**The United States & Japan**

# TWINS IN DENIAL

## IT'S DEMOGRAPHICS, STUPID!

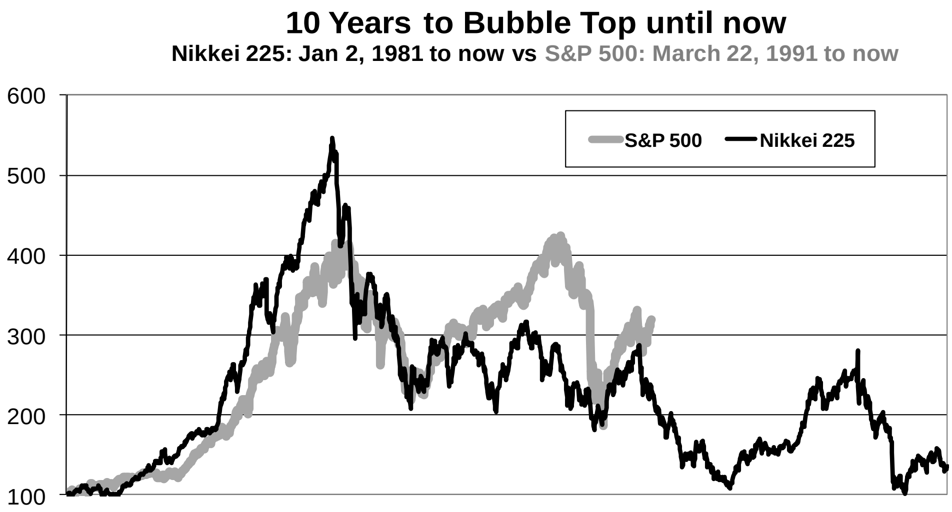
**By Thomas P. Signer**

# INTRODUCTION

America’s “Japan problem” has become impossible to ignore. Without question, Japan’s key predicament, a persistent combination of anemic economic growth, soaring public debt and deflation, has come to haunt the US. To name only two striking parallels in the realm of financial markets: Interest rates on US government securities have reached levels comparable to Japan’s historically low rates, and the US stock market has shadowed the Japanese market’s lackluster performance for a prolonged period of time.

Nearly all of the big players in the sphere of economics and finance have paid lip service to the parallels between the US and Japan at one point or another. In fact, nobody summed up the collective view in the US better than President Obama in his first presidential press conference on February 9, 2009. In response to a question President Obama stated: “*We saw this happen in Japan in the 1990s, where they did not act boldly and swiftly enough and, as a consequence, they suffered what was called the lost decade.”*

With this comment, President Obama neatly captured a comfortable consensus among American leaders in government, the Federal Reserve, and academia over the past decade regarding American economic exceptionalism: While acknowledging parallels to Japan, American commentators invariably point to America’s superior policymaking, signaling their faith that US policy is nimble enough to avoid a Japan-like situation. American officialdom would simply not allow the economy to deteriorate as badly as the Japanese have done.




*Source: Bloomberg, weekly data normalized, own graph*

[An up-to-date graph is available on www.twinsindenial.com.]

While the Japanese may have racked up industrial successes, they would forever lag behind the Nobel Prize-accumulating Americans in the field of economic policymaking.

These platitudes continue to be rehashed, even after the downward spiral in US financial markets; even after the economic downturn proved to be far more brutal than anything experienced earlier by Japan.

America's approach to any suggestion of a parallel with Japan can be summed up in one word: denial. By stubbornly refusing to regard their policy as anything but superior, American policymakers have passed up the opportunity to change course to avoid the once-in-a-century crisis that has now emerged. The captains at the wheel of the Great Ship of State—at the Federal Reserve, in the administration and in business—disregarded the ominous signals emerging from Japan warning of the iceberg ahead. Even those who explicitly professed to having studied and learned lessons from Japan drew the wrong conclusions.

