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A portfolio's cash allocation is dead

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Down with the king

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While the structural forces of high debt loads and deteriorating demographics persist, the cash rate will remain low, delivering negligible cash returns.

As a result, **a cash allocation in a portfolio is now dead**.

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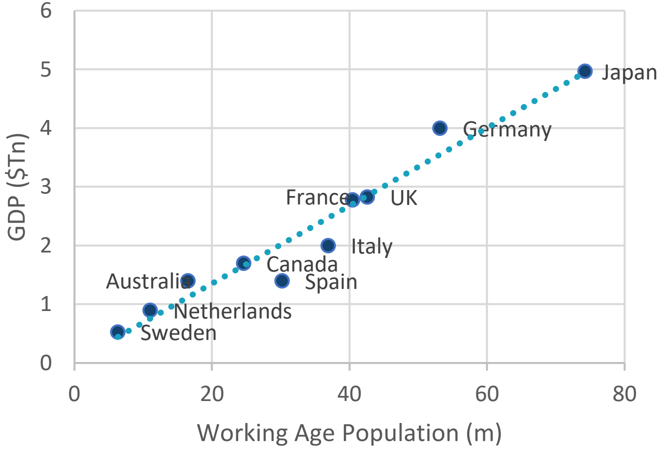
The growth & productivity drag

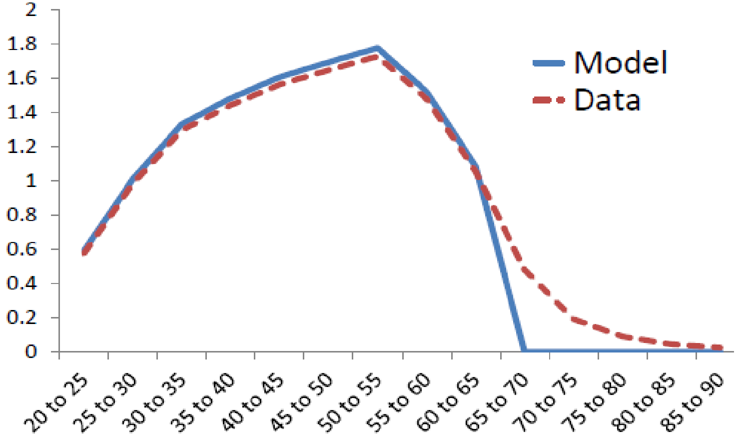
The simplest demographic effect is well known: the more people working in an economy, the greater its potential output will be. But there are far more effects than just this.

Working age population & economy size



Source: United Nations, Bloomberg, as at 2020.

