WILLIS INVESTMENT COUNSEL
Principled Investing

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WHAT DOES WIC KNOW AT THIS JUNCTURE
IN THE ECONOMIC AND MARKET CYCLE?[1]

INTRODUCTION

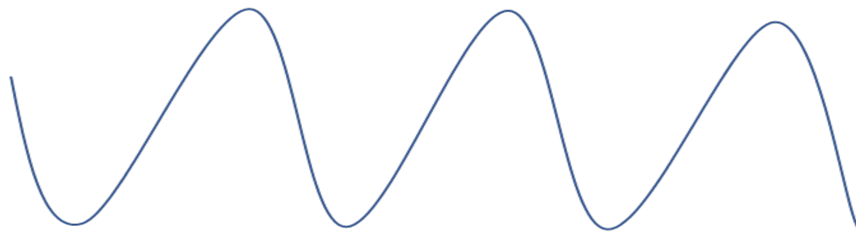
It is well known that all economic expansions eventually run out of gas and slip into a recession. Likewise, we all know rising stock markets eventually reverse course providing negative returns. This time will not be different; but no one knows when the economic and market reversals will occur. The peak is unknowable.

WIC believes common sense is always important with risk management and portfolio decision-making. Common sense is especially important at this late-innings-juncture in the cycle when (i) valuations are stretched with little margin for error, (ii) leverage levels are high and concerning, (iii) the Federal Reserve is increasingly in uncharted waters with monetary policy, and (iv) extrapolation and acclimation risks are naturally high.

At this juncture in the cycle, how do we decide which to weight more heavily – capital preservation or capital growth? Should we move toward a more defensive, or offensive posture? Do we choose to forego potential further gains to be better positioned for the inevitable downturn? Or is that futile market timing? This memo shares our thinking about these questions with you.