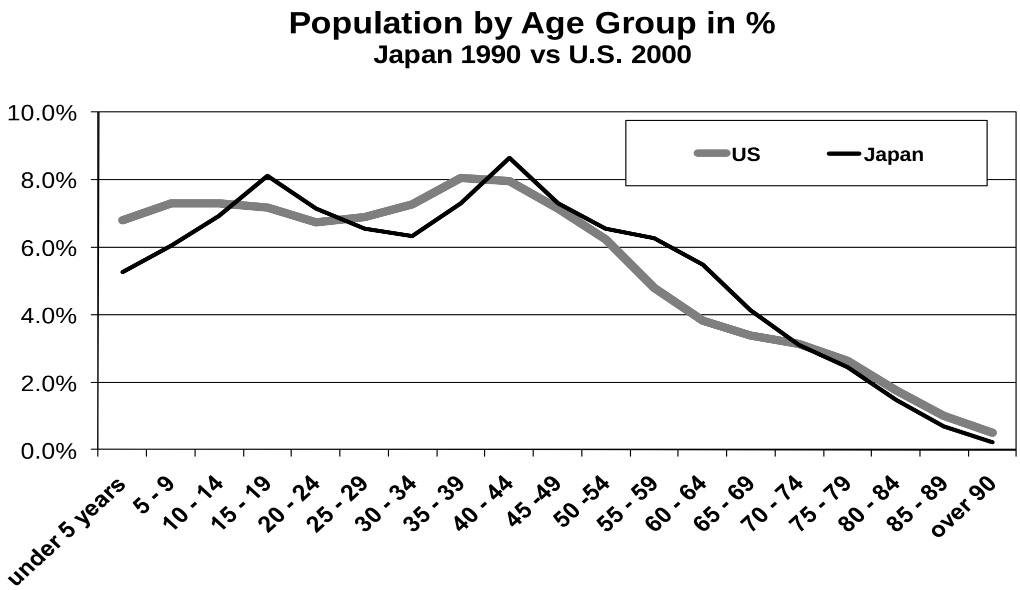
The US is following Japan's trajectory with a time lag of a decade and has broadly done so since the early '90s. America and Japan experienced nearly identical bubbles in the stock and real estate markets, and now America finds itself dealing with the aftermath of a bust that is even more severe than Japan's was in the Asian crisis (1997-1999). Indeed, as I stated in my first book, *The Harder They Fall: Will the US follow Japan into the Abyss?* (2004), Japan is the best and only relevant case study to predict what will happen to the US. Based on Japanese precedent I predicted that *"in general, deflation [...] will pose the greatest problem to the [US] economy for the foreseeable future."* Further, I projected Japan's financial market performance forward to the US and argued that *"with little price pressure, the bond market will perform strongly and long-term interest rates will decline further. In this environment the American stock market will trend down. It won't need to mirror the Japanese market entirely, which dropped eighty percent from its peak at the end of 1989 to a low in 2003. Nevertheless a drop of at least fifty percent from its high is a near-certainty in my view. That will eventually bring the Dow Jones below 6000 and the S&P 500 below 700. Most certainly, the stock market gauges will end the current decade at much lower levels than they started it."* I also envisioned that *"the fall in asset values will hurt those most who own them or have extended credit against them. As in Japan, the entire financial sector will follow a rocky road. Stocks of financial institutions are likely to perform worst as a group."*

As for real estate, I concluded that *"American real estate will perform badly, too… This will weigh heavily on those sitting on mortgage debt … The federally-sponsored mortgage entities Fannie Mae and Freddie Mac will most certainly face big problems by the second half of this decade."* Japan was the perfect case study to show what would happen in the US.

This new book is not a simple restatement of the thesis from my first book. Yes, I do want to make the point loud and clear one more time: the US is shadowing Japan. The similarities are striking while the differences pale.

This time around however, I delve deeper into the origins of the similarities. I must point to a widely disregarded parameter: demographics. Demographics is the elephant in the room that the entire finance profession has regarded with benign neglect up until recently. It had certainly not been a candidate in the search for parallels between the US and Japan.

Yet, surprising as it may seem, the US does share astonishing demographic similarities with Japan, again with a time lag of a decade. The similarities are captured in the following snapshot of the two countries' population structures according to age cohort in 1990 and 2000, respectively. These two dates correspond uncannily to the peak of the bubble in the respective countries' stock markets. Japan's age structure in 1990 (the respective percentage of the population falling into a specific 5-year age cohort) exhibited very much the same camel-back shape as the US ten years later**.**




Source: Statistics Bureau, Ministry of Internal Affairs and Communications (Japan); Bureau of Census (US), own graph

This graph shows that the US is also broadly tracking Japan with a time lag of a decade regarding age structure. Strikingly, the US experienced its giant stock market bubble in the 1990s with a demographic backdrop similar to the one during Japan's bubble in the 1980s. This parallel also applies to the painful busts experienced in both countries.

This book argues that there is a strong causal relationship and, further, that human behavior is age-specific yet constant across time and culture.

These parallels go far beyond the worlds of finance and economics. I assert that the universal validity of my thesis is derived from the observation that the Japanese constitute the ideal "control" group. The very fact that Japan has a unique history, sharing little in common with the West, allows us to rule out the role of many other possible factors—such as culture, customs, or even geography—in creating the stock market and real estate bubbles. Instead, we can pinpoint age-specific behavior and thought patterns as the root cause of US-Japan boom-bust parallels.

