Economics

Special Commentary — January 17, 2022

The Animal Spirits Index Ends 2021 on a Positive Note

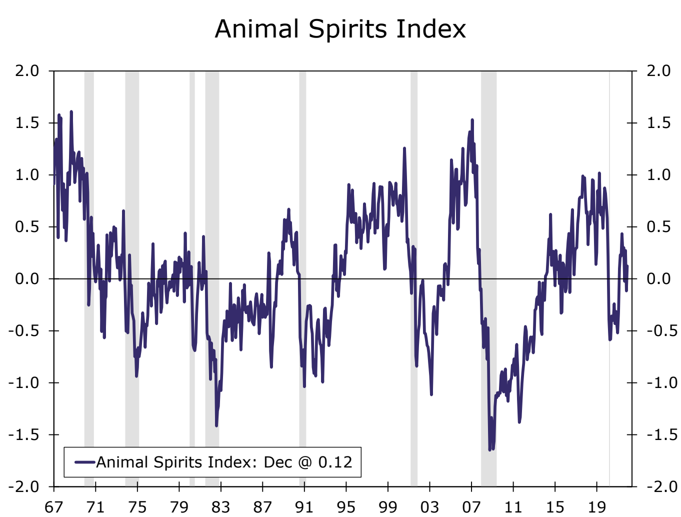
Summary

- The Animal Spirits Index (ASI) turned positive in December as it jumped to +0.12 from -0.12 in November. That said, it averaged +0.09 in Q4-2021, the lowest quarterly average since Q1 of last year, when the index was still deep in negative territory.
- The lost momentum is solidified by negative prints in two of the last four months, which suggests a clear end to the positive streak during March-August of last year.
- There are plenty of explanations for the downbeat sentiment, including but not limited to rising COVID cases from the breakout of the Omicron variant, the highest year-over-year inflation since 1982 and increased policy uncertainty.
- The Economic Policy Uncertainty Index notched another gain in December and has climbed 43 points overall since its pandemic low set this October. Congress' continued debate on new spending packages as well as a more hawkish tone from the Fed have introduced more ambiguity. For more, please see our fiscal & monetary policy section of our most recent monthly economic outlook.
- In the near term, the ASI may encounter a rough patch as soaring inflation and rampant COVID cases collide in the first quarter of this year. However, the job market remains hot, which should continue to support growth in wages & salaries. Furthermore, we expect inflation to roll over after the first quarter, allowing some reprieve, although it will still likely remain above the Fed's 2% target range through 2023.

Economist(s)

Azhar Iqbal
Econometrician | Wells Fargo Economics
Azhar.Iqbal@wellsfargo.com | 212-214-2029

Sara Cotsakis
Economic Analyst | Wells Fargo Economics
Sara.Cotsakis@wellsfargo.com | 704-410-1437



Source: Wells Fargo Economics

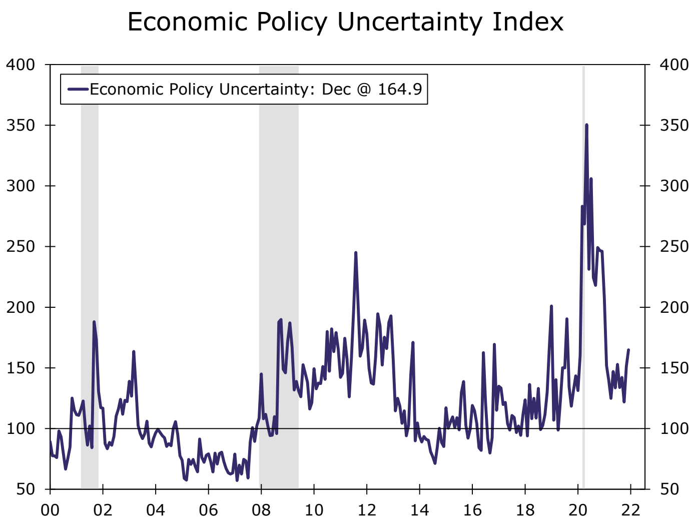
ASI Lost Momentum in the Last Stretch of 2021

