Chapter 4

Where we are headed

A parent's advice to their child in late 1990s Britain: "My dear child, go to university if you feel like it, but don't bother taking a degree in a subject that will help you to do something productive for the world. Instead, buy an apartment in London with borrowed money, perhaps several apartments, and your prosperity will be assured."

A parent's advice to their child in late 1990s China: "My dear child, get a degree in engineering. Then you can work for a consumer products company selling to Westerners living on the debt provided by asset-price bubbles."

All of us would love to be able to see into the future, especially when we worry about the financial security of our children. The purpose of this chapter is to argue that there is a lot of clarity about the next 10 years and beyond, although we might prefer to ignore it.

The key issue is that the next decade will be radically different for all of us, whether we live in the developed or developing world. And by 2021, the world will have realised that the SuperCycle seen between 1982 and 2007 was an exceptional period of time. It will not be repeated in our lifetimes.

The reason is that the economic boom seen during the SuperCycle was driven by the maturing of the Western baby boomers (those born between 1946 and 1970), as we discussed in Chapter 1. They are the largest, and wealthiest, generation that the world has even seen. And they created a surge in demand for housing, autos and electronics as they entered the 25–54 age range, when people typically settle down and have children.

But by 2021:

- Most boomers will have left this age range, and there will instead be 324 million Westerners over the age of 55 years
- They will account for 33% of the Western population (North America, Western Europe, Japan, Australia, New Zealand)
- By comparison, there were only 148 million over-55s in 1970, when the boomers began to move into the 25–54 age group

The over-55s typically spend less and save more. And the boomers will be spending very much less as they retire, because of greatly reduced incomes. They will have learnt the hard way that a pension pot of even $250,000 only provides a very modest income.

Equally, they will have to save as much as they can afford, in order to provide for their extra decade of life expectancy compared with previous generations. Their savings will have pushed down interest rates in the more stable economies to Japanese levels of around 1–2%.

As a result, this is what the world may look like in 2021:

1. Western countries will have increased the retirement age beyond 65 in order to reduce unsustainable pension liabilities. Deep cuts will have been made to social welfare programmes as governments struggle to reduce their debts
2. Taxation will have been increased across the Western world in an effort to tackle the public debt issue. It will no longer be relatively easy to move large sums of money off shore to countries with lower tax regimes, as regulations will have been tightened
3. Western and Asian property markets will be flat, having suffered major price declines. Housing will no longer be seen as an investment that will act as a pension fund. Around the world, house prices will instead be back at levels which are affordable for the majority of wage-earners
4. A major shake-out will have occurred in Western consumer markets. The SuperCycle led to a focus on the middle market as the boomers increased their spending. But by 2021, the middle classes in the West will have largely traded-down to bargain-basement shopping. The mid-market will be a small shadow of its former self. Luxury spending will once again be confined to a small minority as debt levels will be much lower
5. Consumer products companies will have also recognised that in the emerging economies the phrase 'middle-class' doesn't mean that people enjoy Western income levels. Instead it is often used to define those in the middle of the population earning only $2–10/day. Companies who have understood this and have focused on more entry-level products will be reporting very strong sales and profit growth
6. Chemical markets will have become more regional. The slowdown in boomer demand will have reduced the need to outsource production from the West. This will probably have been accompanied by a growth in protectionism as politicians – focusing only on the next election cycle – erect tariff and other trade barriers
7. Social unrest will have become a more regular part of the landscape. Countries with younger populations such as those in the Middle East will be angry at the lack of employment and prospects for income. Those with older populations will complain about the impact of government debt-reduction programmes on their lives and the reductions in entitlement programmes
8. Both young and old will be focused much more on 'needs' rather than 'wants'. Consumers will look for value for money and what is good for the environment as well as their budgets. Frequently asked questions will include "why not make the old car last a bit longer?" or "do I even need a new car?"
9. Investors will be focused on 'return of capital' rather than 'return on capital'. Their prime aim will be to understand the riskiness of any investment rather than its potential to make them rich

overnight. Financial measures such as EBITDA (earnings before interest, taxes, depreciation and amortisation) will have fallen out of favour. Investors' prime aim will be to understand the riskiness of any investment rather than its potential to make them rich overnight .

10. A new mood will also have replaced the consumerism that drove the SuperCycle. In part, this will be driven by anger over the asset-bubble era that left governments bankrupt. But it will also be driven by a growing desire to develop a more sustainable way of life in contrast with the environmental recklessness seen during the SuperCycle.

