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MORE THAN A FEELING: HIGH INFLATION AND WEAK CONSUMER SENTIMENT

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Consumer sentiment in Australia and the United States is at its lowest level in at least 50 years, despite low unemployment and resilient household spending. This note shows that the weakness in sentiment is closely linked to high price inflation and the current cost-of-living shock.

- **Higher inflation is strongly associated with weaker sentiment.** This relationship is visible in both Australia and the United States over more than half a century of data.
- **The effect of inflation builds over time.** Sentiment does not respond only to the latest inflation print. When inflation stays elevated, its effect accumulates, consistent with households reacting to the cost of a sustained rise in prices.
- **The pattern is not country-specific.** The same inflation–sentiment relationship appears across a wider panel of advanced economies. Inflation alone explains roughly one third of the common post-2022 fall in sentiment across these countries.
- **Mortgage rates do not explain the slump once inflation is accounted for.** Measures of borrowing costs have little independent relationship with sentiment after controlling for inflation. The apparent link between rates and sentiment largely reflects the fact that interest rates and inflation move together.
- **The decline in sentiment is broad-based.** Household survey data show similar falls in financial satisfaction across mortgagors, outright owners and renters, pointing to a general cost-of-living shock rather than a mortgage-specific channel.

Taken together, the evidence suggests that weak sentiment is best understood as a response to the cumulative effect of higher prices on household purchasing power. Sentiment is unlikely to recover fully even if inflation falls from its peak. It is more likely to improve gradually as inflation stabilises, real incomes recover, and households regain confidence that the period of rapid price increases is over.

1. The record weakness in consumer sentiment

Consumer sentiment is unusually weak. In Australia, both the ANZ–Roy Morgan Consumer Confidence Index and the Westpac–Melbourne Institute Consumer Sentiment Index are at half-century lows. In the United States, the University of Michigan Index of Consumer Sentiment is also at an historic low.

This is striking because the Australian and US economies have not been particularly weak. Labour markets remain relatively strong, household spending has held up, and real incomes have begun to recover. The 'consumer sentiment puzzle' is that confidence has remained very weak even while standard indicators of household economic activity look more resilient.

This disconnect is very apparent in the Australian data — sentiment and spending tend to track each other over time but a clear gap has emerged in recent years (Figure 1).

This note argues that the missing piece is inflation. Although year-ended inflation has fallen from its 2022 peak, the price level remains higher. Many households are still adjusting to the loss in purchasing power created by the earlier surge in prices. On this view, sentiment is responding not only to current economic conditions, but also to the cumulative cost-of-living shock.

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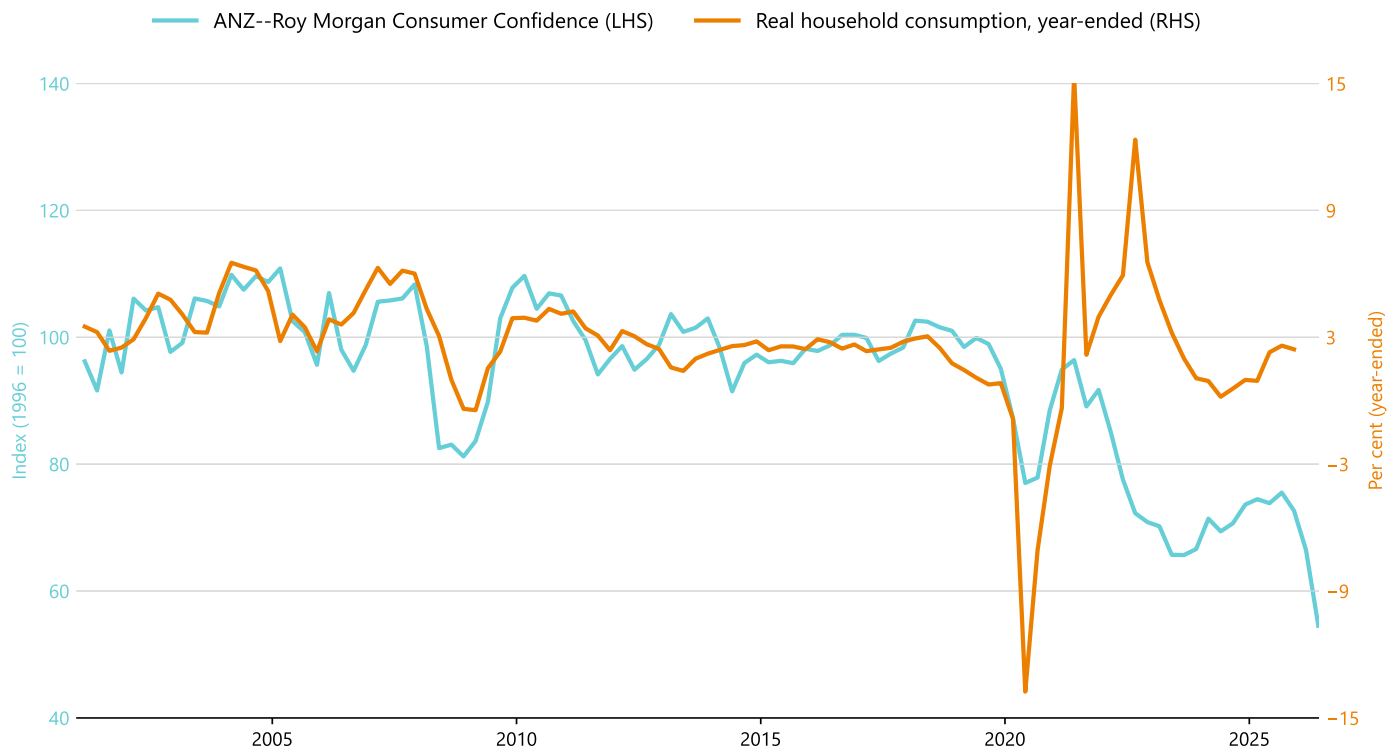
Figure 1: Consumer sentiment and year-ended household consumption growth, 2001--latest