Labour productivity by age

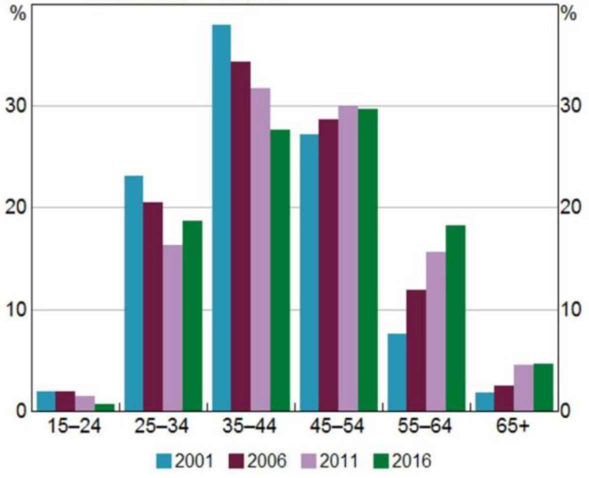


Source: Bank of England, as at 2017

The credit effect

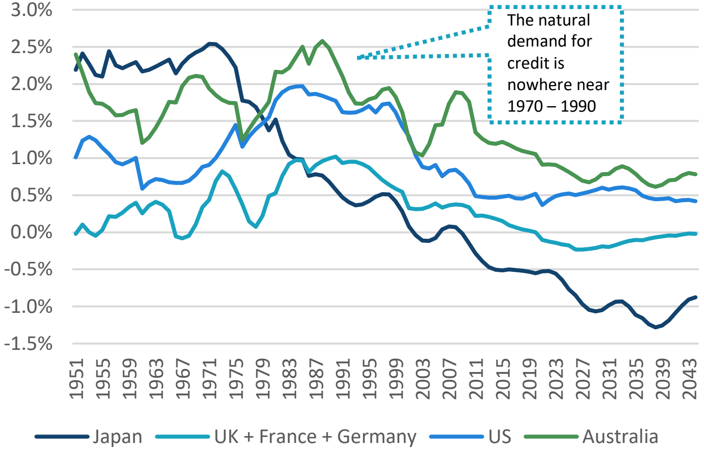
Low rates are often described as ‘pushing on a string’. But the bigger picture shows that as a population ages, it has less use for debt. Household demand for credit should be declining, as an older population has more people retiring.

Age distribution of indebted owner occupiers
Share of households by age of household head (2001 – 2016)



Source: Reserve Bank of Australia

Potential borrower index (1951 – 2043)

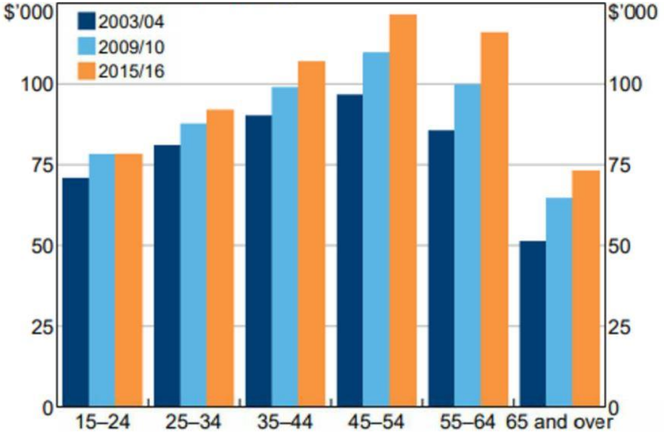


Source: United Nations, Nikko AM

Consumption & income

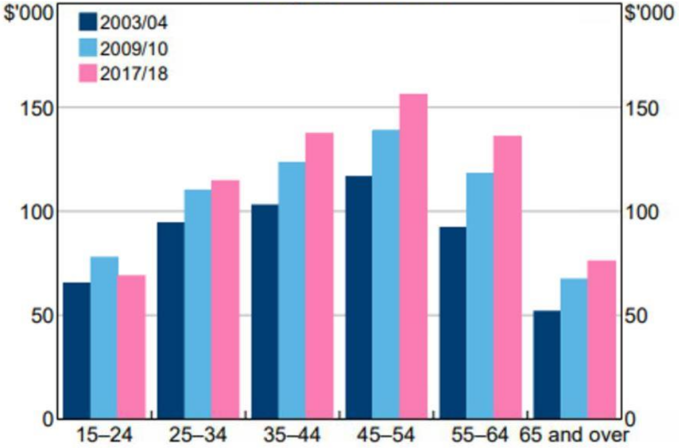
It's not just borrowing. Whenever you look at age, the same distribution appears as it weighs on both income and consumption. How do we generate demand side inflation with this headwind?

Real household consumption
Share of households by age of household head (2003 – 2016)



Source: Reserve Bank of Australia

Real household income
Per household by age of reference person (2003 – 2018)



Source: Reserve Bank of Australia

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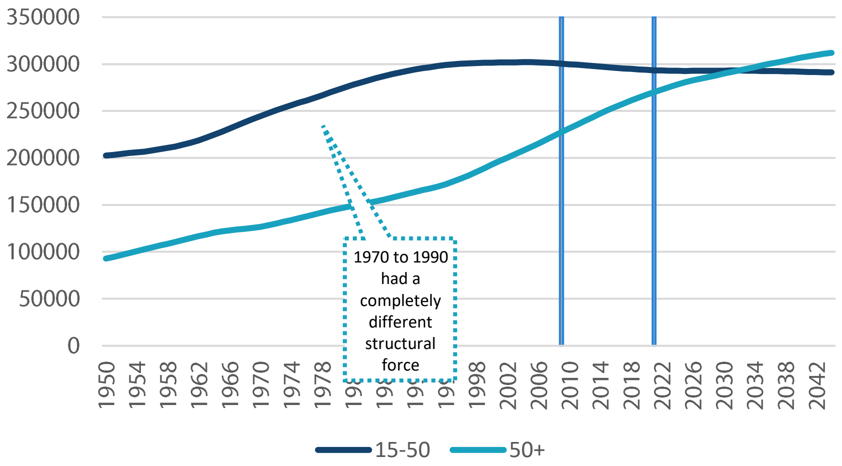
A structural change since 2009

Across the world's five largest developed economies (US, Japan, Germany, UK, France), the number of 15 – 50 year-olds is declining, while the number of 50+ year-olds continues to grow. This should weigh on consumption, wages, productivity, growth, housing demand and inflation. Can central bank policy overcome this? The answer so far is no.