Montage of riots in Greece in 2011

Source: Wikipedia

NO NEW "WEALTH EFFECT"

The evidence is there – we only have to accept it.

"In these circumstances, human nature is to resort to an 'active state of inertia' and look back to what we are familiar with rather than try to define the new paradigm. That kind of Old Normal oriented behaviour is clouding many people's views," wrote Mohamed El-Erian, co-chief investment officer for PIMCO (the world's largest bond fund managers) in an October 2009 article.

The inflation-adjusted income of the median US household fell by 4.8% between 2000 and 2009, according to the US Census Bureau in its annual report released in October 2010. The decrease between 2007 and 2009 was 4.2%.

This was worse than in the 1970s, when incomes rose 1.9% despite high unemployment and inflation.

John Richardson remembers driving through rural Texas in March 2008 and wondering where the next "wealth effect" would come from for the vast majority of Americans following the end of the housing boom.

The surge in real-estate values enabled average and low-wage earners to use their properties as ATM machines – ie the refinancing that drove the consumer-spending boom.

But in the second quarter of 2011, the percentage of those owning a home in the US fell to 65.9%, the lowest in 13 years. This percentage is expected to fall further because of the big stock of unsold homes and persistently high foreclosure levels. Borrowers are also expected to continue to struggle to meet much stricter standards for obtaining a mortgage.

Gone forever are the days of the "no money-down, low-interest-rate mortgage" common in the West during the final years of the SuperCycle.

In the UK, average loan-to-value levels have fallen to ~55% in 2011, with lenders typically requiring deposits worth at least 25% of the value of property. Loan-to-value levels of up to 120% with no deposit were common between 2005 and 2008.

UK mortgage approvals are now at half their rate before the global financial crisis as banks are forced to rebuild their asset bases.

"The simple reality is that house prices are too high in most parts of the country and, until they fall significantly, there will not be a strong housing industry," Jonathan Davis, a financial adviser, was quoted as saying in *The Independent*, a UK newspaper.

Even the US, which launched $5 trillion of stimulus spending, has still not yet seen its GDP recover to pre-Great Recession levels, as shown in Chart 44.

There are many reasons for the slow recovery of the US economy since its 2007 peak, including a failure to create new types of employment to compensate for the great jobs drift to countries such as China.

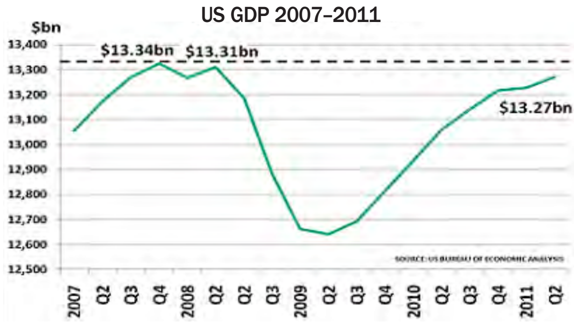

Chart 44: US GDP growth between 2007 and 2011

Source: US Bureau of Economic Analysis

More than eight million American people lost their jobs in the recession, and fewer than two million of those jobs had been regained by July 2011.

Nearly half of the unemployed had been without work for more than six months, the highest percentage since the Second World War.

Many of these workers may well stay unemployed, and so risk losing their self-confidence and self-esteem and seeing their skills atrophy.

An additional problem is that state and federal governments will have less money to support the unemployed, pensioners and those in need of state-funded medical care through these difficult years, because of the unavoidable need to reduce debt levels.

LIVING LIABILITIES

The dream of retiring after 30 years on 50 per cent of your final salary will no longer be an option for most boomers. Pension funds are already suffering as stock markets weaken and government interest rates reduce in the more stable countries.

We focus on the US debt crisis below as, of course, its economy matters the most to the world.

"In addition to our existing $10 trillion of outstanding Treasury Debt, the US has $66 trillion of future liabilities at 'net present cost'," wrote Bill Gross of PIMCO in an August 2011 article. "The combined present cost payment due from Medicaid, Medicare and social security is (therefore) over six times obligations of Treasury debt."

The financial press was used to only measuring paper debt, instead of also including these living liabilities, he continued. But "as long as 330 million Americans require promised entitlements, the $66 trillion figure is as much a liability as the $10 trillion on paper," he added.

As people get older and live longer, entitlements will therefore have to be reduced and retirement ages increased.

