Animal Spirits

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(1) East Coast to West Coast. (2) Keynes on human nature. (3) Keynes on steroids. (4) How will Fed deal with the animals? (5) No end to the endgame and no exit for the Fed? (6) Things could get tricky. (7) Greenspan’s famous question. (8) On the lookout for irrational exuberance. (9) S&P 500 PEG is at average. (10) Are sentiment indicators relevant if corporations are biggest buyers of stock? (11) No cause for exuberance in headline news. (12) The “Cyprus Moment.”

Strategy. Over the past couple of weeks, while visiting our accounts on the East Coast (from Boston to New York to Miami) and on the West Coast (from San Francisco to LA to Newport Beach), I was surprised by the remarkable resurgence of “Animal Spirits” that I observed during my travels. This is the term John Maynard Keynes used in his book, *The General Theory of Employment, Interest and Money* (1936), to describe emotions that stimulate economic activity, risk taking, and speculation.

The original passage by Keynes reads: “Even apart from the instability due to speculation, there is the instability due to the characteristic of human nature that a large proportion of our positive activities depend on spontaneous optimism rather than mathematical expectations, whether moral or hedonistic or economic. 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.”

Although I studied economics under several Keynesian professors, I am no fan of Keynes and his jargon-cluttered theorizing. I am a big fan of a very well written devastating line-by-line critique of *The General Theory* titled, *The Failure of the New Economics* (1959) by Henry Hazlitt, who was "unable to find in it a single doctrine that is both true and original. What is original in the book is not true; and what is true is not original.”

Nevertheless, the fact is that Keynes has never been more influential and more revered by his disciples. They continue to promote the growth of Big Government, along with fiscal and monetary policy excesses that might have shocked even the grand master. Keynesian macroeconomists now control the major central banks of the world. They have gone wild with unprecedented ultra-easy monetary policies, especially unlimited QE, which they believe are necessary to stimulate aggregate demand.

They seem to view the economy as an experimental lab to test their theories. In their opinion, without massive government intervention, the global economy would be in a depression by now. Indeed, both Fed Chairman Ben Bernanke and Fed Vice Chair Janet Yellen, the leaders of the pack, have recently suggested that removing monetary accommodation too soon could cause a depression, as they believe it did in the 1930s. Today’s Keynesians have much greater confidence in government policies than in the private sector’s Animal Spirits. However, investors are starting to fret that these two forces may soon collide as follows:
Are Animal Spirits starting to rise? I think so. I saw it with my own eyes in numerous construction sites in Miami, San Francisco, and LA. In my meetings since the beginning of the year with institutional investors, many of them are no longer accentuating the negatives and no longer asking me to defend my bullish outlook for the US economy and stock market, as they had been for the past four years. Instead, they are starting to accentuate the positives. Some are even willing to consider the possibility that instead of ending badly sooner rather than later, the bull market in stocks might be a secular one lasting several more years with normal corrections along the way.

What if Animal Spirits make a big comeback? If central banks continue their ultra-easy policies, the result will be better-than-expected growth, higher price inflation, and even a melt-up in stock and home prices. So the new hot topic in my meetings is no longer: “When will it all end badly?” Instead, it is: “What is the Fed’s exit strategy?” We all agree that the Fed will never sell the securities purchased under QE, but will let them mature. But if the economy’s improving performance no longer justifies QE, the FOMC surely will have to phase out additional purchases.

What will the Fed do after QE? Here’s where things could get tricky. If phasing out QE purchases causes bond yields to spike, that could put the brakes on the housing recovery and once again raise concerns about a double dip. How will the Fed finesse that? I think Bernanke/Yellen would have to phase out QE, but would still insist on keeping the federal funds rate near zero. They might even push for an explicit target of 2% for the 10-year bond yield to keep longer-term interest rates from rising.

Is there no easy exit for the Fed? The new worst-case scenario isn’t the endgame, but rather that QE has boxed Fed policy and put a lid on the economy’s growth rate. If Animal Spirits are rebounding, then so might bond and mortgage rates, which could hit the housing recovery. If the Fed tries to keep a lid on bond yields, then Animal Spirits could inflate consumer prices and asset bubbles, forcing the Fed to raise interest rates nonetheless. Better economic growth in the short run would narrow the federal deficit, but higher interest rates would worsen the long-term deficit outlook and put more upward pressure on rates if the Fed is forced to abandon its ultra-easy policies.

