Special Commentary — January 28, 2025

Nobody Puts ASI in the Corner...Except Tariffs

A 2024 Review of the Animal Spirits

Summary

- The Animal Spirits Index (ASI) had a soft close to 2024, dropping 0.44 points in December to its lowest level all year. Though the ASI remained in positive territory for all of 2024, it has softened considerably relative to the beginning of the year.
- While oscillating consumer confidence and economic policy uncertainty weighed heavily on the ASI, financial markets showed remarkable strength and boosted the index throughout the year.
- We suspect 2025 will present downside risk to the ASI. Though we look for the FOMC to continue its cutting cycle this year, which will likely boost the index, the potential implementation of tariffs has the scope to weigh on all components of the ASI.

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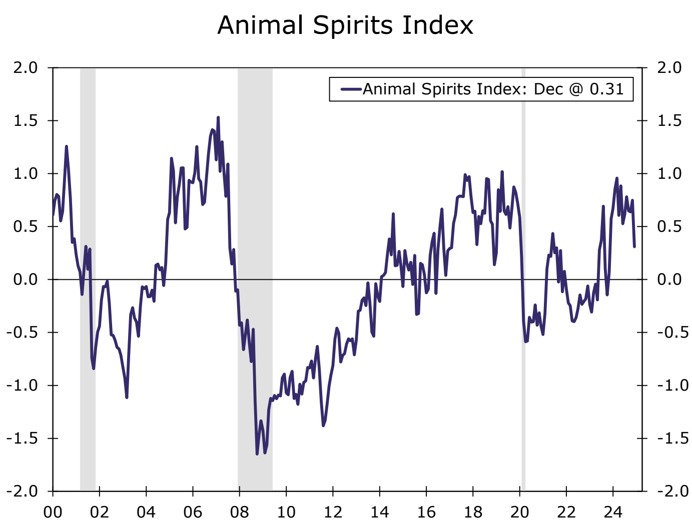
Tariff Threat Shaking the Spirits

The Animal Spirits Index (ASI) finished out 2024 on a soft note, hitting its lowest level since November 2023. The index dropped 0.44 points in December to 0.31—the largest monthly decrease in over a year. Though the ASI remained in positive territory for all of 2024, it has softened considerably from a five-year high of 0.96 in March (Figure 1). The ASI meaningfully dropped at the beginning of the fourth quarter, and it has subsequently trended lower.

The ASI consists of five indicators: the S&P 500 Index, the Conference Board's Consumer Confidence Index, the yield curve (i.e., the spread between the 10-year and 3-month Treasury yields), the VIX Index and the Economic Policy Uncertainty Index. The policy uncertainty and VIX indices inversely affect the ASI. In other words, a rise in uncertainty or volatility decreases the ASI, while a fall increases the ASI, all else equal. Previous reports detail the index methodology, but on a basic level, an index value above zero indicates optimism and a value below zero suggests pessimism.[1] In December, the S&P 500 Index, Consumer Confidence Index and the VIX Index contributed negatively to the ASI.

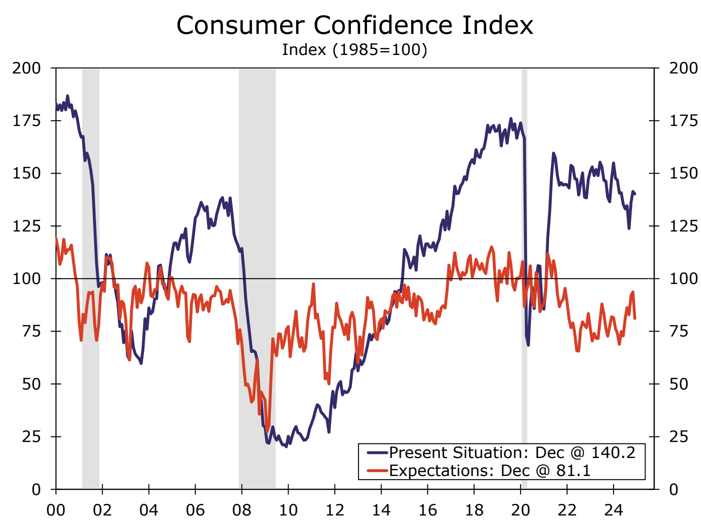
The U.S. economy appeared to gently glide back to its long-run, or "normalized," state in 2024 as the after-effects of the pandemic have faded. After keeping the fed funds rate at a 22-year high to combat inflation, the Federal Reserve began its easing cycle in the latter half of 2024, cutting the target range by 100 bps. Unlike most prior periods of monetary policy easing, rate cuts were not in response to widespread economic weakness, but rather a response to the significant progress the Fed had made in returning inflation back to its 2% target and the moderation seen in the labor market. Though 2024 saw remarkable progress for the U.S. economy, tariffs pose a downside risk to 2025, should they come to pass. In this report, we dive deeper into how the components of the ASI changed throughout 2024 and provide a brief outlook for what to expect in 2025.

