MacroResearchBoard
mrb partners
Independent Investment Strategy
RESEARCH HIGHLIGHT
ECONOMY
October 29, 2024

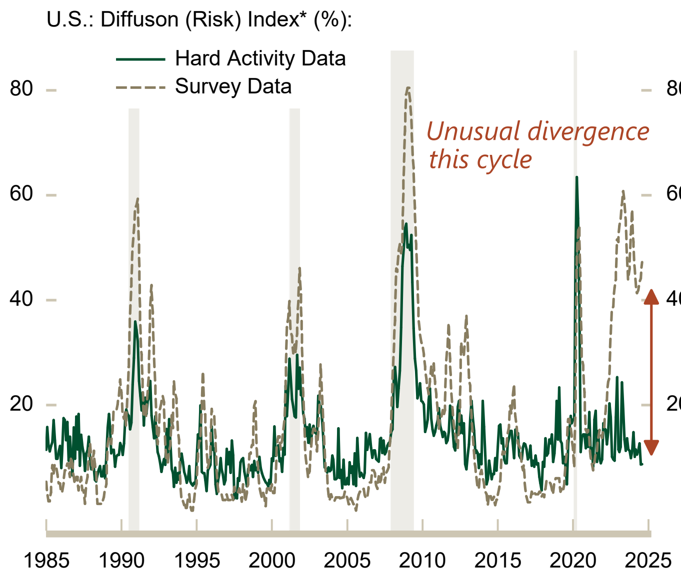
Why Is U.S. Consumer Sentiment Downbeat?

- Downbeat consumer sentiment likely reflects the lingering effects of the post-pandemic rise in inflation.
- The rate of inflation has slowed, but surveys indicate that consumers also care about the ***level*** of prices, which remains high.
- Consumer sentiment also embeds political biases, and it may shift meaningfully depending on the outcome of next week's election.
- So far, weak sentiment has not translated into weak spending. So long as the labor market remains resilient (as we expect), investors should continue to downplay consumer sentiment signals.

U.S. survey-based sentiment gauges dropped during the pandemic and have been slow to recover, in sharp contrast to the solid growth in actual economic activity such as GDP and employment. The persistent and sharp divergence between actual economic activity and economic sentiment is unique to the current cycle **(chart 1)**. The gap between sentiment and reality is apparent for the consumer and business sectors **(charts 2** and **3)**.

There is no doubt that the negative signal from sentiment surveys has skewed the consensus macro view, fueling a persistent undercurrent of U.S. recession fears this cycle **(chart 4)**. Despite these recession fears being since proved wrong, weak sentiment data are ***still*** coloring the macro narrative; an example is the most recent bout of macro bearishness that surfaced following a soft ISM manufacturing PMI report this past July.

Chart 1 Sentiment Data Has Been Over-Bearish And Unreliable



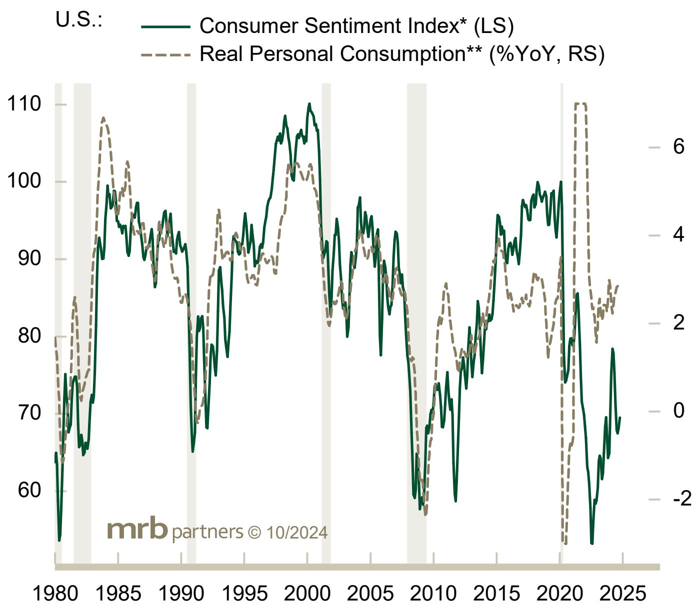
* Percent of standardized data series over 1 std. deviation below mean; MRB calculation based on 580 underlying data series
Note: Shaded for NBER-designated U.S. recessions

mrb partners © 10/2024

MRB has consistently downplayed the excessive weakness in economic sentiment in this cycle[1]. We have maintained that investors should instead give more importance

