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Economics Group

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The Animal Spirits Index Drops into Negative Territory

Our Animal Spirits Index dropped to -0.33 in March, the first negative print since June 2016. The struggle to respond effectively to the ongoing crisis is apparent in the policy uncertainty index, which hit a record high.

The Animal Spirits Index: Quantifying Sentiment

Sentiment and expectations about near-term economic growth play an important role in how consumers spend and businesses invest, but quantifying these factors can be difficult. 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.

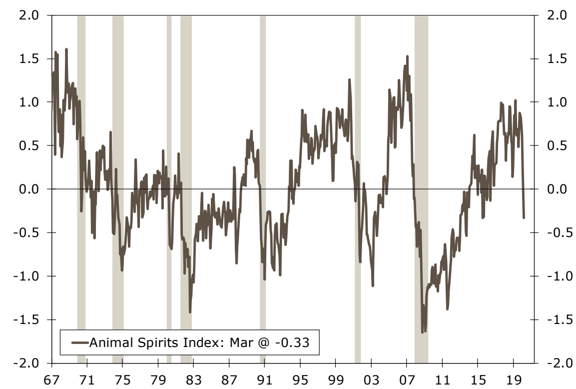
Our ASI goes back to January 1967, giving us the opportunity to analyze the index's behavior during different business cycles and political environments. The ASI hit its lowest value on record (-1.65) in October 2008 and remained in negative territory until January 2014 (top chart). Between June 2016 and February 2020, the ASI stayed in positive territory, surpassing the pre-Great Recession expansion in terms of duration, but still below the extended exuberance of the 1990s.

One Word Behind the Recent Plunge in the ASI: COVID-19

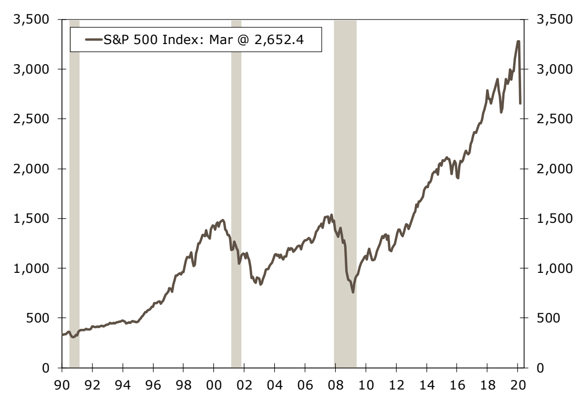
After 44 consecutive months in positive territory, the ASI dropped turned negative (-0.33) in March. The global pandemic has led to a sharp turnaround in sentiment, with four of the ASI's five components contributing negatively to the index. The recent selloff in the equity market brought the monthly average for the S&P index to 2652 in March, the lowest level since January 2019 (middle chart). The policy uncertainty index hit the highest level ever (283.6) in March, as policymakers have been busy trying to mitigate the economic impacts of containment measures (bottom chart). The VIX ended March at 53.54, the highest month-end value in the post-Great Recession era, after hitting a record high daily close of 82.69 on March 16. Consumer confidence dropped to 120 in March, though the further deterioration in the labor market since the March survey's cut-off date suggests April is likely to be even worse. The only positive contributor was the spread between the yield on the 10-year and 3-month Treasuries which turned positive in March after inverting in February. The positive spread likely reflects the ultra-accommodative monetary policy adopted by the FOMC in response to the crisis.

Given the large drop in most major economic indicators, a large decline in the ASI was perhaps inevitable and further deterioration in sentiment is likely particularly in the short run. Going forward, this fledgling sentiment may compound many of the other problems facing the economy. We will continue to update our ASI and report the changes in the index as they develop.

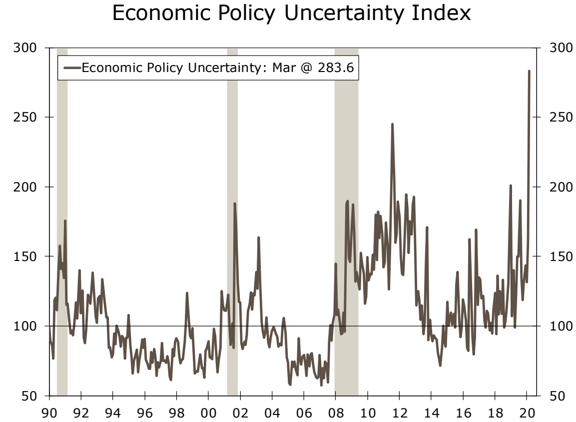
Animal Spirits Index



S&P 500 Index



Economic Policy Uncertainty Index



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

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