The scale of the US debt problem also represents a huge threat to the rate at which the economy can grow, according to academics Kenneth Rogoff and Carmen Reinhart.

They have studied what happens when countries assume liabilities which future growth cannot easily finance. The watershed line is 90 per cent debt to GDP, beyond which economic growth slows by approximately one percentage point as high levels of interest payments stunt potential growth.

"Developed countries in general are approaching or have already gone beyond this watershed. This means we can expect growth of only 2% rather than 3% per year, which represents "stall speed" for the economy," said Gross in another article written for the *Financial Times* in July 2011.

At this low level of growth, corporations lose the incentive to invest because profit growth stagnates and so unemployed workers are not rehired. Economic models of cyclical recovery will no longer apply.

The US Treasury Department announced in August 2011 that gross debt had risen to above 100% of GDP. This meant America had joined a small group of countries whose public debt exceeded GDP. These included Japan (229%), Greece (152%), Jamaica (137%), Lebanon (134%), Italy (120%), Ireland (114%) and Iceland (103%), said the International Monetary Fund.

Chart 45 gives some historical perspective to the US debt crisis up until the end of 2010.

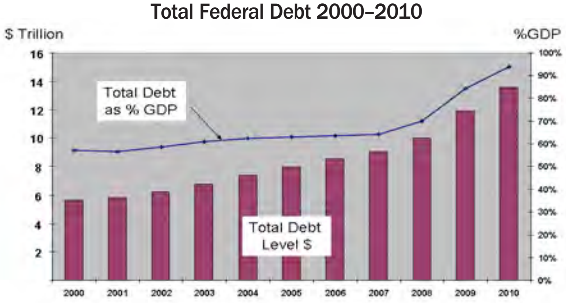

Chart 45: Total US Federal Debt 2000–2010
Source data: BEA, CBO, Treasury Direct
Source of chart: Wikipedia

A FOCUS ON NEEDS RATHER THAN WANTS

A remarkable shift in spending habits is taking place as the middle classes come under enormous pressure in the West.

Some of the changes have already taken place and will remain a permanent feature of the new retail environment. Further changes lie ahead due to the loss of household wealth, the stagnation in wages and fiscal austerity. There will be no return to either the consumption levels or consumption patterns of 1982–2007.

Neilsen Australia, the consumer analytics company, conducted an online survey of changing consumer behaviour in Australia in April 2009, which showed that:

- 56% of shoppers had switched to cheaper grocery brands as a result of the global financial crisis
- Around one-third said they would continue to purchase these cheaper items even when economic conditions improved
- In January 2011, 92% of Australian consumers said they would stick to cheaper groceries or "private label" supermarket brands.

Yet Australia, being an economy based on natural resources, has seen a relatively strong recovery since 2008 compared with most other Western nations.

"People are now spending more time collecting money-off coupons from magazines etc and searching the shelves for 'two-for-one offers'," we were told by a Melbourne-based plastics packaging manufacturer. "I wouldn't be surprised if a survey came out showing that the average time spent shopping had gone up."

Throughout the developed world there has been a shift from frippery to value-for-money. The image of a product has become less important as shoppers focus on a deeper analysis of cost benefits.

Other emerging trends include:

1. The rise of online shopping as "bricks and mortar" retailers are replaced by "clicks and mortar" business models. Tesco, the world's third-largest retailer, expects to see a world where consumers take advantage of cheap offers online and then collect their purchases from a local store. This is in complete contrast to the retail growth model developed during the SuperCycle, where

consumers were prepared to drive out to superstores and load up with purchases. This new hybrid online model is set to accelerate thanks to improved internet connectivity and better customer protection, payment and delivery systems

2. A focus on needs rather than wants driven by the need to save money, plus a growing recognition that much of the wealth created during the SuperCycle was wasted rather than being used to provide the basis for future growth. Thus car owners are keeping their vehicles for longer, while those without a car are wondering whether they really need one even if they can afford it.

NOT AS RICH AS EVERYONE THOUGHT

The New Normal will be a more realistic world where people enquire more deeply into the facts given to them by talk-show hosts. One such 'fact' is the idea that China and India each have a billion-plus consumers and their growth in demand will more than compensate for weak Western demand.

A whole industry has built up to promote the idea that this is the 'Asian century'. It is based on the idea there will be an explosion of demand for autos, washing machines, refrigerators, computers, mobile phones – you name it – in China, India and elsewhere. And we are meant to become optimistic and excited by the opportunities of turning China and India into another America.