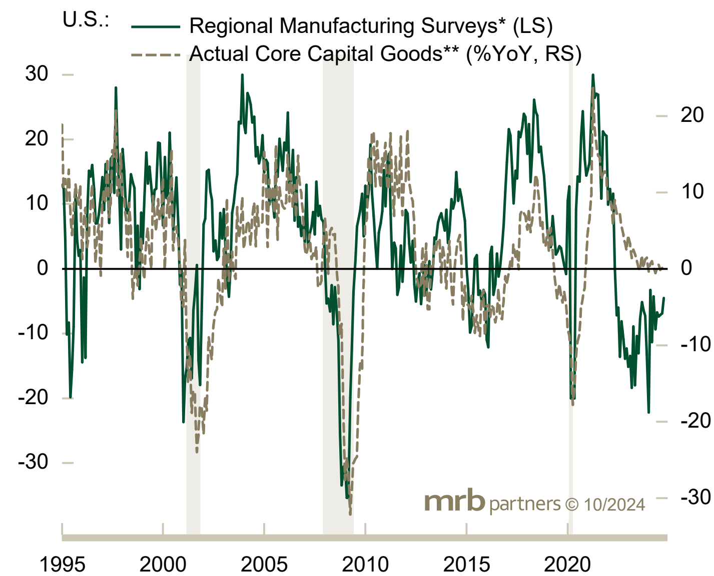
[1] **MRB:** "***U.S. Economy: Revisiting Recession Risks***", April 27, 2023

Chart 2 Consumer Spending And Consumer Sentiment Have Diverged



* Smoothed; University of Michigan
** Smoothed; source: U.S. Bureau of Economic Analysis; truncated below-3 & above 7
Note: Shaded for NBER-designated U.S. recessions

Chart 3 Business Sentiment And Activity Have Also Diverged

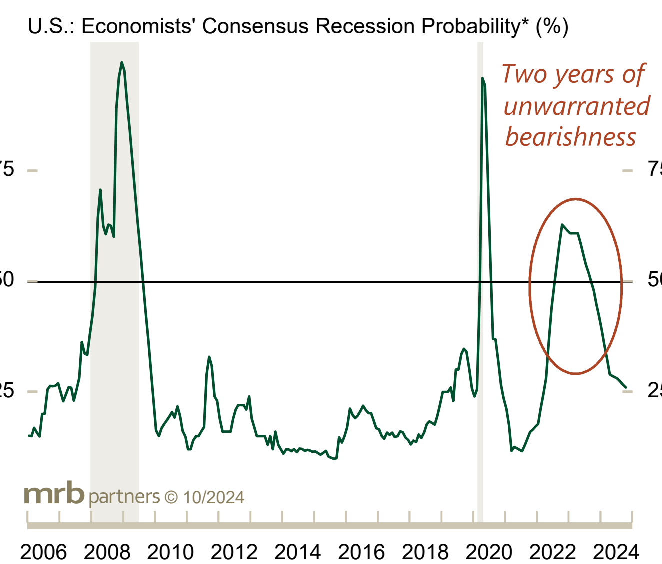


* Smoothed; source: Regional Federal Reserve Banks, manufacturing surveys
** Smoothed; source: U.S. Census Bureau
Note: Shaded for NBER-designated U.S. recessions

to actual economic activity, which has been more aligned with the strong underlying fundamentals of the economy.

The question is: should investors continue to discount sentiment signals indefinitely? After all, sentiment surveys were historically useful leading indicators of economic activity, (and are included in most U.S. business cycle trackers). Will sentiment surveys “normalize” and become insightful again? Below we probe this issue with respect to consumer sentiment.

Chart 4 Recession Fears Were Unreasonably High This Cycle



* Source: The Wall Street Journal
Note: Shaded for NBER-designated U.S. recessions

The Sentiment Slump

The unusual, persistent weakness in consumer sentiment this cycle may be natural given the atypical nature and large scale of the pandemic’s shock, whose effects were somewhat slow to dissipate. However, the pandemic is now receding far in the rearview mirror in most key respects. The labor market has long recovered from the pandemic job losses, and household balance sheet health is better than it was in 2019. The relatively slow improvement in consumer sentiment cannot be pinned on the remaining psychological impact of the pandemic alone.

