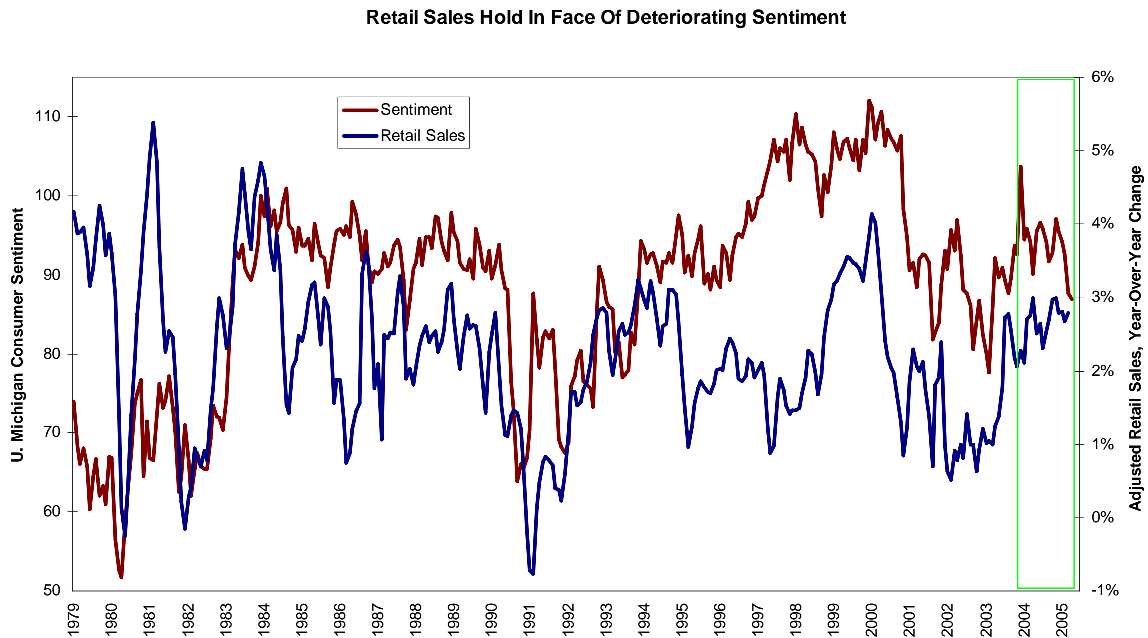
Are You Confident About Sentiment?

Market data fall into two categories, reasons and excuses. This ignores, of course, both the excusable over-reactions and the reasonable excuses for action, but those are higher-order effects. The monthly release of retail sales data and of various consumer sentiment surveys tend to fall into the excuse category. The only plausible reason why anyone should care about sentiment surveys is if they led retail sales, and the only reason anyone should care about retail sales is if they could be demonstrated to be a leading indicator of other markets. While we are at it, let's see if financial markets, stocks in particular, feed back into either consumer confidence or retail sales. None of these effects, as we shall see, occur.

First, there is a major difference between attitude and behavior. Attitude is what you think, while behavior is what you do. Confidence surveys, no matter how well constructed – and both the Michigan and Conference Board polls are crafted carefully and consistently – cannot measure behavior. No product of the human mind peers deeper and more honestly into the soul than the cash register. This suggests that both the level and the growth trend of retail sales should be the key behavioral yardstick.

The retail sales series is quite noisy even after the Commerce Department's seasonal adjustment. We can smooth it; the method chosen here is the percentage change in sales for the current three-month period over those for the current twelve-month period.



