Santa Barbara Independent WHO. WHAT. NOW.

What's Consumer Sentiment Got to Do With It?

Expect a Rebound if History Is Any Guide

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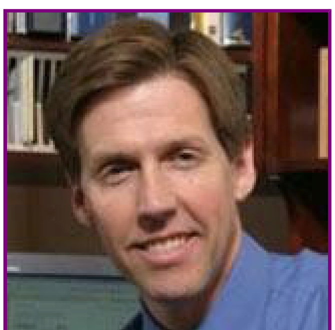
“This time is different.” “I want to watch it for a while.” “The global economy has never experienced anything like this before, at least not since the depression.” “I’m sitting on the sidelines for now, I’ll move back in when the market starts to go up.”

These words are uttered thousands of times every day by investors across the nation. Whether talking to their spouse, neighbor, or stockbroker, investors are uniformly afraid to be in the capital markets.



Money Talks

It’s understandable. As of the close of business on Thursday, November 20, 2008 the S&P 500 had lost over 50% of its value from the high recorded in October of 2007 (source:Yahoo Finance). Much of that loss was experienced during the months of October and November of 2008.

Even experienced investors, using sophisticated investment strategies including asset allocation, have been hurt because in this turbulent market nearly all asset classes have performed poorly. All portions of the stock market have fallen, along with nearly all portions of the bond market.

What’s an investor to do?

Every individual is unique, but let’s look at some history and see what conclusions can be drawn.

One often used statistic is consumer sentiment, as reflected in a monthly poll released by the

University of Michigan. For the last 30 years, consumer sentiment has been a contrarian indicator for the stock market: The worse consumers feel, the better the stock market performs over the coming year.

In fact, whenever the index has been greater than 110 (indicating a very happy consumer), the average return of the S&P 500 was -1.2% over the following 12 months. What was the average return following a consumer sentiment less than 60 (an indication of extreme consumer pessimism)? The S&P 500 returned 23.1% on average over the next 12 months (source: “The Case for Optimism,” LPL Financial Research).

What do we learn from this? We learn that human nature, if allowed to control our investments, will almost certainly doom us to failure. We might feel bad and sell, then buy when we feel good. Unfortunately, investing is counterintuitive. A look at flows into and out of investments bears this out. Money flows out of investments just before the markets turn up, and into investments just as the capital markets peak and begin to sag.

What is consumer sentiment today and what does that tell us? November’s number came in at 57.9. If history is to be used as a guide, we may experience a rebound in the stock and bond markets over the next 12 months, although past performance is no guarantee of future results.

Is this time different? Yes, it absolutely is different. Black Monday on October 19, 1987, when the stock market lost 22% of its value in one day, was also different. The S&L crisis of the late 80s and early 90s was different. The bursting of the Internet bubble was different, and certainly the terrorist attacks of 2001 were different. The debacle surrounding Enron and Worldcom was different.

Each of these events were one of a kind, and during those difficult times, investors said things like, “This time it’s different,” and “I want to watch it for a while, see where it goes.”

If you catch yourself saying things like this, remember that by the time it goes up and you feel better about investing, it’s too late. You missed the rise and are likely to buy in just in time to catch the fall.

In future columns, we will look deeper at what happens to the stock market after very difficult times like the one we’re experiencing.

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