HISTORY IS NOT PREDICTIVE, BUT IT SHOULD NOT BE IGNORED

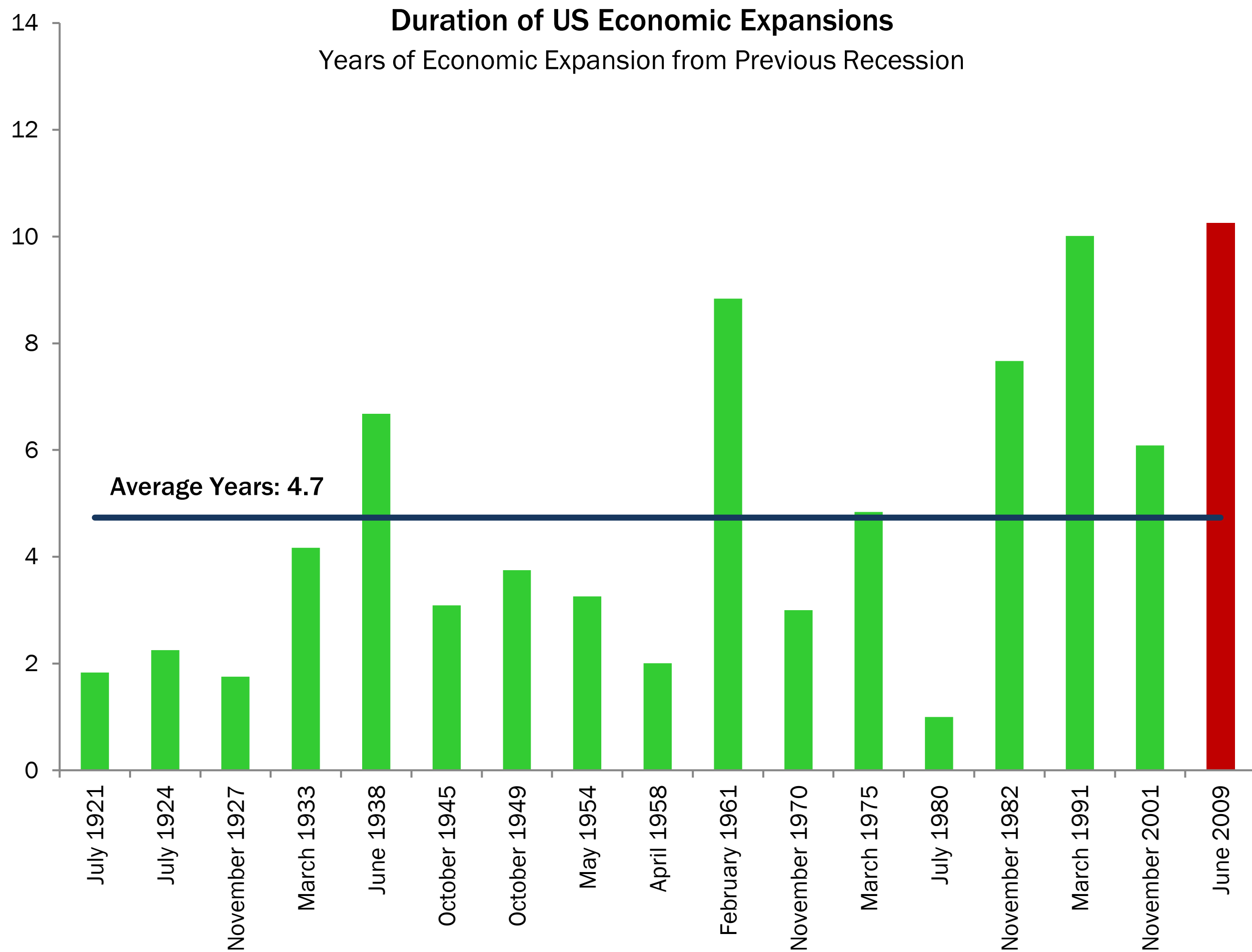
The following image reminds us of the inherent nature of economic cycles, market cycles, political systems, geopolitical power shifts, dynasties, animal spirits, and risk-taking:



[1] WIC is acutely aware that much of what we need to know is inherently unknowable. We also are very cognizant of the unreliability of economic and market forecasts.