Sadly, the truth is far more prosaic, as Chart 46 demonstrates in the case of India.

India will only have 11 million "affluent" households by 2013, according to India's National Council of Agriculture & Economic Research. Its definition of affluent is any household earning more than $4,675 a year.

In the West, entitlement systems would kick in for any individual, never mind household, earning anywhere close to this amount. They would be classified as very poor.

An even more striking figure is that the aspirers, those households hoping to become middle class, earn just $975–4,675 per year. They will total 124 million by 2013. This is a level of poverty beyond the comprehension of most Westerners.

This is not going to be a nation of mid-priced SUV buyers, of families who can afford one modest foreign holiday a year and the odd flat-screen TV.

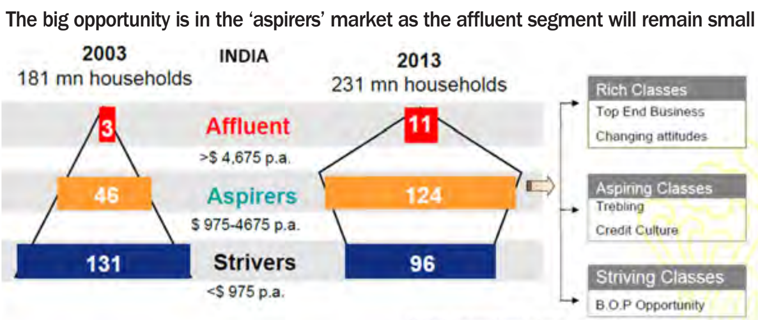

Chart 46: The Real Nature Of The Indian Opportunity
Source: National Council of Agriculture & Economic Research, India

China's 'aspirers' and 'affluent' are the main urban growth market

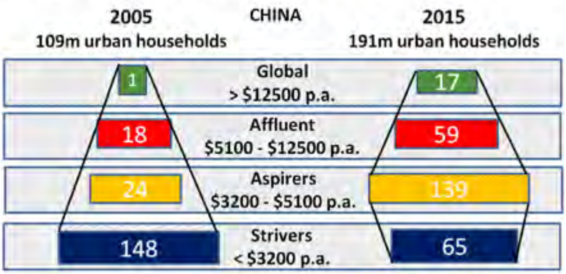

Chart 47: What It Means To Be Middle Class In China
Sources: National Bureau of Statistics, McKinsey Global Institute, Beijing Axis

These are "dirt poor" by the definition of Western consumer-goods companies, with the 96 million households earning less than $975 a year by 2013 way off the scale for any conventionally-minded company.

Indians, despite the high-profile millionaires and billionaires, will predominantly get about on scooters or push-bikes and if they can afford TVs they will want the most basic of designs. And they will probably buy only one such TV for their extended family.

They will be ferociously cost-conscious and they will continue to shop hard for bargains and re-use and recycle – skills Westerners are going to have to learn.

An Indian bargain is a single-serve sachet of shampoo at one rupee a time. Tens of millions of Indians are so poor that consumer-goods companies provide numerous personal care and food items in single-serve pouches. Being too poor to afford a whole bottle of shampoo is beyond the imagination of most Westerners, who are used to collecting such sachets as free gifts from even the cheapest of hotels.

The story is the same in China as Chart 47 also illustrates.

As with India, consumer goods companies are going to have to produce very-low-cost products to meet the needs of China's Affluent and Aspiring households.

This will require a great deal of innovation and creative thinking to find cheaper ways of making existing product lines while also developing whole new product lines. Can a computer be manufactured that will retail at less than $100 and can it be made to last several years?

And as China's economy has been so focused on exports, it risks considerable disruption as it moves to become more focused on the domestic market. This differentiates it from India, which is much poorer, but whose economy has always been primarily domestic-focused.

This might be the Asian century in the sense that emerging economies such as India and China will, perhaps, continue to grow at higher rates than the West. But it will take several generations before most of those in India and China are anywhere close to being as rich as the American or Western European middle classes, as we discussed in Chapter 1.

Maybe the transition to a Western way of life will never be achieved in countries such as China. Resource constraints could make it impossible for the Chinese to, for example, end up with per-capita car ownership the same as the US.

The New Normal might instead offer us a new model for economic growth, based on the megatrends now being pursued by some leading companies.

IT DOESN'T HAVE TO BE THIS WAY

The New Normal offers the potential to restore a greater balance to society if companies refocus their creativity and resources on real needs, as we shall discuss in the next chapter. These include the global megatrends of increasing life expectancy, improving water availability, increasing food production and reducing carbon footprints.