Let’s hope that Animal Spirits don’t go as wild as the central bankers have been going in recent years. That’s an important assumption underlying my 60% Rational Exuberance scenario with the S&P 500 reaching 1665 by the end of the year. Otherwise, get ready for a melt-up followed by a meltdown, or at least a very nasty correction, in my 30% Irrational Exuberance scenario. In the 10% scenario, the market takes a dive on a geopolitical event shock coming out of the Middle East or Asia. And, of course, there is always the Euro Mess that could trigger yet another nasty correction, as discussed below.

Strategy II. For the past four years of the bull market, most investors were on the lookout for Apocalypse Now. I was as well, but regularly concluded that the end was not near. Since the start of the year, the focus of investors’ concern seems to have shifted to the fear that there is nothing to fear so let’s worry about irrational exuberance. As Alan Greenspan famously asked on December 5, 1996: “But how do we know when irrational exuberance has unduly escalated asset values…?” (He did not answer the question at the time.) So far, such speculative euphoria is more of a risk than a reality, but let’s remain alert and on the lookout.

Consumer confidence is mixed. As Debbie discusses below, there certainly wasn’t any irrational exuberance in the preliminary reading for the Consumer Sentiment Index in early March. The overall index dropped 5.8 points m/m to a 13-month low of 71.8, led by an 8.5 point drop in the expectations component to 61.7, the lowest since November 2011 (Fig. 1). On the other hand, the Bloomberg Consumer Comfort Index rose during the past six weeks through the week of March 9, but remains subdued (Fig. 2).
Valuation multiples remain reasonable. As I noted last week, Professor Robert Shiller, the man renowned for spotting irrational exuberance, is starting to warn that based on the valuation multiples he compiles, stocks aren’t cheap. However, his P/Es are controversial for all sorts of reasons including his use of 10-year trailing earnings to calculate them. I much prefer analysts’ consensus expected 52-week forward earnings based on a time-weighted average of their latest forecasts for the current and the coming years’ earnings estimates.

For the S&P 500, the forward P/E was at 13.5 on Friday (Fig. 3). Monthly data show that the ratio of the forward P/E to consensus expected long-term earnings growth (which tends to have an upwards bias) was 1.26 during February (Fig. 4). That’s about the same as the 1.21 average of this PEG ratio since 1985.

Market capitalization isn’t extended. Another useful valuation measure is the ratio of the market value of all stocks traded in the US to nominal GDP (Fig. 5). It is highly correlated with the market capitalization of the S&P 500 divided by S&P 500 revenues. Both of these measures have recovered from their lows of 2009, but remain well below their previous two cyclical peaks.

Volatility is down, and so is volume. Last week, I noted that volatility as measured by the S&P 500’s VIX fell to the lowest since early 2007. NYSE stock trading volume is also down sharply. It did spike during the bull market’s corrections over the past four years, but the 52-week moving average dropped from 7.0 billion shares at the start of March 2009 to 3.6 billion last week (Fig. 6).

Are these signs of worrisome complacency? I’m not sure that these and other technical indicators, which tend to reflect the sentiment and activities of individual and institutional investors, are as useful as in the past because the biggest buyers of stocks have been corporations doing so through buybacks.

Since the start of the bull market during Q2-2009, S&P 500 corporations injected $1,228 billion into the market through stock buybacks and paid out dividends of $872 billion. That’s a total of $2.1 trillion. Over this same period, households and mutual funds had net equity outflows totaling $560 billion (Fig. 7). Institutional investors reduced their equity portfolios by $309 billion, though they might have increased their exposure to equities with ETFs instead. On the other hand, foreign investors and equity ETFs had net equity purchases of $65 billion and $378 billion, respectively. (Click ★ to add US Flow of Funds: Equities to MyPage.)

Headlines should continue to keep a lid on euphoria. Just last Thursday, I wrote: “Since the start of the year, institutional investors seem to have stopped reacting to headline risk as quickly and intensely as they did since the start of the bull market. ‘Risk Off’ periods now tend to last a couple of days rather than several weeks. Instead, investors seem to be focusing more on the performance of the US economy and taking comfort from its surprisingly good performance. At the same time, they have been remarkably relaxed about the bad economic performance of Europe, where stock prices are also moving higher nonetheless.”