Economic Expansions and Recessions

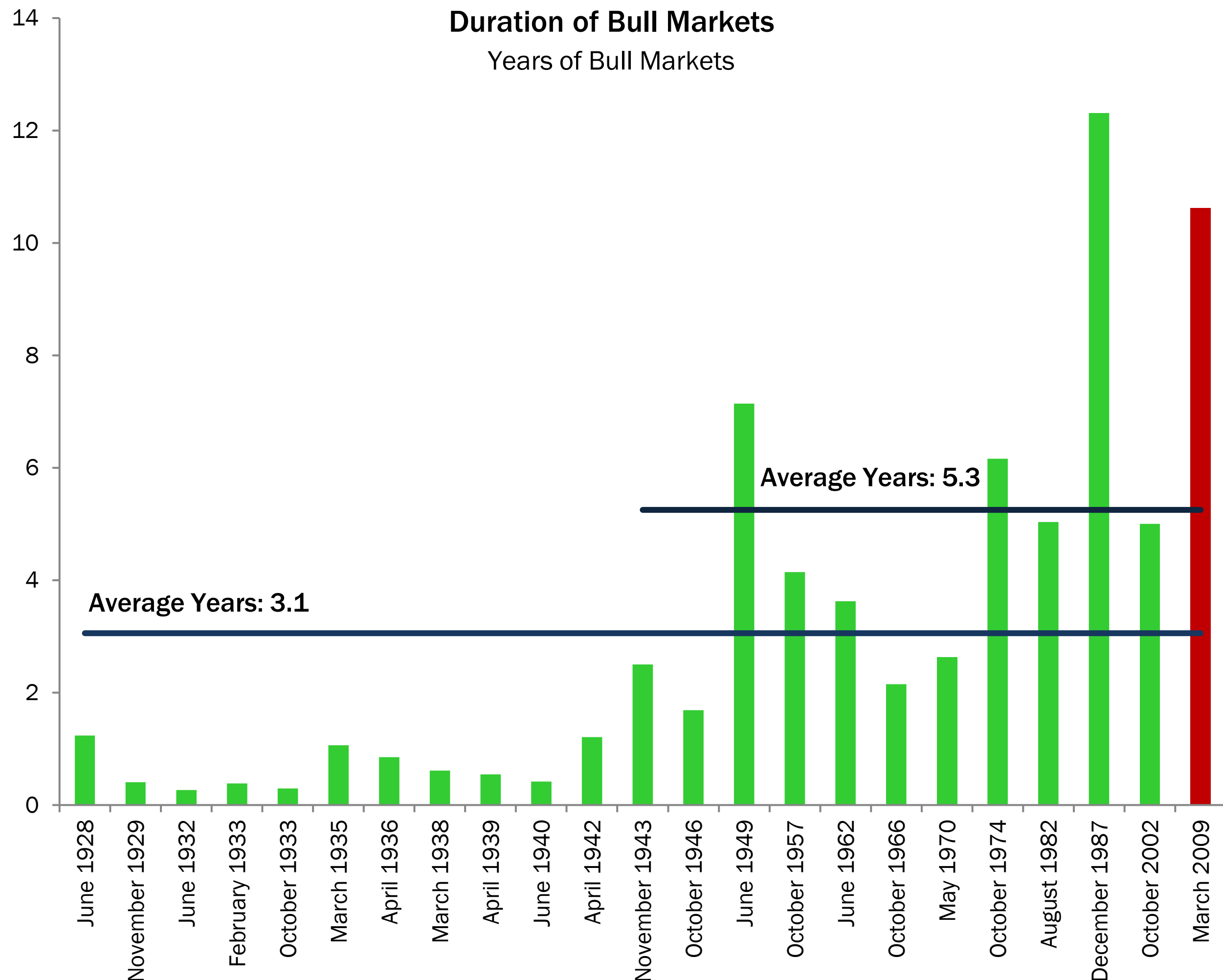
The following graph looks at all U.S. economic expansions since 1921. Each bar measures how long the economic expansion lasted before it ran out of gas and the inevitable recession took over:



We do not believe that an economic expansion ends just because it is X years old. But we do believe there is a tendency for economic expansions to sow the seeds of the next recession. Expansions – especially those that are long in duration – often breed excessive risk-taking, lax lending standards, and complacency. An article in the August 28, 2019 issue of *The Economist* (page 62) provided a good reminder that recessions "can indeed appear as if out of the blue." Humans are wired to need explanations; there is a natural preference for cause-and-effect order. But economic causation is often not present or clear-cut. Sometimes, recessions are triggered when there is the proverbial straw that broke the camel's back – when something goes wrong with an economy's ability to roll with the punches (again, *The Economist).*

Stock Market Rising Periods Before the Downturn

The following graph looks at all rising stock markets (bull markets) since 1928. Each bar measures how long the rising trend lasted before it fizzled out and the downturn or correction began.



Bull markets do not end after a prescribed X years either. Just because the current bull market has been running for over ten years, and is the second longest running bull market since 1928 (by some measures it's the longest), does not mean it has to end within the next six months. No one has that crystal ball. While it is not the purpose of this paper to list reasons for and against whether the bull market may continue for many months to come, WIC believes at junctures like now, when the economy and the stock market appear to be very late in the cycle, appear to be very late innings, common sense is especially important to risk management. That is one reason we continue to be cautious and defensive.

ACCLIMATION RISK

Among the most powerful heuristics are *availability*, *extrapolation* and *over-confidence*; together, they are almost impossible to resist. These cognitive short-cuts often overwhelm rational decision-making. WIC has studied these psychological short-cuts to human decision-making for decades; nonetheless, we know we too are susceptible to their seduction.

