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FIRST Trust ADVISORS L.P.

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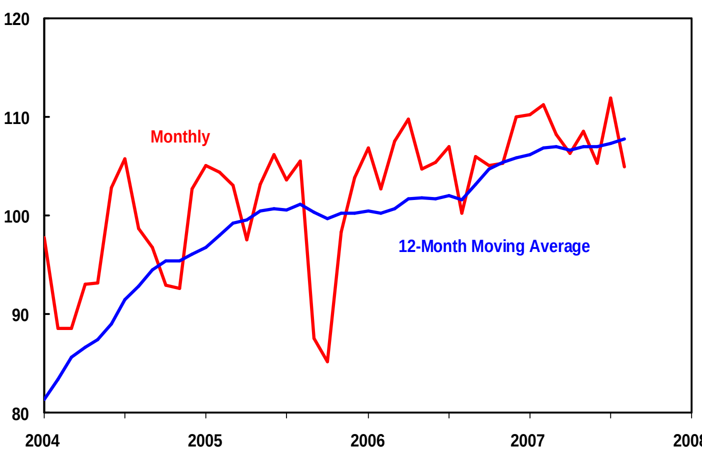
Economic Commentary

Confidence Data Do Not Signal Consumer Slowdown

One fear of investors is that housing weakness and credit problems will curtail consumer spending, and possibly lead to recession. So, when consumer confidence as measured by the Conference Board experienced its largest monthly drop in almost two years, falling to 105.0 in August from 111.9 in July, the market acted as if this fear was coming true.

But hold on. While consumer confidence fell the most in about two years, this followed a large jump in July. Consumer confidence is a volatile data series. Smoothing out the month-to-month gyrations by using a twelve-month moving average shows that confidence is still in a rising trend (see chart below). Nonetheless, the appropriate response by investors to all of this should be a collective: who cares!

Consumer Confidence



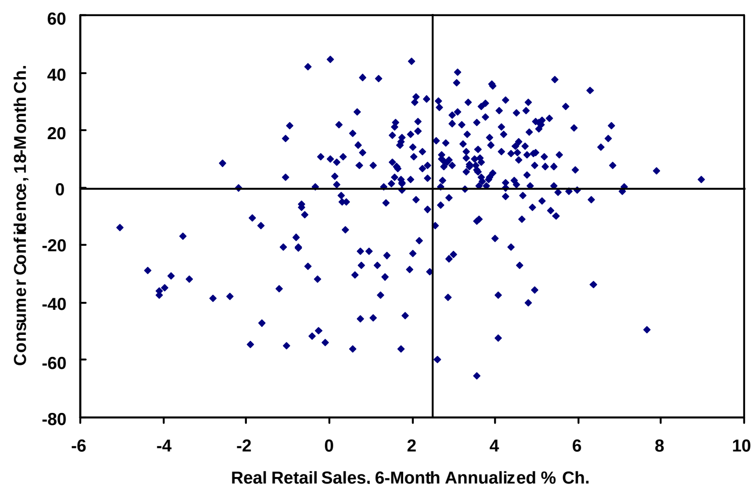
Source: Conference Board / First Trust Advisors www.FTAdvisors.com

Demand-side economic theory (the view that the consumer drives the economy) is a deeply flawed view of the way the world works. Moreover, statistical models show virtually no relationship between consumer confidence and future retail spending.

We took the confidence numbers and tortured them until they screamed trying to find some relationship to future consumer spending. The best relationship we found for the past twenty years was that the change in consumer confidence over an 18-month period predicted 11% of the variation in real retail spending growth (ex-autos) over the following six months. In other words, 89% of the change in retail sales is not explained by consumer confidence.

The scatter plot below, showing this relationship, looks more like a shotgun blast than a tight fit. Looking closely, it is possible to tease out a slight upward tilt to the right in the scatter pattern.

Confidence Versus Retail Sales



Source: Census Bureau / Conference Board www.FTAdvisors.com

But the distribution is very wide. There have been plenty of gains in real retail sales above the 2.5% twenty-year average that have followed large declines in confidence. Similarly, sales have often fallen below trend despite gains in consumer confidence.

In sum, investors relying only on consumer confidence data to predict retail sales should have almost no confidence in their forecast.

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