Notes: sentiment is the quarterly mean of monthly ANZ–Roy Morgan Consumer Confidence readings, rebased to 1996 average = 100 following the RBA's convention. Consumption is real household final consumption expenditure, aggregate chain volume, year-ended growth. Sources: ABS; ANZ–Roy Morgan.

The long-run data support this interpretation. In both Australia and the United States, consumer sentiment tends to be lower when inflation is higher. The relationship is visible during the high-inflation episodes of the 1970s and 1980s, and again after the COVID-19 pandemic (Figure 2).

There are several reasons inflation may weigh on sentiment. The most direct is purchasing power: when prices rise faster than incomes, households feel worse off. But inflation may also matter because it is visible, uncertain and often perceived as unfair (D'Acunto et al., 2023; Shiller, 1997; Stantcheva, 2024). A related possibility is that households are responding not to inflation itself, but to the higher borrowing costs that often accompany it. Recent work by Bolhuis et al. (2024) argues that mortgage costs may be an important omitted part of households' perceived cost of living.

The analysis below tests these explanations directly. I estimate the relationship between sentiment, inflation, household spending growth, unemployment and mortgage rates in Australia and the United States. I also test whether the results are robust to controlling for real household disposable income growth, and whether mortgage rates have an independent relationship with sentiment once inflation is taken into account.

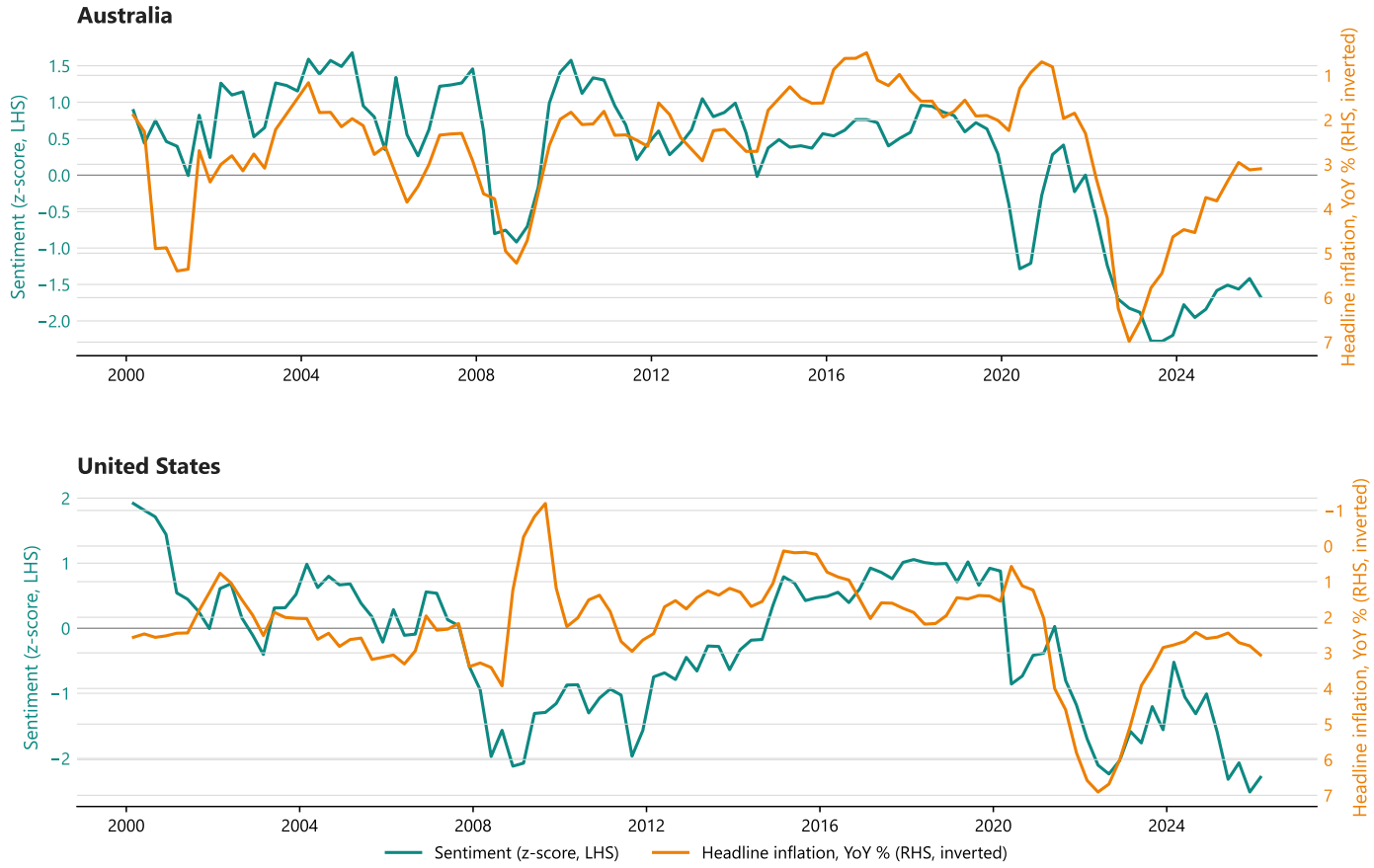
2. Estimating the inflation–sentiment link

