Sound Thinking

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Balancing paranoia and complacency

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There's nothing more disconcerting than the feeling that everything's going well.

Any parent knows what I mean. After hours of running around, the house is finally in order, the work of the day is done, the dinner is cooking, and the precious chance to take two minutes sitting down (maybe with a small drink) is grabbed with both hands. Everything is good, and the house is quiet. And then, just as the adrenaline of the day begins to drain from the system comes a sudden horrifying realization that there is just TOO MUCH quiet coming from the room where the children are playing...[1]

Of course, this doesn't just apply to children. Across the human experience it's a fairly solid assumption that when things are going well, and have been going well for some time, there's likely to be a road bump just around the bend. Remembering that's the case helps us keep our eyes open for that road bump – no doubt the instinct comes from our time being the weakest animal in the food chain.

Let's call this first instinct the paranoid instinct.

Humans are complicated creatures, though. At the same time that the paranoid instinct makes sure we are kept alert, we have a balancing instinct that fights against it.

This second instinct is the one that makes us anchor our expectations of what might realistically happen in the current environment. We might expect the weather to get a little better or a little worse, but we don't normally expect a hurricane or tornado every time the sky filled with dark clouds or we'd spend most of our time in the basement. We get used to driving with the flow of traffic on the freeway – we don't expect a car to speed by us in the inside lane at twenty miles over the speed limit.

Let's call this second instinct the complacency instinct.

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1. *Compared to that, the circumstances under which I write this, sitting at my kitchen table being intermittently eaten by a Dinobot attached to a four-year old, are comparatively restful. Chaos seen and understood is chaos managed!.*

Happiness is a balance between paranoia & complacency

Successful investment is about balancing these two instincts, as they both have a place in the decision making and information assessment process that we apply as investors.

The paranoid instinct is important because it keeps us focused on what might go wrong. As we climb the wall of worry in bull markets it makes us keep an eye out for problems that might be hiding from sight. When we hear the excitingly positive story from a charismatic CEO (or indeed from the CIO of a portfolio management company pitching for business), the paranoid instinct helps by constantly reminding us that not everything is as it seems, that there are likely to be unexpected problems that are being ignored, and that the things that have driven recent success may turn from advantages to disadvantages in the near future. It helps us remember that every success carries within it the seeds of its own demise.

At the same time, the complacency instinct is also important. It makes sure that we're not always twitching at shadows. Even if we know that very unusual things do sometimes happen, the complacency instinct helps us remember that, normally, most of the time things are mostly normal[2]. Unusual events might be fun to talk about and interesting to analyze but allowing them to take up too much of your time distracts from the truly likely outcomes and ends up leading you down blind alleys. The high yield market is a great example of where the complacency instinct is important – while it's a market where there can be big bad events, and where there can be times where things go badly wrong, most of the time that isn't the likely outcome. Even when those bad events do happen, history shows that the long- term return that you receive from the asset class compensates you for the losses experienced during bad periods[3].

Balancing these two instincts is difficult, but important. We need to remember that focusing too hard on either can be detrimental. The paranoid instinct can lead us to be over-concerned about what might happen, at the cost of backing away from risk at the wrong time. The complacency instinct can lull us into a false sense of security, making us continue to take risky portfolio bets when the right move is to take money off the table.

Where is the imbalance today?

One worthwhile exercise, then, is to sit down and make a dispassionate assessment of what each of the two instincts involved are saying to us – and where they might be leading us in the wrong direction. Doing this can help us avoid the drumbeat of concern from investment newsletter commentators, and the burbling that we hear from the commentators on CNBC.

So what's the biggest dissonance between these instincts and reality today?