The Animal Spirits Index (ASI) turned positive (+0.12) in December, jumping from -0.12 in November. Previous reports detail the methodology, but on a basic level, an ASI value above zero indicates optimism, while a value below zero suggests pessimism. It consists of five indicators: the S&P 500 index, the Conference Board's consumer confidence index, the yield spread, the VIX index and the Economic Policy Uncertainty Index. December's increase was broad-based, with four of these five components positively contributing. But before celebrating too much, the larger picture shows the index averaging only +0.09 in Q4 of last year. That marks the lowest quarterly average since Q1-2021, which included values that were deeply negative. Further evidence of the ASI limping across the finish line comes from the fact that two of the last four prints were negative—the only negative values since February of last year. The upbeat final data point for 2021 is a good note to end on, but zooming out suggests that confidence in the ongoing recovery has begun to fade.

The only negative contributor to the ASI was the Economic Policy Uncertainty Index, which increased 13.6 points to 164.9 in December (Figure 1). This December increase is even more remarkable when combined with November's drastic change. Since October, a pandemic low, the index has risen 43 points, signifying a rapid introduction of uncertainty in the past few months. This has come amid months of debates in Congress over new spending packages as well as a sharp change in tone from the Federal Reserve, as rising inflation has put pressure on officials to tighten monetary policy. Even with the recent ambiguity, the current level remains much lower than that seen during the tumultuous first year of the pandemic, but the recent gain does show uncertainty at its highest since January 2021.

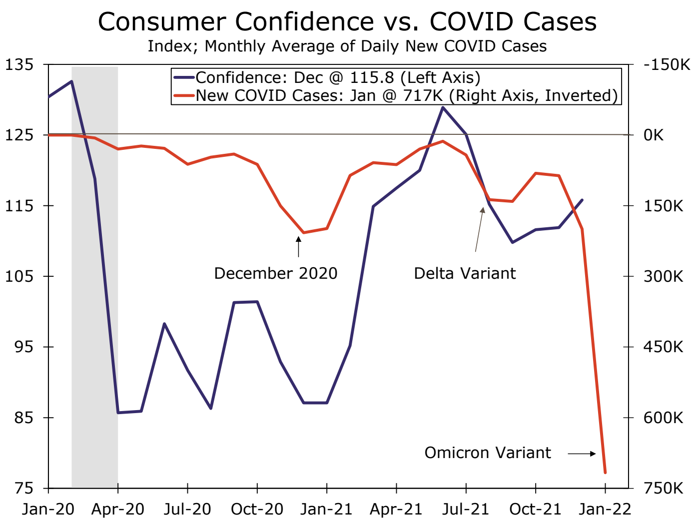
That said, the other four indicators factored into the headline were encouraging. Kicking off the positive contributions is the Conference Board's Consumer Confidence Index, which increased for the third consecutive month in December to 115.8, signifying an improved perception of economic conditions. Furthermore, the S&P 500 index recorded another all-time high in December, and the VIX dropped to 17.22 from 27.19. The spread between the 10-year and three-month Treasury yields narrowed in December, but the recent surge in the 10-year yield solidified expectations for longer-lasting inflation.

Figure 1



Source: Baker, Bloom & Davis and Wells Fargo Economics

Figure 2



Source: The Conference Board, Bloomberg Finance L.P. and Wells Fargo Economics

2022 Off to a Rocky Start

The ASI's Q4-2021 roller coaster ride can be traced to the many starts and stops experienced as the economy responds to rapidly changing data concerning the public health situation as well as supply chains. While there is some evidence that consumers have been desensitized with each COVID wave and may continue their daily activities, it is hard to predict their behavior as there is fluidity with how consumers are processing new information. What has become clear in recent weeks is that the highly contagious Omicron variant weighed on spending in Q4-2021 and will likely take its largest toll on the first quarter of this year. As a result, we have knocked down our forecast for real PCE growth in Q4-2021 to 5.0% (from 5.5%), and now see real PCE growing only 2.3% in Q1-2022, which is down almost a percentage point from our recent forecast. We forecast real PCE growing at 3.4% over the year in 2022, which is slightly lower than the 3.7% we expected in December. This change comes as surging COVID cases threaten the service sector recovery in early 2022, but that said, both 2022 and 2023 should see the pace of real spending exceed the pre-pandemic trend.

