The Overconfidence Effect?

by Craig D. Hafer, President

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The presidential election of 2016 will be remembered for many reasons. For those who watched the results on election night, the greatest of these was the sheer surprise that despite the universal consensus of experts, Hillary Clinton would not win the oval office. The outcome sent overnight markets crashing, as the Dow futures market plummeted 900 points, only to rebound the following day. If there is a lesson to be learned, it is the tale of the overconfidence effect: how people make predictions, and how experts often have the most difficult time accepting outcomes that differ from what they anticipated.

The overconfidence effect is what occurs when people overestimate how much they know and/or their ability to predict the future. It is this preconceived ability to predict the future that often causes the most problems! It permeates almost every facet of our lives, from sports to the economy, and explains why those who try to time the stock market eventually come up short. A great deal of psychological research suggests that overconfidence in predicting the future is our main cognitive weakness. Daniel Kahneman's book *Thinking, Fast and Slow* describes an exhaustive collection of experiments demonstrating how people often come to conclusions confidently and wrongly.

One group of experts who have been confident but wrong are economists and various bond fund managers who have been predicting since 2010 that higher inflation rates were imminent. The list of experts includes some of the industry's biggest names, including Fed Chair Janet Yellen. For over two years, Yellen predicted that as the economy improved, inflation rates would increase. This has not occurred. According to the November 27th *Barron's*, regardless of Federal Reserve actions and a rebounding economy, inflation has stubbornly refused to rise above the desired 2% level. This, Yellen lamented, is a "mystery."

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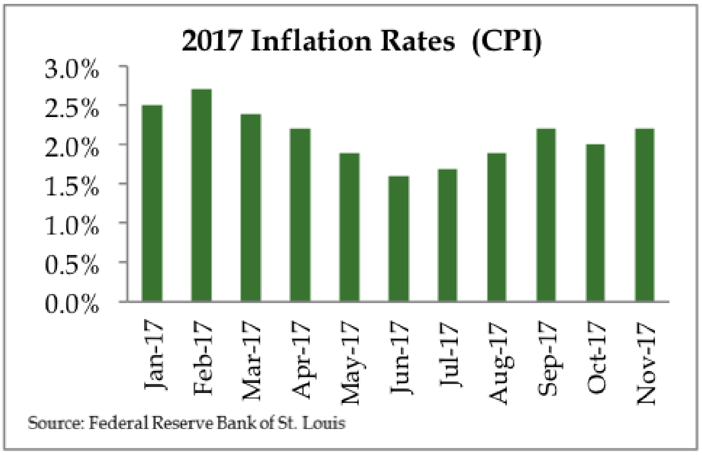
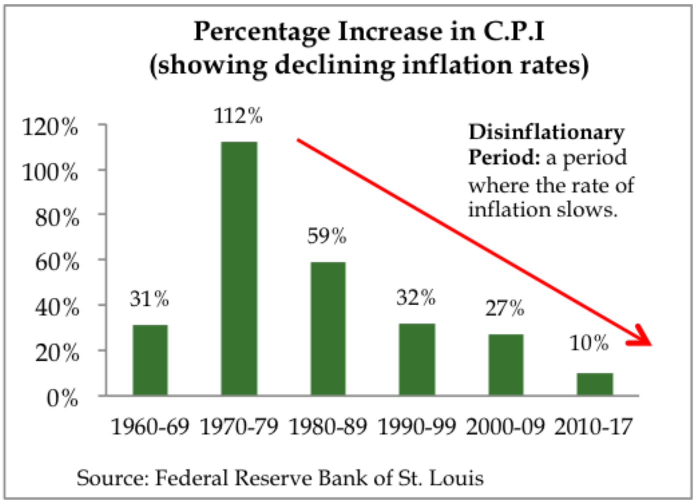
The lack of inflation has not been a mystery to us, however. In our spring 2016 newsletter, we wrote that "for investors, the decades of [falling inflation rates] have been rewarding, and it appears that it will continue for the foreseeable future." Our analysis proved to be correct, as the S&P 500 Index increased 28% from spring of 2016 to December 1, 2017.



An updated chart from our spring 2016 newsletter is to the right. As one can see, not only has disinflation continued since our letter, but (as shown in the above chart) the inflation rate has struggled to stay above 2%.

The problem with disinflation is that it can lead to deflation. Disinflation occurs when the rate of price increases declines (prices increase, but at a lower rate). Deflation is when prices decline. If prices are declining, there is little incentive to purchase big ticket items, as they most likely will be less expensive in the future. There also will be no incentive to borrow, as the loan amount will soon be greater than the value of whatever was purchased. For these reasons, deflation is a bank's worst nightmare. During the Great Depression, prices fell 30%, causing over 9,000 banks to fail in the 1930's. This is why the Federal Reserve encourages some level of inflation, with a target of at least 2%, which is becoming increasingly difficult for them to achieve!

As the nation's number one banker, Janet Yellen's problem with disinflation is that it conflicts with her world view and her "expert" opinion on how inflation *should* react. Her judgment is supported by one of the "holy grails" of economic theory, the Phillips Curve. The Phillips Curve illustrates that as unemployment rates fall, inflation should begin to rise. It appears that what the Phillips Curve would predict and what is actually occurring are not in sync. From December 2009 to November 2017, the unemployment rate fell from 10% to 4.1%, while inflation has remained under 2% on average. In other words, we have low unemployment and low inflation with little-to-no indication that inflation will rise. With the economy growing, this period of low inflation has been good for companies, as they are able to contain their costs and become more profitable. However, for many individuals, low inflation has been detrimental, especially for retirees who live on fixed income investments (such as cd's and bonds) and social security.



With tepid inflation, there would appear to be no compelling argument for raising interest rates at this time. Regardless of this, the Fed did increase its benchmark federal funds rate on December 13th by a quarter percentage point, to a range of 1.25% to 1.5%. They have also indicated that they plan to further increase the rate in 2018. The Fed's reasoning for increasing rates is to ward off out-of-control inflation before it starts. However, the vote to do so was not unanimous. Two members of the Bank's board, Chicago Fed President Charles Evans and Minneapolis Fed President Neel Kashkari, voted against the other seven members, who favored the increase. Both cited weak inflation as a reason to hold off on increasing interest rates. Yet, the stakes are high for the Federal Reserve. If their prediction of future inflation is wrong, the rate increases could slow a rebounding economy. Only time will tell if the Fed's prediction for higher inflation rates will come to fruition, or if it is another example of the overconfidence effect.