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Outlook

FIRST QUARTER 2017

EQUITY REVIEW

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Animal Spirits

Human psychology and emotion arguably influence economic decision making.

In the first quarter, optimism, premised on the ability of Trump's proposed policies to stimulate reflation, defined the market tone, and continued to buoy equities. The reflation beneficiaries, best evidenced by the pro-cyclical sectors including financials and industrials, enjoyed early relative outperformance versus other sectors of the market. Challenges emerged, however, with the unsuccessful attempt to pass the American Health Care Act, the new administration's replacement for Obamacare. The narrative for the market soured modestly as investors judged this failure as a weak litmus test for Trump's ability to enact comprehensive tax reform and regulatory relief. While the market remained close to record highs, doubts crept into the investor psyche, as money flows began to be channeled toward more traditionally defensive sectors. Outside of the political realm, the performance of the equity market was underpinned by improving economic data suggestive of a cyclical recovery and higher corporate earnings. Overall, the S&P 500 returned approximately 6% in the first quarter of 2017, posting its best start to the year in four years, and contributed handsomely to the double digit return achieved since Trump's election.

Notably, soft economic data, illustrated by sentiment driven indicators such as consumer confidence, advanced commandingly while hard data, as evidenced by actual activity like retail sales and industrial production, did not mirror the same robustness. While the differential between soft and hard economic data is certainly grounded in mathematical explanation, the differential could, in part, also be explained by the resurgence of "animal spirits." Upon hearing this phrase, the imagination conjures up a vision of wild creatures dancing on their hind legs around a camp fire with their shadows illuminating against the smoky darkness; these animals feel compelled to revel in the moonlight. More practically, the term animal spirits was originally derived by John Maynard Keynes in his 1936 publication "*The General Theory of Employment, Interest and Money,*" and was coined to describe the human emotion that drives confidence and trust. In essence, it is the element that motivates people to take positive action even in the face of uncertainty and in turn, influences economic decision making. By its sheer presence, economic activity could accelerate despite the late cycle nature of the current environment.

For more information on this topic, contact the author:

Michele Matzinger
Head of Equities &
Senior Equity Manager
michele.matzinger@neamgroup.com

neamgroup.com

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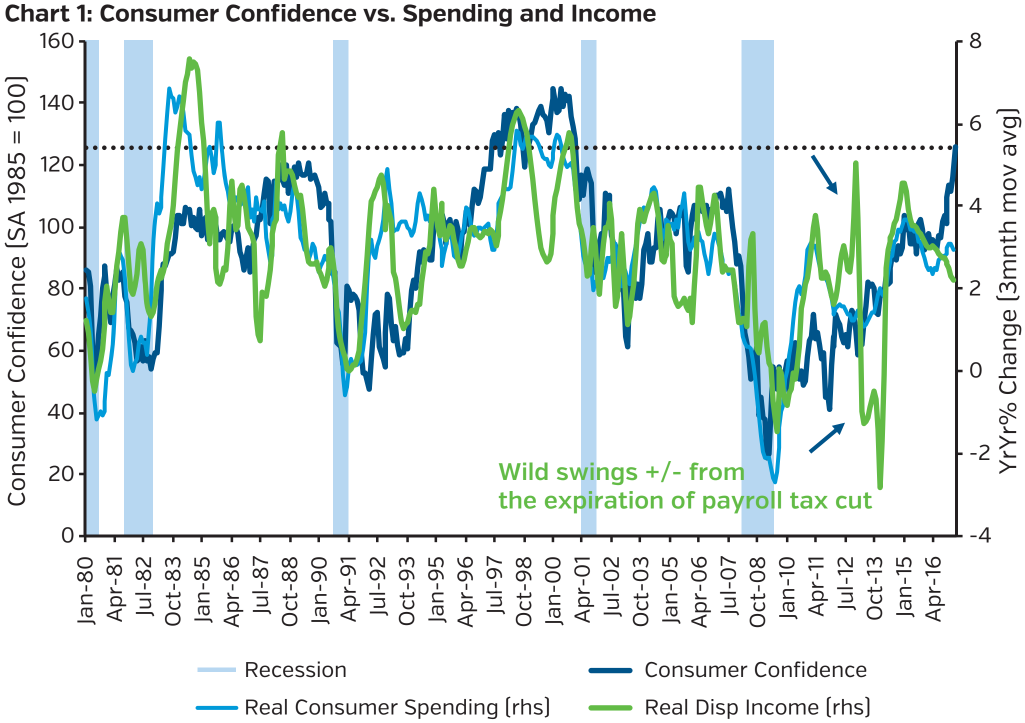
Debate now centers on the contributory impact of animal spirits toward the equity market's continued ascent. The advent of this behavior potentially validates higher prices for risk assets as investors discount higher growth and corporate profitability that will result from the unleashing of said confidence. On the flip side, its existence may be rooted in the very definition of late cycle behavior, as data and optimism tend to peak nearing the end of a business cycle, arguing for a measure of caution. Either way, a deeper understanding of animal spirits is relevant in assessing the outlook for risk asset pricing.

