

Index of Consumer Sentiment Misleads on Consumer Spending Consumer Pulse[®] Proves to be a Good Indicator

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The Index of Consumer Sentiment (ICS) compiled by Westpac / Melbourne Institute consistently fails any analytical tests of its ability to predict future or even current discretionary consumer spending as measured by retail sales.

By contrast, Consumer Pulse, developed by myself over the past 15 years, does correlate significantly with contemporaneous retail sales growth. It does, therefore, offer several benefits to retailers and their suppliers, market analysts, and economic policy decision makers:

- It provides a gauge of the current state of consumer discretionary spending before official statistics are released by the Australian Bureau of Statistics;
- To the extent that the present is a guide to the short-term future, it is an indicator of future discretionary spending in the absence of economic or psychological shocks.
- As a good indicator of current spending, demographic breakdowns indicate what types of consumers are modifying their discretionary spending. This is important information for retailers and their suppliers as it provides a basis for tactical redirection of marketing activity. It is important information for economic policy makers because it provides a guide as to whether the expected types of consumers are reacting to policy as planned – for example, the April 2008 measures suggest that any further interest rate rises are likely to evoke a disproportionate reaction from consumers.

ICS Misleads

Over the past 20 years, my econometric modelling has always failed to establish a statistically significant relationship between retail sales and ICS. Nor have I seen any analysis which convincingly establishes a relationship.

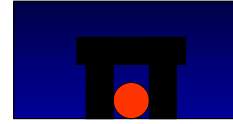
In 2002, Reserve Bank of Australia researchers reached a similar conclusion – that ICS doesn't tell us anything we didn't already know (RDP2001-09, "What do sentiment surveys measure?", available at www.rba.gov.au).

Our analysis has since confirmed that ICS is like a rear vision mirror, reflecting past economic news. It is especially sensitive to the value of the Australian dollar (direct relationship), unemployment (inverse relationship), and interest rates (inverse relationship).

Don Harding, professor of economics at Latrobe University, also believes that ICS is a poor indicator – in the Australian Financial Review of 6 May 2008, he wrote "Maybe demand will weaken in the remainder of 2008. Consumer confidence has

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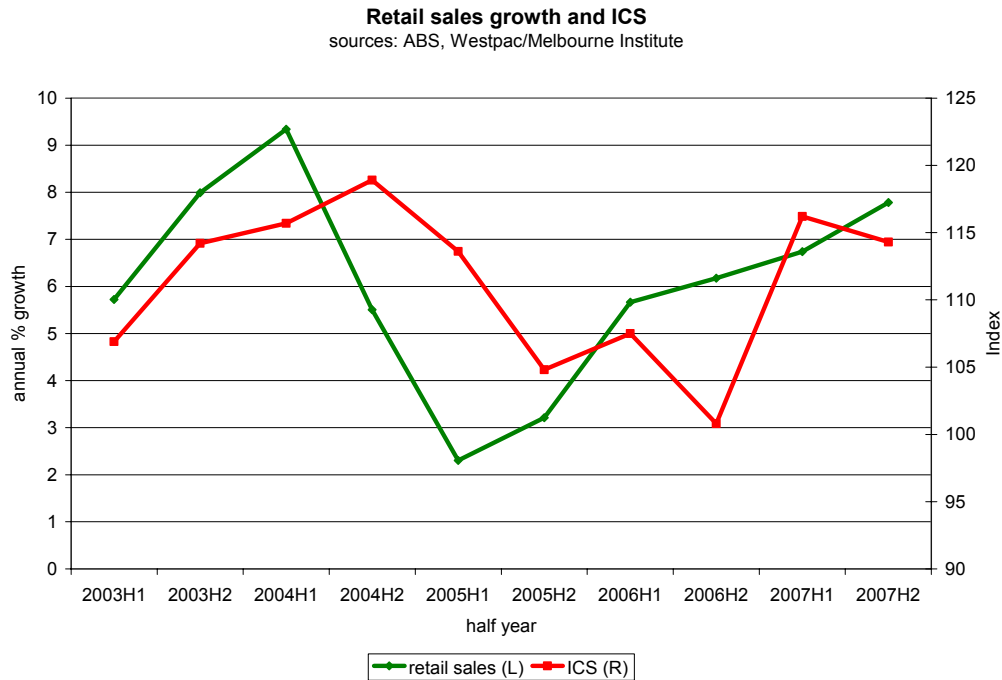


fallen to 15 year lows, but it is a very volatile series and provides a weak indication of the future state of demand.”

