# INVESTMENT OUTLOOK

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## FIRST QUARTER 2017: RETURN OF ANIMAL SPIRITS?

*Man and the animals are merely a passage*
*and channel for food, a tomb for other animals,*
*a haven for the dead, giving life by the death of others,*
*a coffer full of corruption.*
*-Leonardo da Vinci, The Notebooks*

The Wall Street Journal reports that we are entering a new age of entomophagy. A new age of what, you say? A new age of eating insects. Apparently, millennial entrepreneurs (yep, another knock on this privileged generation) are "farming" crickets, selling bags of the whole roasted critters—flavored with sea salt and vinegar, sour cream and onion, or Texas barbeque—to discerning snackers. And lest you think this is a flash in the pan, as it were, note that the global edible insect market was valued at $424 million last year, and Persistence Market Research projects sales to grow to $723 million by 2024. Not exactly small potatoes. Two billion people worldwide dine on such lean protein delicacies as grasshoppers, fried locusts, and water bugs.

So much for the vegan movement. But if animal bodies are at risk of human consumption, what about their souls?

There, the news is better, as there appears to be a revival of interest in animal spirits. Animal spirits is the term John Maynard Keynes used in his 1936 book *The General Theory of Employment*, *Interest and Money* to describe the instincts, proclivities and emotions that ostensibly influence and guide human behavior, and which can be measured in terms of, for example, consumer confidence.

Animal spirits were clearly in evidence in public financial markets during the first quarter, as optimism about improving domestic and global economies drove markets higher around the world.

| Asset Class | Index | 1st Quarter Results |
|---|---|---|
| US Large Cap Stocks | S&P 500 Total Return | 6.1% |
| US Small Cap Stocks | Russell 2000 | 2.5% |
| International Developed Markets | MSCI EAFE | 7.3% |
| Emerging Markets | MSCI EM | 11.4% |
| Real Estate | MSCI US Real Estate | 1.0% |
| Commodities | Bloomberg Commodity | -2.5% |
| Bonds | Bloomberg Barclays US Aggregate | 0.8% |
| Cash | Citigroup 3 month UST Bill | 0.1% |

SOURCES: THE WALL STREET JOURNAL, STANDARDANDPOORS.COM, CITIGROUP, MSCI, MARKETWATCH.COM

US large cap stocks generated strong three-month returns, besting smaller cap stocks, which produced more modest gains. International equities were the stand-out asset classes in the first quarter, with developed markets up better than 7%, and emerging markets appreciating an exceptional 11%. These advances were driven by accelerating economic growth.

Real estate securities inched up, pushing against possible rate increases, and commodities lost ground as US energy producers ramped up drilling activity, over-supplying the market and driving down oil prices. (Livestock futures, however, rose 1%.)

Bonds were up modestly, as interest rates stabilized, while cash continued to mark time.

## GREYHOUNDS AND SLEEPING DOGS: SOFT DATA AND HARD FACTS

*All animals are equal,*
*but some animals are more equal than others.*
*-George Orwell, Animal Farm*

Animal spirits are everywhere in evidence in surveys taken across numerous constituencies: consumers, corporate leaders, small business owners, and manufacturing executives, among others. The Conference Board reported that US consumer confidence is at its highest level in 16 years. The Business Roundtable reported that chief executives at America's largest companies are the most optimistic they've been in 7 years. The National Federation of Independent Business reported that their members are expressing a substantial rise in optimism since the election. And the National Association of Manufacturers reported that more than 93 percent of manufacturers feel positive about their economic outlook, the highest reading in the survey's 20-year history.

All of these surveys, in essence, ask us how we're feeling. Economists refer to their results as "soft data"—they're not measuring how many widgets were sold, but how widget producers perceive the outlook for selling widgets. The critical question is when do animal spirits—or economic optimism—translate into higher economic activity?

The hard data tell a different story. GDP for the fourth quarter rose at annualized rate of 2.1%, and the Atlanta Fed's GDPNow suggests the economy grew at a mere 0.9% for the just-ended first quarter. Auto sales appear to have peaked. Commercial and industrial loan demand has fallen over the last several months. Manufacturing production in February rose a scant 1.3% over the prior year. And even though job growth has been fairly robust, it is not translating into higher consumer spending; the Commerce Department tells us that in February, personal incomes rose 0.4% but personal expenditures were up only 0.1%. This is not news, but we have been experiencing the weakest expansion in the post-World War II era—even as labor and real estate markets have healed significantly.

In an era of fake news and alternative facts, what data—soft or hard—are we to believe? It is reasonable to believe that increased confidence may lead to increased economic activity: investing and producing by businesses, and spending by consumers. And, in fact, the historical record provides some support for that thesis…but not always. We may not know, for a number of months, whether to trust the soft data. Maybe, as Ronald Reagan prescribed in dealing with the Russian bear, we need to trust, but verify.