Leads And Lags

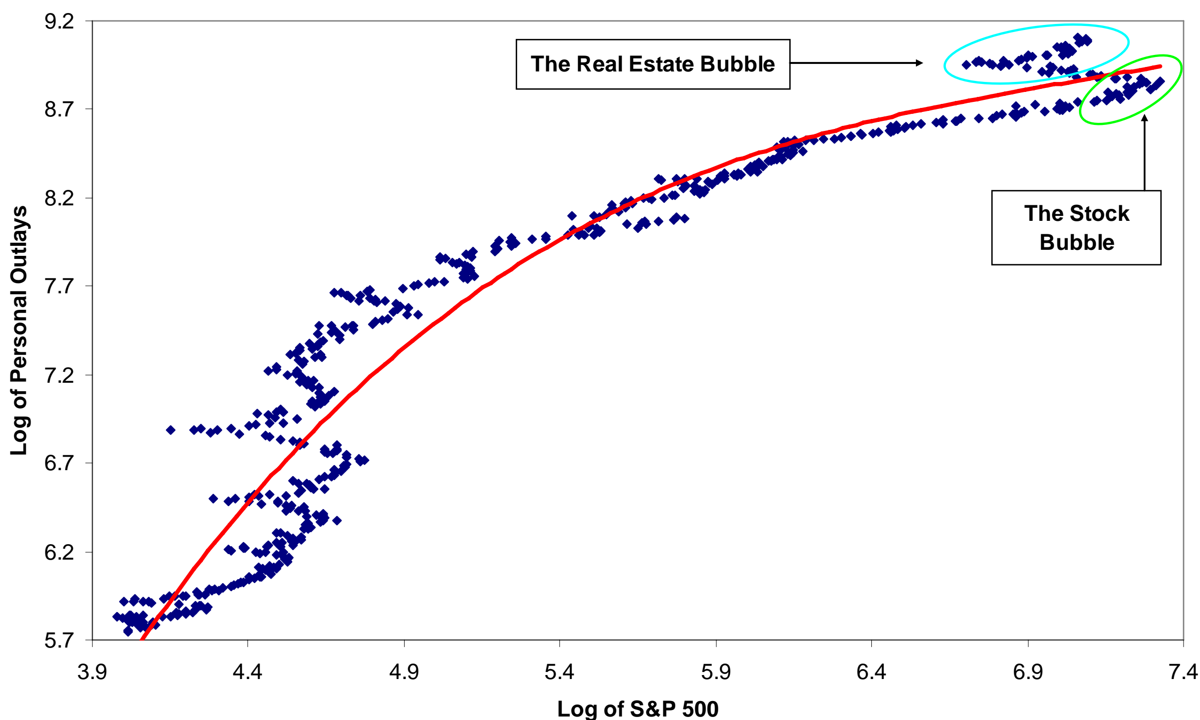
The smoothing process employed should give concurrent consumer confidence a head-start in leading the retail sales series, but this does not appear to be the case. If anything, retail sales appear to lead the confidence numbers; this certainly was the case during the early 1980s on the way up and again during both the late 1980s and early part of this decade on the way down. Only once, during the very end of the 1970s, did consumer confidence lead retail sales.

Moreover, consumer confidence and retail sales can diverge from each other, as they have since the start of 2004, a period highlighted in the chart. Many Americans consider the economy to be weak, fragile and subjected to all manner of untoward influences, yet they are not deterred from spending. This divergence between attitude and behavior is reflected in the burgeoning levels of consumer debt, a growth enabled still by historically low interest rates, an assertion for which evidence will be provided below.

Let's pause now and introduce a subject to which we shall return shortly, the wealth effect. The stock market bubble of the 1990s was feared by some, including the Federal Reserve, as an inflation precursor; the logic was investors would increase their spending without a concomitant increase in the supply of goods and services. An

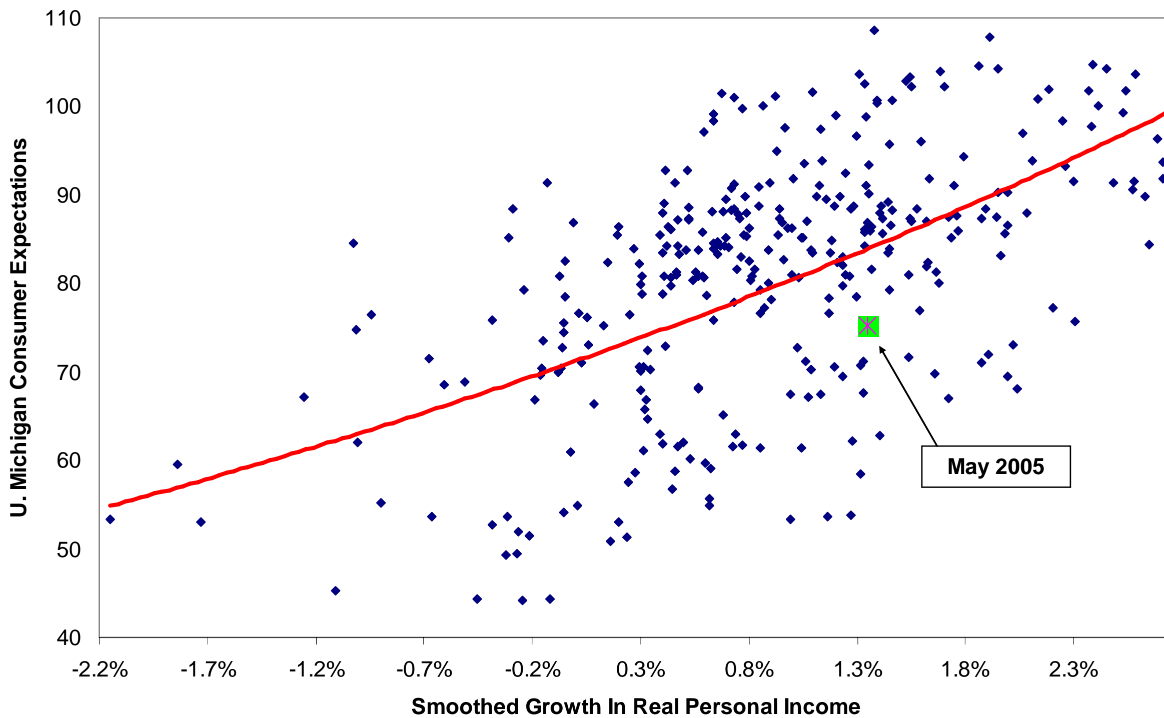
elasticity number of 4%; that is investors would increase their spending by 4% of their unrealized gains, gained currency.

