The Animal Spirits Index Shows Improvement in June

Our Animal Spirits Index improved in June, but remains below zero. All but one of the index’s components were positive, indicating some momentum, but COVID-19 remains a pressing risk to improving sentiment.

ASI Improves, but Remains in Negative Territory

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 how willing consumers and businesses are to spend and invest. Our Animal Spirits Index (ASI) is a five-variable dynamic-factor-model approach, 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.

The ASI Bottomed Out in April

In June, the ASI came in at -0.19, a significant improvement from May, but still negative. After only a marginal increase in May, June’s 0.35 point move—the largest sequential gain in more than a year—was a clear sign that sentiment bottomed in April. Four out of the index’s five components improved on the month. The policy uncertainty index showed the largest improvement, declining to 221.1 from an all-time high in May. The S&P 500 continued its march higher, but showed some signs of faltering. Accelerating COVID-19 case growth across the United States have renewed concerns over the economy’s recovery and revived financial market volatility. The VIX jumped to nearly 41 in mid-June before settling down near 30 at month-end. In the bond market, yields on U.S. Treasuries remain historically low. The curve had begun to steepen after the tumult of March and April, but the spread between the yield on the 10-year and 3-month Treasuries has since remained relatively steady.

Consumers’ view of the economy continued to improve in June, driven by an increase in the expectation sub-index, which is now above its 2019 average. While consumers’ assessment of the current situation remains bleak, consumers’ view of the labor market was less bad, following a string of encouraging employment data releases.

These positive jobs reports, which indicated businesses began to re-hire workers much faster than many anticipated, could provide justification for further improvement for these components and for the ASI overall. However, a number of states are reporting a reacceleration of COVID-19 case growth, leading some states to pause or reverse their re-opening plans. While sentiment seems to be moving in the right direction from its April bottom, it is difficult to remain optimistic in the face of the ongoing public health crisis. Failure to contain the outbreak would undoubtedly stifle the burgeoning recovery. That said, Congress, which reconvenes in mid-July, has the opportunity to buoy sentiment with another stimulus bill.

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