## MORE HAWKISH FED, MORE DOVISH INVESTORS

*I think I could turn and live with animals,*
*They are so placid and self-contained,*
*I stand and look at them long and long.*
*They do not sweat and whine about their condition,*
*They do not lie awake in the dark and weep for their sins,*
*They do not make me sick discussing their duty to God,*
*Not one is dissatisfied, not one is demented with the mania of owning things,*

*Not one kneels to another, nor to his kind that lived thousands of years ago,*
*Not one is respectable or unhappy over the whole earth.*
*--Walt Whitman, Song of Myself*

We may not live with animals, as Walt Whitman would, but we do live with animal spirits, and we have to incorporate them into our portfolio decision making. In March, the Federal Open Market Committee raised interest rates, in what may be seen perhaps as a tacit admission that animal spirits, indeed, may have taken hold. Of course, interest rates remain extraordinarily low by historic standards, and the Fed continues to maintain a bloated balance sheet with $4.5 trillion of assets—up from $800 billion before the financial crisis.

What is certain is that financial markets have been in rally mode. Domestically, the policy agenda of the new administration—less regulation, lower tax rates, increased fiscal spending—is viewed as economically stimulative, giving rise to the aforementioned flowering of both business and consumer confidence. Elsewhere, there is mounting evidence of better growth. Europe appears to be slowly crawling out of its malaise. The populist threat has, at least temporarily, been turned back in the recent election in the Netherlands. In China, the growth story seems to be more intact than previously thought; emerging markets in general have reaccelerated as well. Overall, the narrative is of synchronized global growth—a near-perfect backdrop for rising equity markets. It appears that we are indeed living with animals—specifically, with the bulls, and they are running, while the bears remain in hibernation.

That said, anyone who has been to Pamplona knows that running with the bulls can be a risky affair. The bulls have pushed markets sufficiently high that lofty valuations are a nontrivial risk. The US equity market now trades at 18.5 times estimated 2017 earnings, versus an average 15.5 times current year earnings. And those 2017 earnings expectations are lofty, too, projected to grow 10% over 2016 levels. Investors need to be wary not to get skunked by an excess of hope.

## TORTOISE OR HARE, OR IS IT CHICKEN LITTLE?

*We are, perhaps uniquely among earth's creatures,*
*the worrying animal.*
*-Lewis Thomas, The Medusa and the Snail*

Eight days after the presidential inauguration, we began the year of the rooster, according to the Chinese lunar calendar. (Irony, anyone? Anyone?) The rooster is the sign of dawn and awakening, and rooster years are a blend of righteousness and justice, bombast and logistical efficiency. According to one Chinese horoscope, triumph and success can only be achieved at the price of hard work and patience.

Active money managers are crowing, as their hard work and patience have been rewarded with favorable conditions for our focus on fundamentals. Rising interest rates are slowly undoing the distortions from years of zero interest rate policies; corporate profits are increasing, and correlations among stocks have dropped dramatically. Many more active managers are reporting strong relative as well as absolute returns, giving rise to optimism that the tide may have turned after a long stretch of better results from passive investments.

Still, it is premature to take a victory lap, and we can find many things to worry about. Domestically, the markets' warm reception of the Trump agenda may shift as the travails of governing stall growth plans. The failed healthcare bill is a concerning omen, suggesting that tax reform and infrastructure investment efforts may also meet resistance. Markets may suffer downdrafts if the faster economic growth narrative fades. This is particularly a risk with elevated, not to say stretched, valuations and margin debt levels at a record $528 billion.

Internationally, the European Union is fragile as it faces Brexit negotiations and possible rising nationalism influencing elections in France, Germany, and Italy. Syria continues to be the locus of ISIS strength, while North Korea has adopted an increasingly aggressive posture in weapons development.

We have been over-weight US equities, and under-weight real estate and commodities, positioning which has worked well this year. We are warming, however, to international equities in view of improving economic conditions and lower valuations.

Within US equities, portfolios have benefited from over-weighting the information technology sector and under-weighting utilities. It is more than challenging to game winners and losers from inside-the-Beltway, so we prefer secular growth stories. As uncertainty rises, we renew our focus on high quality companies with superior returns on capital and shareholder-friendly managements. And as valuations rise, we become more price-sensitive, looking for mis- or under-priced securities which are relatively safer because they are less expensive.

In the fixed income arena, compensation is inadequate in our view for lower rated and longer dated bonds, so we are fishing in the investment-grade short-to-intermediate pond. Municipal bonds are comparatively attractively priced.

More, generally, we're trying to avoid discovering that we're Wile E. Coyote, having run over the edge of a cliff, hanging in midair…until we plummet into a canyon. Not that we'd rather be Road Runner. We're sticking with the rooster, for whom we're told that loyalty, hard work and commitment are some of the characteristics that will be rewarded this year.

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