



# Bradley, Foster & Sargent, Inc.

## Quarterly Market Commentary

April 2007

### Demography: A Key to Future Stock Market Returns?

Civilizations die from suicide, not by murder.

Arnold Toynbee, *A Study of History*, 1934-1961

Some people think about political and military power, and other people think about money. There is a tendency not to see how intimately connected they are.

Niall Ferguson, Tisch Professor of History, Harvard University, 2007

Demography is the discipline of studying changes and trends in various categories of populations. Major demographic changes are underway globally, and our quarterly market commentary seeks to describe these changes and to explore what impact they might have on the investment world. Demography is an important analytical tool in helping to explain the history of civilizations and nations. In brief, demographics + resources (power) + will = national destiny. In this equation, we use the word, will, to mean the collective determination of a people to accomplish a given objective. Thoughtful observers of the global scene have been able to analyze the state of world affairs and make remarkably accurate predictions of a nation's character and destiny. One remembers Alexis de Toqueville's prediction in *Democracy in America*, published in 1835, that America and Russia would ultimately compete for global superiority.

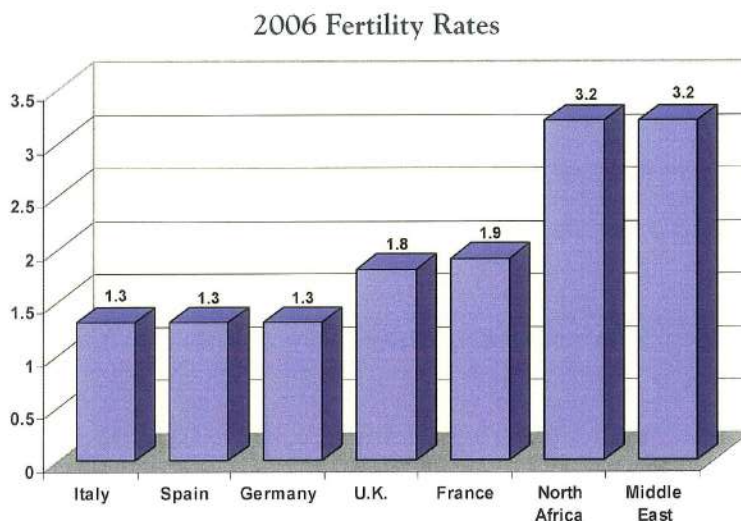
Living in America, one might be less aware of major global demographic changes than someone living in Europe or in Russia. For example, what does it say about Europe that the most popular baby boy's name in Belgium (and in Amsterdam and Malmo, Sweden) is Mohammed? Or that more Muslims now attend weekly religious services in the U.K. than Christians?

However, before jumping to conclusions like Chicken Little who believed that the sky was falling, we need to be cautious in extrapolating short term trends for decades or even a century, thereby drawing extreme and foolish conclusions. A few recent examples from Mark Steyn's book, *America Alone*, will suffice:

- In its 1972 study, *Limits to Growth*, the Club of Rome announced that the world would run out of gold by 1981, tin by 1987, zinc by 1990, petroleum by 1992 and copper and lead by 1993.
- In 1976, Lowell Ponte wrote a major bestseller called *The Cooling: Has the Next Ice Age Already Begun? Can We Survive?*
- In 1977, President Jimmy Carter opined that "we could use up all of the proven reserves of oil in the entire world by the end of the 1980's."
- In 1968, Paul Ehrlich wrote in his hugely popular book, *The Population Bomb*, that "in the 1970's the world will undergo famines – hundreds of millions of people are going to starve to death."

