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Economic and Market Perspective

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Animal spirits?

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The contemporary economic recovery is one of the longest in U.S. history. The stock market has surged more than three-fold from its 2009 crisis low. Aggregate U.S. household net worth, at more than $90 trillion, has recovered to a level nearly 35% above its previous record high in 2007. Relative to peak levels in the last recovery, the economy has enjoyed 25% to 30% gains in nominal GDP, nominal disposable personal incomes and in corporate profits. Finally, the unemployment rate is currently below 5% with payroll employment at a record level more than 5% higher than its peak during the last recovery.

Despite this impressive list of attributes, the recovery has never generated widespread optimism about its future or boost confidence enough to spur the animal spirit behaviors often associated with past recoveries. Borrowing and lending propensities have been paltry, capital spending (suggestive of business confidence) has remained disappointing, the personal savings rate (fearing a rainy day) has trended higher for longer than at any time since the early 1970s and consumer "big-ticket" spending on durable goods and housing (confident household spending behaviors) has also remained subpar. Moreover, despite a three-fold increase in stock prices, this bull market has mostly been driven by conservative investment behaviors. Net new cash flows into equity mutual funds have only been positive in one calendar year since 2009. And, until recently, the stock market has been led primarily by more stable large cap companies, defensive bond surrogate sectors and by low volatility consumer stocks.

Perhaps the economic recovery will end before private sector confidence is fully restored and before animal spirit economic and investment behaviors become evident? However, the U.S. economy has recently returned to some semblance of full employment, global deflation is finally showing signs of easing (e.g., both U.S. wage and core consumer price inflation has recently accelerated and oil and other commodity prices have bottomed), both U.S. and global real GDP growth are accelerating again after an almost two year hiatus, profit growth has also recently been revived, and the Federal Reserve appears poised to finally begin normalizing monetary policy. Will these recent changes in the global economy finally boost private sector confidence and awaken animal spirit behaviors? If so, how might the stock market respond?

Measuring animal spirits?

"Animal spirit behavior" has no official definition but is a euphemism for economic actions originating from highly confident businesses, consumers or investors. The collective economic decisions of private sector players reflect the degree of animal spirits on a scale of fear to greed. For example, companies do not often expand operations (i.e., undertake a major capital spending program) unless they are confident in the future of the economic recovery. Similarly, someone imminently frightened about losing a job is not likely to buy a home. When signing loan documents, both lenders and borrowers are confident it will be repaid. Finally, investors pile into the stock market only when they are optimistic about future return prospects. That is, the types of behaviors evident in the economy describe the degree to which animal spirits are driving the recovery.

Chart 1 illustrates an estimate of animal spirit behavior. It calculates the proportion of total nominal GDP comprised by spending tied primarily to strong private player confidence. Specifically, it is the sum of household big-ticket spending (i.e., personal consumption on durable goods and housing outlays) and business capital spending as a percent of nominal GDP.

Post-war, "confidence spending" has ranged from about 20% to 29% percent of overall nominal GDP. When fear dominants this ratio is low while a high ratio represents periods when animal spirit behaviors are prevalent. The 2008 crisis essentially suspended animal spirits as confidence spending relative to GDP declined to near 20% in 2009, almost 2% lower than at any other point in the post-war era! Although confidence spending has recovered some during this recovery, it remains close to levels associated with past recessions and is still lower than about 80% of the time since 1947.

The inability of this recovery to generate confidence and arouse animal spirit behaviors has been disappointing. However, as shown in Chart 1, there is ample room for confidence spending to eventually play a bigger role yet in the balance of this recovery. Even a rise in the confidence ratio to 25% or 26% would likely improve economic growth and boost prospects for the stock market.

So, will the animal spirit continue to slumber or is it poised to soon awaken and dominate the rest of this recovery?

