Prosperity is a State of Mind

A large contingent of investors has been perplexed by the resilience of the markets and the economy throughout this cycle. Volatility in both stocks and economic growth remain muted even though they've been given plenty of excuses to go berserk.

Eventually this stability will come to an end (it always does) but it's worth discussing why it's remained for so much longer than anyone would have predicted.

While there is any number of legitimate reasons you could tick off for every single bull market and economic expansion in history, much of it comes down to the human element.

For example, the roaring 1920s saw a huge boom in innovation for the mass consumer. People were introduced to a number of things we now take for granted -- radios, refrigerators, washing machines, irons, the assembly line, and cars, to name a few. And people were purchasing these and other items on credit en masse for the first time in history.

The stock market boomed as it never had before. The ensuing market crash unwound the boom and more. Frederick Lewis Allen's book Only Yesterday: An Informal History of the 1920s captured the sentiment of this boom, and it's aftermath, beautifully:

Prosperity is more than an economic condition: it is a state of mind. The Big Bull Markets had been more than the climax of the business cycle; it had been the climax of a cycle in American mass thinking and mass emotion. There was hardly a man or woman in the country whose attitude toward life had not been affected by it in some degree and was not now affected by the sudden and brutal shattering of hope. With the Big Bull Market gone and prosperity going, Americans were soon to find themselves living in an altered world which called for new adjustments, new ideas, new habits of thought, and a new order of values. The psychological climate was changing; the ever-shifting currents of American life were turning into new channels.

We still don't really know the exact cause of the Great Depression but this is the best stab at it that I've seen (and this was written in 1931 before it was even over). Basically both the boom and bust were a function of people's attitude and emotions.

This isn't the answer investors would like but beyond all of the market and economic indicators, it's likely that simple.

Things went too far in both directions because people tend to extrapolate and go overboard. That's just how we function in large groups. Both the slumps and the prosperity become exaggerated because of this.

One of my favorite explanations of this idea comes from legendary investor and economist John

Maynard Keynes in his book The General Theory of Employment, Interest, and Money*:*

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 on a mathematical expectation, 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 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.

Only a little more than an expedition to the South Pole, is it based on an exact calculation of benefits to come. Thus if the animal spirits are dimmed and the spontaneous optimism falters, leaving us to depend on nothing but a mathematical expectation, enterprise will fade and die; though fears of loss may have a basis no more reasonable than hope of profits had before.

Michael and I both loved this description and the term animal spirits so much that we named our podcast after it.

Statistics don't matter very much when this line of thinking takes hold. This entire system is driven more by confidence, trust, hope, and fears than many would care to admit.

Of course, this "instability due to the characteristic of human nature" works both ways. I'm sure the current lack of volatility is driven more by the collective state of mind of investors than anything else. And at some point, for reasons that everyone will be unaware of at the time, the tide will shift. The psychological climate will change. Mass thinking and mass emotion will shift from optimism to pessimism.

I wish I could tell you exactly when and why that will happen but the truth is no one really knows because market cycles are based on a state of mind.

To those people guessing exactly when it will come to an end, I say to you, "good luck with that."

Sources:
Only Yesterday
The General Theory of Employment, Interest, and Money

Further Reading:
The Unintended Consequences of Innovation