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Chief economist's comment

No confidence in confidence data?

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- Financial markets love confidence numbers. There are lots of confidence data releases, covering business and consumer confidence, which means traders always have something to talk about. In theory, confidence data gives timely information on the economy.
- Confidence data (sometimes called "soft data") has been diverging from real world data ("hard data"). The question is which data set investors should trust.
- Sadly, there are five clear reasons why confidence data cannot be taken at face value. Real economic data has its problems as well, but the broad range of real economic data is more reliable than opinion polls on confidence.
- Confidence data should converge with the real economic data over the next few months. Real economic data is showing that the world is growing at a good, trend-like rate - not the very high rate of growth implied by the confidence numbers.
- The fact that financial markets love confidence data may create some noise as confidence comes back to more realistic levels. Investors should focus on the underlying economic data when thinking about the longer term.

No confidence in confidence data?

Financial markets treat surveys of business sentiment with considerable reverence. The headline measures are among the most widely forecast economic releases. If investors are prepared to go so far as to pay economists to forecast data, that tells us that the data is considered important in the financial markets. Current sentiment surveys reveal very high levels of confidence, signaling stronger economic activity than is reported in reality. UBS CIO believes these sentiment indicators are exaggerated, and will narrow the gap with real world data.

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There are five reasons such surveys may be flawed indicators:

1. **Surveys do not pretend to report growth**, though are often presented as if they do. The media frequently reports on them inaccurately by offering statements like "manufacturing expanded in Italy" when what happened was an opinion poll of manufacturing sentiment among a sample of Italian firms was more optimistic. These two things are not the same.
2. **Few people fill in surveys anymore.** The declining response rate to official surveys is a worrying trend for statisticians producing government economic data. With electronic surveys littering email inboxes, fatigue seems to have set in. This risks what economists call "selection bias." Those who can still be bothered to fill in surveys are unlikely to be typical. People fill in surveys when they have something that they strongly wish to communicate. This is the economic version of Groucho Marx's quote "I don't want to belong to any club that would have me as a member"; even if survey respondents seem normal on the surface, the fact that they are filling in a survey means that they are not normal.
3. **People fill in surveys incorrectly.** They answer the question they want to answer and not the one being asked. A good example involves export orders in purchasing manager surveys, which explicitly inquire about what is happening to the volume of export orders. But when there is currency volatility (causing the volume and value of exports to diverge), respondents often report the unrequested value figure, not the requested volume figure. This is why currency weakness will tend to produce a strong export orders confidence figure from a survey, but then the reality of the export data disappoints.
4. **Surveys overreact.** In recent years, the volatility of many surveys has increased relative to the volatility of the underlying real economic indicators they are supposed to track. (German data is the exception to this trend.) Media influence may be responsible for this state of affairs as the financial media has become demonstrably more sensationalist in recent years. When asked to fill in a survey, people tend to answer what they think they should answer (which is influenced by what the media is telling them about the state of the world). If the media is more sensationalist, then the answers of surveys are likely to be more sensationalist.
5. **Respondents may "game" the system.** Because those filling in surveys know that the results have a high profile, they may skew answers in the hope of influencing policy outcomes. Political bias can play a role in this as well. When Obamacare, the US healthcare program, was going through Congress, US small business sentiment reported dire consequences in the form of rising job losses. Small business owners were generally politically opposed to the measures. In fact, small business employment continued to grow - the reported pessimism just did not reflect reality.

A vote of no confidence in confidence

So where does this leave investors? The answer is difficult. Opinion polls on business and consumer confidence are popular with markets, and markets will react to them. The fact that surveys may be wrong in what they imply about the real world does not seem to affect the enthusiasm with which the results are met. So a short-term investor should pay attention to the survey results. For a strategic investor, however, the value of surveys has diminished over the past ten or fifteen years as the five problems outlined here have increased. While surveys may be useful in indicating direction, and the detail of surveys is subject to fewer problems than the headline statistic, a strategic investor needs to be careful in interpreting the numbers.

Appendix

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