Synchronized growth, normalization, balance sheets and pent-up demand

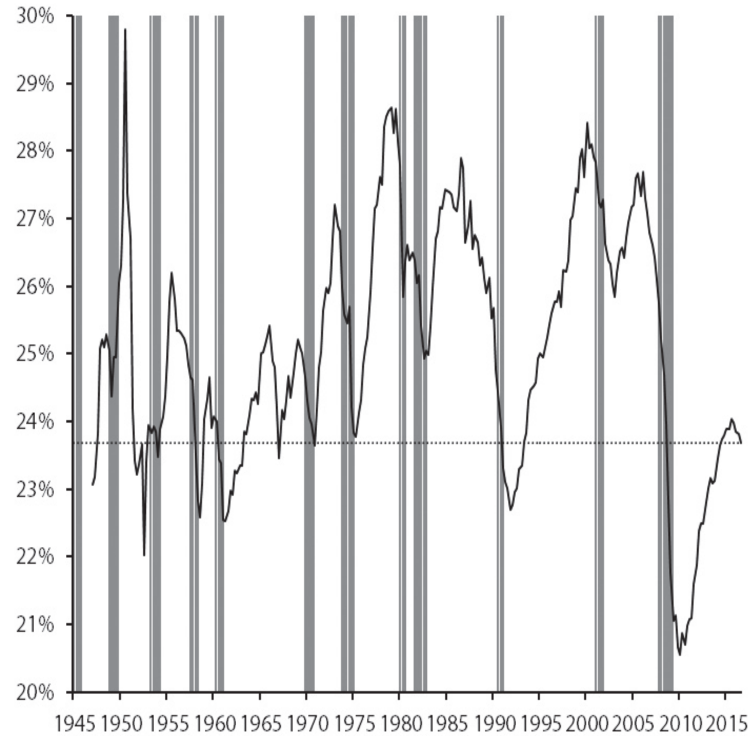
There are a few encouraging trends which could stimulate animal spirit behaviors. First, the pace of economic growth has recently accelerated in a synchronized fashion about the globe. Real GDP growth in the U.S. bounced to 3.2% in the third quarter and Japan grew at 1.3%. Data out of the eurozone has also recently improved and the U.K. economy is responding favorably to a weaker currency. China is finally showing signs of bottoming as manufacturing stabilizes and Canadian economic activity is improving again with energy prices. That is, the global recovery may not be quickening as much as it is broadening. Signs showing more and more economies returning to health in a rare synchronized fashion may finally boost business and investor confidence.

Second, the persistent shadow of the 2008 crisis is finally fading. As oil and other commodity prices stabilize, as core consumer price and wage inflation accelerate in the U.S., and as nominal GDP growth improves about the globe, fears of the deflationary abyss seem to be lessening. Moreover, private sector confidence and aggressiveness is also be bolstered as interest rates lift away from zero in various parts of the world (e.g., the 10-year eurozone and Japanese sovereign bond yields), by hopes that regulatory burdens will lessen in the next few years and as the U.S. Federal Reserve finally seems poised to begin normalizing monetary policy.

Chart 1

Confidence spending* as a percent of nominal GDP

*Sum of personal consumption expenditures on durable goods plus gross private domestic fixed investement as a percentage of nominal GDP.



Third, as shown in Charts 2 and 3, private sector balance sheets have returned to health and they could be used to drive significant run in confidence spending should animal spirits awaken. The U.S. household liability to asset ratio has declined by almost one-third since the crisis to a level not seen since the late 1980s. Similarly, the U.S. corporate debt-to-profit ratio is almost as low today as it was in the late 1960s! U.S. private sector balance sheets are no longer compromised suggesting the "animal" could take them out for a leveraged test drive.

Finally, as illustrated in Chart 4, private sector pent-up demands appear considerable. Confidence spending is comprised by durable goods (e.g., automobiles, appliances, homes and business investments) purchased today but consumed only over time. Consequently, confidence spending cycles run in fits and spurts between pent-up (a strong rise in demand built up over time because of postponed purchasing) and saturated (weak future demand trends because most have recently purchased new durable goods).

Chart 2

U.S. household total liabilities as a ratio of total assets

Chart 3

U.S. corporate debt as a ratio of corporate profits

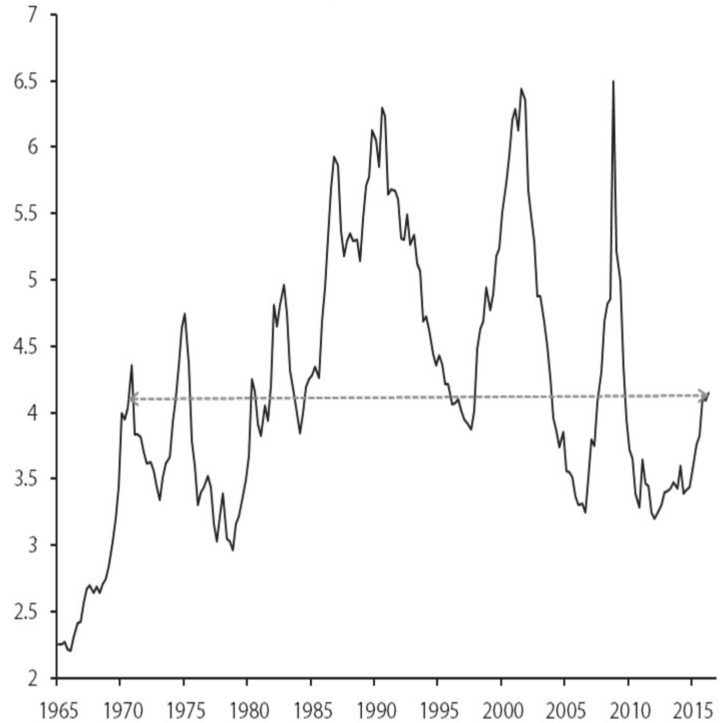


Chart 4

Total U.S. real confidence spending* versus trenlinde average

Solide line — *Real confidence spending (real business capital spending, housing outlays and real household durable goods spending).