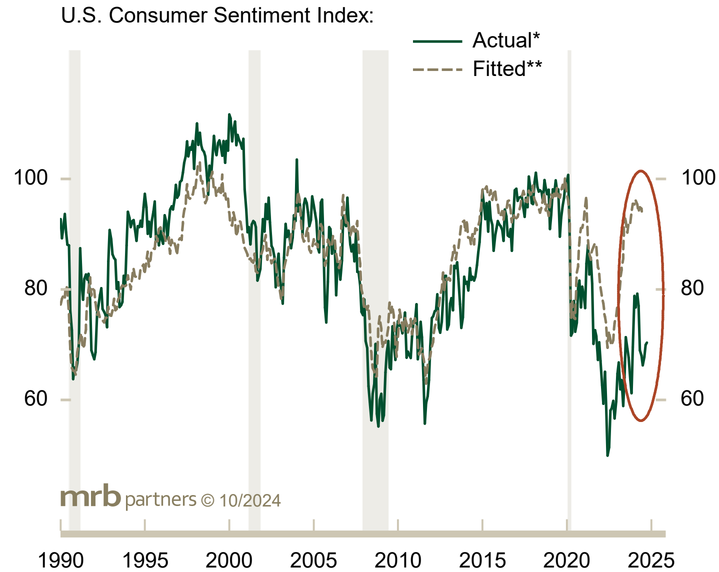
Historically, we find that consumer sentiment has been fairly well predicted by five main factors, namely the unemployment rate, the growth rate of home prices, the growth rate of stock prices, the ***current rate of inflation and the expected rate of inflation*** **(chart 5)**.

Accordingly, we find that at least a part of the weakness of consumer sentiment can be attributed to the post-pandemic surge in inflation (which, unlike economic activity, has not fully "normalized", although it has moderated). Long-term inflation expectations, which are still close to a percentage point higher than they were before 2020, are also playing a role in dampening sentiment **(chart 6)**.

That being said, consumer sentiment this decade has been weaker than would be explained by the five drivers listed above. In our view, that additional factor dampening sentiment is likely related to the ***level of consumer prices*** in the economy**.**

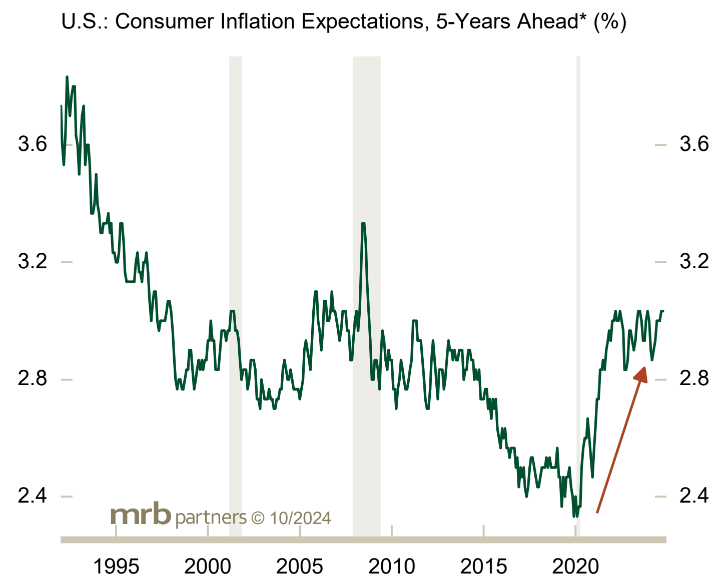
Although the rate of inflation has eased back meaningfully since 2022, the level of prices is more than 8% higher than what would have prevailed had inflation averaged 2.5% this decade **(chart 7)**. The negative impact of a much higher level of prices is strongly visible in consumers' assessments of buying conditions for durables and vehicles. The share of individuals stating that durables and autos prices were "too high" to make a purchase rose sharply after the pandemic and remains elevated to-date **(chart 8)**.

