Time To Worry About Sentiment?

Is it any wonder a staple of horror stories is the creature that will not die, at least not until killed at least five or six times in a conventional manner and for a final time via some subterfuge? We see this in financial markets all the time. Stories that should have died a spectacular death long ago, such as the dollar is going to collapse and foreigners are going to sell all of their bonds, keep coming back, Rasputin-like, for an encore.

As promised in a Columnist Conversation from last week, it is time to update another financial market Terminator: Declining consumer sentiment is going to kill either the economy or the stock market, or both. The first column I wrote debunking this notion was in March 2001, five and one-half years ago, in the depths of a recession so severe that we had to debate afterwards whether it was in fact a recession at all.

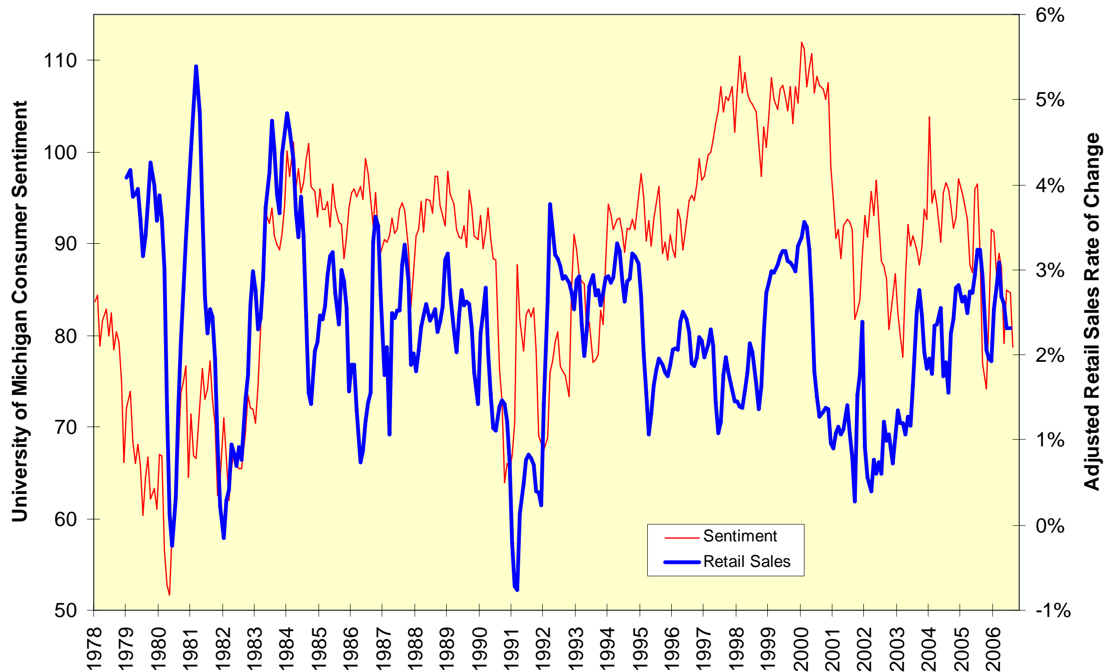
Succeeding columns on the same topic of consumer sentiment were written in March 2003, a time of uncertainty regarding the start of the Iraq War and then-high crude oil prices approaching $40 per barrel, and again in February 2004, a period when several prominent economists who should have known better were telling us Alan Greenspan had executed his last rate hike ever.

This history is important. While stocks fell and fell hard after March 2001, not bottoming until October 2002, they have remained in a bull market since March 2003. Retail sales have risen almost 25% in nominal dollar terms since March 2001, and this rise has fueled another persistent story, that the American consumer is going to drown in debt. Restated, rumors of the importance of consumer sentiment are exaggerated.

Attitudes And Behavior

As should be obvious by now, I am not a big fan of sentiment indicators of any stripe. Not only do these surveys often catch respondents unawares with a question they are not certain how to interpret, the responses themselves are notoriously unreliable. People have a tendency, sometimes conscious, sometimes unwitting, to give they answer they think the questioner wants to hear. It is much better to use concrete, market-derived data, the results of behavior as opposed to the expression of attitudes, to ascertain what is really occurring. In this sense, the cash register or its modern equivalents peers more deeply into the human soul than any other device yet invented.