This notion will certainly be tested over the next few days by this past weekend’s news that euro zone finance ministers agreed on a shocking bailout plan for Cyprus. It requires bank accounts with balances above €100,000 to be taxed at 9.9%, while those with less will be taxed at a 6.75%, to raise €5.8 billion for the near-bankrupt nation. This marks the first time in the euro zone crisis that depositors in the bloc’s banks will lose money. This unprecedented move to make depositors contribute to a bailout is stoking fears of deposit runs hitting all fragile euro zone banks.
I don’t expect this “Cyprus Moment” will turn into a Lehman Moment for the euro zone. However, the plan could shatter the calm in the euro zone following the pledge at the end of last July by ECB President Mario Draghi to do whatever it takes to defend the euro. The only upside is that we won’t have to worry about irrational exuberance until this latest mess in the Euro Mess is cleaned up.

CALENDARS

US. Mon: Housing Market Index 47. Tues: Housing Starts & Building Permits 919k/925k, FOMC Meeting begins. (Bloomberg estimates)
Global. Mon: China Property Prices. Tues: UK CPI, UK PPI, EU & Germany ZEW Economic Sentiment, Italy Industrial Production. (DailyFX estimates)

PERFORMANCE & ASSET ALLOCATION

Global Stock Markets Performance (link): The S&P 500 rose 0.6% last week, the same as the MSCI World index and ranking 10th of the 41 stock markets we monitor in a week when 18 markets rose. The S&P 500’s performance trailed the 0.8% gain for MSCI EAFE, but was ahead of the MSCI Emerging Latin America (-2.1), MSCI Emerging Asia (-2.1), and MSCI Europe (0.3) indexes. The S&P 500’s 9.4% rise so far in 2013 trails the MSCI EAFE (11.1) and MSCI World (9.9) indexes. Lagging the S&P 500 ytd are MSCI Emerging Latin America (-2.3), MSCI Emerging Asia (-0.1), and MSCI Europe (8.6).

S&P 1500/500/400/600 Performance (link): How did the three S&P cap groups perform last week? SmallCap (1.1%) beat both MidCap (0.9) and LargeCap (0.6) as 27/30 sectors rose w/w. MidCap sectors account for four of the top five sector winners so far in 2013: MidCap Industrials (16.9), SmallCap Energy (16.4), MidCap Consumer Staples (15.8), MidCap Utilities (14.9), and MidCap Health Care (13.4). SmallCap Telecom (-13.6) is the worst performer ytd, followed by MidCap Telecom (-2.3) and LargeCap Tech (4.2). Looking at the three cap sizes ytd, MidCap (11.9) is still in front of SmallCap (11.6), and both have been pulling away from LargeCap (9.4).

S&P 500 Sectors and Industries Performance (link): The S&P 500 rose 0.6% last week, logging its tenth weekly gain in the past 11 weeks. Eight of the 10 sectors and 89/129 industries moved higher last week, down from all 10 sectors and 120/129 industries rising in the prior week. The best performers last week: Financials (1.3%), Utilities (1.2), Energy (1.1), and Materials (1.0). All 10 sectors and 117/129 industries are up ytd. Just over two percentage points separates the top four ytd performers, up from 0.8 percentage points last week. The top ytd performers: Financials (12.4), Health Care (12.0), Consumer Discretionary (10.9), and Consumer Staples (10.2). The worst underachievers among sectors, trailing the S&P 500’s 9.4% ytd gain by the most, are Tech (4.2), Materials (5.9), and Telecom (6.7).

Commodities Performance (link): Eight of the 16 commodities that we follow rose w/w last week and are up so far in March, down from 11 rising in the prior week and for all of February. The top-performing commodities last week were Natural Gas (6.7%), Cotton (6.5), and Wheat (4.8). The greatest underperformers: Soybean (-5.5), Heating Oil (-1.2), and Brent Crude Oil (-1.2). Prices were higher in 2012 for 13/16 commodities, but the strength has been waning so far in 2013, with only eight up so far this year. The leaders so far in 2013: Cotton (23.1), Natural Gas (15.5), Stainless Steel (6.1), and Platinum (3.5). 2013’s laggards to date: Wheat (-7.1), Gold (-4.9), and Silver (-4.5).