Chart 5 Sentiment Diverged From Its Historical Drivers After 2020



* Source: University of Michigan
** Generated by regressing sentiment on the unemployment rate, annual growth of stock prices & home prices, and current & expected annual consumer inflation
Note: Shaded for NBER-designated U.S. recessions

Chart 6 Long-Term Inflation Expectations Are Higher This Decade



* Smoothed; source: University of Michigan

Chart 7 The Consumer Price Level Is Significantly Above The Pre-Pandemic Trend

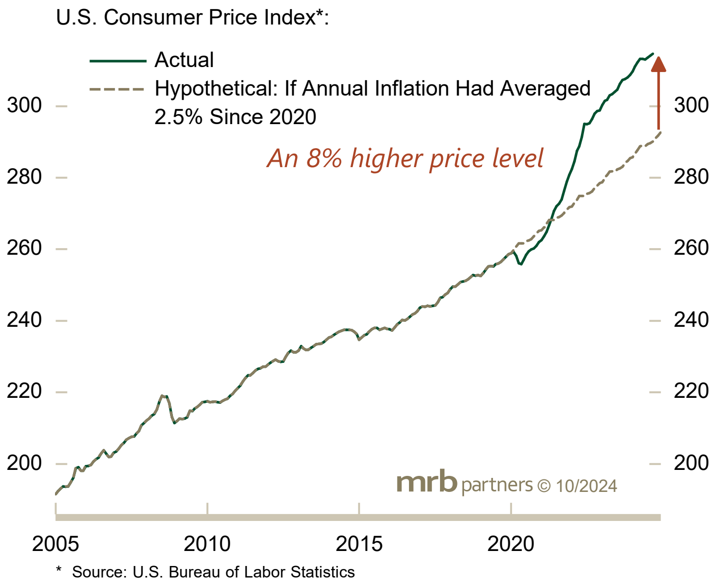
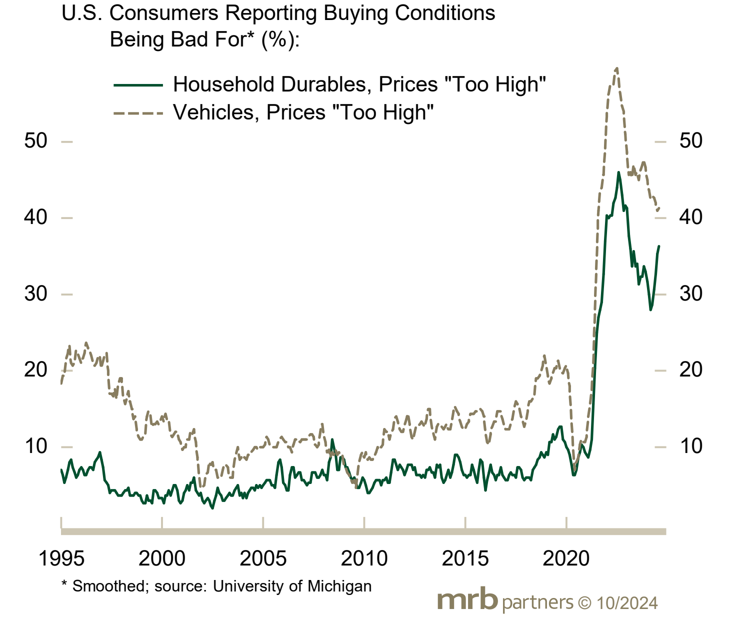


Chart 8 Consumers Are Still Feeling A Sticker Shock

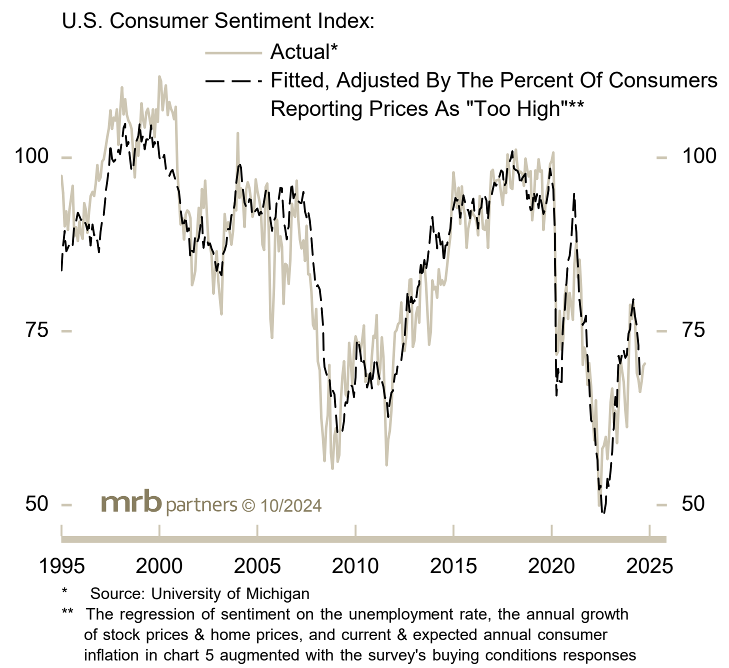


The detrimental effect of a high level of prices explains most of the "excessive" consumer pessimism observed in this cycle **(chart 9)**. Incidentally, this lingering negative impact of high prices is also relevant for small businesses, who continue to flag high inflation as the "single most important problem" that they are facing[2] **(chart 10)**.