Figure 1



Source: Wells Fargo Economics

Figure 2



Source: The Conference Board and Wells Fargo Economics

Consumer Confidence Index

Despite the strength in economic output, 2024 was a volatile year for consumers, and the ups and downs were captured in the Consumer Confidence Index. The index faced a series of declines in the first six months of the year but began to rebound in the second half. In November, the index hit its highest level in over a year (112.8) before tumbling 8.1 points in December to 104.7. The Expectations Index, which is based on consumers' short-term outlook for income, business and labor market conditions, fell 12.6 points in December, which is the largest monthly change since 2021. The drop in expectations was due to increased pessimism about business conditions, the labor market outlook and income prospects. The share of consumers viewing jobs-as-plentiful fell over the year from 42.7% in January to as low as 31.3% in September, though it rebounded in December to 37% (Figure 2).

In general, consumers' pessimism about the labor market last year reflects the gradual cool-down experienced through 2024. Employers added 186K net jobs-per-month on average over the year, well-below the overheated pace seen from 2021–2023. The unemployment rate also ticked up.

The measure started 2024 at 3.7%, gradually increasing until it reached a two-year high of 4.2% in November before decreasing a tenth of a percentage point to 4.1% in December. As we wrote in our January U.S. Economic Outlook, we continue to expect payroll growth to moderate over 2025. While we look for growth in the labor supply to slow down, tepid demand for new workers should help keep the unemployment rate a little over 4% this year, even as we expect payroll growth to moderate to a monthly pace of about 130K. So long as consumers continue to work, strong gains in real disposable income will help to underpin growth in real consumer expenditures, potentially lifting the ASI.

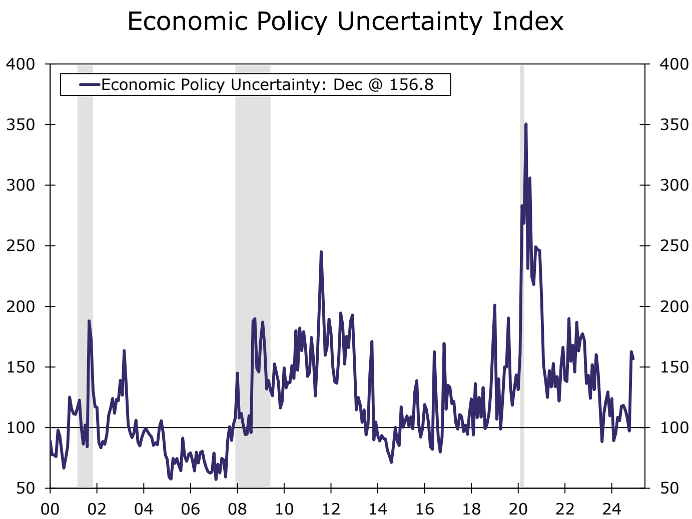
Downside risks to the Consumer Confidence Index (and thus the ASI) in 2025 remain. In December, mentions of tariffs increased in consumer responses, with 46% of consumers expecting tariffs to raise the cost of living in the short term. Higher tariffs, if imposed, would impart a modest stagflationary shock to the economy, resulting in higher prices and slower economic growth. Higher prices would impart a negative shock to real income growth, thereby weighing on growth in real consumer spending, which would soften purchasing power and confidence.