As we should expect by now, that 4% number had little, if any, origin in fact. The experience of the past three decades is a diminishing response in personal outlays relative to stock market gains. Investors realize, prudently, the principle of easy come, easy go and spend an ever-decreasing percentage of their stock market wealth. We can see this is the highlighted and below-trend outlays of the late 1990s. The same cannot be said for the present bubble in residential real estate: Personal outlays have increased more rapidly in response to the combined effects of cash-out refinancing of homes (see "*Bonds Begin At Home*," August 2003) and the higher nominal wealth capitalized into those homes by low interest rates. The present level of personal outlays in the current environment is above the long-term trend indicated by stock market levels; people appear to trust the ephemeral gains from their illiquid homes more than they do for their liquid stocks.

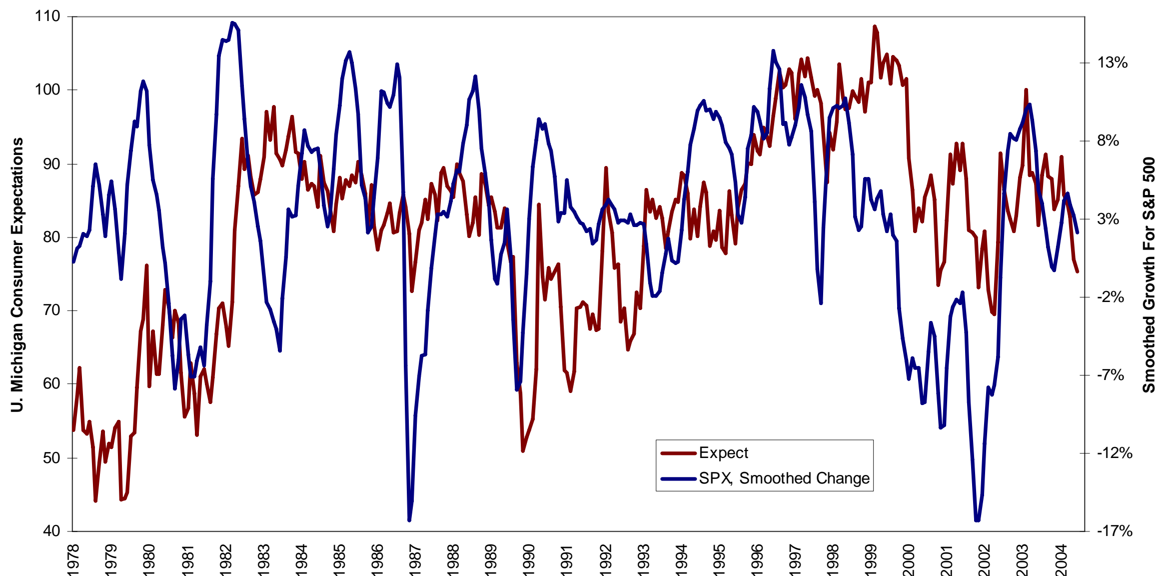


Wealth And Expectations

A reasonable objection at this point would be to note markets are supposed to capitalize expectations. This is a nice theory, but from whence do consumers derive these expectations, from their immediate pasts or from reasoned views of the future? The answer, familiar to anyone who has constructed a trend line from the requisite two data points, appears to be from past experiences. If we map consumer expectations against a smoothed series of inflation-adjusted personal income growth, we see the better things have been, the better we expect them to be. This is how manias, booms and bubbles – an entertaining trio – form. The reading for May 2005, highlighted on the chart, is consistent with the post-2004 pattern of seeing economic conditions as worse than they measurably are.