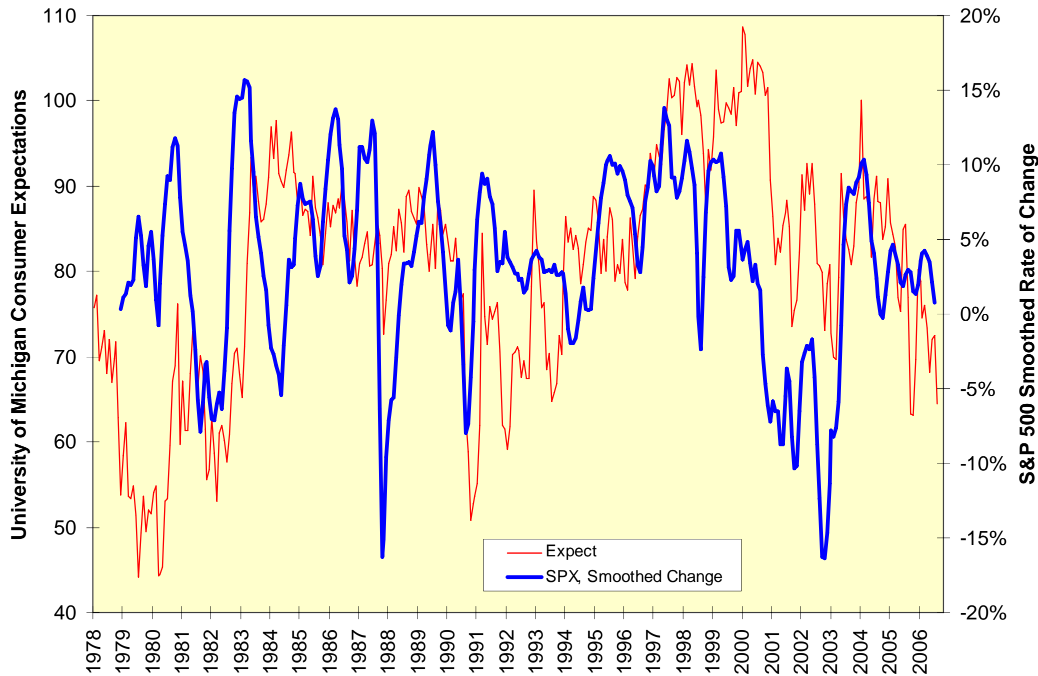
Thus saying, let’s take a look at how a smoothed rate of change for retail sales maps against University of Michigan consumer sentiment data. The smoothing used is the three-month total divided by the one-year total.



The two series appear to diverge for long periods. For example, sentiment rose almost continuously from 1992 through 1998, but the rate of gain in retail sales declined throughout much of this period. And while sentiment declined sharply from February 2000 through a final low in March 2003, the rate of change for retail sales started to turn higher as early as March 2002. The present downturn in sentiment may yet lead to deterioration in retail sales growth, but that likely will be far more a function of trends in personal income and the wealth effect, as discussed below, than anything related directly to sentiment per se.

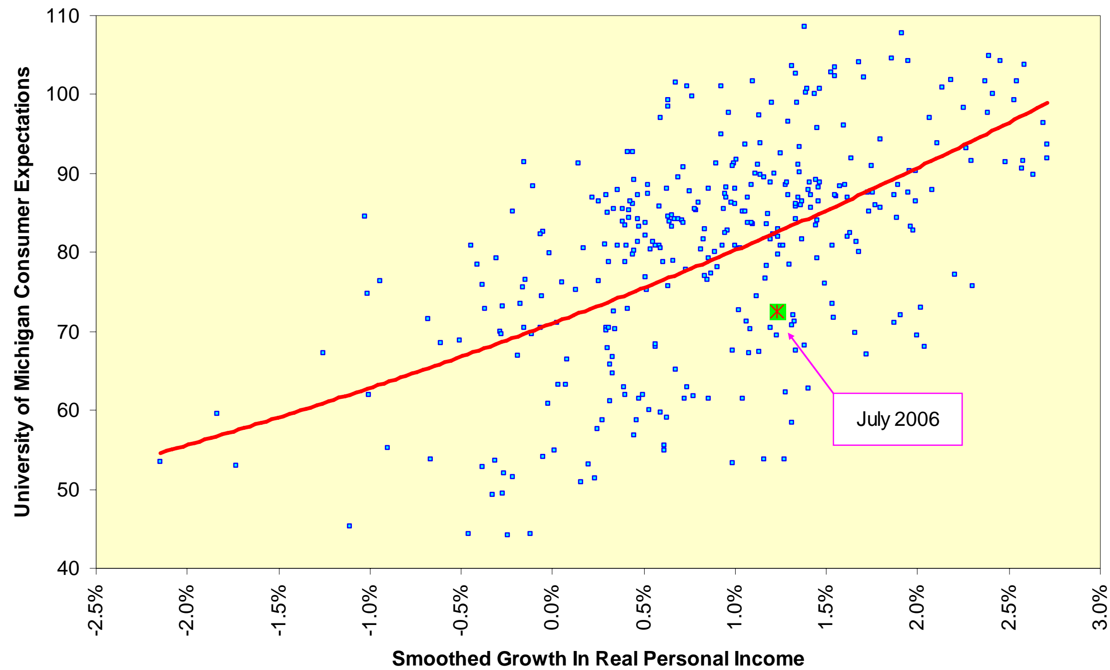
Expectations and Stocks

The recent readings on consumer expectations are worrisome to be sure; one would have to be a real Pollyanna to say otherwise. But how many of us were aware that with the prominent exception of late 2003 these expectations readings have been on a downtrend since February 2000? Has this been a time of recession in the United States? Hardly: Real GDP has increased 17.8% since the end of 1999, a very healthy growth rate of 3.0% over a period including wars, the shock of 9/11, the worst bear market in stocks since the Great Depression, and a tripling of energy prices. This 3.0% growth rate used to be considered the economy’s speed limit.