"As a consequence of climate change, farmers will face growing unpredictability and variability in water supplies and increasing frequency of droughts and floods," said the Food and Agriculture Organization of the United Nations.

"By the 2080s, land unsuitable for rain-fed agriculture in sub-Saharan Africa due to severe climate, soil or terrain constraints may increase by 30 to 60 million hectares.

Water shortages caused by climate change are just one of the megatrends that provide tremendous opportunities for economic growth over the next decade and beyond if companies have the will and ability to develop the necessary solutions.

The examples we give here are not meant to be exhaustive – you can even add your own.

Returning to water, what about the problem of leaking old ceramic and metal water pipes in urban areas? How should companies innovate in order to provide cost-effective solutions to this problem?

It is not just about just preserving water but about treating water. Millions of people die every year in developing economies and suffer serious illnesses because of water-borne diseases. The SuperCycle led to a world where the affluent rich worried about obtaining the latest smart phone, while the majority of the world's population worried about access to safe water and sanitation.

Food preservation is a huge challenge in countries such as India. More than 50% of food rots before it gets to the people who need it. This is nothing short of tragic, perhaps criminal in this current age of

Projected climate change impact on agricultural GDP and cereal production by 2080

Region	Percent change in agricultural GDP	Percent change in cereal production
World	-1.5	-1.4
Developed	-0.5	+2.8
North America	+7.5	+1.3
Europe	-14.7	-3.4
Developing	-1.9	-3.9
Sub-Saharan Africa	-4.9	-0.6
Asia	-4.3	-8.6
Latin America	+3.7	+15.9

Chart 48: Projected climate change impact on agricultural GDP and cereal production by 2080
Source: Food and Agriculture Organization of the United Nations

supposed technological advancement. As population pressure increases in India, lowering this percentage would be another route to profitability and employment – and to a stronger sense of social justice.

Because the West is getting older, the lifestyle and healthcare opportunities are also nothing short of enormous. Is there a way of manufacturing a lightweight, very cheap chairlift that can be self-installed? What about the scope for constant innovation in food supplements, and gene-based pharmaceuticals to tackle key ailments?

Sustainability is in itself a megatrend. The boomers fiddled around the edges of the problem with heavily-subsidised government renewable-energy schemes. As Bill Gates has argued, solar-cell panels and wind turbines are "cute", but don't do anything to solve the problems.

There is an urgent need for companies to focus on basic research rather than on using government grants to deploy old technologies. Industrial-scale solar-cell schemes in the desert might just do the trick of providing viable alternatives to fossil fuel-based energy.

Solutions such as this will have to be the result of long-term partnerships between governments and companies.

Things also need to be made to last. Gone will be the days of throwaway junk. This will be better for the environment in many ways, not just in terms of CO_2 emissions. Companies successfully tackling this problem will benefit both from heightened environmental consciousness and the need to save money because of the much-more straitened economic circumstances of the vast majority of Westerners.

Queueing for essentials in Britain during the Second World War
Source: Associated Newspapers/Rex Features

A DIFFICULT JOURNEY

These are going to be difficult times, less comfortable and less assured for many millions of Westerners.

The wider population will find itself following the model of the ageing boomers as it gets used to consuming less and saving more. Rather than expecting their assets to grow magically in value every year, they may find instead themselves struggling to pay-down debt left over from the credit binge.

Education systems are going to have to change in order to enable a transformation in manufacturing industry. More engineers and more scientists are going to be required to create the new products that will serve the needs arising from the megatrends. But this will take time, even if we start today.

It is easy to make fun of how useless "soft degrees" from third-rate educational institutions have become. But it is going to be very difficult to return to a world where a degree really means something and is much harder to attain. How long will it take to convince young people that a greater focus on vocational skills is required?

This highlights the key issue of mindset. Recognising the scale of the problem is the first step towards changing attitudes. The acceptance of failure as a learning experience will also be crucial as companies search for solutions to the megatrends.

We will also need to find politicians with sufficient vision to lead the biggest economic and social transformations since at least the Second World War. If such politicians are going to survive in office, voters will have to accept that economic problems are not going to be solved overnight.

Of course we could, as Mohamed El-Erian says, simply decide to ignore all of this unpleasantness and sink into an "active state of inertia".

But doing nothing is not a solution. It will mean we miss the opportunity to create a new wave of global growth from the megatrends. And we will instead end up with even more uncomfortable outcomes.