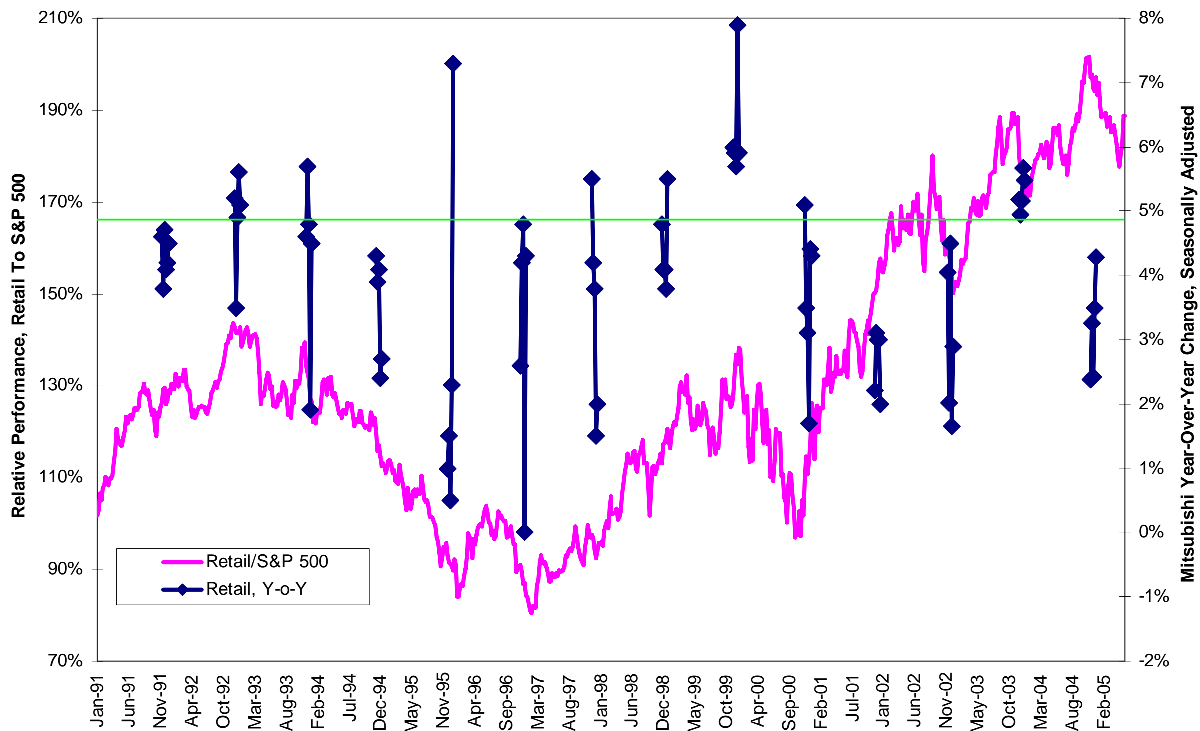
If consumer expectations reflect previous changes in personal income, where do they stand in relation to stock prices? Once again, our sentiment indicator for consumer expectations appears to lag, not to lead. The smoothed growth of the S&P 500, once again calculated by comparing the rolling three-month to the twelve-month periods, definitely appears to lead changes in consumer expectations. If you know the rate of growth of stock prices today, you know what consumer expectations will be in coming months. But if consumer expectations do not lead either retail sales or financial markets, what good will this number do for you?



