

## **Spending Our Children's Inheritance: How Retirement Assets Support the Economy**

By most accounts, retail sales should be lower than currently the case. The combination of a moribund homebuilding industry, declining home values, and soaring energy prices seems the perfect storm for causing a sharp economic contraction. In fact, such a fall-off in economic activity has been forecast since the end of last year.

What keeps the economy going and employment higher than would otherwise be the case is first rising government expenditures. The growth in the size and expense of the federal government has been one of the most consistent anomalies of the current administration. For a political party that prides itself on its conservatism and prudent fiscal management, the budget deficits have been not so much an aberration as a revolution in political thinking. While this growth in government spending has not been embraced by all members of the Republican Party, it has had in the short run the salutary effect of keeping the economy going through the use of fiscal stimulus. The longer-term effect can be inflationary as the debts that are accumulated will have to be repaid with cheaper dollars.

There is another group that is contributing economic stimulus by engaging in deficit spending. This group though is spending its accumulated capital. This is the demographic group of those over 65 who are collectively classified as retirees, even though not all of them are retired. By living off and in some cases invading their accumulated wealth, retirees are generating demand for services which would not otherwise exist.

The reason the economic impact of retirees is understated has to do with the way personal income is computed for economic statistics purposes. Such income consists of wages and salaries as well as Social Security and pension (defined benefit) checks. It does not include the proceeds from IRA accounts or other defined contribution accounts. The rationale for this is that such accounts are disbursed at a rate often dictated by the participant. Since this can change to a great degree it cannot be forecast.

At one time IRA distribution income was negligible compared to Social Security and company pensions. Since companies converted pensions to what eventually become IRAs this is no longer the case.

Much has been made of the impact of the generation now approaching 65, collectively known as the baby boomers (those born from 1946 through 1964). Most of the impact is framed as being burdensome on the greater economy. What is often overlooked is that this demographic group holds the largest concentration of financial assets. Once retired, most start living off the assets or in some cases invading them.

To the extent assets are spent the economy benefits from the demand for goods and services from someone who is making no demand for employment in return. In this sense the demographic impact of those over 65 mirrors that of those under 18. Like the younger group, retirees do not for the most part demand employment in exchange for their economic contribution. The difference is that the young depend on government or parents to pay for their goods and services. Retirees depend on the government and their own assets.

To cite but a few examples of the impact of those over 65 on the economy: according to the Bureau of Labor Statistics, the second fastest growing sector in personal consumption for the next ten years is medical care and insurance with a projected growth rate of 3.6 percent per year. Growing even faster is a category called "recreation" with a forecast growth rate of 4.5 percent per year. With more time on their hands those over 65 are more likely to indulge in recreational activities. Since recreation is not something covered by government reimbursement as is medical care it perhaps represents a more accurate picture of the buying power of this group and its potential economic impact.

This is not to say retirees are oblivious to the current state of the world. Part of the current slowdown in consumer spending stems from some reluctance of those over 65 to spend. This is resulting in a sharp gain in cash assets among consumers as a category as buyers go on strike. This phenomenon is most striking in housing. There is a demographic case to be made for demand for housing but consumers as a group are afraid to buy a house that may be available for less at a later date. This causes the price of housing to fall which in turn reinforces the reluctance to buy. What is important to recognize is that the consumer is not tapped out as the mainstream press would indicate. Rather the consumer is accumulating cash assets, witness the balances in various cash accounts from banks and credit unions to money market funds.

However, the willingness of those over 65 to spend keeps the economy moving. In several industries, from restaurants to retail to cruises, the spending by retirees keeps the revenues from going negative. Clearly this is the segment that is generating the most economic demand at the present time. With paid-for homes and fewer financial obligations, the willingness of those over 65 to pay for medical and vacation services from their own assets if necessary has been a powerful and often unrecognized economic stimulus. While such spending may not be enough in itself to cause the economy to get back into high gear, it may prove enough to prevent the development of a serious recession.

## **The Economy**

The economy continues to stumble along in a slow but positive manner. Spending growth is minimal but positive. So is government appropriations and business investment. Exports have been the most standout performer year to date.

Consumer confidence is in the doldrums. This is caused more by housing and higher fuel and food prices. Clearly the increase in the cost of energy is having an impact on the choice of consumer products in demand as consumers seek out items that minimize energy use. Food prices are already correcting and should be coming down in some categories.

Housing is a more difficult situation. As buyers become more realistic in what they can get for their homes, expect the market to begin to function again. The high demand for seats at foreclosure auctions shows that in many areas there is a demand for housing at a low enough price. The best forecast for the revival of the housing market is around year-end to the first of next year.

## **Inflation**

Inflation is showing a high level of endurance in the price of oil and other commodities. Whether this is due to speculation or world-wide demand depends on the specifics of each commodity. Commodities such as food are seeing the first signs of a significant increase in supply which should in turn push down prices. Other commodities such as petroleum are more difficult to account for, making the argument of demand or stockpiling more difficult to ascertain.

One factor in inflation most people are not focusing on is the increase in the minimum wage set to take effect in July. Unlike the prior increase which affected few people due to the fact that the wage had not been increased in 11 years previous, the next increase to \$6.55 an hour will pull more workers along.

## **Interest Rates**

After a rebound in the latter half of March and April, interest rates have seemed to stabilize for Treasury securities. The perception of greater economic stability overall is holding up the credit markets.

While interest rates are still low by the standards of recent history, there does not at this time seem to be enough desire to lend to cause interest rates to increase in meaningful amounts. For this reason we expect rates to continue to be slack until credit demand comes back in a material way.

### **The Stock Market**

After advancing in a fairly strong fashion since the mid-March collapse of Bear Stearns, the stock market gave up a large chunk of its rally last week.

Such backing and filling is symptomatic of a market that is range-bound by low interest rates on the one hand and a lack of earnings visibility for most companies on the other.

While investing in such an environment requires more faith than when clarity is perceived to be greater, it can be more rewarding if done judiciously.

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