

## Economics Group

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# The Animal Spirits Index Remains Volatile in Q3

*Our Animal Spirits Index (ASI) bounced back to 0.63 in September after a sharp decline in August. Policy tensions, equity market volatility and an inverted yield curve were behind the ASI's volatility.*

### The Animal Spirits Index: Quantifying the Spirits

In our past work, we have introduced an index to quantify Keynes' "animal spirits."<sup>1</sup> Our Animal Spirits Index (ASI) is constructed from five variables: (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. These variables were selected to capture the actions and expectations of important economic actors across the economy.

An ASI index value above zero indicates optimism, or positive animal spirits, while a value below zero suggests pessimism, or negative animal spirits. Our ASI goes back to January 1967, giving us the opportunity to analyze the index's behavior during different business cycles and political environments. The lowest value of the ASI (-1.65) was during the Great Recession, in October 2008 (top chart). The ASI stayed in negative territory until January 2014, which is consistent with the slow recovery from the Great Recession. However, the index has remained above the zero line for a majority of the time since February 2014, as the economic expansion gained steam and optimism (positive animal spirits) returned.

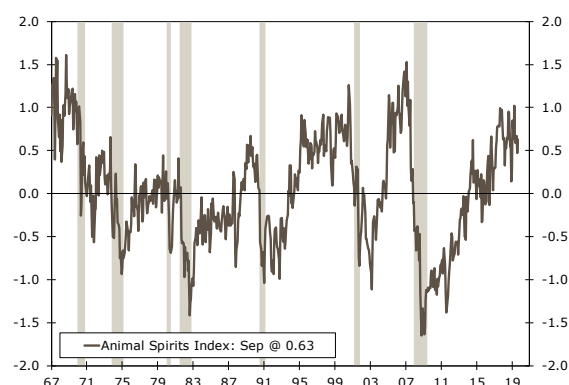
### What Factors Are Behind the Recent Volatility in the ASI?

The ASI remained volatile into Q3, bouncing back to 0.63 in September (after a sharp decline in August to 0.47 from 0.67). The fluctuations in the equity market and policy tensions have been the key factors behind the volatility of the ASI in 2019. For example, the S&P 500 index dropped to 2752 in May and then closed September with an all-time high of 2976.7 (middle chart). Despite this volatility month to month, the VIX has remained relatively calm in 2019. The policy uncertainty index dropped to 138.7 in September after jumping to 190.5 in August (bottom chart). As we noted in a recent [report](#), the impeachment inquiry announced on September 24<sup>th</sup> is likely to further strain the relationship between Congress and the President. This could make it more difficult to reach a consensus on USMCA and a budget for FY2020, potentially creating more policy uncertainty in the coming months.

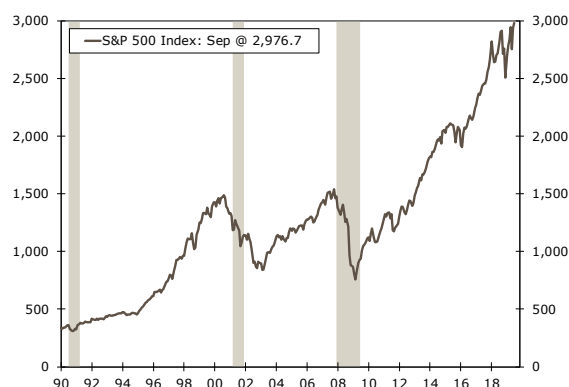
There are two components of the ASI that remain under stress. The yield spread between the Treasury 10-year note and 3-month bill remains negative and the consumer confidence index dropped in September to 125.1 from 134.2 in August.

In spite of these factors, the ASI still remains elevated relative to historical standards, indicating sentiment has yet to nose dive, despite increasing talk of recession. Equity markets and economic policy indices were able to drive the ASI higher in September, but it remains to be seen if they can keep on the bright side through the end of the year. We will continue to update our ASI and report any significant changes in the index.

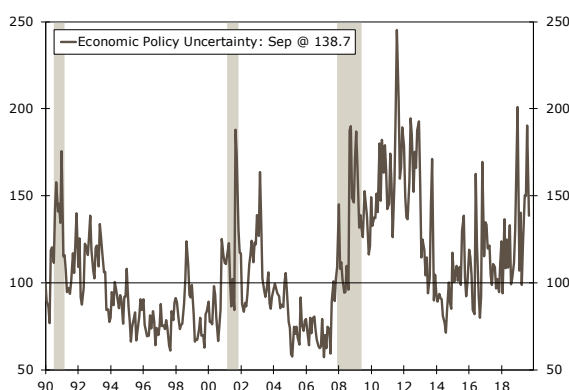
Animal Spirits Index



S&P 500 Stock Price Index



Economic Policy Uncertainty Index



Source: Baker, Bloom and Davis, IHS Markit and Wells Fargo Securities

<sup>1</sup> For additional detail please see, "[The Roar of the Animal Spirits: A New Index](#)" (January 18, 2018) and "[Finding Neverland: What Drives Animal Spirits](#)" (January 31, 2018).

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