World's top five developed economies: Age structure
(1950 – 2043)

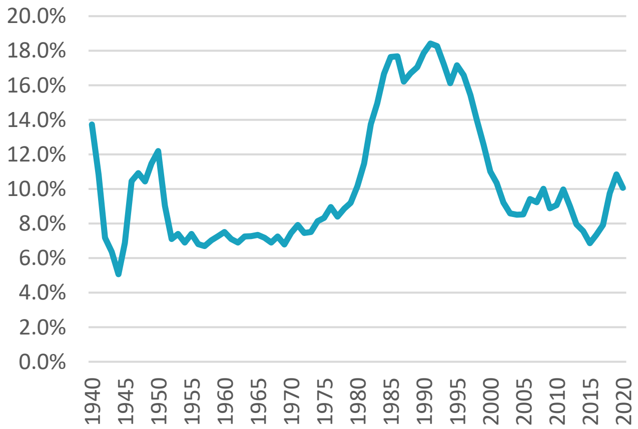


Source: United Nations, Nikko AM

Government

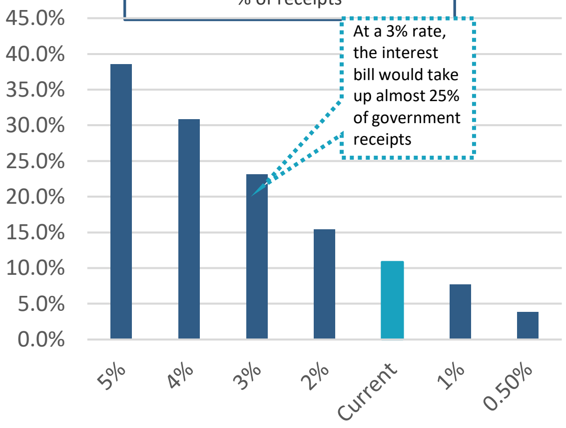
An often overlooked factor of interest rates is that they must reflect what debt holders can afford to repay. As government debt increases, low rates will be required to run big deficits.

US Federal interest outlay
% of receipts (1940 – 2020)



Source: FRED Database, Nikko AM

Interest cost on USD27 trillion
% of receipts



Source: Bloomberg, Nikko AM, as at 2020

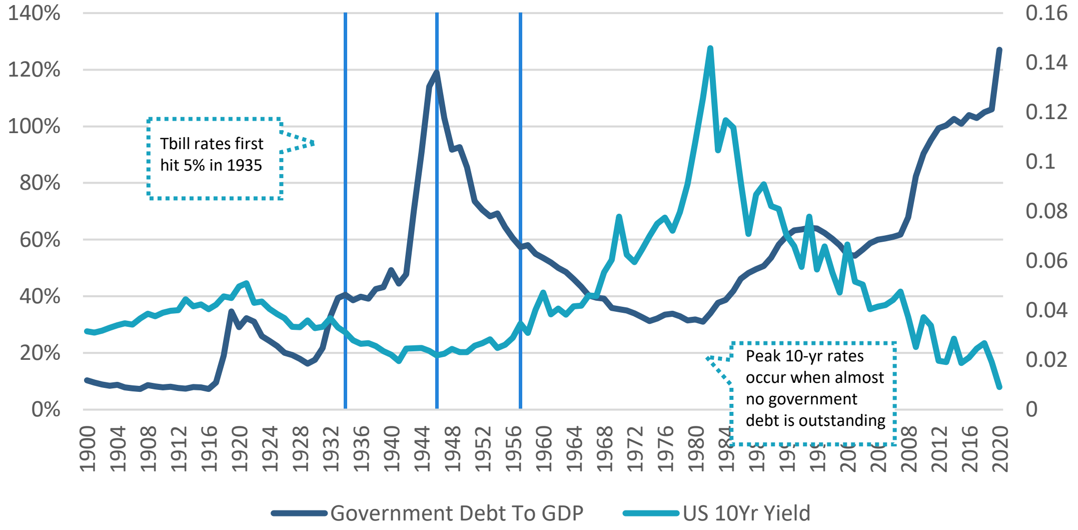
Nineteenth-century Ministers of Finance… thought of…their national debts in terms of the annual interest charge against revenues rather than in terms of a principal amount which must be repaid.