Up to this point, we have not seen a complete fallout in consumer confidence, but the December data only encapsulate the beginning of the Omicron-related surge that ruined many consumers' holiday plans (chart). Average cases for January are already 260% higher than those for December. The preliminary January data for the University of Michigan's consumer sentiment index, which is not included in the ASI but overlaps frequently with movements in the consumer confidence index, showed a 1.8 point decline. If consumer confidence follows this same trajectory, it could weigh on the ASI in the early part of this year. In addition, we forecast inflation will reach its peak annualized rate of 7.0% in Q1, which means that consumers are also in for a rough beginning of the year as far as prices go. Economic policy uncertainty may remain elevated in January as consumers continue to recover from the whiplash resulting from the hawkish change in the Fed's tone as well and unresolved spending package debates. But unless there is new information from Congress or another surprise coming out of the FOMC meetings, it is not likely to break meaningfully higher.

As we enter our third pandemic-affected year, there are also encouraging trends in the job market that could combat some pessimism. For one, the jobs market remains extraordinary hot and should continue to support incomes in the forms of wages & salaries. In December, average hourly earnings climbed another 0.6% and shifted to the year-over-year pace to 4.7%. Looking past the first quarter, we expect the rate of inflation will begin to moderate through the remainder of the year and into 2023, which should somewhat boost spirits. That said, we still expect the rate of inflation to remain above the Fed's target through the end of next year. In the near term, these bright spots may be overwhelmed by the one-two punch of rising COVID cases and peaking inflation, but should help buoy sentiment in the latter months of the year.

Subscription Information

To subscribe please visit: www.wellsfargo.com/economicsemail

The 2022 Annual Economic Outlook: Restoring Balance in the Post-Pandemic Economy is available at wellsfargo.com/economicoutlook

Via The Bloomberg Professional Services at WFRE

Economics Group

Jay H. Bryson, Ph.D.	Chief Economist	704-410-3274	Jay.Bryson@wellsfargo.com
Mark Vitner	Senior Economist	704-410-3277	Mark.Vitner@wellsfargo.com
Sam Bullard	Senior Economist	704-410-3280	Sam.Bullard@wellsfargo.com
Nick Bennenbroek	International Economist	212-214-5636	Nicholas.Bennenbroek@wellsfargo.com
Tim Quinlan	Senior Economist	704-410-3283	Tim.Quinlan@wellsfargo.com
Azhar Iqbal	Econometrician	212-214-2029	Azhar.Iqbal@wellsfargo.com
Sarah House	Senior Economist	704-410-3282	Sarah.House@wellsfargo.com
Charlie Dougherty	Economist	212-214-8984	Charles.Dougherty@wellsfargo.com
Michael Pugliese	Economist	212-214-5058	Michael.D.Pugliese@wellsfargo.com
Brendan McKenna	International Economist	212-214-5637	Brendan.Mckenna@wellsfargo.com
Shannon Seery	Economist	332-204-0693	Shannon.Seery@wellsfargo.com
Nicole Cervi	Economic Analyst	704-410-3059	Nicole.Cervi@wellsfargo.com
Sara Cotsakis	Economic Analyst	704-410-1437	Sara.Cotsakis@wellsfargo.com
Jessica Guo	Economic Analyst	704-410-4405	Jessica.Guo@wellsfargo.com
Karl Vesely	Economic Analyst	704-410-2911	Karl.Vesely@wellsfargo.com
Coren Burton	Administrative Assistant	704-410-6010	Coren.Burton@wellsfargo.com

Required Disclosures