Economic Policy Uncertainty Index

The Economic Policy Uncertainty Index was elevated for much of 2024, sitting above its long-term average of 100 for nine months of the year. This is unsurprising, considering the index has historically risen ahead of presidential elections. Indeed, November marked the biggest jump in the index since 2020, increasing roughly 65 points over the month to 162.7. The index fell back down slightly in December, but it remains elevated on a historical basis (Figure 3). Though the election is officially in the rearview mirror, President Trump is continuing to iron out his policy agenda. During his first week in office, President Trump signed a litany of executive orders spanning a number of areas, including immigration, energy, foreign policy and trade. Notably absent, however, were executive orders on tariffs. Although the president has alluded to a 25% tariff on imports from Canada and Mexico, some of the other comments he has made have been less hawkish, highlighting how much trade discussions remain in flux. Until an official policy has been decided, the Economic Policy Uncertainty Index is likely to weigh on the ASI in the near term.

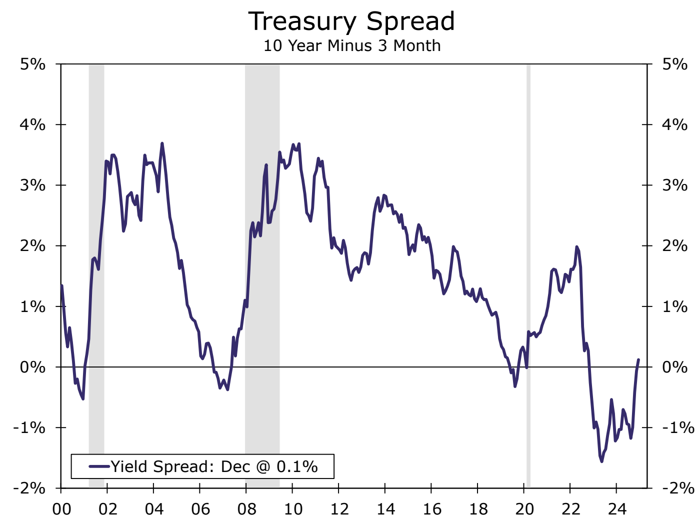
The Federal Open Market Committee (FOMC) cut its target range for the federal funds rate by 100 bps in 2024. However, progress on returning inflation to the Fed's target of 2% has been painfully slow in recent months, with many FOMC members questioning the need for further policy accommodation at this time. We currently look for the FOMC to maintain its target range at 4.25%-4.50% through the first half of the year. In the second half, we have penciled in 25 bps rate cuts at the September and December policy meetings. We then look for the FOMC to remain on hold at 3.75%-4.00% throughout 2026. That noted, the FOMC's policy actions in coming months will be dictated in part by policy choices, especially related to tariffs, that the Trump administration makes. In our view, uncertainty related to the new administration's economic policy imparts uncertainty onto the outlook for monetary policy, and thus has scope to weigh on the ASI this year.

