Are Americans Too Pessimistic About the Economy?

These days there's a wide gap between what Americans think about the economy and the state of their personal pocketbooks. What's going on?

I study households' economic expectations and their financial decisions and believe people may be overreacting to the current news cycle with their pessimism about how the economy is doing.

Objectively, U.S. households are in pretty good shape. We have a higher level of savings than before COVID, thanks to the government stimulus payments during 2020 and 2021 that have yet to be fully spent.

Some of the federal stimulus money sent to states is just now being deployed to fund infrastructure and other projects that will generate jobs. Wage growth has been strong, and the labor market continues to be very tight — not only is the unemployment rate very low at about 3.5%, but the ratio of job openings to the number of unemployed people is almost 2 to 1.

Also, for many Americans, most of their wealth comes from the value of the home they own. From March 2020 to October 2022 (latest available data), home prices increased by an astonishing 39%, as measured by the Case-Shiller Index. And while the stock market did poorly in 2022, this didn't really impact the financial well-being of many people because only half of Americans have investments in the stock market — including those with assets in retirement accounts where the median holding is only about $40,000.

For those who have investments, it's worth noting that the S&P 500® Index is still well above its February 2020 level. In other words, in terms of wealth, most people are doing better than before COVID. They have more money in their savings accounts, and their homes are worth a whole lot more, which should be more than sufficient to compensate for the recent loss in the value of any equity holdings. This, plus the strong labor market, suggests that most Americans are in good shape.

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Yet some of the recent measures of consumer sentiment and poll results suggest that many people believe it's all doom and gloom when it comes to the economy. For example, the University of Michigan Survey of Consumer Sentiment Index is at a very low level, similar to where it was in the depths of the Great Recession, in 2008.

Glass Half-Empty?

So why the gloomy assessment that comes in various polls and surveys? Based on my research in household finance, I find it quite possible that we're overreacting to news about the economy, and right now consumers are unduly pessimistic.

In my work, I have found that people become too pessimistic about future economic conditions when they have been in an environment with some bad economic news. Under these circumstances, even the slightest bit of additional bad news leads people to overreact in their assessment of just how bad the economy will do in the future. Moreover, people overreact to the same bit of news heard multiple times.

Neuroscientists have shown that our brains, especially after we experience adversity, get more attuned to bad news than good news. In other words, after going through a difficult time, many of us tend to see the world through a lens of "the glass is half-empty" rather than half-full.

A glass-half-empty mentality generally reflects our current situation. In the past year, we've been inundated with news about inflation reaching levels not seen in the prior four decades and the stock market dropping quarter after quarter. So, it's easy to see how someone could react too much to another high monthly inflation reading and forget about the rest of the economic reality that surrounds them. The 24/7 news cycle can also exacerbate our tendency to have a negative outlook on how things are going.

But while some surveys suggest that many people are worried about the economy, this may just show a temporary bout of pessimism. It turns out it's not all gloom and doom in every survey, nor when we look at consumer behavior.

For example, while still down relative to February 2020, the Conference Board Consumer Confidence Index is currently at levels seen in normal, non-recessionary economic times and has generally been increasing since last summer. Additionally, the Michigan Survey of Consumer Sentiment shows that U.S. consumers don't think inflation will spiral out of control in terms of one- and five-year inflation expectations. The five-year expectation is about 3%. In other words, most people are optimistic about the medium or long run, even though they feel the pinch of inflation today.

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Looking Ahead

Consumer behavior also shows that it's not all bad here. Spending is at healthy levels. Banks report low delinquency rates on credit cards and consumer loans. The financial debt of U.S. households is at a low level relative to what we saw during the Great Recession, decreasing the likelihood of high levels of financial distress going forward. All these indicators point to a U.S. economy that's on a fairly strong footing, much better than many other countries.

Will the gloomy views of Americans change in 2023? It remains to be seen. Clearly, in terms of spending, and wealth and labor market outcomes, we seem to be doing just fine. The negative outlook some surveys show doesn't seem to be affecting spending.

That's good news for the U.S. economy, and it could also be good news for investors. Uncertainty is a part of investing, and in periods following market downturns, pessimism about the economy could naturally extend to the fear of further market declines.

While no one can predict the future, investors would likely be well-served by sticking with a glass-half-full mentality and focusing on the long term.