

## Homo Economicus

April 5, 2009

### Beauty in the Details

The only way to teach economics in a semester or two is to simplify it beyond recognition. But the beauty of life is often in the details. And so in this letter we focus on the intangible and hard to measure but massive effects of human psychology in the markets. Bennet used to say that to be good at understanding markets you shouldn't get an MBA with a finance concentration but instead should learn history, psychology, sociology and macroeconomics.

The concept of a rational human who makes economic decisions with a full set of data, and pursues enlightened self interest is personified by Homo Economicus<sup>1</sup>. It is just such a mythical economic figure that allows us to simplify our models of the economic world. The concept is enticing because it has a hint of emotion (self-interest), but is a complete failure to describe reality because this emotion is masked by a false stability. In other words, there is no ability for homo economicus to adjust its emotions in a pendulum fashion from greed to fear and then back to greed again. But this pendulum of emotion is precisely what happens in markets that are comprised of real humans, not economic models of humans.

Two common market axioms that you may have heard are based on this very idea. "Buy from the fearful and sell to the greedy", and "The crowd is always wrong at extremes" are useful because psychology is always important.

### Changes in Behavior

Simple: When you were young and learning how to use a hammer, you swung with abandon at that nail until you hit your finger for the first time. Suddenly, your method of swinging the hammer changed and has remained changed even up to today.

Not as Simple: When you were young, you may have feared roller coasters. But then your friends liked them and so you tried them, and whadd'ya know? It was fun. But then maybe you started to get older and roller coasters started to make you feel queasy or your bones rattled too much and your neck hurt afterwards. You changed your behavior a few times, but now you probably have made up your mind whether you like'em or not.

Complex: That string of condos that you flipped sure was sweet. It was a lot of fun making money without doing any real work. Thank goodness that the loss you took on the last one only wiped out all of your previous profits, and didn't really put you under. Now how will you decide to take risk in the future? Are you chomping at the bit with all of these new "cheap" prices, or have you changed forever?

Changes in behavior typically occur after consequences are revealed and absorbed. The amount of change in behavior and the permanence of the change is a function of the amount of pain felt and the length of the pain endured during the learning process. Trying to get us to go back to our previous behavior is nearly impossible if the consequences suffered are severe enough.

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<sup>1</sup> Wikipedia - *Homo economicus* is a term used for an approximation or [model](#) of [Homo sapiens](#) that acts to obtain the highest possible well-being for himself given available information about opportunities and other constraints, both natural and [institutional](#), on his ability to achieve his predetermined goals. This approach has been formalized in certain [social science](#) models, particularly in [economics](#).

To me, this is one of the most pressing questions facing us in regard to our markets and how they will evolve in the next period. Will the consequences of our previous actions lead us to a changed behavior? Or will the government succeed in trying to get us to go back to our former practice of wild consumption?

### The Lesson at the Pump

Use your imagination for a moment and put yourself in the robe of an Arabian Prince. You are the potential beneficiary of a globally needed commodity (oil) of which you have a large but finite amount. Your job essentially is to maximize the amount of revenue that you can collect selling this oil. This is the simplest of economic equations: Price x Quantity = Total Revenue. Up until now, the demand seemed to be insatiable and so the best idea was to continue to increase price while pumping as fast as possible.



But take the robe off and come back here to the ole' USA. Somewhere along the way, filling up that Suburban or Escalade went from costing \$50 per tank to costing nearly \$150 per tank. Now I'm not suggesting this was the only influence on the decline in oil prices, but I do believe that an important psychological tipping point was reached. Americans suddenly in a few short weeks realized that big SUVs had the potential to cost an enormous portion of their weekly paycheck to drive. Filling up that shiny urban tank suddenly came at the expense of putting food on the table.

Oil peaked in July of 2008 and by year end had fallen from about \$140/barrel to around \$40/barrel. Gasoline at the pump went from \$4.50/gallon in some areas down to around \$1.75/gallon. Now it wasn't so expensive to fill up the truck, so was all good in the world again, or did we learn something last summer?