## Demographic Trends in Europe and the Middle East

One of the most dramatic recent demographic changes is the remarkably low fertility rates evidenced by most European nations. Most European countries face declining populations over the coming decades. In order to maintain a steady population without immigration, a country requires a fertility rate of 2.1 (average number of children born to a woman over her lifetime). The chart below lays out the 2006 fertility rates for key European countries compared with the predominantly Muslim countries of the Middle East and North Africa:



Source: Population Reference Bureau, 2006

If these fertility rates in Europe persist over the next three decades, **there will be as many as 75 million fewer Europeans than there are today.** What does this mean for Europe? Declining populations are not good news for social-democratic nations with robust entitlement programs. Where are the young workers who must support the generous state pensions, unemployment benefits and socialized medical programs? Most welfare states do not have funded social security programs but instead depend upon increasing populations to sustain them. Yet in 1970 there were 4.6 million Italians under the age of five; in 2004, there were only 2.6 million. Thus, this crisis does not depend upon extrapolating current trends into the future; it has already arrived. How can many fewer workers support a dramatic increase in the number of retirees? There is only one way: immigration. In Europe, the immigrants are coming from the largely Muslim Middle East and North Africa and have fertility rates over 3.0, as the chart above shows. France is already challenged by this situation. Approximately 9% of its population is Muslim (according to the June 24, 2006 edition of *The Economist*). What *The Economist* does not report is that experts estimate that almost 30% of the French population who are 20 or younger are Muslim.

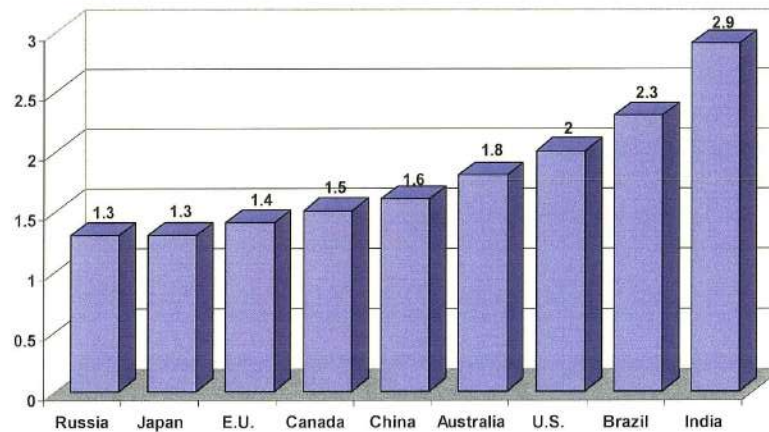
### Eurabia

Eurabia is a term that has only recently entered mainstream media usage. It refers to the allegedly failed assimilation of a young and rapidly growing Muslim population in Europe and the resulting tensions like the 2005 riots in France. The term was originally popularized by Bat Ye'or, a British writer who wrote *Eurabia – The Euro-Arab Axis*, a book which outlines her view that the European Union is being influenced by Islamic hostility to European culture and values. Another recent book on this subject is *Londonistan* by Melanie Phillips whose premise is: "Jihadi Islamism, whatever its historical or theological antecedents, has become the dominant strain within the Islamic world, and that its aims, if not its methods, are supported by an alarming number of Muslims in Britain, and that to date, no Muslim representative institutions have arisen to challenge it."

It would be easy to judge these writers and their views as extreme and ignore this potentially toxic cocktail of demography, immigration, failed assimilation or self-imposed withdrawal, and alienation in Europe. However, there are simply too many data points to ignore. There were the 9/11 terrorists, many of whom were middle class, well-educated Muslims radicalized in mosques in Europe. Then came the horrific bombings in the subways of Madrid on March 11, 2004 and of London on July 7, 2005, which killed and wounded a total of 3,000 people. One year after the London bombings, the *Times* of London took a poll of British Muslims. The results were jarring: 7% agreed that “suicide attacks on civilians in the U.K. can be justified in some circumstances”; and 2% “would be proud if a family member decided to join al Qaeda.” With approximately 2 million Muslims in the U.K., this means there are potentially thousands of citizens whose first loyalty may not be to the U.K.

This is a problem of major proportions – not just in the U.K. but throughout Europe. In 2004, the Dutch movie director Theo Van Gogh was murdered by Mohammed Bouyeri, a militant Muslim who is a Dutch citizen, in the streets of Amsterdam because of his films (the most offensive to Muslims being *Submission*). A year later, there were riots across the Middle East and Europe to protest cartoons in a Danish newspaper, *Jyllands-Posten*, which caricatured the prophet, Mohammed. These events help, in part, to explain why the U.S. is receiving increasingly less help from her European friends and allies in the War on Terror against militant, radical Islam.

