

January 2017

## Animal Spirits

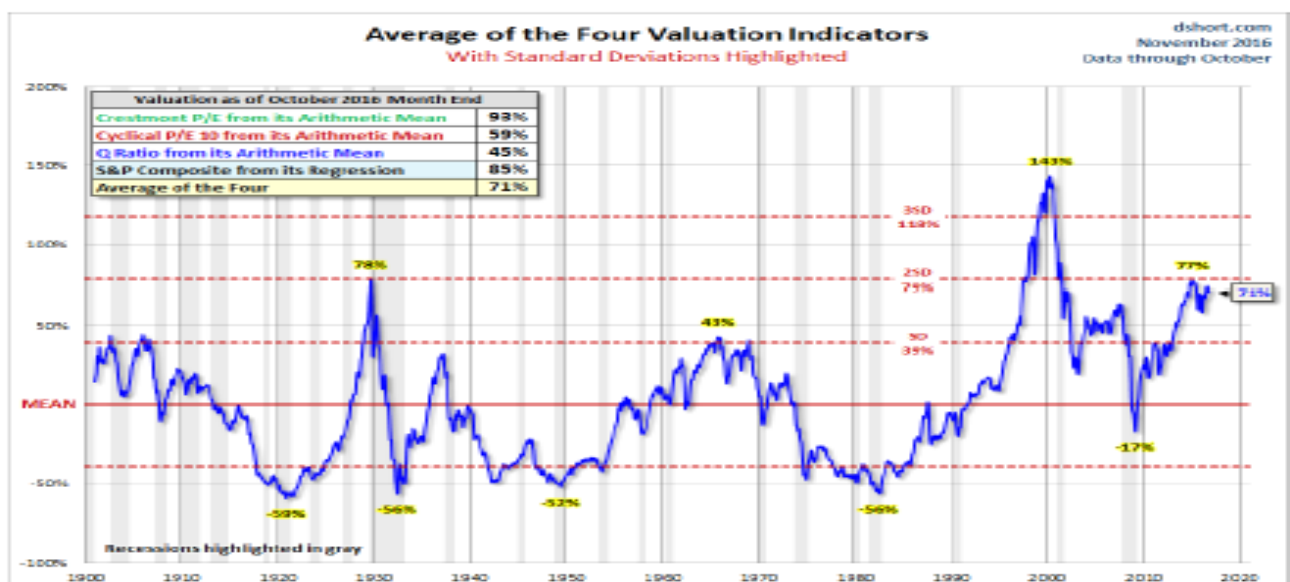
*"Most, probably, of our decisions to do something positive, the full consequences of which will be drawn out over many days to come, can only be taken as the result of animal spirits – a spontaneous urge to action rather than inaction, and not as the outcome of a weighted average of quantitative benefits multiplied by quantitative probabilities."* – J.M.Keynes

John Maynard Keynes was born in England in 1883 and lived until 1946. He is widely considered the father of modern macroeconomic theory. Prior to Keynes the dominant theory was “neoclassical economics” which held that free markets would lead, in the short and intermediate term, to full employment and economic prosperity. However, after the Great Depression many in academic circles (including Keynes) grew frustrated by the cycles of “boom and bust” that were prevalent at the time.

Lord Keynes believed that both fiscal and monetary policies were essential in mitigating the deleterious impacts of recessions and depressions (fiscal policy is controlled by governments and involves taxation and spending, and monetary policy is controlled by central banks through various measures, primarily by influencing interest rates and the money supply). This belief formed the foundation for a new style of “economic management” that began to be far more interventionist than it had ever been in the past.

As with many well-intentioned policies, there have been unintended consequences along the way. By placing so much control in the hands of so few, we have unwittingly traded the appearance of stability for the reality that markets can get severely out of balance because of these outside influences.

Case in point; by most objective standards the US stock market is overvalued (based on historic norms) somewhere between 45% and 93%, with an average of the four below measures at 71% above historic averages.

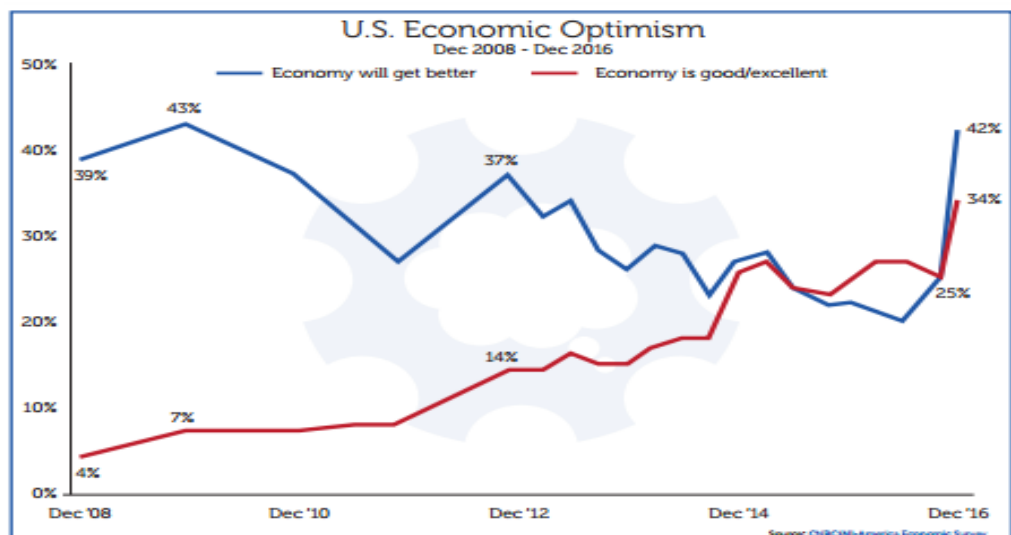


Advisor Perspectives November 2, 2016 – Jill Mislinski

Looking at the graph on the preceding page you'll see a repeating pattern of stock market highs and lows. 1929 marked the beginning of the worst period for the stock market, and the overall economy, in the past century. Notice the steep drop in stock market average valuations after 1930. What is interesting is that since that time, and with all of the intervention that has been imposed on the US economy since then (both fiscal and monetary), we haven't seemed to dampen the volatility of the stock market at all. In fact a strong argument can be made that the cycles have become more dramatic (see 1980 to current) – the opposite of the intended effect.

When talking about animal spirits, Lord Keynes was commenting on how the common man (woman) was driven not by data and rational thought, but by a “spontaneous urge to action”. I'm not sure whether he intended to include policymakers in this group, but I suggest that they fall squarely in this camp.

Animal spirits were on full display after the recent election. Following a lackluster performance for the first three quarters of the year, the stock market rolled to new highs (after falling almost 1000 points on election night). Bonds fell as investors fretted that a Trump Presidency would lead to higher rates of inflation and higher interest rates. To be clear, thus far nothing has changed – with the exception of peoples' perceptions. No new policy measures have been put in place. No new spending or taxation policies have been implemented. It was (is) the anticipation of these changes that moved these markets.



The above shows the dramatic shift in the average American's perception about the economy following the election (the feelings of Democrats in general were quite different than Republicans, but the consensus is captured above). Time will tell whether this new found optimism is warranted.

I'm not about to argue that the US stock market must fall from here. In fact, it can (and may) go even higher. Although the US seems to be finding some economic footing, many of the world economies are still struggling. It will be interesting to see if the US remains an island of prosperity in a sea of paucity

In the meantime, rather than trying to predict the direction of animal spirits, we try as best we can to be protected from them, regardless of whether they come dressed like the common man, or wear pin striped suits and peer studiously over their reading glasses.