<sup>2</sup> The chart above is the seasonally adjusted annual rate of light truck and SUV sales in the United States since 1977.

Was the impact strong enough to change the rate of purchasing light trucks in America? Light truck sales began to slide off a cliff in late 2008 just as oil was peaking in July 2008. Since then we have had heavy incentives in the form of “employee discount pricing” and 0% interest rates for those willing to purchase again, but so far the lesson learned doesn’t seem to be reversing.

### **The Lesson at Home**

On a much grander scale than SUV’s, people are being caught off base by homes that they cannot afford. This event took a long time to build to this level of crescendo and there were many forces at work. From greed, to cheap money, to unscrupulous lenders, to personal dishonesty, all contributed to some degree to the build up. Along with the bigger house came more washing machines and stainless steel refrigerators. New sofas, plasma tv’s, and barbecues were all required to add to the new abode, and all financed with cheap money available anywhere you looked. 0% down payment, interest only for 5 years, floating rate payments. Even interest free balance transfers between credit cards. These were all wonderful incentives to create the biggest party ever in consumer-land. Parking lots at strip malls and home improvement centers could have charged a fee and it still wouldn’t have slowed the crowds.

But eventually, the excess comes to an end. You simply can’t afford that much debt. You have to pay it off, or default (bankruptcy) at some point. We all knew that, we just pretended it wasn’t reality. But it was.

So now the consumer based economy has fallen on hard times, or is headed back to what I like to call “normal”. This is where you put a little aside each month and build up a cushion for a rainy day. You save to buy things that you can’t immediately afford, and you stop caring about what someone else owns. If we’re lucky, we may even end up in a place where we learn to help others and donate our time and money.

### **Aggressive Reversal Approach**

During the Depression, the United States was a massive creditor nation. We had loaned vast sums of money to Europe and other parts of the globe. Part of this effort was the rebuild of Europe after World War I, which allowed us to create another trading partner and economic ally. But this time around, we find ourselves to be a massive debtor, and must rely on the kindness of others to help us out. Hopefully our existing lenders will find us “too big to fail” and will keep on lending in an effort to get us out of this mess. But in the end we all agree, you can’t borrow your way out of debt no matter if you are an individual with a house you can’t afford, or a massive debtor government who is trying to borrow and spend their way out of this crisis. New debt doesn’t fix old debt.

The government is trying to do everything to get this economy restarted. Giving money to the banks, taking the toxic assets, bailing out auto companies (even though we have let plenty of them fail in the past), insurance companies, tax breaks for middle to lower income, taxes on the rich, etc. All of these efforts are meant to restart the economy. The hope is that the banks will have the capital to start lending again and get us back on track. Everything they are doing is begging us to take another sip of the punch.

### **Permanent Damage**

But even if you could wave a magic wand and make all of the old debt disappear, do you think that people have made a significant psychological shift yet? Do you think we would just go right back to consuming the way we used to?

My partner Tom Fant and I are of the opinion that it’s a 50/50 call at this point. If this equity market rally is right, and we have seen the peak in unemployment, we may not have created enough psychological damage to influence a



generation's spending habits. If however, the pain felt is greater, unemployment continues to rise, and hard times extend through 2009 and well into 2010, this may be just enough to cause our old ways of consuming to slow for an entire generation. This may feel bad at first, but in the end will be a better outcome that cleanses our economy.

At the tipping point, you change the entire approach to the economy. The consumer model of the last 30+ years goes away for a long time. People who have lost their house won't lever up again with cheap money. Consumers who have had to declare bankruptcy won't rush out to buy that shiny new Viking grill for the backyard on the 15<sup>th</sup> Visa card offer of the week. Creating cheap or free money won't have an effect on the consumer. You are then "pushing on a string". You can make the loans cheap and easy to get, but you can't make me borrow and spend.