I think it centers on one of the most discussed questions about the economy (and therefore the markets) – how long will the expansion last? While there's no way to be certain, the way we talk about

2. *At least in the practical, if not the statistical, sense.*
3. *A good example is the 10-year period beginning just before the start of the global financial crisis, where the cumulative return over the period was an entirely respectable 113% (BBgBarc U.S. Corporate High Yield Index, October 2007 – September 2017).*

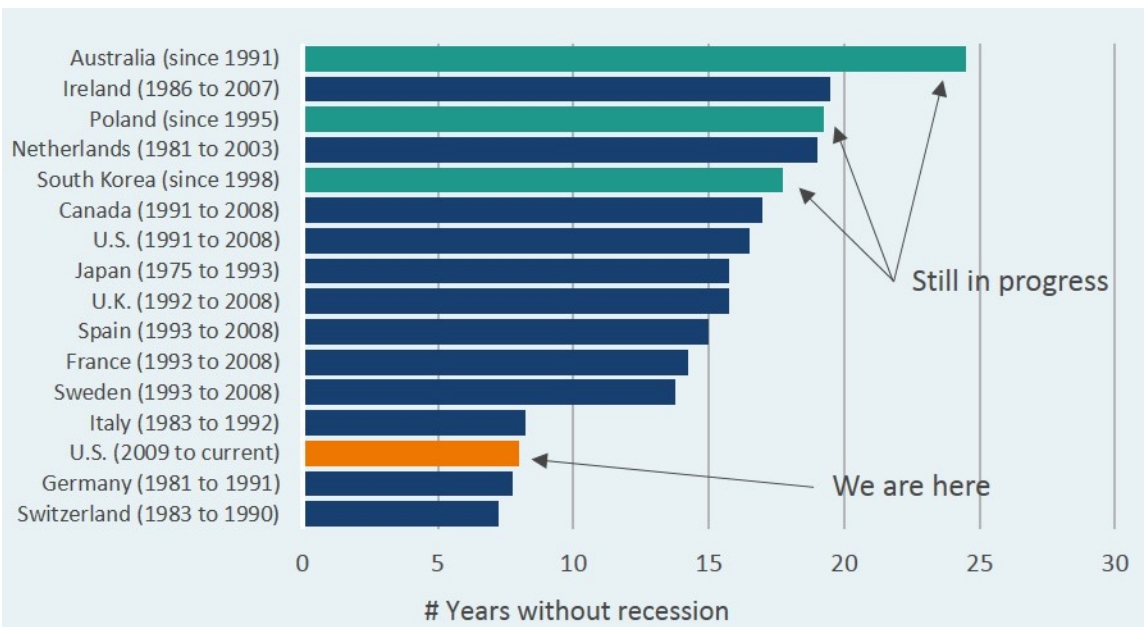
this has an underlying misconception embedded in it – and that this misconception plays too well into the paranoid instinct, leading us to be more concerned than we should be.

What's the underlying misconception that I'm referring to? The idea that the length of the economic expansion is governed by the clock – that there's a natural length of expansion which creates an artificial time limit. Once we cross a certain length of expansion, this theory would suggest, a great cosmic whistle blows and all bets are off. It's clear how this fits well with the paranoid instinct. It's the underlying truth that good things can't last made manifest.

The problem is that it's wrong – not in essence (all expansions come to an end) – but in practical terms. In reality, expansions are more complicated than that, and they are broken not by the simple passing of time, but by something more complex.

We can see this clearly by looking at Chart 1. This simply looks at the length of expansions for a range of different countries – the length of time between recessions. What jumps out from this is the simple fact that there have been a good number of countries that have experienced expansionary periods much longer than the current U.S. expansion. This doesn't tell us how much longer ours would last, of course, but it does clearly demonstrate that there have been plenty of longer expansions.