—A History of Interest Rates (2005, Homer & Sylla)

A longer history

In prior periods when the US government debt hit these levels, it took 10 years to de-lever debt by 50% and reach a point where interest rates could rise.

US government debt and 10-year yields
(1900 – 2020)

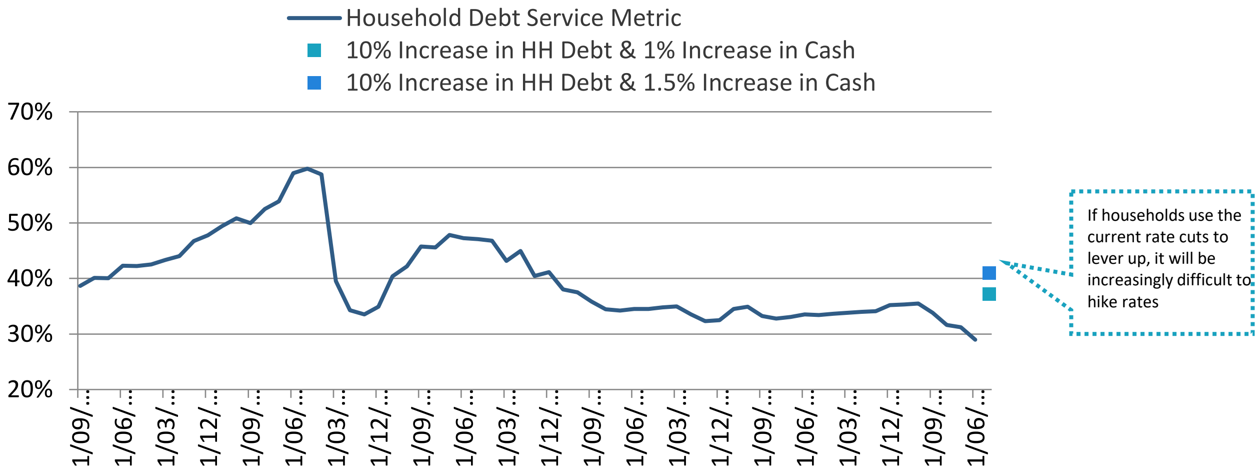


Source: Bloomberg, InvestmentOffice.com, Nikko AM

The household

Since the cash rate is the driver of mortgage rates, an important question to ask is: "How much can the household sector service?"

Household debt service metric (2004 – 2020)



Source: Bloomberg, InvestmentOffice.com, Nikko AM

How to deleverage

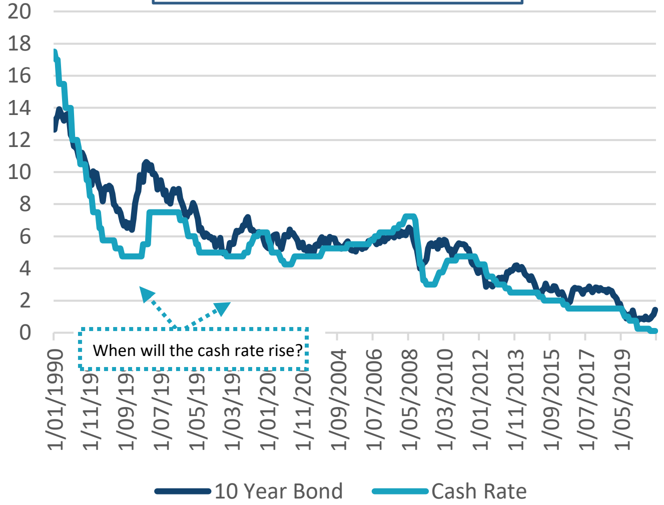
> The paper examines large debt changes in 14 European and 5 non-European advanced economies and finds that…major debt reduction episodes are primarily explained by primary surpluses (with the exception of the 1945 – 1970 period).