### **Inflation Worry**

In the attempt to solve this current economic malaise, the governments of the world seem to be in a competitive race to devalue their currencies by printing as much money as possible and distributing it freely. They are attempting to clean up the mess of debt with more debt and too much money. Because of this approach, there are many people that are beginning to worry about inflation.

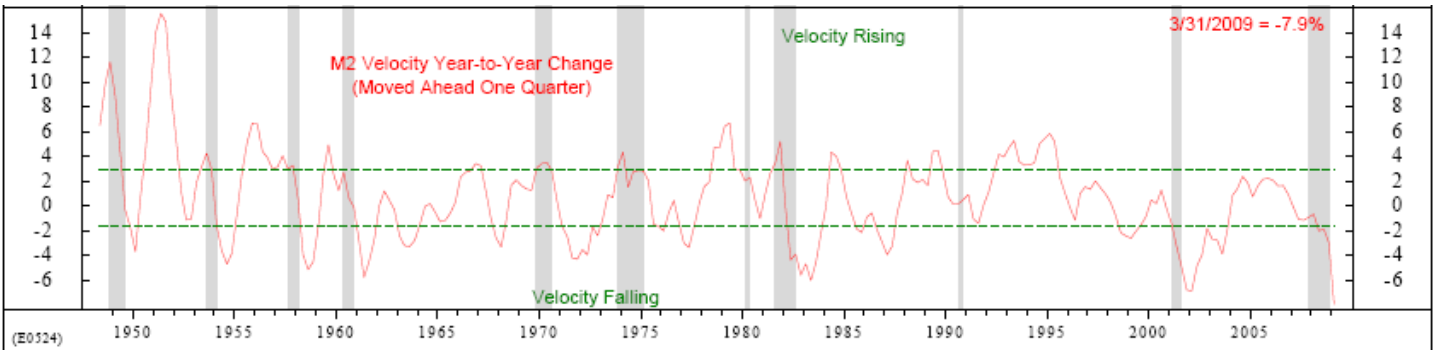
Inflation is essentially measured as the level of prices. Prices rise as you have too much money chasing too few goods.

I hated diagramming sentences in 4<sup>th</sup> grade, but let's have a look at the preceding sentence. We are worried about prices rising (inflation). We have too much money in the system (agreed). But now the interesting part...

In the following graph we see capacity utilization since 1970. For those of you fortunate enough not to be obsessed with economics, this measures how much of our ability to produce stuff is currently being used. At 100%, we are running the factories at full tilt. Currently we are at 70% which implies a large ability to create more goods if the consumers decide to crowd back into the shopping malls.



And finally, we look at the word “chasing” in the sentence, which to me means consuming. This can be measured in economic geek terms as Velocity of Money. Without wanting to spark a debate on how to measure velocity, I would simply present the following chart from Ned Davis Research which shows the precipitous drop in velocity since 2005.



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Will we have inflation? Can we get the consumer to start spending recklessly again? Will I ever be able to flip a condo? The cold precision of homo economicus won't give us any answers unfortunately, so close your textbooks.

The issues that we are currently dealing with in our economy are massive and are moving at glacial pace. As I have mentioned in the past, we believe that the massive overhang of debt is the principal issue that is being dealt with, and will take quite some time to work through. But as we have seen in the past and will continue to see in the future,

markets are driven by individuals who experience greed and fear, euphoria and pain. Sometimes we learn from our mistakes, and we change our behavior. Sometimes we don't, and we postpone the inevitable lesson to be learned.

Do you want to understand what is going to happen in the next several years? Talk to your neighbors, your waiter, your siblings, your friends. Gauge their emotions, their behavior, and note the changes taking place versus their behavior of just a year or two ago. The emotion is what guides them and it is what will guide our economy going forward. Take note of these changes, and think about how they will affect our economy.

But just remember the other axiom I mentioned earlier, because when everyone is going in the same direction you can be sure that "the crowd is always wrong at extremes".

## Rob Roy

President

Atlantic Advisors, LLC

[RRoy@atlanticadvisors.com](mailto:RRoy@atlanticadvisors.com)

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