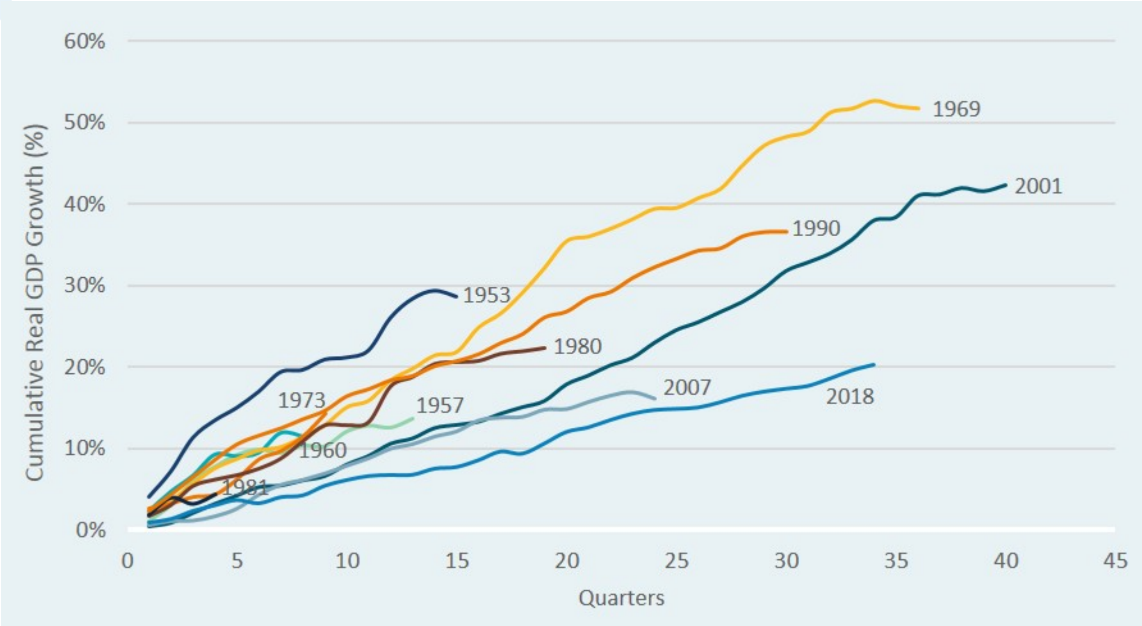
CHART 1 – HOW LONG CAN EXPANSIONS LAST?



Source: Australia Trade and Investment Commission

There is an alternative way to examine the topic, which compares the current U.S. expansion with previous U.S. expansions. We can see this in Chart 2, which looks at length of expansion and compares it to the actual amount of growth experienced by the economy during that expansion.

CHART 2 – CUMULATIVE REAL GDP GROWTH IN U.S. EXPANSIONS



Source: FRED, as of 12/31/17

On this basis, the current expansion is clearly one of the longest in U.S. history. It's also clear, however, that the absolute amount of economic value added during that expansion has been much less than in previous expansions. This is particularly dramatic when we remember that the amount of expansion we're measuring is measured from the nadir of the global financial crisis. In other words, while the time dimension of this chart is accurate, a larger part than usual of the upside economic value added represents simply digging out of the huge hole created by the worst financial crisis in a generation.

So there seems to be little evidence that some underlying calendar will bring the current expansion to a close. The paranoid instinct may be winning out more than is appropriate. That means we need to think harder about the types of things that cause economic downturns – and also look at signals that will provide advanced indications of problems in the current expansion.

Our world today

What is the current probability that a significant and sudden downturn in growth will happen? If the paranoid instinct is currently overpowering the complacent one, what are the signs we should look for that might suggest that the relatively benevolent environment we've been benefiting from will come to an end?

We can look at a number of places to answer this question.

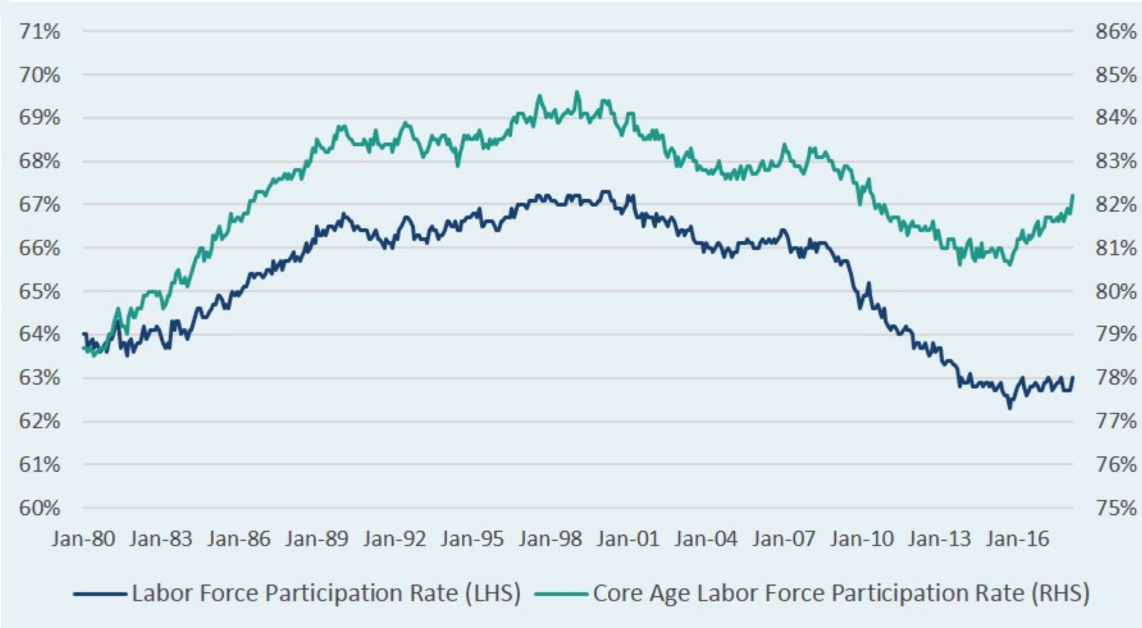
First, we can simply look at where the rate of growth of the economy stands relative to history. Chart 3 covers the long run of this statistic. While it's easy to see we're moving forward, there is little evidence of excesses that might traditionally lead to a reversal to the downside.

