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WHAT IF “ANIMAL SPIRITS” KICK IN?

*... due to the characteristic of human nature, a large proportion of our positive activities depend on spontaneous optimism rather than on a mathematical expectation ... most of our decisions to do something positive ... can only be taken as a result of **animal spirits** – of a spontaneous urge to action rather than inaction, and not as the outcome of a weighted average of quantitative benefits multiplied by quantitative probabilities.*

John Maynard Keynes, 1936.

CONCLUSION

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.

DISCUSSION

For the purposes of this paper, it is unimportant whether one voted for Trump or Clinton. And because the thesis posited herein is about the potential positive impact of confidence, optimism and animal spirits, it is not important to ponder the unknowable outcomes of future Trump administration policies. Rather than attempt a forecast, this paper simply encourages one to consider the possibility that corporate confidence could materially increase in the coming years resulting in increased commercial activity.

Some combination of the following could encourage corporate and business decision-makers (including individuals and small businesses) to take more risks – to spend and invest more:

- A generally more pro-business *tone* coming out of the White House¹
 - The *perception* and hope of lower taxes and fewer regulations²
 - The *belief* corporate cash trapped overseas will be brought back to the U.S.
 - *Relief* that the next four years will not mean yet more regulations/tax
- Perception, alone, could become a sufficient animal spirits spark.**

Here, what may be the “right policy”, and what potential outcomes might emanate from a given policy, is not the point. Instead, the focus is on the possibility of an increase in risk taking and commercial activity arising from a change in perception and beliefs.

The above posits there could be an increase in the *willingness* to take risks. What about the *capacity* of corporate America to expand property, plant and equipment; to hire more employees; to enter into new commercial ventures; etc.? A review of 1500 publically-traded companies’ balance sheets, income statements, and statements of cash flow – going back 37 years to 1980 – suggests corporate America’s:³

- Liquidity is above average⁴
- Cash coverage of debt is above average⁵
- Debt levels and leverage are above their 37 year average, but these levels are ameliorated by historically low interest and carrying costs⁶
- Debt structure and interest carrying cost are favorable⁷
- Recent investment of cash flow into capital expenditures (capx) has been below average, suggesting a possible pent up need for capx⁸

One can evaluate the foregoing data and of course reach different conclusions. For example, one can reasonably conclude cash levels are not significantly higher than the 37-year median and leverage is higher (worse). The point herein is that corporate balance sheets are not over-extended with debt; and cash levels are quite healthy. While leverage is somewhat greater than the 37-year median, that is largely offset by the positive affect of historically low interest rates. Looking at interest coverage and interest expense as a percentage of outstanding debt, the interest burden is meaningfully less than the 37-year median.

¹ The key point is the potentially powerful influence of perception and belief; especially at the margin.

² Again, perception and hope can overcome the finer points of actual legislation and regulations.

³ I reviewed data provided by Standard and Poor’s Research Insight database (formerly Compustat). This data goes back to 1980 and medians (not means) were evaluated; not market-cap or balance sheet-sized weighted. See Appendix for supporting data.

⁴ Cash as a percentage of total assets.

⁵ Cash as a percentage of total debt.

⁶ Asset-to-equity leverage; total debt-to-total assets; debt-to-ebitda was most elevated.

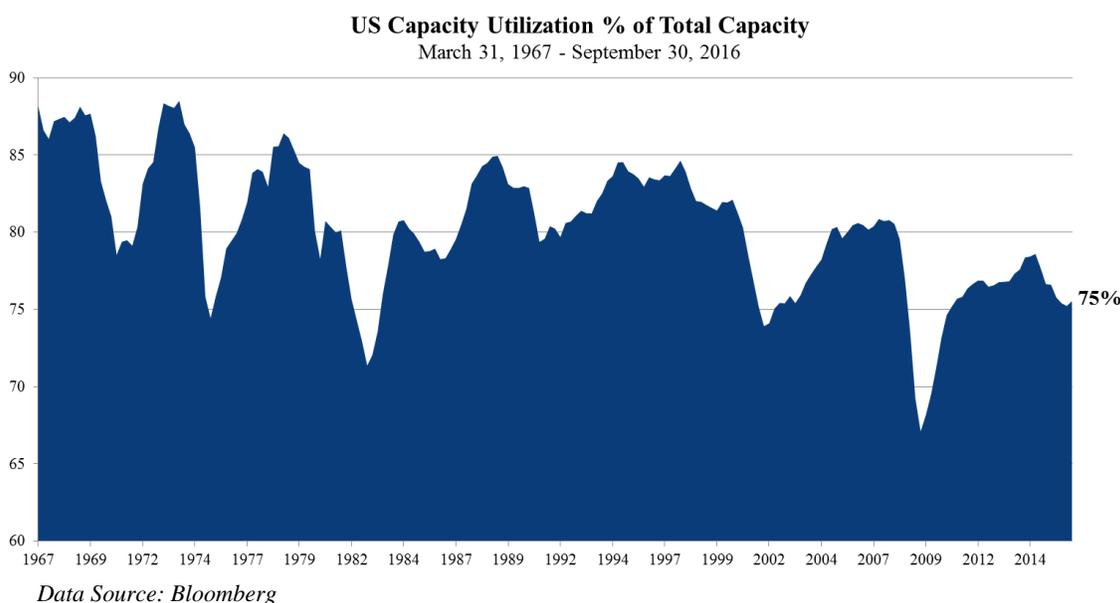
⁷ Corporations have been refinancing over the last five years extending maturities at 3-4% average interest rates. Using Bloomberg functions for interest expense for trailing 12 months and total debt, the median interest expense rate (interest expense/total debt) for the S&P 500 companies is currently approximately 3.90%. Per the *S&P U.S. Issued Investment Grade Corporate Bond Index*, the current par weighted coupon is 4.01%; similarly, 4.08% is the average coupon for the *Barclays Aggregate Bond Index* (corporates only).

