The Animal Spirits Index Drops in July

Our Animal Spirits Index declined in July and notched its fifth consecutive month below zero. Despite a better-than-expected recovery in some economic data, the index suggests sentiment remains under pressure.

ASI is Heading in the Wrong Direction

The Animal Spirits Index (ASI) came in at -0.36 in July—a sizable drop from June—reversing the prior month’s progress. Previous reports detail the index’s methodology, but on a basic level an ASI value above zero indicates optimism about the economy and a value below zero suggests pessimism. While the index has been negative since March, it was at least headed in the right direction in May and June. July’s step back matches the stalling recovery seen in some high frequency indicators through late-June and July, as COVID-19 case growth surged in the nation’s Sun Belt.

Among the ASI’s sub-components, the economic policy uncertainty index (EPU) was the largest negative contributor. With parts of the CARES Act lapping at the end of July, focus turned back to Capitol Hill in anticipation of more stimulus. This pushed the EPU index up to 295.3, its second highest level ever. With legislative negotiations ongoing, it seems unlikely that the index will recede much in the near term. Consumers’ perception of the economy also soured in July, with the Conference Board’s Consumer Confidence index dropping to 92.6. As case counts rise and the labor market recovery begins to slow, consumers seem to have tempered their optimism.

Financial markets, however, have kept the index from testing its April-May lows. The S&P 500 ended July above 3200, with the VIX dropping below 30 as the stock market rose. Yields on U.S. Treasuries remain historically low, and the spread between the yield on the 10-year and 3-month Treasuries narrowed only marginally in July.

Are Economic Agents Nervous About a Second Wave?

Many major economic releases for July continued to surprise to the upside. Improving measures of business activity and expanding payrolls should help buoy confidence, all else equal. Rising COVID-19 case growth, however, hampered individuals’ and businesses’ ability to engage in normal economic activity. This slowing recovery in activity likely exposed the vulnerability of the nascent economic recovery. Uncertainty surrounding the next round of fiscal stimulus likely only compounded these concerns.

As we have written before, how quickly the economy is able to return to its pre-COVID level will depend primarily on the virus, but also on how willing consumers and businesses are to spend and invest. While this month’s retrenchment is not necessarily a sign that the sky is falling, five consecutive months of negative ASI values do constitute a worrying trend. Historically, prolonged periods of negative ASI prints have been associated with weaker recoveries. While the virus and fiscal policy are likely to shape the near term outlook, it will be important to watch the trend in sentiment to understand potential permanent changes in economic behavior among businesses and individuals.

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