheng Liu and Mark M. Spiegel of the Economic Research Department of the Federal Reserve Bank of San Francisco. Their August 22 Economic Letter asks, "Boomer Retirement: Headwinds for U.S. Equity Markets?"

Liu and Spiegel compare demographic trends and trends in the price/earnings ratios of stocks and conclude that Baby Boomer accumulation helped inflate the stock market after 1982 and that Boomer decumulation will in due course deflate the market.

"Between 1981 and 2000, as baby boomers reached their peak working and saving ages, the M/O ratio [the ratio of the size of the age 40-49 cohort to the age 60-69 cohort] increased from about 0.18 to about 0.74," they write. "During the same period, the P/E ratio tripled from about 8 to 24.

"In the 2000s, as the baby boom generation started aging and the baby bust generation started to reach prime working and saving ages, the M/O and P/E ratios both declined substantially. Statistical analysis confirms this correlation.

"We estimate that the M/O ratio explains about 61% of the movements in the P/E ratio during the sample period. In other words, the M/O ratio predicts long-run trends in the P/E ratio well."

How far might the P/E decline? "Given the projected path for P/E* [the potential P/E ratio] and the estimated convergence process, we find that the actual P/E ratio should decline from about 15 in 2010 to about 8.3 in 2025 before recovering to about 9 in 2030," they conclude.

Liu and Spiegel have reviewed the literature, and they admit that factors like retention of equities for bequest purposes and foreign demand for U.S. equities could dull the demographic undertow. But they note that Europeans and Asians are also getting older and are subject to the same decumulation trends.

This question seems to be part of a larger question—will U.S. industry and workers be productive enough to support a large non-working population in the future? Will domestic companies generate high earnings, employ lots of people, and pay them salaries high enough to keep the economy churning and the prices of assets high? If equity prices decline, it won't be because the Boomers aged per se. It will be because we didn't collectively rise to the challenge.

The 2006 GAO report offered a dour kind of comfort. It suggested that the threat of Social Security and Medicare insolvency, public pension underfunding, widespread financial illiteracy and other broad issues, are likely to pose much bigger problems for the vast majority of Boomers, who never owned much in the way of stocks or bonds in the first place.