CONFIDENCE RISING

When "spirits" are positive, confidence generally overrides fear. Recently, reported data showed consumer confidence approaching a level not seen in fifteen years. When dimensioned relative to its own long-term average, known as the Z-score, consumer confidence currently resides one standard deviation above trend. Historically, this level of confidence has been associated with much higher rates of real consumer spending. Illustratively, growth in consumer spending was north of 5% during the tech bubble, a notable period characterized by its euphoric psychology. While that magnitude may not be achievable again, awakening animal spirits could potentially narrow the differential between confidence and spending, lending itself to a potentially bullish scenario whereby earnings increase and equity prices rise further. The slowdown in real disposable personal income, however, presents a formidable challenge as spending power remains under pressure, given normalizing energy prices, rising inflation and other cost headwinds. The equity market will be attuned to the interdependency of these variables to better gauge if confidence is a reliable indicator for consumption (Chart 1).

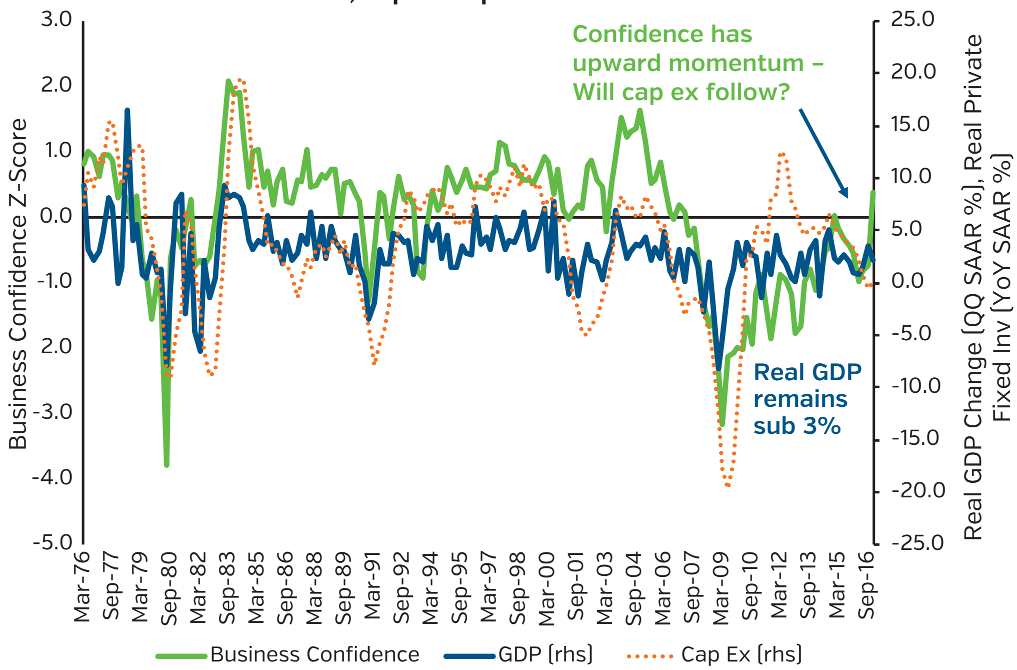
Chart 1: Consumer Confidence vs. Spending and Income



Source: National Bureau of Economic Research, The Conference Board, Bureau of Economic Analysis, Haver, NEAM

Similarly, Corporate America may be embracing animal spirits, as evidenced by the recent rise in business confidence levels. For most of the last decade, business leaders have been cautious. This is a sharp contrast to the preceding 25 years where executives exhibited greater optimism and the economy experienced higher average rates of capital investment and real GDP growth (Chart 2). The historic linkage suggests acceleration in capital expenditures awaits given rising CEO confidence. While this precedent may exist, increased investment is not a certainty as today's backdrop imbeds structural challenges from debt, demographics and technology disruption. Additionally, global excess capacity persists, capping U.S. utilization rates in the mid-70%s, a level more reminiscent of recessionary periods. Higher capacity utilization would provide a compelling reason to invest and in its absence, smaller scale projects could be the focus. Tax reform could be a game changer as animal spirits could be further unleashed should capital investments become fully tax deductible immediately, rather than depreciated over the life of the investment.

