The Animal Spirits Index Remains in Negative Territory

Our Animal Spirits Index increased marginally in May, but remained well in negative territory. That said, four of the five components improved on the month, suggesting sentiment is moving in the right direction.

ASI Avoids Further Deterioration in May

With containment measures being relaxed around the country, economic activity is slowly starting to pick up from the virtual standstill in April. How quickly the economy is able to return to its pre-COVID level of output will depend primarily on the virus, but also on how willing consumers and businesses are to spend and invest. Our Animal Spirits Index (ASI) is a five-variable dynamic-factor model, which attempts to capture how people feel about the economy. The inputs are (1) the S&P 500 index, (2) the Conference Board’s consumer confidence index, (3) the yield spread, (4) the VIX index and (5) the economic policy uncertainty index. Previous reports detail the index methodology, but on a basic level an ASI index value above zero indicates optimism, while a value below zero suggests pessimism.

In May, the ASI came in at -0.53, a slight improvement from April, but still firmly negative. Though small, the increase in May was certainly a welcome move after steep declines in the past couple months. Yet more optimism can be found in the index’s components, all of which improved on the month, except for the policy uncertainty index. Financial markets continued to be the standard bearer of sanguinity. The S&P 500 ended May above 3000, after having climbed 13% in April. This move higher also came with reduced volatility. While the VIX’s May close of 27.5 falls above the index’s long term average, it is has receded meaningfully from its record-high in March. Yields on U.S. Treasuries remain historically low, but the curve has begun to steepen, and the spread between the yield on the 10-year and 3-month Treasuries continued to widen in May. Consumers’ seem to share some of this positive sentiment, as the expectations sub-index of the Conference Board’s Consumer Confidence index improved for the second straight month. In May, this was enough to marginally boost the headline index, though the overall index remains well below the levels that prevailed through 2019.

Did the ASI Bottom Out in April?

The surprisingly positive May jobs report, which indicated businesses began to re-hire workers much faster than many anticipated, should provide justification for further improvement for all of these components and for the ASI overall. It is less clear, however, what the surprise net job gain in May will mean for the economic policy uncertainty index—the sole negative contributor on the month—which hit another all-time high in May. While some may use the employment report as justification for phasing out the extensive relief programs, others may point to the 21 million Americans who remain unemployed. With the election looming & ongoing questions about ongoing relief efforts, it may be difficult for policy uncertainty to improve with the rest of the index. While sentiment seems to be moving in the right direction, we will need to see more than a tick higher before we can call the bottom in sentiment.

Source: Baker, Bloom & Davis, S&P Dow Jones Indices and Wells Fargo Securities