—Abbas & Belhocine (2011) Historical Patterns of Public Debt

Bond yields vs cash

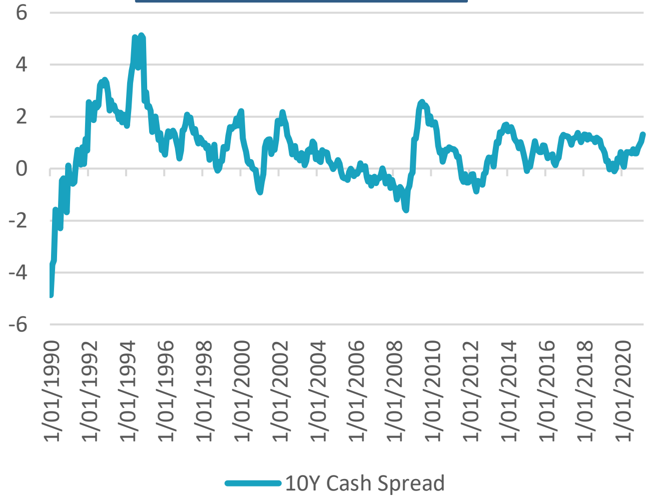
Bond yields typically trade in a defined range against cash, giving a strong indication of where bond yields should be. If the cash rate can't move, then bond yields should be capped.

AUS 10-year bond and cash rate
(1990 – 2020)



Source: Bloomberg, Nikko AM

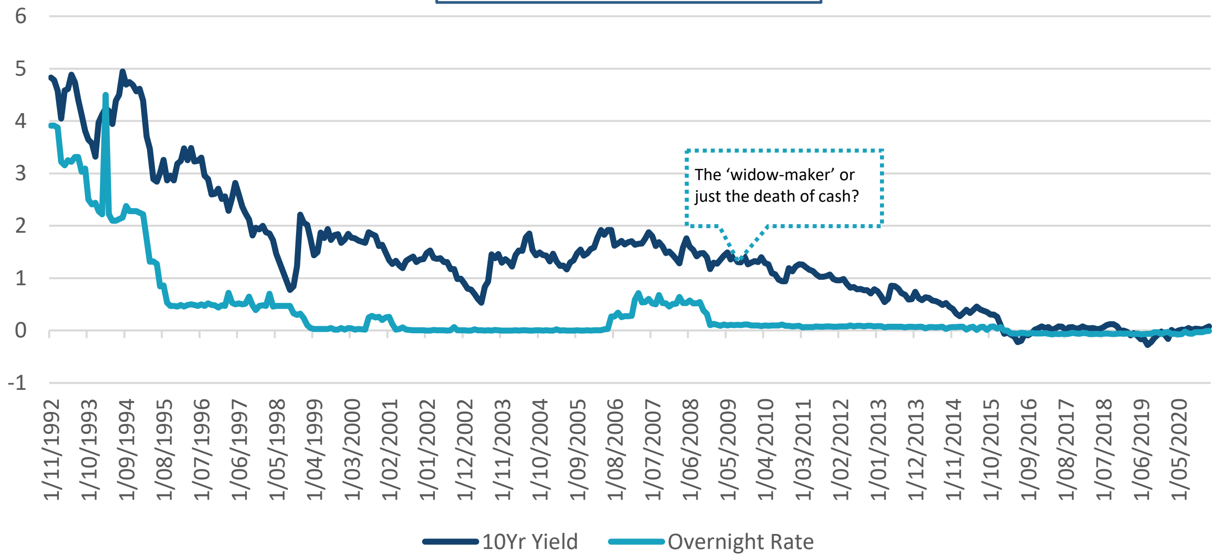
10-year bond vs cash
(1990 – 2020)



Source: Bloomberg, Nikko AM

A longer example

Japan 10-year yield and cash rate
(1992 – 2020)