Clearly, consumers care a lot about the fact that prices are high. To be fair, this does not seem to have translated to actual weaker spending –real consumption growth is stronger than sentiment would predict.

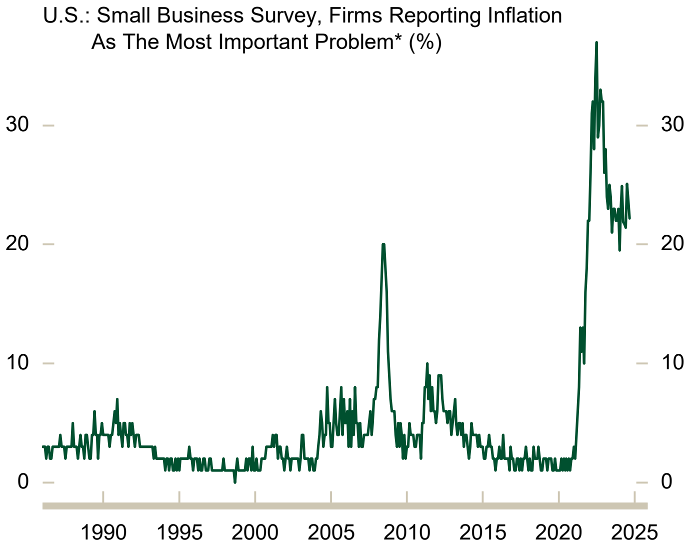
So long as the labor market remains resilient (as we expect) then what consumers will actually do (spend) will remain stronger than the expectations they provide in surveys. Note that consumer surveys that elicit assessments of general economic conditions and expectations are vulnerable to the increasingly bearish news media. (On that account, the Conference

Chart 9 High Prices Explain The Unusually Weak Consumer Sentiment



[2] As we have repeatedly noted, poor sales are not seen as a significant problem by small businesses, yet another indicator that recession fears have been overblown.

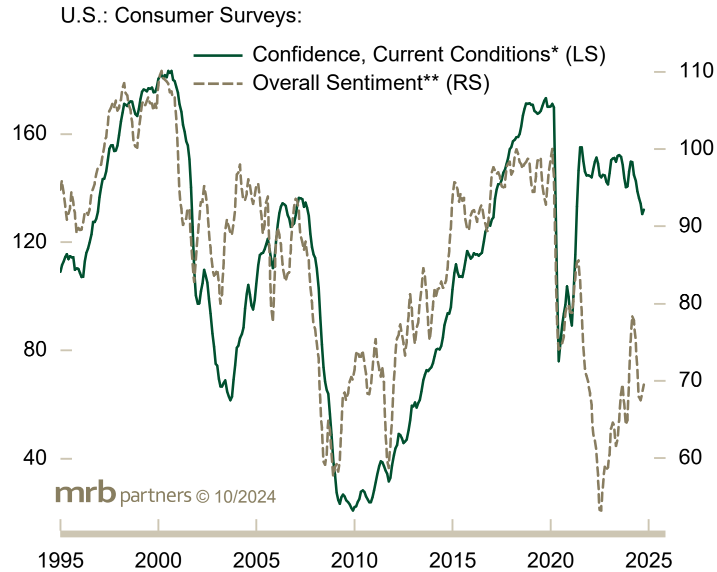
Chart 10 Inflation Is Weighing On Business Sentiment As Well