Assets Sorted by Spread w/ 200-dmas (link): Spreads between prices and 200-day moving averages (200-dmas) strengthened last week for 11/19 commodities, 1/9 global stock indexes, and 28/44 US stock indexes--worse than the week-earlier performances (13/19, 9/9, and 43/44). Nine of the 19 commodity indexes trade above their 200-dmas, down from 11 a week ago. Commodities’ average
spread rose to 2.1% last week from 1.5%. Eight of the nine global indexes trade above their 200-dmas, down from nine a week ago. The average global index spread fell to 8.8% from 11.2% a week earlier, but is up from 1.7% in December. Forty-two of the 44 US stock indexes trade north of their 200-dmas, the same as the week earlier; their average spread (10.3%) rose w/w (from 9.9%).

Commitments of Traders (link): What were Large Speculators doing in the futures pits on March 12? They were bullish on the S&P 500 and slightly bearish on the 10-year Treasury Note. They were very bullish on the US Dollar and slightly bearish on the Euro. They turned bearish on the Canadian Dollar, but were bullish on the Aussie Dollar. They were very bearish on the Pound and the Yen. They were still very bullish on Gold, but less so. They had near-record bullish positions in Crude Oil and Gasoline.

US ECONOMIC INDICATORS

Industrial Production (link): US factories revved up production in February to a new cycle high. Manufacturing output increased for the third time in four months, up 0.8% in February and 3.5% over the period. Auto output led February’s increase, rebounding 3.6% after a 4.9% drop in January. Ex motor vehicles, manufacturing output was up a solid 0.6%. Business equipment production jumped 2.5% following a 1.3% decline in January, and was up 4.9% the past four months. February’s gain was widespread, led by output of transit equipment (up 4.7%), with industrial and information equipment advancing 2.2% and 0.3%. The housing recovery boosted production of construction supplies for the fourth straight month by 6.6% in total. Consumer goods production logged its fourth month in a string of gains totaling 2.7%.

Capacity Utilization (link): Capacity utilization hit a new cycle high in February, but there’s still enough excess capacity in the US economy to contain inflation. The headline rate climbed to 79.6% in February, but is still below April 2007’s 80.8% peak despite the age of the “recovery,” well over two years old. The rate also remains below its long-run average of 80.2%. The story is similar for the manufacturing rate, which climbed to 79.0% last month, just below April 2007’s 79.2%.

Empire State Manufacturing Survey (link): Manufacturing activity in New York state cooled a bit in March after snapping back into positive territory in February. The general business index was little changed at 9.2 in March, after jumping 17.8 points in February to a nine-month high of 10.0 (following six months in contractionary territory). The new orders (8.2) and shipments (7.8) indexes remained above zero, though were lower than February levels. Labor market conditions were sluggish. The employment index slipped 4.9 points in May to 3.2, relinquishing some of February’s 12.4 point jump. The average workweek index was at zero, improved from below breakeven for the prior six months. Indexes for the six-month outlook pointed to increasing optimism, with the future general business index (36.4) the highest in nearly a year.

Consumer Sentiment Index (link): Consumer sentiment unexpectedly dropped in mid-March after improving the first two months of 2013. The University of Michigan’s Consumer Sentiment Index (CSI) sank to a 15-month low of 71.8 after climbing 4.7 points the prior two months to 77.6. Consumers were less optimistic about both the present and the future, though mostly the future: The present situation component slipped 1.5 points to 87.5, still within 3.1 points of November 2012’s cycle high. Consumer expectations tumbled 8.5 points to 61.7, the lowest since November 2011. The expectations component had gained some traction during the first two months of the year, climbing 6.4 points.

GLOBAL ECONOMIC INDICATORS

Global Industrial Production (link): Production is holding up well in emerging economies, but is mostly weaker in the G7. Output in most of the emerging countries we track is stalled around recent
highs, with China, Indonesia, the Philippines, and South Korea at record highs. Output in Eastern European economies is fluctuating around recent highs, except for the Czech Republic, where it's drifting lower. In the G7 economies, production levels in the UK, Japan, France, and Italy remain around recent lows (or at new lows); German production is off its recent highs. US output rebounded to new cyclical high in February; Canadian production has been hovering around its high through December.

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