Identifying the role of age-specific factors in driving the US-Japan parallel is furthered by the fact that the prices of stocks and real estate are determined by a large, diverse group of individuals. The prices of stocks or bonds are the result of the demand and supply relationships of a myriad of individuals, and, directly or indirectly, through their stakes in pension funds and mutual funds. Financial variables like stock indices or interest rates on government bonds are not easy to manipulate for any prolonged period, allowing us to infer quite a lot about the collective behavior of the individuals involved. In short, stock and bond markets offer a fabulous universe to study human nature. They are great representations of the collective, for in all cultures and societies humans undisputedly share one trait: everybody wants to become better off. As Voltaire once succinctly put it: "When it is a question of money, everybody is of the same religion." This renders financial markets the perfect testing ground to analyze human nature.

The parallels between the US and Japan allow us to closely examine the hypothesis that mankind exhibits constant age-specific behavior and that the overall direction of a society is substantially determined by its age composition. This goes far beyond simply attributing developments to "human nature" or "animal spirits." Over time I have come to believe that the changing age composition of a country is the *key* driver of inflationary and deflationary trends and of asset price cycles, including equity and real estate bubbles. The implications that follow from the recognition that stock and bond market performances are themselves the product of society's collective aging process have the potential to make a profound impact on our understanding of market behavior.

Readers may be wondering why I focus only on the US-Japan parallels and leave Europe out of the picture. My objective is simple: By showing that two peoples as diverse as the brash Americans and rule-abiding Japanese can produce the same outcome for a given dominant age structure, my thesis gains validity and rules out other possible causal factors such as culture or ideology.

My age-specific behavior thesis runs directly counter to some prominent arguments, including those forming the central element of Nassim Nicholas Taleb's thought-provoking book “The Black Swan.” In it, Taleb makes a number of extraordinarily new and intuitively appealing observations that were, maybe not entirely coincidentally, partially gained during a professional career similar to my own. Taleb argues that the world is driven largely by random events, the impact and frequency of which are hugely underestimated. Many of his observations and inferences are beautiful and often entirely valid, but on the whole they are not very useful, especially for guiding government policy. While I agree with many of his arguments, I believe Taleb’s key point—that human history is essentially the result of randomness—is fundamentally flawed.

A nation’s biography, in my view, is largely shaped by demographic trends that are generally highly predictable, albeit with some modest background noise.

My own life story brought me to this particular view of the world, and my own stage-of-life behavior—that I can see now as I look back—provides substantiation for this. Born in Switzerland in 1964, at the very end of the baby-boom generation, I grew up as the youngest of six children in a middle-class family. Following a year at a Swiss university, I transferred to a college in Ohio, returning after graduation to become a salesman of Japanese stocks at the Swiss subsidiary of Nomura Securities, then and now Japan’s premier investment bank. There I participated in the heyday of the stock market bubble in the late 1980s.

In the fall of 1988, I returned to the US to enter business school. After graduation I re-joined Nomura, this time as an associate in the company’s structured finance department on Wall Street, where I helped create early prototypes of the WMD instruments which later, in a more sophisticated form, helped cause havoc on a global scale. In 1994 I joined Morgan Stanley, selling equity derivatives in Zurich and in London. There I witnessed first-hand the giant “new economy” bubble in the making. In 1998 I returned to Switzerland to set up a short-lived hedge fund.

Licking my wounds from that humbling asset management experience, and a good deal wiser, I chose to remain independent and to advise others on how to manage their finances. In recent years I have supported attorneys as an expert witness in disputes involving asset management activities (a classic conversion from poacher to gamekeeper). I also teach finance to MBA students in Switzerland and outreach programs in countries of the former Soviet Union. And, finally, I have started to manage money again—this time with positive results, thanks to the lessons learned that I have recounted in this book.

As for my private endeavors, there aren’t any that point to particular sophistication or foresight. I don’t regularly frequent the opera, am likely to applaud at the wrong moment in a classical concert and haven’t read the classics (if you exclude Michel Houellebecq).

One characteristic that does set me apart from my average peer is that I have had plenty of what most people are forever short of: time. Time to wander, watch the world and wonder. This is a byproduct of the narcissistic traits common to many authors that have left me without the serious obligations of caring for a wife or serving as role model to children.

With this lengthy introduction of myself, I hope to make two points. Firstly, my career is by and large a byproduct of the boom and bust cycles in stock and real estate prices in Japan and the US, whose striking parallels I will seek to demonstrate. It seems natural to use it as a backdrop to revisit the key events and developments over the past two decades. Indeed the zigzags of my career provide the general outline of this book, as does my continuing proclivity to be in the right place at the right time (if being in the right place means spending twenty years in heavy seas).

Secondly, I hope to have succeeded in establishing my “everyman” qualities, which are critical to justifying the use of my biography as a template—for age-specific, predictable behavior.

Demography is indeed destiny. It moves slowly, with generational effects moving through culture like a “pig through a python”; too slowly to make the news or to grab the attention of the masses. Given its measured pace, a country’s demography is predictable years into the future. Since my case substantially rests on demography, I hope to show readers that predictions about the future can be made that have important ramifications not only for investment decisions but also for their personal contentment.