MAERKI BAUMANN & CO. AG

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INVESTMENT COMMENT

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Animal Spirits

It has now been more than six months since the election of Donald Trump as President of the USA. Contrary to initial fears that the world order would be radically reshaped overnight, it can now be stated that much less has changed than many observers feared. Or at least very little that is tangible – by which we mean new legislation and the implementation of prominently announced reform projects such as reform of the healthcare system, the revision of tax law, or the redesign of immigration rules. At the same time, however, a number of macroeconomic leading indicators have improved further from what were in many cases already handsome levels. Surveys of both companies and consumers indicate a level of optimism that has not been seen in the US for years, if not decades. Plenty of observers have also pointed to the very promising picture currently painted by the so-called "soft" data, in contrast to the "hard" macroeconomic data such as retail sales, industrial production, and corporate investment, which have not (yet?) risen significantly above the last years' average.

Why this discrepancy? What are the factors driving this divergence of surveys and concrete economic data? An explanation currently very much in vogue is the concept of "animal spirits". According to this theory, "animal spirits" in the US have been buoyed by the prospects of the Trump administration pursuing an economy-friendly policy, which in turn has resulted in very positive growth expectations for the US economy. Seen from this standpoint, all that is required is a bit of patience before the real economy reflects this latest "upturn in mindsets" (which is rather reminiscent of certain posters that appeared in Switzerland at the beginning of the 1990s). In this publication, we take a rudimentary look at the concept of "animal spirits", before then undertaking an (interim) assessment of Trump's plans (as well as their implementability in the US political system) and asking ourselves what the possible repercussions of all this might be for investors.

Most people probably accept that an economy does not just consist of purely rational protagonists. Indeed, the underlying assumption of the classical school of economics, namely that homo oeconomicus is a fully rational being, has come under fire from a number of different quarters, including from representatives of a more recent branch of economics, namely behavioural economics. Two economists working in this specialist area, George Akerlof and Robert Shiller, published an intriguing book on the topic of "animal spirits" back in 2009, following the financial crisis. They consider the simplest definition of this concept to comprise all non-economic motives and irrational forms of behaviour, i.e. all the characteristics that a homo oeconomicus does not possess. The two Nobel Prize winners also provide another description of "animal spirits", namely as follows: The term encompasses a restless and inconsistent element of the economy that relates to how people deal with ambivalence and uncertainty.

Uncertainty over the future is one of the unchanging principles of human existence. Sometimes we view this uncertainty as a positive, i.e. as promising and encouraging, but at other times we perceive it to be unsettling – frightening even – and demotivating. These two sides of the same coin can also be recognized at a social and economic level; phases of confidence or trust in the future alternate with phases of distrust and defeatism. How often have economic downturns gone hand in hand with a "loss of confidence" in the past? Or to put it rhetorically: Has there ever been a recession that has not unfolded against a backdrop of lost confidence? In addition to confidence, Shiller and Akerlof have added four further aspects of "animal spirits", namely fairness, corruption and antisocial behaviour, "money illusion", and the importance of "stories".

The problem of the measurability of all these aspects is an obvious one. The key question that arises in the context of this investment commentary is whether, on the basis of the plans of the Trump administration, the "confidence" of economic protagonists can be positively stimulated for a number of years or more. It appears clear that the stock market gains of the last six months have been driven by expectations that Trump's plans will actually bear fruit. Tax cuts for companies have the effect of boosting earnings, which initially feeds through into lower valuations at the level of P/E ratios, and in a second step can lead to greater investment, as earnings are themselves a driver of corporate investment. Lower taxes for natural persons lead to a rise in their disposable incomes. This can have the effect of increasing overall macroeconomic demand (and therefore economic growth), as long as people do not hoard their tax savings in expectations of taxes being raised again at a later point in time. We would observe at this point that no empirical proof exists of any such complete "Ricardian equivalence". What's more, the higher (expected) economic growth also has the effect of ratcheting up corporate earnings expectations even more, which in turn supports stock market prices.

The price rises of recent months can therefore be seen as wholly rational. Or can they? We have our doubts, because for all the grandiloquent proclamations, there is a very long way to go before the corresponding legislation is rubber-stamped by Congress. A good example of the administration's declarations of intent having very little substance can be found in the tax-cutting plans that were announced at a press conference at the end of April. The documentation handed out to journalists spoke volumes: It amounted to just one A4 piece of paper with a list of bullet points comprising just under 250 words. The possibility of such plans being simply waved through Congress without the individual details of each plan being pored over appears remote in the extreme. What's more, even if the Republicans were to succeed in forcing through the above-mentioned legislative package, the deficit – according to estimates released by the non-partisan Tax Policy Center – would rise by USD 9.4 trillion in the coming decade, and by USD 16.8 trillion in the following ten years. By way of comparison, the total outstanding debt at federal level, i.e. not including states and local municipalities, amounted to some USD 14.2 trillion as at the end of 2016 (source: Congressional Budget Office). During the presidency of Barack Obama, the Republicans adopted the stance of champions of a balanced budget. The idea that they might now jettison all these principles just like that appears to us to be fanciful. Accordingly, the administration's tax reform plans could well be – just like the proposed healthcare reform at the end of March – rejected or at least heavily watered down.

What does all this mean for the financial markets? The expected correction to global equity markets, which has become overdue following six months with no reverse of more than 2%, would now take place. That said, we are not expecting "animal spirits" in the US to suddenly flip from optimism into pessimism. The talented self-promoter that is Donald Trump will doubtless find a way of keeping the American public in good spirits over the next few months with grandiose-sounding announcements. So as long as he does not become even more embroiled in the scandal over the Russian contacts of his administration, share prices still have upside potential. Furthermore, we do not believe that the ongoing economic recovery in Europe will be derailed by political turbulence stateside. In other words, "animal spirits" this side of the Atlantic are likely to continue to prove buoyant.

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