Chart 2: Business Confidence, Capital Expenditures and Real GDP Growth

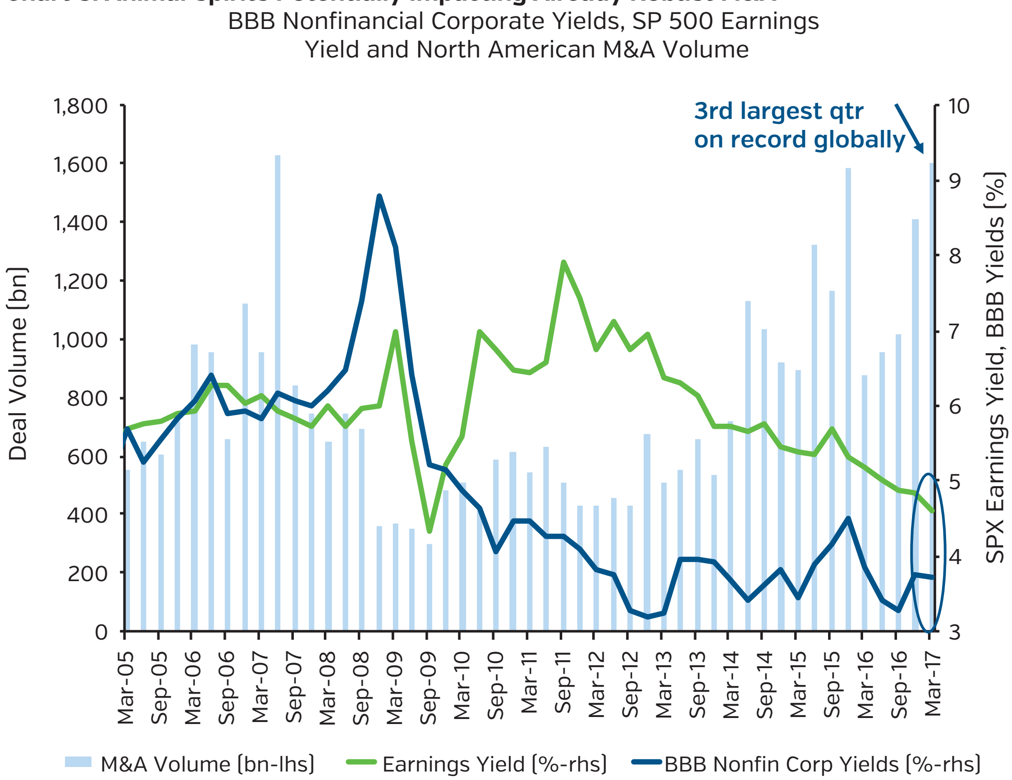


Source: National Federation of Independent Businesses, Bureau of Economic Analysis, Haver, NEAM

Similarly, merger and acquisition behavior exhibits conceivable animal spirits. While the rationale for M&A resounded throughout corporate boardrooms prior to the election of Trump, the pick up in confidence adds another dimension to the prism. According to data compiled by Citibank, the final quarter of 2016 was the third largest quarter on record for global M&A activity.[1] For North America specifically, this robust pace continued into the New Year with first quarter volumes pacing over 80% higher than the corresponding period in 2016 (Chart 3). Citibank estimates larger deals, defined as transactions sized $10 billion or larger, constituted almost 35% of total value, an increasing proportion of deal activity year-to-date.

Collectively, these developments demonstrate potentially tangible evidence of animal spirits. Of note, potential changes in U.S. corporate taxes could hinder this momentum. The proposed removal of tax deductibility of interest would potentially reduce the appeal of debt financed transactions, a key driver to the existing M&A cycle. As depicted in Chart 3, low financing costs allow companies to borrow debt at affordable levels to buy a higher earnings yield, otherwise known as a carry trade. Anything diminishing this positive arbitrage could help curtail the M&A cycle and mitigate the benefits of animal spirits.