Figure 3



Source: Baker, Bloom & Davis and Wells Fargo Economics

Figure 4



Source: U.S. Department of the Treasury and Wells Fargo Economics

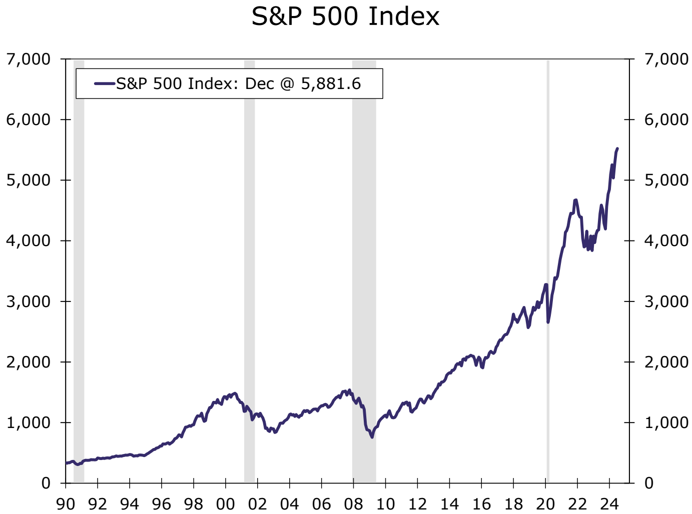
Yield Spread

The spread between the yield on the 3-month Treasury bill and the 10-year Treasury note sat in negative territory starting in November 2022. In December—over two years later—the yield spread finally returned to the green (Figure 4). Investors expect a positive yield spread between a long-dated Treasury security and a short-dated one to compensate for the risk associated with locking up money for an extended period of time. When the yield of a long-term Treasury drops below the yield of a short-term Treasury, the yield curve inverts. Yield curve inversion is a famous recession predictor, as it indicates that market participants feel pessimistic about near-term economic conditions. We look for the yield curve to remain un-inverted and suspect yields at the long-end will fall somewhat as the year progresses but not to a meaningful degree due to an elevated federal funds rate and higher term premiums.

S&P 500 and VIX Index

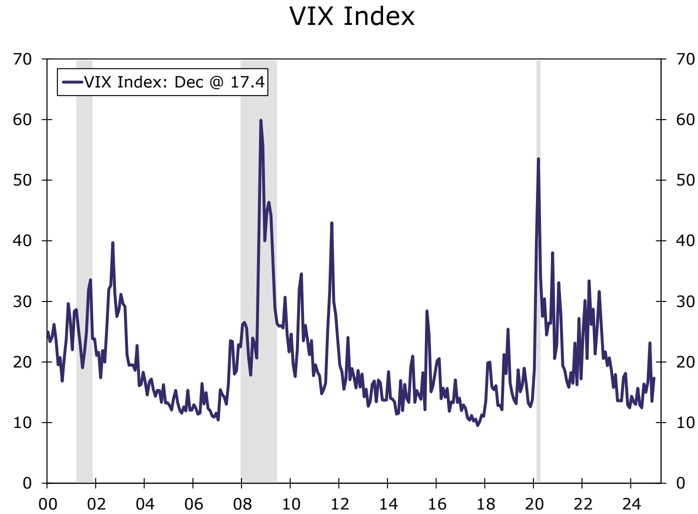
The S&P 500 had a record-breaking year, beating its previously-set high nine times in 2024. The index rose 21% in 2024, and it contributed positively to the ASI in all but three months (Figure 5). Though an outsized portion of the S&P's rally was driven by the performance of big tech stocks, the continued strength seen in the economy contributed to the gains as well. However, there remains scope for the S&P 500 to weigh on the ASI in 2025. Potential trade policies implemented by the Trump Administration may rekindle inflation and suppress growth, leading to a downshift in the index. The VIX Index also poses another downside risk to the ASI. The index contributed negatively to the ASI six times in 2024, and even reached its highest level since 2022 in October. The index ended the year at 17.4, roughly three points higher than its level in January (Figure 6). Though the S&P 500 Index outperformed throughout 2024, uncertainty of its future movements as measured by the VIX Index could weigh on ASI in the coming months.

Figure 5



Source: Bloomberg Finance L.P. and Wells Fargo Economics

Figure 6



Source: Bloomberg Finance L.P. and Wells Fargo Economics

It's a Long Way Down

Historically, the ASI has been correlated with broader gauges of economic activity, and the gradual softening of the ASI in the past year largely reflects the cool-down seen in the U.S. economy in 2024 as it has returned to its normalized state. Looking ahead, we see downside risk for the ASI as President Trump irons out his policy agenda and potentially begins to implement tariffs on U.S. trading partners. Should tariffs come to fruition, almost all components of the ASI have scope to contribute negatively to the index in coming months. The modest stagflationary shock resulting from any tariff implementation could cut into consumers' purchasing power, leading to a downshift in consumer confidence. Additionally, slower economic growth would constrain activity in financial markets. In sum, policy uncertainty imparts some downside risks to the economy, and thus the ASI, in coming months.

Endnotes

1 – Please see The Roar of the Animal Spirits: A New Index (January 2018) and Finding Neverland: What Drives Animal Spirits? (January 2018). (Return)

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