⁸ Last fiscal year-end capital expenditures (capx) as a percentage of cash flow from operations (cfo). But see operating capacity comment on next page.



Because corporate cash levels are strong (and could get stronger with repatriation), because corporations have the capacity to borrow more for expansion at historically low interest rates, and because operating profit margins are robust, the capacity to expand appears more than sufficient. Combine that capacity with the potential of an increase in confidence and optimism, together with animal spirits, and the stage could be set for unexpectedly strong economic activity.

Counterpoint. The foregoing makes a case for increased *willingness* driven by animal spirits, and for the balance sheet and borrowing *capacity* to act on that willingness; but what about *need*? If a manufacturing company is operating with excess capacity and believes even with increased demand for its products it can handle said demand with its existing, under-utilized facility, why would it expand? Based on the current capacity utilization rate of approximately 75% (see graph), which is below the normal rate of around 80%, one could argue many corporations may not need to expand their property, plant and equipment to handle an increase in economic activity. Fair point.



To those that might dismiss an analysis long on psychology and short on econometric modeling and forecasting, the unreliable track record of economic forecasting should be remembered and triangulation should be embraced.⁹ Perhaps Churchill did not reject that which was not erudite when he reminded us that:

Out of intense complexities, intense simplifications emerge.

⁹ Reminding the reader of the research that indicates economic forecasters have a questionable track record (not reliably predictive) is not a dig at economists. Rather, it reminds the reader of the near impossible task of forecasting something as complex as the economy that is not subject to the “laws of physics”. It is partly because of psychology, emotion, crowd behavior, and the whims of animal spirits that make forecasting so difficult. For further reading on using multiple approaches (triangulation) and not overly-relying on econometric models, see *The Life and Times of Alan Greenspan* by Sebastian Mallaby; *Models Behaving Badly* by Emanuel Derman; *The Signal and the Noise* by Nate Silver; and *CBO’s Economic Forecasting Record 2013 Update* published by the Congressional Budget Office. The more one reads about the efficacy of forecasting, and the more one reads about the history of the Federal Reserve, including the memoirs of its governors and Chairmen, the more one comes to appreciate and respect the need to be skeptical of the accuracy of modeling and forecasting. Forecasting is necessary and represents an indispensable tool – but it is only one tool, it is not dispositive.



APPENDIX

The following table contains 37-year medians from Standard and Poor’s Research Insight database (which begins in 1980, the year the data used herein starts with). To avoid skewing the data by using data based on market capitalization or balance sheet size, the metrics were calculated for each company and then the median of the companies’ metrics were calculated. The below table looks at two Research Insight sets:

- The *S&P 500* set of the largest 500 publically-traded companies
- The *Superset* which contains approximately 1500 companies including mid-cap, small-cap, and micro-cap companies (market cap as low as \$80 million are included) to provide a broader spectrum of corporate America

First metric is current reading / second metric is 37 year median

Metric	Superset – 1500 companies	S&P 500
Cash / Total Assets	7% / 6%	7% / 5%
Cash / Total Debt	27% / 22%	26% / 23%
Assets / Equity	2.39 / 2.18	2.83 / 2.44
Total Debt / Assets	25% / 20%	29% / 22%
Total Debt / Ebitda	2.09 / 1.43	2.23 / 1.49
Total Debt / Total Cap	41% / 34%	48% / 37%
Total Debt / CFO*	2.70 / 1.76	2.99 / 2.10
Interest Expense / Sales	1.00% / 1.00%	2.00% / 2.00%
Interest Coverage	6.45 / 5.96	7.69 / 6.61
Interest Expense / Debt	4.23 / 7.07	3.97 / 6.88
Capx / CFO*	28% / 35%	27% / 35%

*CFO is cash flow from operations (not net of capx; not free cash flow)

For related information and data, see *S&P Capital IQ Global Credit Portal* paper on corporate cash and debt levels dated May 20, 2016 and *Bloomberg Intelligence Credit Means Study* posted June 7, 2016.

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