Availability refers to the tendency to latch on to the most available, easy to access information, and believe it. *Extrapolation* refers to the tendency to naively believe that whatever trend appears to be present will continue; the longer the trend has been in place, the stronger the tendency to extrapolate it – to believe it will continue. *Over-confidence* is one of the hardest cognitive biases to keep at bay because most of us naturally believe we are smarter than the average bear. Information about the economy and stock market is omnipresent; the current economic and market expansions have been going on for a long time and seem almost unstoppable; and our natural over-confidence convinces us these strong trends will continue. And that is precisely what concerns us – *acclimation risk.*

WIC often uses the frog metaphor to admonish us to be careful about acclimation risk and complacency.[2] We are well aware how easy it is to rationalize and explain away risks and thereby fail to realize we have begun to boil. Some of the risks we have been internally discussing to keep us from "boiling" follow:

- An economic war with China; a war of power mongers; an aggressive deal-maker on the U.S. side who favors nationalism versus an opportunity on the China side to show the world China is a super-power; China is much stronger than the Soviet Union was during the cold war, and far more integrated into the global economy; China could very well have the economic power and resolve to not back down and bow to Trump
- Late innings; again, the economic and market cycles are very late innings
- Rich valuations with little margin for error (which seems to be ignored by many)
- A U.S. election only 11 months away could make an already volatile president increasingly impulsive and aggressive – Trump could push even harder as the election approaches – especially if the economy is faltering
- A social media society that prefers thin slicing to reading; a president who may prefer tweeting to debate; combine that with a world where facts increasingly don't matter and all of that could ignite reactionary *brush fires* that quickly spread fear and pessimism; the impeachment proceedings and upcoming presidential election are explosive fuel
- Pessimism alone can begin to fuel a recession – see negative *animal spirits* below

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[2] The frog metaphor refers to the human tendency to become acclimated to, and eventually accepting of, a condition. WIC's portfolio managers are no different from the rest of the species – we too can slip into accepting, and just rolling with high valuations, the markets strong upward trajectory, etc. We call all of this *froggy,* and it's a big behavioral risk. Our brains are wired the same as all humans, so we too get acclimated and accustomed to (i) the extraordinarily long economic expansion and bull market, (ii) the budget deficit and national debt level, (iii) inexplicable negative interest rates, (iv) high PEs and rich valuations, and (v) the tweet insanity, and we slip into rationalization (we get *froggy*).

- Recession fears framed by the media and spread by social media could become a self-fulfilling prophecy; especially if presidential election motivated/driven; see Shiller below
- A European economy that has weakened to the point of negative interest rates
- China's debt; and the possibility China has house-of-cards fissures
- Although inverted yield curves are not dispositive and are characterized by imperfect timing, the recent inversion should not be dismissed
- A Federal Reserve whose independence is being assaulted by the White House
- A FOMC that is already in uncharted waters and which may have few bullets left with which to fight a recession
- A Congress that will likely have great difficulty agreeing on fiscal policy to deal with a recession
- A Congress led by Democrats who would love to saddle Trump with a weakening economy and declining stock market going into the election

But there is always such a litany of concerns/worries. For decades, WIC has known it may be impossible to know where constructive disciplined thinking ends and destructive dogma begins. Because forecasting and market timing are unreliable, ineffective, and even counter-productive (true, but still can become harmfully dogmatic); because valuation-based indicators looked to for reducing portfolio risk may also be unreliable[3]; because of the fundamental strength of the economy; and because of the overall solid operational performance of most of our companies; we have been gradual over the last 18 months in reducing our clients' equity exposure even as valuations have become stretched and the margin for error has shrunk.

