MARKET INSIGHTS

Monthly Commentary

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A Whiff of Confidence

The single biggest on-going survey of consumer confidence in the United States is conducted by Rasmussen, who survey 500 consumers every night on their views of the U.S. economy and their personal finances. Since October 2007, there has not been a single month in which the index produced by this survey has exceeded 100. However, since the start of May it has averaged well above this level.

Other readings on consumer confidence, such as the University of Michigan's index of consumer sentiment, have also been improving. Although unlike the Rasmussen, most are not, as this is written, at post recession highs yet. Still, there are clear signs that confidence is improving, begging the questions of what is causing this surge in optimism and what does it mean for the economy and markets.

The first question is relatively easy to address. Statistical analysis shows that four factors can account for almost 80% of the swings in the index of consumer sentiment since 1997. Specifically, consumer sentiment reacts negatively to increases in the unemployment rate and gasoline prices and responds positively to gains in stock prices and home prices.

Now consider economic progress in recent months:

- The unemployment rate has fallen to 7.5% in May from 7.8% last December and 10.0% at its worst in October 2009.
- Gasoline prices have been moving sideways in recent weeks at a time of the year when they normally climb.
- The S&P 500 index has risen to all-time highs and is up more than 20% year-over-year.
- All major measures of home prices are showing substantial improvement as the demand for housing outstrips the supply produced by a still recovering home-building industry.

Going forward, while forecasting gasoline prices and stock prices is extremely difficult, labor market conditions should gradually improve while supply/demand dynamics suggest home prices will continue to rise. This being the case, barring shocks, it is probable that confidence will continue to improve.

For the economy, rising confidence is clearly a positive as it not only supports consumer spending but also tends to boost hiring and other business spending. So far this year, the economy has overcome substantial fiscal drag from Washington as spending has been assisted by increases in household wealth and pent-up demand. Rising confidence going into the second half of the year could provide further support possibly allowing real GDP growth to move above its recent near 2% trend growth rate.

For markets, rising confidence could also have an impact on the Federal Reserve as a growing perception of an improving economy casts further doubt on the appropriateness of the extreme quantitative easing currently in place.

This could lead some Fed officials to argue for an earlier tapering off of quantitative easing than the market currently expects, which, in turn, could lead to higher long-term interest rates.

Confidence is also very important for the stock market. 2013 continues to be a very strong year for stocks with the S&P 500 already up by a double-digit percentage year-to-date. For the first few years of the stock market rally, rising stock prices could be ascribed to a surge in earnings or falling interest rates. However, neither of these forces has been particularly strong in 2013.

Rather, it appears that higher confidence is boosting P/E multiples. There has always been a strong relationship between P/E multiples and consumer confidence as investors who feel confident are more willing to pay up for future earnings. Indeed, statistical analysis over the past 20 years suggests that a 10 index point rise in the index of consumer sentiment is associated with a roughly 2 point increase in forward P/E multiples.

It should be noted that while people feel more confident as the stock market rises, strong market gains today do limit future gains. Nevertheless, given current relative pricing which still favors stocks relative to bonds and cash, the prospect for a continued rise in confidence still points to the advantages of being a little over-weight stocks relative to fixed income and cash in an appropriately balanced portfolio.

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