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Does psychology dominate company fundamentals?

■In a recent survey of 469 CFOs of US companies, 84% expect that the US will have entered recession by the first quarter of 2021 ■This raises the concern of self-realising bearish expectations ■A positive correlation between business confidence and company decisions could reflect (anticipations of) strong fundamentals. It could also be due to animal spirits ■The role of the latter is confirmed by empirical research by cesifo using data for German companies. In the aggregate, optimistic animal spirits have a bigger impact than pessimistic animal spirits

In a recent survey of 469 CFOs of US companies, 84% expect that the US will have entered recession by the first quarter of 2021[1]. This very high percentage is a matter of concern, considering that empirical research in the US shows that CFO earnings expectations for the next 12 months are highly correlated with planned and actual corporate investments[2]. When many CFOs expect a recession, one would assume this will be reflected in lower earnings forecasts and cutbacks in capital expenditures. This could even lead to self-realising bearish expectations: recession fears end up causing recession. For the time being, this is not yet showing up in the numbers: revenues are expected to increase 6.3% and capital expenditures 8.2%[3]. Moreover, the level of 'own company optimism' increased in March to 70.4 after a brief dip in December. However, the degree of optimism on the economy in general continued to slide. This may create a belief that, eventually, a recession will start and hence influence corporate business plans.

Indicators of business confidence are an important input in economic analysis. Surveys tend to be available more quickly than certain drivers of corporate investments such as company earnings[4]. A positive correlation between business confidence and company decisions in terms of recruitment, marketing, investment could simply reflect the anticipation of company fundamentals (turnover, profitability, financing costs, etc.). This is the signalling role of confidence.

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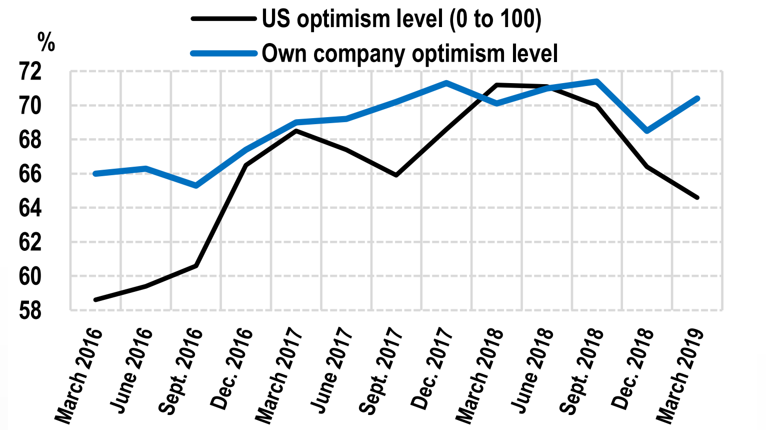
US BUSINESS OPTIMISM



Source: Duke's Fuqua School of Business / CFO Magazine Global Business Outlook, BNP Paribas

[1] Source: Duke's Fuqua School of Business / CFO Magazine Global Business Outlook, March 2019.
[2] Gennaioli Nicola, Ma Yueran, Shleifer Andrei (2015), Expectations and Investment, NBER Working Paper No. 21260.
[3] The March survey did not report an earnings forecast.
[4] For an overview, see: William De Vijlder, What is driving corporate investment, BNP Paribas, Conjoncture, September-October 2016

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ECONOMIC RESEARCH DEPARTMENT

BNP PARIBAS

The bank for a changing world

The relationship between confidence and business decisions can also reflect "animal spirits". According to John Maynard Keynes, they reflect a spontaneous urge to action. Nowadays, the concept "*refers to our peculiar relationship with ambiguity or uncertainty. Sometimes we are paralyzed by it. Yet at other times it refreshes and energizes us, overcoming our fears and indecisions.*"[5] The implication is that they can cause a disconnect between company fundamentals and company decisions, depending on whether executives feel optimistic or pessimistic.

What this concretely implies has been analysed in a recent paper by Enders et al.[6] The authors compare at the individual company level the responses to business surveys in Germany and the pricing and production decisions. In this comparison, the effect of company fundamentals is filtered out. The authors find that optimistic (pessimistic) companies increase (lower) their production more than companies which feel neutral about the future. They are also more likely to raise (cut) prices. As mentioned before, these results may reflect an anticipation of company fundamentals or a pure animal spirits effect. To disentangle the two, the authors analyse the role of forecast errors: companies that turn out to have been too optimistic/pessimistic display animal spirits. The correlation between sentiment and production and pricing decisions mentioned above, also holds for companies that turned out to be incorrectly optimistic or pessimistic, i.e. which were making forecast errors: animal spirits do play a role. Finally, they construct an indicator of aggregate optimism/pessimism and how it is related to fluctuations in the economy at large. Industrial production and the price level react strongly and significantly to an increase in incorrect optimism. In case of incorrect pessimism, the effects are much weaker and, for industrial production, insignificant. Against this background, we should perhaps be a bit less concerned about the high recession likelihood in the CFO survey of Duke University.

William De Vijlder

[5] George A. Akerlof and Robert J. Shiller, Animal spirits – How human pychology drives the economy and why it matters for global capitalism, Princeton University Press, 2009
[6] Zeno Enders, Franziska Hünnekes and Gernot J. Müller, Firm expectations and economic activity, cesifo working paper 7623, April 2019