* Source: National Federation of Independent Business

mrb partners © 10/2024

Chart 11 Consumers' Confidence In Own Current Conditions Is Better



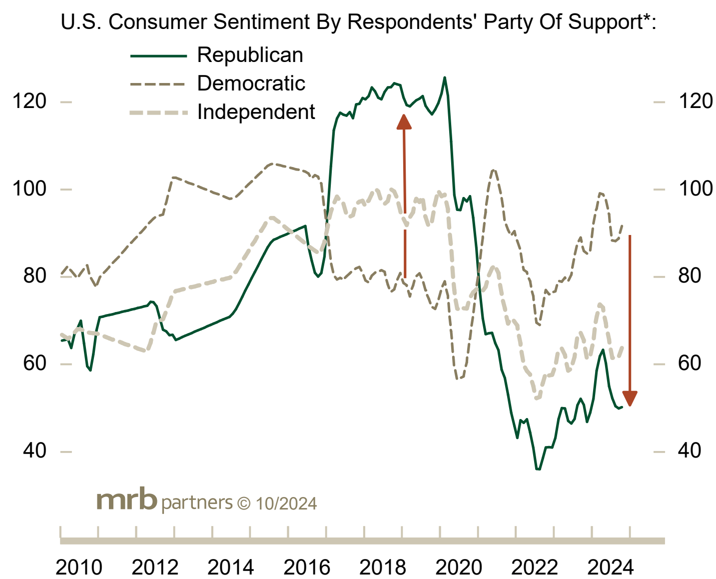
* Source: The Conference Board
** Source: University of Michigan

Board consumer survey's Present Situation Index which is based on questions regarding respondents' own circumstances, is much more consistent with current spending**, chart 11)**.

The broad implication of the discussion above is that investors should continue to downplay signals of weakness in consumer sentiment in the near term at least, with the memory of pre-pandemic pricing likely to gradually fade from consumers' psyche.

The other factor worth mentioning in the context of consumer sentiment is politics.

Chart 12 Consumer Sentiment Is Skewed By Political Preferences



* Source: University of Michigan

Consumer sentiment varies sharply by political party support **(chart 12)**. For instance, according to the University of Michigan consumer sentiment survey, the assessment of current economic conditions among Democratic party supporters is 50 points higher than Republican party supporters and 30 points higher than other voters. (In contrast Republican voters were far more upbeat than Democrat voters or independent supporters during the Trump Administration. Basically, reported economic sentiment is higher when the favored party is in control of Congress and the White House).

Investors should note that dissatisfaction around elevated consumer price levels could potentially have repercussions for the outcome of next week's elections. In turn, the result of next week's elections could also have a material impact on consumer sentiment.

So long as the labor market holds up however, any such gyrations of consumer sentiment should not matter much for consumer spending.

Final Word: *Weaker-than-usual consumer sentiment reflects a lingering impact of the post-pandemic surge in inflation. The rate of inflation has ebbed, albeit leaving the level of prices still high, relative to pre-pandemic expectations. The negative sentiment around elevated prices is likely to fade only slowly. This implies that investors should continue downplaying bearish consumer sentiment data. It is important to note that consumer sentiment is not a pure reflection of economic conditions or expectations, but it is also heavily impacted by politics. It is likely that the result of next week's elections will skew sentiment meaningfully one way or another, depending on the outcome. This will not have any direct implications for consumer spending though, as long as the labor market remains resilient.*

Prajakta Bhide
Strategist, U.S.

MacroResearchBoard

mrb partners

Independent Investment Strategy

MRB - The Macro Research Board is a privately-owned independent top-down research firm that provides integrated, global, multi-asset investment strategy as well as actionable absolute and relative return ideas. Our views incorporate a long-term outlook based on in-depth thematic research, together with a rigorous set of frameworks and forecasting models/indicators that drive 6-12 month asset market performance. MRB's team of analysts and strategists leverage the firm's robust research engine and their extensive experience to form one cohesive house view and ensure that investment strategy is articulated in a client-friendly manner.

London
24 Old Bond Street, 3rd Floor,
London, W1S 4AP, United Kingdom
Tel (+)44 (0) 20 3523 9618

Montreal
1275 Ave. des Canadiens-de-Montréal, Suite 500
Montreal, Quebec H3B 0G4, Canada
Tel +1 514 558 1515

New York
1345 Avenue of the Americas, FL 2
New York, NY, 10105, United States
Tel +1 212 390 1148

For more information, please contact:
Client Relations
clientrelations@mrbpartners.com

MRB Research Coverage

Weekly Macro Strategy	Global Equity Strategy
Global Macro & Investment Themes	U.S. Equity Sectors Strategy
Tactical Asset Allocation Strategy	Global Fixed Income Strategy
Absolute Return Strategy	Foreign Exchange Strategy
Developed Market Strategy	Commodity Strategy
Emerging Market Strategy	Weekly Webcasts