Stock prices are alleged to be forward-looking, and therefore should correspond somewhat to changes in expectations. And yet we can see how expectations do not align well with the rate of growth of stock prices, by the three-month average of the S&P 500 compared to its one-year average. The rate of change for stocks began to deteriorate in May 1997, well before actual prices peaked in March 2000, and did not bottom until September 2002. Expectations continued rising into February 2000. We would have to conclude consumer expectations are much more of a coincident indicator of where stock prices are rather than a leading indicator of where they will be.

Another observation we can make regarding expectations is they are something of a coincident indicator of real personal income. If we map expectations against the inflation-adjusted growth in personal income, smoothed per above, we see a generally positive relationship. This should surprise no one: We project the most recent trends and levels forward on the assumption the future will look much like the present.

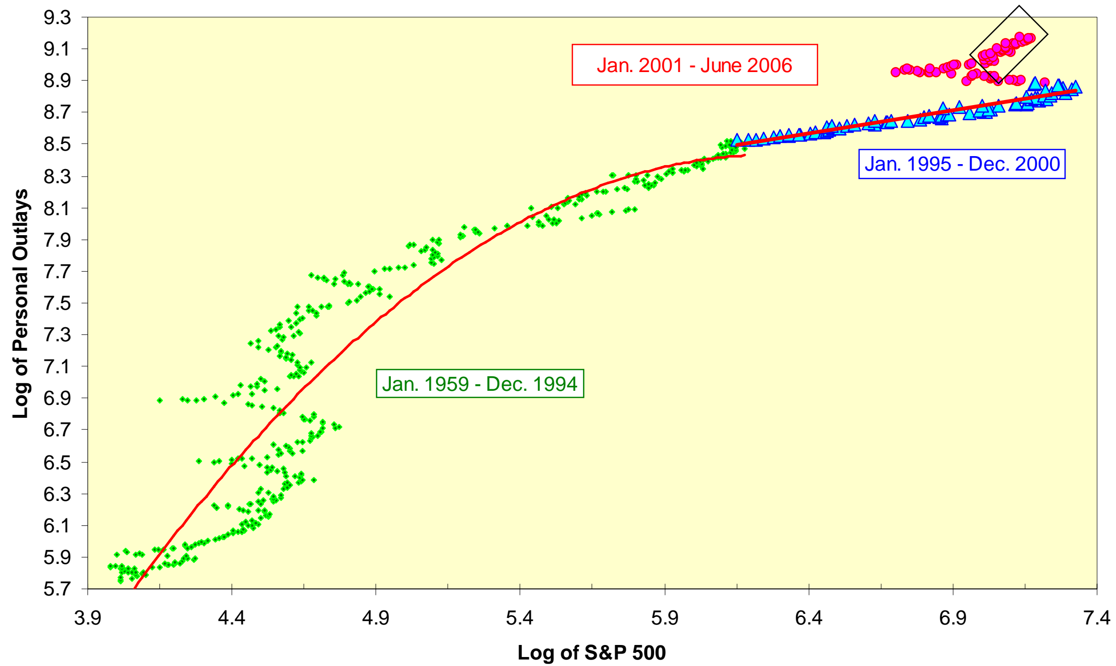


The Wealth Effect

Finally, let's return to the wealth effect. If we map personal outlays since the data were available in 1959 against the S&P 500, we find three distinct regimes. The first, January 1959 through December 1994, showed a decelerating wealth effect; personal outlays rose at a declining but still positive rate as stock prices rose. The second, January 1995 through December 2000, showed a near-linear but still positive relationship of outlay growth versus stock price growth. As these series are plotted on logarithmic scales, we can describe this as a constant elasticity of expenditure to stock price wealth.

The third regime, still ongoing, actually has two phases. The first was one of modestly growing outlays during the 20001-2002 bear market. The second, highlighted with a rectangle, corresponds to the combined bull markets in real estate and equities since the start of 2003.

The Wealth Effect



If we are to be concerned about anything it is the negative spending behavior that may result from a decline in residential real estate, with or without a decline in stocks. If either asset class falters, so will consumer spending. The sentiment measures will fall as well, but that will be the least of your worries at the time.