Source: Bloomberg, Nikko AM

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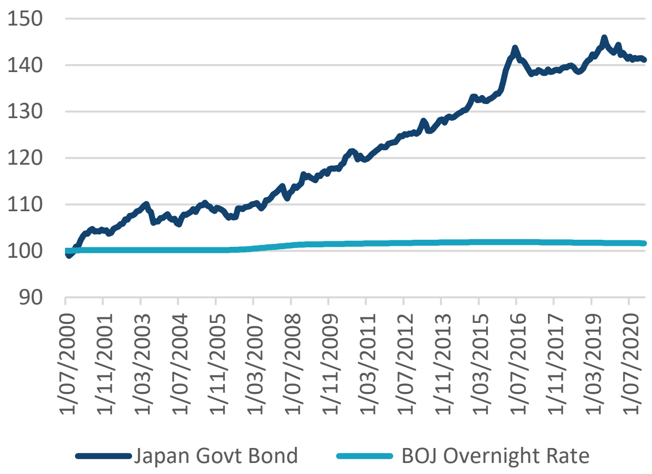
Cash returns vs bonds

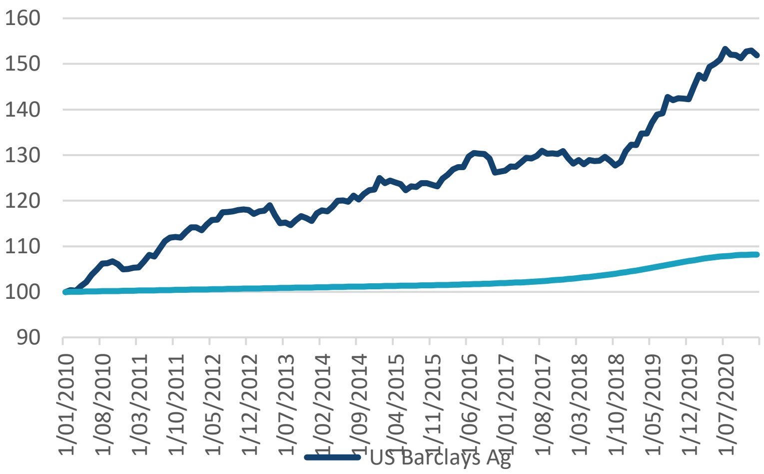
When the cash rate is stuck at zero, bond allocations outperform.

Return on Japan bonds vs cash since 2000



Source: Bloomberg, Nikko AM

Return on Barclays Agg vs Fed funds since 2010



Source: Bloomberg, Nikko AM

Yields and active management

Outside of bond funds outperforming through these periods, there are also other implications.

1. With lower yields, active management becomes even more important. Adding even 50 basis points over the benchmark can be substantial when yields are only 1%.

2. As government deficits are larger, the index composition will change. Composite indexes should see a larger exposure to government bonds.

3. Since governments issue longer maturity bonds than corporates, the duration of bond indexes should also extend.

Further reading

Demographics

- James Feyrer (2008) *Aggregate Evidence on the Link Between Age Structure and Productivity*
- Yihan Liu and Niklas Westelius (2016) *The Impact of Demographics on Productivity and Inflation in Japan*
- Tomas Cokis and Kate McLoughlin (2020) *Demographic Trends, Household Finances and Spending*
- Jeremy Kronick and Steve Ambler (2018) *Do Demographics Affect Monetary Policy Transmission in Canada?*
- Patrick Imam (2013) *Shock from Graying: Is the Demographic Shift Weakening Monetary Policy Effectiveness*
- Igor Fedotenkov (2016) *Population Ageing and Inflation with Endogenous Money Creation*
- Faith Karahan et al. (2019) *Demographic Origins of the Startup Deficit*
- Gabriel Ashfeldt et al. (2018) *The Generation Gap in Direct Democracy*
- United Nations World Population Statistics https://population.un.org/wpp/

Debt

- Ali Abbas et al. (2011) *Historical Patterns of Public Debt – Evidence From a New Database*
- Ali Abbas et al. (2014) *Sovereign Debt Composition in Advanced Economies: A Historical Perspective*
- Barry Eichengreen et al. (2019) *Public Debt Through the Ages*

Interest Rates

- Sidney Homer and Richard Sylla (2005) *A History of Interest Rates*

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The end of an era

As structural forces weigh on the ability for central banks to move the cash rate, extended periods of zero interest rates should be expected. The implication of this is that Australian Government bonds will outperform cash, marking the end to a cash allocation in a portfolio.

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Important information

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