I would replace “weak” with “no” on the basis of my analysis.

Chart 1 shows retail sales growth and ICS, by six month periods, over recent years.

Chart 1



Over this period, ICS has lagged retail sales growth by six months. Indeed, retail sales growth is a statistically significant predictor of ICS over this period. ICS equals 100.2 plus 1.98 times retail sales growth six months earlier. The relationship is statistically significant ($p = 0.015$) and the fit is quite good, with 51% of the variance in ICS explained by past retail sales growth.

There can be little doubt that the early 2008 plunge in ICS to 15 year lows is a reflection of bad economic news from the US and on the Australian stockmarket.

Consumer Pulse

Consumer Pulse is a set of measures which I have developed over a 15 year period, aimed at overcoming the absence of a reliable indicator of discretionary consumer spending. After trials initially involving just capital city consumers, during which the measures were developed and tested, the survey went national in 2003.

The measures include both willingness and ability to spend, interest rate expectations, interest rate preference, and house price expectations.

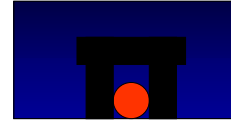
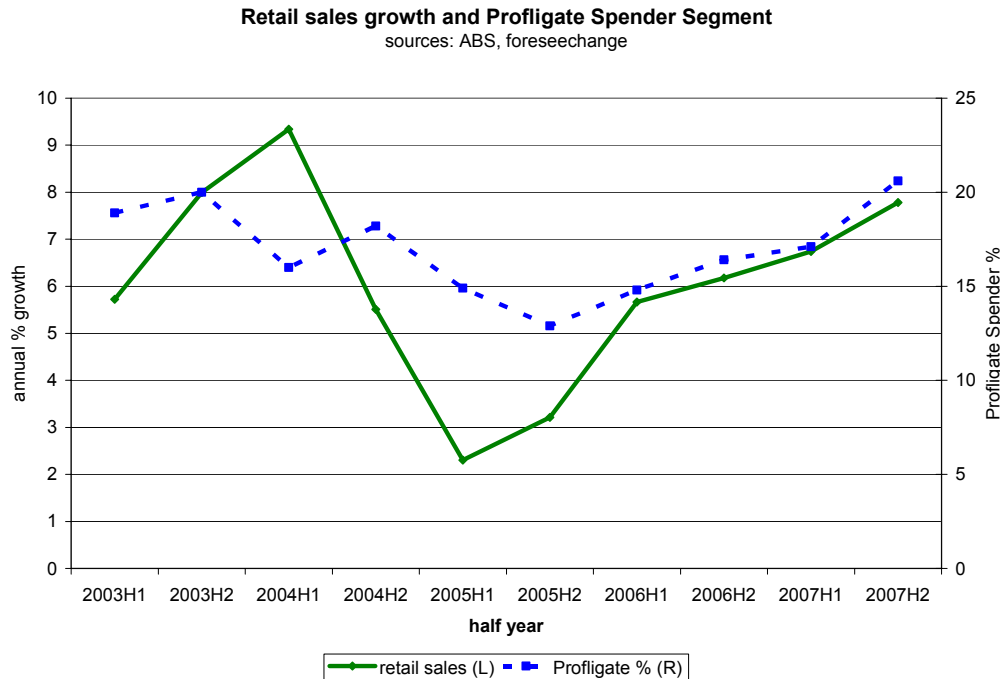


Chart 2 shows retail sales growth and the size of the Profligate Spender segment – that is, the segment which is both willing and feels able to spend on discretionary items.

Chart 2



The correlation is statistically significant ($p=0.035$) and 35% of the retail sales growth variance is explained.

The April 2008 survey suggests that discretionary consumer spending growth will be softer than in 2007, but not as slow as in 2005.

Future Research

I plan to increase the frequency of measurement and to further refine relationships between the portfolio of indicators and consumer activity.