Dotted line — Trendline average since 1950.

Natural log scale.

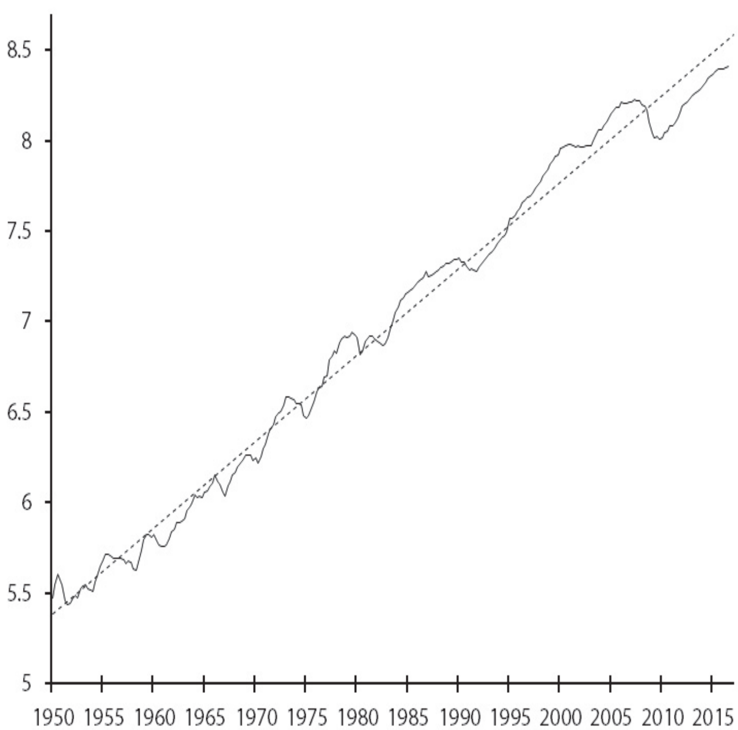


Chart 4 shows the level of real confidence spending in relation to its post-war trendline. Periods of saturation are exhibited when actual spending rises above trendline and rising pent-up demand is suggested by spending falling below trendline. As shown, confidence spending dropped significantly after the 2008 crisis and has remained far below trendline throughout this recovery. Consequently, pent-up demands may be stronger today compared to any other time in the post-war era. Since durable goods buying has been postponed for so long, the need is certainly rising should the animal spirit awaken.

Broader global participation in the economic recovery, fading 2008 crisis fears, renewed balance sheet health and a considerable rise in pent-up demands is a nice recipe for awaking animal spirits!

Animal spirits and the stock market?

If the private sector animal is finally rising from its slumber, what are the implications for the stock market?

Chart 5 examines a remarkably consistent relationship between changes in animal spirit behaviors and future movements in the U.S. stock market. The solid line is the level of the S&P 500 index as a percent above or below its trendline average. The dotted line is the level of confidence spending (a proxy for animal spirits) as a percent of its trendline (i.e., from Chart 4). The dotted line is pushed forward or is leading by 20 quarters and is shown on an inverted scale (i.e., periods of weakening confidence spending are shown by a rise in the dotted line).