2006 Global Fertility Rates



Source: Population Reference Bureau, 2006

### Global Demographic Trends

Japan's fertility is so low that it has already joined Germany and Italy in the ranks of countries whose populations are already declining. And whereas Germany and Italy are seeking to solve part of the problem through immigration, the Japanese are an ethnocentric nation that is unlikely to resort to immigration to solve its demographic challenges. Japan is now closing 300 schools a year. Russia, too, is facing a rapidly declining population. Not only is Russia's fertility rate of 1.3 one of the lowest in the world, but there are also very high rates of HIV and alcoholism in Russia. Some demographers are projecting a Russian population of less than 100 million by 2050 (by way of comparison, Mexico currently has a population of over 100 million). A country with such a large land mass as Russia containing huge oil and mineral resources and a dwindling population might present a tempting target for expansion-minded neighbors. China and India face a different kind of problem. In both countries, there is a preference for boys over girls. The natural ratio is 103 boys for every 100 girls. In both countries, many families are abandoning or aborting girls with the result that there are 70 million boys growing up in each country who will never find wives. What kind of social and political problems will these countries face with such a lopsided ratio?

## Investment Implications

Nineteen of the lowest fertility rates in the world are on the European Continent; the 20<sup>th</sup> lowest rate is Japan. Can countries with overall declining populations show strong GDP growth over the long haul? It seems unlikely – even for export driven economies. Nations with sharply declining numbers of workers and increasing numbers of retirees, who require growing financial support, will result in weak GDP. Corporate profit growth in these countries will eventually ebb as well. Thus, except for countries with an exceptional level of technology and innovation or those with multi-national firms with profits coming from abroad, investment opportunities in these countries will diminish. Good investment opportunities should be available from time to time but the overall level of growth of these countries' stock markets will probably slow. On the other hand, nations with increasing populations and democratic capitalist systems (such as Australia, Brazil, and India) could potentially offer excellent international investment opportunities. China is an anomaly because, although it has had remarkably strong GDP growth which should continue for the foreseeable future, its population will eventually age rapidly with the government's mandatory one-child-per-family policy. China also has not yet made the transition from Communist control, which endangers property and human rights, to democracy and the rule of law.

Niall Ferguson, the famous and provocative Harvard history professor quoted at the beginning of the commentary, has been warning that investors are **not properly gauging the current level of global geopolitical risk**. He compares the current situation in the Middle East with the start of World War I, when many investors were blindsided by the outbreak of war and suffered economic consequences. With Iran proceeding with its nuclear ambitions at breakneck speed, the unstable situation in Iraq, and the anti-war sentiment in the U.S., he believes that investors must consider the geopolitical and economic implications of an American withdrawal from the Middle East. The more recent attack of militant Islam on the West started more than 30 years ago, and there is little reason to believe that it will cease any time soon. Thus, investors need to be very clear about their investment objectives and tolerance for risk and volatility, weighing carefully their need for capital preservation, income and growth of principal.

Ferguson's warning deserves consideration. In our view, despite many seemingly intractable problems, America continues to offer a stable political system with a 400 year old democratic heritage. America also has a fertility rate of 2.0, which is nearly self-sustaining, and with its immigration policy (both legal and illegal), the American population will continue to grow by the tens of millions each decade for the foreseeable future. Moreover, America has had a strong record of assimilating immigrants from diverse races, cultures and religions, whether it be in the form of a "melting pot" or a "salad bowl." From an economic perspective, America has a vibrant capitalistic and entrepreneurial culture, which has caused GDP to grow at 3.5% annually for many decades. Finally, America has the military power to prevail over its foes – assuming that it does not suffer from a failure of will.

Because of the above factors, the U.S. has been a haven for foreign capital, and American investors, before committing significant capital to foreign stock markets, need to analyze carefully not only the economic prospects of a country but also the geopolitical, demographic and social situation as well. While we enthusiastically follow foreign stock markets and believe that there often are (and will be) good opportunities to invest in selected markets abroad, we at Bradley, Foster & Sargent, Inc. continue to believe that the preponderance of an American investor's assets are best invested in the U.S. capital markets. This includes, of course, the ownership of key American multi-national companies which derive significant revenues and profits from their international operations.

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