Tis The Season

Each and every fall, speculation starts to mount regarding the upcoming Christmas sales season. The presumption behind all of this is if retailers cannot make it at Christmas, they are in trouble. Let's take a look at the relative performance of the S&P Retail index to the S&P 500 as a whole mapped against the year-over-year retail sales

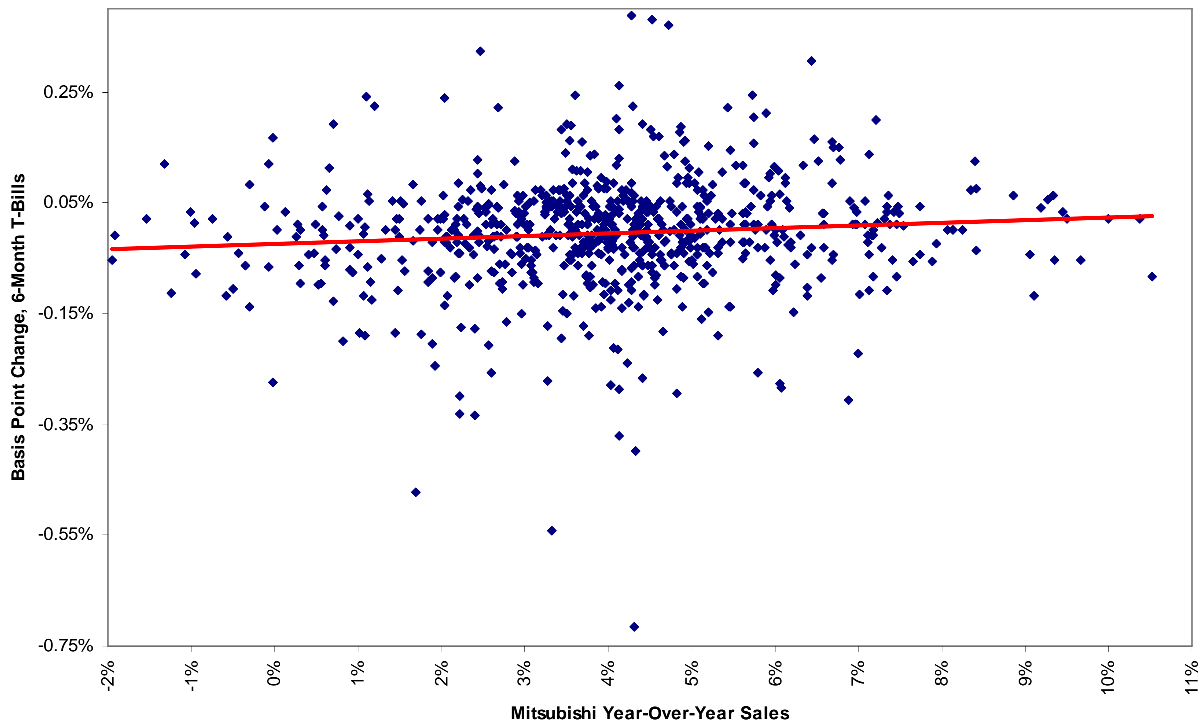
comparisons as reported by Bank of Tokyo-Mitsubishi/UBS. Only the weekly comparisons for the Thanksgiving-New Year's period are displayed to isolate the Christmas season. The average yearly gain of 4% is highlighted.



There are no discernible connections between the Christmas season and the retailers' stock price performances. Years with strong sales gains, such as 1999, preceded strong relative downturns in retailing stocks. The weak sales figures in 2001 and 2002 occurred within the context of a long-term outperformance by retailers against the broad market. Reasons behind the strong relative gains for retailers since the 1996 season include China's emergence as a low-cost supplier of retail goods to chains such as Wal-Mart and Costco and the margin-enhancing effects of Internet sales and supply-chain management. The knee-jerk reactions to weekly retail sales reports increasingly are misplaced in a world driven more by costs than by top-line sales.

Retail Sales And Interest Rates

As long as we are on the subject of knee-jerk reactions, let's take a look at the short-term interest rate market's response to retail sales. This market always is willing to assume the worst; that any positive economic data will bring the wrath of the Federal Reserve down upon our heads. Once again, the data do not bear out this assumption: If we map out the weekly changes in six-month Treasury bill rates against the year-over-year changes in the retail sales numbers, we get a random, albeit positively sloping, relationship.



No Faith In Confidence

The relationships between the economy, consumer confidence, retail sales and financial markets are compelling. Confidence follows past events, wealth gains from stocks in particular, but increased confidence does not lead either increased retail sales or increase stock prices. All this suggests the regular histrionics following the release of the consumer sentiment data are time wasted. This conclusion, of course, will prevent nothing.

Incredibly, several large-scale macroeconomic forecasts still build the confidence-leads-sales relationship into their models. This is akin to the Phillips curve folly of linking inflation and unemployment, and may help to explain the demise of econometric modeling as a respectable endeavor.