Chart 3: Animal Spirits Potentially Impacting Already Robust M&A

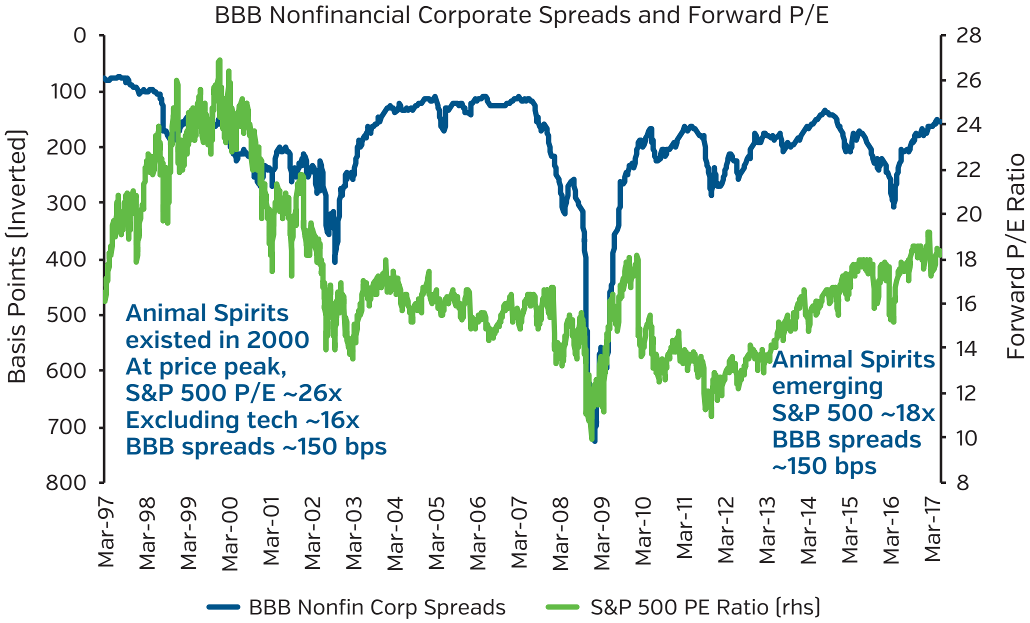


Source: Bloomberg, NEAM

ANIMAL SPIRITS AND RISK PRICING

Risk pricing, as exhibited by P/E ratios and BBB non-financial corporate bond spreads, already imbeds high expectations. The equity market is trading at ~18x forward earnings, above its long-term average, and corporate bond spreads remain tight (Chart 4). Placed within the context of history, bond spreads approximate comparable levels to the dot com bubble, a period when exuberance existed, while the S&P 500 trades at an absolute P/E level notably below the spirited levels achieved at the market peak in 2000. Recall, technology comprised ~30% of the S&P at the time, trading at over 50x imbedded estimated earnings. As such, the euphoria generated from the commercialization of the internet and "new economy" technology enabled business models exaggerated overall market valuation. Normalizing for this contribution, the market traded at ~16x forward P/E, excluding technology. Today, the market trades two turns higher than that level with the technology sector's valuation approximating that of the broad market. This suggests that multiple expansion is the less likely driver to further market gains, making the earnings contribution the key driver for market appreciation in the face of animal spirits.

Chart 4: Comparative Risk Asset Pricing



Source: Bloomberg, NEAM

CONCLUSION

Human psychology and emotion arguably influence economic decision making. Rationality is also a necessary ingredient, but the relative quotient may vary. When "spirits" are positive, confidence overrides fear. We are perhaps embarking on such a period. Fundamental reasons for confidence include the low unemployment rate, the uptick in wage growth, low borrowing costs and strong stock market performance. Expectations for fiscal stimulus have further goosed consumer and business confidence numbers with optimism centered on infrastructure spending, major tax reform and regulatory relief. The ongoing cyclical upturn could be elongated, and potentially strengthened, should fiscal stimulus be meaningfully enacted. However, to the extent these policy initiatives fail to materialize to the magnitude expected, animal spirits could reverse as confidence proves overstated implying potential downside for risk assets. It remains our view that we are late cycle. The market can certainly grind higher with improving economic data, upward revisions to earnings estimates, and improving sentiment elongating this peaking process. If these elements disappoint, there is little room for error at current valuations. Thus, we remain cognizant of balancing downside risk with potential reward as we watch the animal shadows dance in the moonlight.

ENDNOTE

[1] "Animal Spirits Are Back", Global Equity Strategist, Citibank Research, February 24, 2017

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