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When Do Economic Environments Change?

Peter L. Bernstein

Except for those youngsters who have just begun their careers in finance, everybody in this business has experienced one or more changes in the fundamental economic environment. Most of these régime shifts have brought good cheer, although some have brought great anguish. Recognizing change after it has occurred is easy, because responses to familiar stimuli appear to have shifted: Often what is good news in one environment may be bad news in another. But you cannot make much money by recognizing change after the fact. All of us dream of knowing ahead of time when a change in the environment is going to occur.

I propose an explanation. New environments are always mysterious and uncertain. Environments tend to persist, however, as long as we are still in the process of learning what their driving forces are all about. When we finally come to understand (or believe we understand) what drives an environment, a new environment arrives and takes us by surprise. I offer a few brief examples of this thesis and then an explanation of why I believe it works.

It took until 1933 before people finally understood what was driving the Great Depression. Only then could they solve the puzzle of how to reverse the decline and create a turn for the better—abandon the gold standard, loosen money supplies, and run a budget deficit. And it was well into the 1950s before people recognized the Great Depression was a thing of the past, and it was time to take risks again—the country was flush with funds, private debts were minuscule, birthrates were surging, and huge backlogs of demand had accumulated during World War II. It took until the end of the 1970s before people understood why prices kept rising, why interest rates were in double digits, and why we could have inflation and unemployment at the same time—monetary policy had been flabby and fearful. Only then could Paul Volcker receive the mandate to stamp out inflation, regardless of short-run costs.

The years from 2001 to 2006 also offered conundrums. People were surprised we could have such vigorous growth with long-term interest rates and inflation so low. We all watched with wonder as the U.S. deficit on current account grew and grew, but the dollar did not collapse. How could the U.S. economy roll along so easily in the face of an explosion in debt, both at home and to foreigners?

All these developments of the past several years (and my list is partial) were puzzles when we first saw them after the bubble burst. Now everyone claims to know the answers. Besides accelerating globalization, there were four forces at work: the Federal Reserve's generosity with liquidity; the rest of the world's dependence on exports as the engine of economic growth; the unanticipated miracle of growth in Asia; and the stirring revival of productivity growth in the U.S. after the brief recession of 2001.

And why does an environment come to an end when we convince ourselves we understand its driving forces? Because risk aversion is an inverse function of understanding.

When everything looks easy, and we think we know what is going on, risk-taking becomes increasingly attractive. The unwinding of risk aversion accelerates the pace of an environmental change. In true Hegelian fashion, however, action produces reaction. When there are too many risk-takers taking too many risks, change is inevitable. Either the authorities spring into action or natural forces—such as a shrinkage in expected returns—come into play. Usually both happen at once.

The same process works in reverse in recession or depression. Risk aversion intensifies until an understanding develops, at which point radical corrective action is acceptable and takes hold. Then risk aversion starts to abate.

Recognizing when the moment of truth has arrived is difficult. But a peak in understanding is the signpost to watch for.