So how do we deal with acclimation risk? Risk and risk management are matters of mindset and thinking about what we don't know and cannot know. Just thinking about a wide range of possibilities, even though we cannot foresee all possibilities, fosters a better risk-attuned mindset. WIC's mindset is better educated and better prepared for acclimation risk when we (i) read about economic and market history, including the causes of severe economic and market downturns, (ii) resist thinking the normal cycles have been repealed and the next downturn will necessarily be mild, (iii) remain vigilant about the seduction of extrapolation, and (iv) insist on a large measure of common sense. More practically…

PRACTICAL APPLICATION TO OUR CLIENTS' PORTFOLIOS

Where the rubber meets the road is the actual composition of our clients' portfolios. The weighting of WIC's strategies – Core Equity, Small Cap Value, Managed Volatility and Income, and Fixed Income – along with cash reserves – varies client-to-client based on each client's profile.[4] We evaluate the appropriateness of each client's portfolio composition on an ongoing basis and

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[3] Market Timing: Sin a Little, Resolving the Valuation Puzzle; *Journal of Investment Management*; third quarter 2017; Cliff Asness, Antio Ilmaner, and Thomas Maloney – all with AQR.

[4] Client profile reflects many elements including net worth, degree of reliance on WIC portfolio, client's temperament and patience, objectives, risk vs. return preferences, tax issues, asset-liability matching, etc.

compare each client's needs and objectives to the foregoing risks and investment landscape – including considering where we believe we are in the cycle and reflecting acclimation risk. The primary internal report we use to monitor client portfolios has three rows for each client containing client profile and objectives information; and columns of client portfolio data including the weighting of each of WIC's above four strategies. It is that composition and that weighting of our strategies that primarily drives risk and return outcomes. When we are reviewing our clients' portfolios, each page of this monitoring report has the following table in the top right corner to remind us to think about where we are in the cycle:

Where are we in the economic and market cycle?

DECREASE PORTFOLIO RISK	INCREASE PORTFOLIO RISK
Weakening economy	**Stable economy**
Tightening/more restrictive FOMC	**Accommodative FOMC**
Rich valuations; low margin for error	Attractive valuations
Late in the cycle (economic or market)	Not late in the cycle
Complacency/little caution/**acclimation risk**	Sufficient caution

Decrease risk. Generally, the more we believe the conditions/characteristics on the left are present, the less risk we want to expose our clients' portfolios to; the more we want to decrease risk and tilt the portfolio toward capital preservation. When the condition is in bold font, we believe that condition is currently present. **We are particularly concerned about growing acclimation risk.**

Increase risk. Generally, the more we believe the conditions/characteristics on the right are present, the more risk we want to expose our clients' portfolios to; the more we want to increase risk and tilt the portfolio for growth. When the condition is in bold font, we believe that condition is currently present.

Because of the weakening economy (non-U.S. economies also considered), rich valuations with little margin for error, being late in the cycle (see page two and three hereof), and evidence of complacency and acclimation risk, we have been cautious and defensive for the last 12-18 months.

ANIMAL SPIRITS II

In many ways, we are "finance geeks"; we enjoy working with data, including artificial intelligence and machine-learning data. But making portfolio decisions and evaluating risk versus return is more than just crunching numbers. We also study economics, market history, geopolitical trends, and cognitive science, including the psychology of narratives and *animal spirits* to add balance and perspective to our thinking.

Robert J. Shiller, the Yale economist and Nobel Prize winner, was a pioneer in behavioral economics and the related psychology of investment decision-making. He is a prolific writer on animal spirits and related principles. We have been an ardent follower of his research, especially his research related to investor psychology. *Irrational Exuberance* explains how investment analysis and decision-making are not rational, cold-blooded decisions. In Shiller's latest book, *Narrative Economics – How Stories Go Viral and Drive Major Economic Events,* he explains the power of stories. Much of the last section of this paper is based on Shiller's research related to animal spirits and behavior.