CHART 3 – REAL U.S. GDP GROWTH (YOY)

Source: Bloomberg, as of 12/31/17

Second, we can look at the level of unemployment relative to the labor force participation rate. While unemployment as a whole has come down (both on the relatively narrow definition of U3 and the much broader definition U6) and participation rates in the core age group are moving up, when we look at the labor force as a whole, participation is still materially lower than during the 1990s and 2000s. We can see this in Chart 4. This implies that the level of wage growth that could cause a derailment of the economy is less likely to arise – instead of wages rising too quickly, they are likely to be constrained by the pull of workers back into the economy (especially non-core workers), and by the continuing rise of automation.

CHART 4 – U.S. LABOR FORCE PARTICIPATION RATE



Source: FRED, as of 2/28/18

Third, we should always be aware of forward-looking signals from the credit markets, particularly the high yield market. Significant gaps in credit spreads may act as an early warning sign for the economy, and in particular as a sign of overleveraging. When spreads are tight (see Chart 5) we are inclined to be less worried. When spreads move significantly wider and stay at elevated levels, we may begin to worry.

CHART 5 – U.S. CORPORATE HIGH YIELD SPREADS

Source: Bloomberg, as of 3/8/18, based on the BBgBarc U.S. Corporate High Yield Index

Finally, inflation and earnings growth are important. In Charts 6 and 7 we can see both that inflation levels (and expectations) are quite limited, and that earnings growth remains strong. Both of these fundamentals may help justify rises in asset prices.

CHART 6 – U.S. INFLATION & INFLATION EXPECTATIONS

Source: FRED, as of 2/28/2018

CHART 7 – U.S. EARNINGS GROWTH (YOY)

Source: MSCI, as of 2/28/18, year-over-year growth in forward EPS

None of these indicators are currently sending strong warning signs, but all of them are worth watching to help understand the balance between paranoia and complacency.

Conclusions

A healthy balance between paranoia and complacency helps us stay focused on the things that really matter. That balance today seems to be slightly off in the marketplace, especially when it comes to the question of how long the economic expansion can last. While there are plenty of things that could derail economic growth, it seems that concerns over them are excessive. While a downturn in the economy is possible, and continuing volatility in the capital markets is quite likely, we believe investors should keep leaning into risk where possible. The wheels of the economy don't seem to be wobbling quite yet.

ABOUT THE AUTHOR

Mr. Toner has a degree in Law from the University of Oxford in the United Kingdom and is a CFA charter holder (Chartered Financial Analyst). He is a regular author and speaker on a range of investment topics. He is a member of the Audit / Finance Committee of The Medina Foundation in Seattle. He is also a member of the CFA Institute and the CFA Society of Seattle. Mr. Toner is a trustee of Charles Wright Academy, an independent co-educational school based in University Place, WA, where he also sits on the finance and endowment committees. He is also a board member at the Seattle Metropolitan Chamber of Commerce, where he co-chairs the finance & audit committee. He has been happily married to his wife, Heather, for nearly 25 years, and is the proud father of two children.

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