Scary Story: Global Stock Declines and the Baby Boom

In the past decade or so, an economist asked to tell a horror story over toasted marshmallows at a cookout would not have conjured up empty McMansions haunted by subprime ghosts (though in retrospect that would have been a pretty good tale). Instead, among friends if the mood was right, we might say to each other in a spooky voice "think what will happen if the baby boomers all decide to cash in their stock investments at the same time!" Followed by nervous laughter and a quick change of subject.

At first blush, it seems that we were barking up the wrong tree. Today's global conflagration originated in the market for subprime mortgage securities, which has little evident connection to boomer retirement investment decisions. It is easy to follow a direct chain of links from the subprime sparks that first flared in the spring of 2007 all the way through to last week's stunning losses in stock markets around the world.

The problem with this narrative is that it is like explaining a devastating forest fire by reconstructing the exact pattern by which sparks jumped from one stand of trees to another, when the key question is really why the forest was so flammable in the first place.

Put it another way: Last week's massive losses on global stock markets cannot plausibly be attributed to lingering concerns (however justified) about the creditworthiness of American subprime mortgage-backed securities, because the amount of vanished global wealth dwarfs the value of all the subprime mortgages put together. Something else is going on.

That 'something' is probably best described as a sudden sharp increase in global risk aversion. It will be weeks or months before a clear picture emerges of who is fleeing risk, and why. But when the dust settles, I am guessing that the answer will be clear: The recent rout has been driven by too many baby boomers and retirees (not just in America but around the world) trying to crowd through the risky-asset exit doors at the same time.

The reason economists have been worried that this might happen is that personal finance books are right when they advise people to reduce their exposure to financial risk as they age. As your marketable skills diminish over time, you gradually lose the option of going back to work in response to a bad financial shock. The rational thing to do is to reduce your exposure to financial shocks with age.

In a population with a stable age structure, these portfolio shifts can be accomplished without even a hiccup in market prices; older people with a declining appetite for risk just sell their stocks to the equally large up-and-coming younger generation.

But a baby boom demographic bulge is like a hamster eaten by a snake: The hamster is so large that it distorts the snake's body on its way through the digestive tract. Similarly, perhaps the movement of the baby boom bulge through the financial system has led, at least in part, to the recent dislocations.

In detail, the story might go as follows. When the baby boom hamster reaches middle age and accumulation of home equity and retirement savings are at their peak, boomer demand bids up the prices of homes and stocks (perhaps also causing a housing construction boom). Then, approaching retirement, the boomers all try to downsize from their empty-nest homes and switch from stocks to safe investments at roughly the same time, setting off housing price and stock price declines.

Economists have treated this scenario as an implausible campfire story rather than a sober economic forecast for several good reasons. First, despite many attempts spanning several generations of researchers, it has proven difficult to find the expected kinds of demographic effects in aggregate saving data; for example, since boomers' late middle age should be their peak saving years, we should have seen an increase in the American personal saving rate over the last decade if demographic shifts drive aggregate saving. But saving rates have declined. Furthermore, with the baby boom generation so heterogeneous (spanning a 20 years of birth dates, in varying states of health, and with diverse preferences for risk), it seemed that changes in risk preferences should be gradual enough to prevent destabilizing "stampede" effects – especially with foreigners (until now) willing to step in and buy the risky investments as the aging boomers sold them. Finally, the timing seems wrong – one would expect a boom in housing before the boom in stocks, the opposite of the pattern we have seen.

Nonetheless, it seems increasingly plausible that the financial panic has pushed a lot of boomers and recent retirees over a tipping point of concern; they'd been thinking for years that it was time to start reducing their exposure to that risky stock market, but never quite got around to it. Now everyone wants out at once.

Here's a fact that lends some credence to this story: 2008 is the first year that any members of the American boomer generation have been eligible to receive Social Security retirement benefits. The *really* scary thing is that 2008's trickle of retirees is just the start: The wave of retirements coming in the next decade will exceed anything ever seen before.

The one reassuring thing about this explanation is that it provides a rational, testable reason for the recent frightening events, and also provides a reason to believe that the damage will be contained. The stock market fell by 89 percent from its peak in 1929 to its trough in 1933, a decline that was not driven by a rational force like demographics. In fact, if everybody who was sitting on the fence until last week has now jumped off, maybe there is reason to hope that stock prices are close to a bottom, from which they can resume a more normal pattern of growth.

Only time will tell.