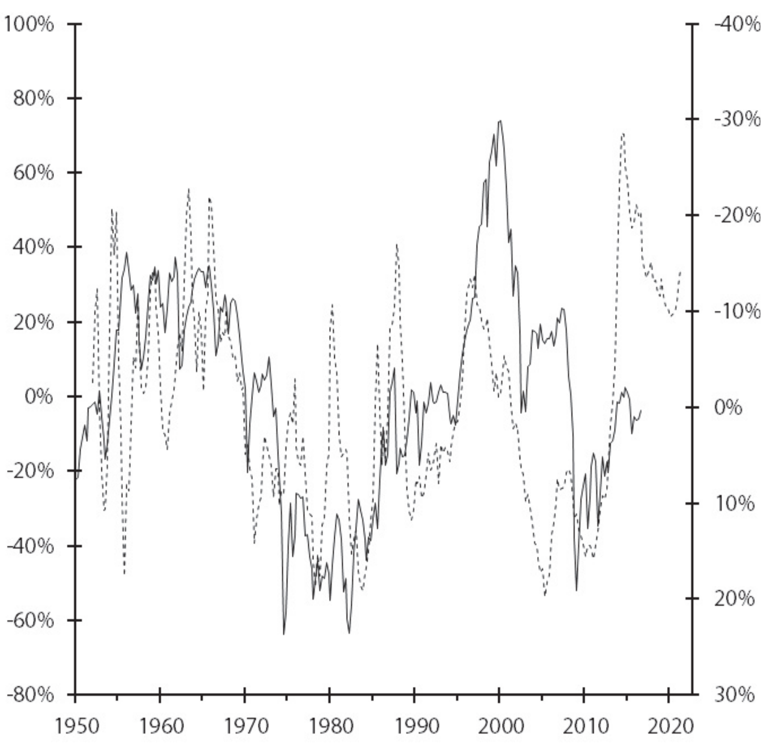
Chart 5

U.S. stock market versus real confidence spending*

*Includes real business capital spending, housing outlays and household durable goods spending.

Solid — S&P 500 Index as a percent above or below its trenline average.

Dotted — Real U.S. confidence spending as a percent of its trendline average (leading or pushed forward by five years).



During the post-war era, periods dominated by animal spirits (i.e., strong confidence spending) have typically been followed in the next several years by a weaker stock market. Alternatively, periods of weak animal spirit spending have generally been followed by a stronger stock market.

This relationship is far from perfect. For example, the stock market rose much more than suggested by the lagged impact of weak confidence spending during the 1990s and has not increased as much as confidence spending suggested in the last five years. However, the behavior of confidence spending has proved to be a decent indicator of where the stock market may be headed during the next several years. Essentially, once animal spirits rule for a period and pent-up demands becomes saturated, risk in the stock market rises. Alternatively, if the animal slumbers and pent-up demands surge, future returns in the stock market typically improve.

Currently, because animal spirits have been almost nonexistent in this recovery, real confidence spending is about 15% below trendline. That is, pent-up demands are substantial. Therefore, despite a bull market that is old by calendar standards, there could be more upside left in the stock market should animal spirits finally awaken.

Conclusions

In contrast to most post-war expansions, the contemporary recovery has never generated widespread confidence nor awakened private sector animal spirit behaviors. Consequently, an important question faced by equity investors today is whether this recovery will end before animal behaviors emerge or whether an era of aggressive, animal spirit optimism still lies ahead before the next recession?

The economic recovery is already the third oldest in U.S. history and this alone argues that recession risk is rising. For this reason, many investors are probably leaning toward more conservative, risk-off allocations for the balance of this recovery. However, in most recoveries, animal spirits have generally emerged before the onset of a recession and when they do, cyclical risk-on investments typically lead. Therefore investors face a quandary.

Normally, by the eighth year of an economic recovery, the Fed would have already been tightening for some time and bond yields would have already risen significantly. Cyclical stocks probably would have been outpacing and risk-off investments like bond surrogates and low volatility consumer stocks probably would have been poor performers. Typically, in a recovery this old by calendar standards, both bond yields and the stock market's price-earnings multiple would have risen substantially leaving the stock market's valuation extended relative to bonds and other defensive, yield-oriented investments.

However, in the contemporary recovery, animal spirits have so far been a no show, the Fed has not yet really begun to tighten, bond yields have yet to rise significantly and many defensive sectors remain extended. Should investors move toward a more risk-adverse posture today because the recovery is already quite old and probably nearing the next recession? Or, are risk-off assets simply too risky because interest rates remain artificially (i.e., they have been pegged by policy officials) to low and will still likely rise much more yet before the next recession?

Historically, when animal spirit behaviors have dominated the economic recovery, the stock market has done well, bond yields have risen and leadership has usually been concentrated among cyclical, risk-on sectors. If the animal is finally awakening in this recovery when interest rates are still below equilibrium levels and while the economy has returned to full employment, investors may want to consider remaining more aggressive than is traditionally comfortable for an eight-year old recovery.

Thanks for taking a Look!!
Jim

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An investment management industry professional since 1983, Jim is nationally recognized for his views on the economy and frequently appears on several CNBC and Bloomberg Television programs, including regular appearances as a guest host on CNBC. *BusinessWeek* named him Top Economic Forecaster, and *BondWeek* twice named him Interest Rate Forecaster of the Year. For more than 30 years, Jim has published his own commentary assessing economic and market trends through his newsletter, *Economic and Market Perspective*, which was named one of "101 Things Every Investor Should Know" by *Money* magazine.