On November 28, 2016, shortly after President Trump was elected, we posted a paper on our website titled "What If "Animal Spirits" Kick In"? That paper suggested businesses and investors might become emboldened with increased confidence (due to an improved business tone in Washington) with the result of a stronger economy. The paper opened as follows:

> If the animal spirits John Maynard Keynes wrote about eighty years ago kicks in, corporate America's balance sheet is in sufficiently good shape to provide a demand-side stimulus to the U.S. economy. The psychology of confidence-driven-risk-taking (animal spirits) can be powerful, especially when corporations have the capacity to invest.
>
> Today, corporations have sufficient cash on hand and borrowing power to expand if they choose to do so/if they are willing to do so. It is sometimes not enough for corporations to have the capacity to expand; they also must have the willingness to incur the risk of uncertain outcomes. Economic activity includes psychological factors such as the animal spirits Keynes wrote about in his seminal *The General Theory of Employment, Interest, and Money.* If a "spontaneous urge to action rather than inaction" materializes, economic activity could increase more than expected.

Animal Spirits II. So here we are three years after we wrote the above, and we continue to believe psychology has a substantial impact on economic and market direction. The "spontaneous urge to action rather than inaction" (animal spirits) that Keynes wrote about eighty years ago works both ways – the urge to act and the urge to not act (to wait and see). We believe the narrative may be changing and the pendulum may be moving toward inaction due to (i) the ongoing uncertainty around trade, (ii) the upcoming election with the leading Democratic candidates making strong anti-capitalism statements, (iii) the impeachment proceedings, (iv) more stories about a recession in the offing (such stories of course ebb and flow), and (v) what we see in CEO and CFO surveys about their expectation of a recession within the next 6-12 months.

In his *New York Times* column dated March 22, 2018, Shiller wrote: Consider how easy it is to be lulled into complacency about the current state of the economy … Contagious words and stories … could be enough to change the public mood about the Trump boom. Maybe a shift will come from the kind of stories that contributed to the dot.com collapse – tales of recently revered companies that turned out to have taken too many chances and so flamed out and crashed … A downturn could be set off by compromising stories about Mr. Trump, possibly those impugning

his judgment in starting an international trade war. Or maybe it will be something more subtle, whose link to animal spirits and mass psychology is only indirect. End of quote.

Returning to *The Economist* (8/24/19 issue) provides a good closing summary to ponder: The downturn of the 1990s was an example of what Paul Krugman, a Nobel economics laureate, has called a "smorgasbord recession", the product of a mix of troubles in modest proportions. In these garden-variety slumps, people and firms with the capacity to spend more, who might normally leap at the chance to buy discounted goods or hire overqualified workers, instead allow their cash to pile up. At its heart, this behavior is a matter of mass psychology, or "animal spirits"…Faith in economic expansion is self-fulfilling. But it is not invulnerable. Contagious pessimism can flip an economy from one equilibrium to another, in which cautious consumers spend less and hiring and investment fall accordingly, validating the initial outbreak of pessimism…Confidence, though, is slippery. It may wane as interest rates fall, leaving central banks less room to jolt economies out of their pessimism, and as government policymakers fumble their fiscal tools. It may wilt in the face of leaders' erratic and self-defeating behavior. Recessions, to no small degree, are a state of mind. End of quote.

WIC will continue to seek the right balance of art and science, evaluate math-driven discounted cash flow valuation models alongside animal spirits, and apply the judgment and common sense that our firm's 40-year history has given us. Because our clients often say this is very important to them, it is worth repeating – WIC's partners are invested in the same strategies and securities that you are – we eat our own cooking and strongly believe it should be no other way.

Disclaimers: *The views expressed represent the opinion of Willis Investment Counsel's research and portfolio management team. The views are not intended as a forecast or guarantee of future results. This material is for informational purposes only. It does not constitute investment advice and is not intended as an endorsement of any specific investment or strategy. Past performance is not predictive of future results, which may vary. Investing is subject to risks and uncertainties; future returns are not guaranteed, and loss of principal may occur.*

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