

Investment Update



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March 2010

Even the Animal Spirits are Depressed

If 2008 was described as the year of panic and 2009 was the year of relief, then 2010 may go down as the year of anxiety. After emerging from the financial crisis and surviving its aftermath, investors now are faced with numerous concerns that are negatively influencing our collective consumer confidence and, consequently, our behavior. Even a brief conversation with the man on the street would surface a condensed list of worries including unemployment, inflation, taxes, the federal budget deficit, state and local budgets, Fed exit strategies, the housing market, government effectiveness and intervention, access to credit by small companies, sovereign debt, a double dip recession, commercial mortgages, consumer deleveraging, China, Iran and, undoubtedly, many others.

In his 1936 book titled *The General Theory of Employment, Interest and Money*, John Maynard Keynes used the term “animal spirits” to convey the impact emotions have on human behavior and, in turn, their effect, as measured by consumer confidence. His original quote was: “Even apart from the instability due to speculation, there is the instability due to the characteristic of human nature that a large proportion of our positive activities depend on spontaneous optimism rather than mathematical expectations, whether moral or hedonistic or economic. Most, probably, of our decisions to do something positive, the full

consequences of which will be drawn out over many days to come, can only be taken as the result of animal spirits — a spontaneous urge to action rather than inaction, and not as the outcome of a weighted average of quantitative benefits multiplied by quantitative probabilities.”

This disquietude weighs heavily on consumers and small business confidence especially. Normally, optimism would spur action. Instead, the ambiguous future has us paralyzed by fear. While we are seeing some signs of consumers emerging from their shells, small businesses remain hunkered down. Considerable uncertainty, combined with lack of credit availability, has created an almost impenetrable haze for the small business outlook.

The Networkers

One area where these concerns have caused the “urge to action,” as cited by Keynes, is on the political front. In the 1976 film *Network*, Peter Finch played Howard Beale, a news anchor who learns that, due to a ratings decline, he only has two more weeks on the air. Upon hearing the news, he makes dire threats on live television about what he will do during a subsequent broadcast. He is summarily fired, but then is allowed to return for a supposedly dignified final farewell. However, instead of parting with kind words, he rants about life in general. During this final diatribe, he exhorts the country to throw open their windows during a storm to shout, “I’m as mad as hell and I’m not going to take this anymore!” Well, it may have taken a while, but life now appears to be imitating art.

The 2010 political environment will continue to be shaken by the emergence of a new party that I would like to call the Networkers. From many windows, we now are hearing a similar refrain. It was heard most recently in Massachusetts but it seems unlikely to stop there. The upcoming mid-term elections also may be noisy with this refrain. The challenge for entrenched politicians is that this new party is far less unified than either the current Republicans or Democrats. These ‘Mad as Hellers’ comprise outliers from both primary parties, many Independents as well as Tea Partiers. The collective slogan of the Mad as Hellers may become, “We’ve tried change; now let’s try progress.” The problem with change is that it always sounds better in theory than in practice, and it seems more palatable looking from the outside. Because the goals of this disparate group are nowhere near unified, each faction has a different view of what progress may look like. Their amalgamated views and priorities likely will engender more change and uncertainty in the future.

Déjà Vu

How does all of this tie together? On the surface, the investment environment may appear uniquely complex and opaque by historical standards. On the contrary, this lack of clarity is a common characteristic following inflection points. While this recovery’s specific list of challenges may be unique, the collective fog these issues create is a hallmark of what typically follows an economic bottom. In fact, the market response also has followed a classic pattern.

After a collapse, negative sentiment becomes extreme, allowing markets to rebound quickly as recognition spreads that worst case scenarios have been avoided. Investors then begin to anticipate recovery. Having traversed the relief and recovery phase, markets now may begin to reflect the expansion phase. At this point, the rally frequently pauses as participants digest all that has transpired and try to discern their next step. After a period of backing and filling, markets often move higher on the reflection of improvement and reduction of uncertainty. This stage tends to bring stock movement in fits and starts. Indeed, stock prices remain near levels seen at the start of the year, but are incurring increased volatility.

Looking Forward

We have written extensively about some of the concerns investors are facing and certainly do not underestimate them individually. However, not every fear will manifest; every issue will not end in a negative outcome. Our collective worries are likely to weigh on the markets and economy for some time. As some stumbling blocks resolve or diminish, however, we believe that reduced uncertainty will translate into progress for both the stock market and the economy. Seemingly lost in current cross currents is the clear improvement both in global economies (with notable and well publicized exceptions in some of the weaker EU countries) and in corporate profits. If prices remain level or decline while profits continue to climb, as we expect, valuations will improve to the point of being compelling to more investors — even in light of the uncertainties.

While the near future may not look exactly like the past, we continue to see opportunities. We think that it is too early to move towards an overly defensive portfolio. However, as we highlighted in last month's Investment Update, the environment likely will continue to require more active and dynamic portfolio construction. Not every portfolio decision in this regard will be about adding incremental return. At some point, possibly even during 2010, investors may also benefit from risk reduction moves.



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