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Decomposition of Consumer Sentiment and the Effects of Cyclical Component on Macroeconomic Variables

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ABSTRACT

Consumer sentiment is believed to impact the business cycle and the macroeconomy, as optimism drives spending and investment, while pessimism can trigger economic slowdowns by reducing spending. Conventional empirical models occasionally incorporate sentiment to explain business cycle movements but rarely distinguish consumer optimism or pessimism from overall sentiment. Therefore, I decompose consumer sentiment into trends and cycles using various econometric methods. To mitigate discrepancies arising from specific statistical methods, I construct an average cycle based on five distinct measures, i.e., Hodrick and Prescott filter, Hamilton filter, correlated Unobserved Components model, Beveridge-Nelson filter, and Multivariate Beveridge-Nelson decomposition. Then, I analyze the impact of average cyclical sentiment shocks, representing consumer over-optimism or pessimism, on inflation expectations and macroeconomic variables such as unemployment, core CPI inflation, CPI inflation, and industrial production, using monthly U.S. data from 1978 to 2022. The findings show that average cyclical sentiment shocks significantly impact inflation expectations, unemployment, and industrial production. However, the responses of core CPI inflation and CPI inflation to average cyclical sentiment shocks are ambiguous.

KEYWORDS Consumer Sentiment; Business Cycle; Decomposition; Cyclical Sentiment; Local Projection; Impulse Responses

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