I estimate the relationship between consumer sentiment, inflation and other macroeconomic indicators using the following baseline model:

$$S_t = \alpha + \beta_1 \Delta p_t + \beta_2 \Delta \ln c_t + \beta_3 u_t + \beta_4 \Delta i_t + \gamma_1 covid_t + \gamma_2 volcker_t + \varepsilon_t. \quad (1)$$

Sentiment is measured using the ANZ–Roy Morgan Consumer Confidence Index for Australia and the University of Michigan Index of Consumer Sentiment for the United States, standardised within each sample. Inflation is measured using the household final consumption expenditure chain price index in Australia and the personal consumption expenditures price index in the United States. The results are robust to using CPI inflation instead. Household activity is measured using real household spending growth. I also include the unemployment rate and the change in the headline mortgage rate, to test whether

Figure 2: Consumer sentiment and headline inflation, 2000--latest



Notes: the inflation axis is inverted so that high inflation displays downward and the negative co-movement with sentiment is visually obvious. Sources: ABS; BEA; ANZ–Roy Morgan; University of Michigan.

borrowing costs have an independent relationship with sentiment once inflation is taken into account. The COVID dummy is one for 2020 Q1–2021 Q4 in both countries. The Volcker dummy is one for 1980 Q1–1982 Q4 in the United States and zero in the Australian sample. Standard errors are heteroskedasticity- and autocorrelation-robust, using Newey–West standard errors with a four-quarter lag truncation.

2.1 Consumer sentiment is highly correlated with inflation

Inflation is strongly associated with weaker consumer sentiment in both Australia and the United States (Table 1). A one-percentage-point increase in quarterly inflation is associated with sentiment being lower by around 0.5–0.7 standard deviations. The relationship is also strong when inflation is measured as the year-ended rate: a one-percentage-point increase in year-ended inflation is associated with sentiment being around 0.17–0.21 standard deviations lower. The year-ended specification fits slightly better than the quarterly specification in both countries. This suggests that sentiment is not responding only to the latest inflation print. It appears to incorporate the cumulative pressure from several quarters of price increases, a point explored directly in Section 2.3.

The other controls are less important. Household spending growth has the expected positive sign, but is only statistically significant in Australia in the quarterly inflation specification. The unemployment rate is negative in the United States, though only marginally significant, and is not significant in Australia. The change in the mortgage rate is not statistically significant in either country.

As a further check, I add growth in total real household disposable income to the baseline specification. The inflation coefficient remains large and statistically significant in both countries.[1]

Table 1: Baseline model: Australia and United States

	Australia (1979–2025)		United States (1972–2026)	
	(1)	(2)	(3)	(4)
Inflation	−0.663***	−0.213***	−0.530***	−0.172***
	(−6.71)	(−6.08)	(−3.39)	(−4.39)
Household spending growth	+0.086**	+0.059	+0.218	+0.195
	(+2.41)	(+1.64)	(+1.55)	(+1.34)
Unemployment rate	+0.021	+0.046	−0.132*	−0.125
	(+0.25)	(+0.54)	(−1.72)	(−1.55)
Change in mortgage rate	+0.295	+0.298	+0.042	+0.014
	(+1.21)	(+1.38)	(+0.29)	(+0.10)
Inflation measure	Quarterly	Year-ended	Quarterly	Year-ended
N	192	192	219	219
R^2	0.25	0.34	0.28	0.32

Heteroskedasticity- and autocorrelation-robust t-statistics (Newey–West, 4-quarter lag) in parentheses. Columns (1) and (3) use the quarterly change in the consumer-price deflator as the inflation regressor; columns (2) and (4) use the year-ended change. The unemployment rate enters in levels; the mortgage rate in quarterly first differences. Sentiment is z-scored within sample. COVID dummies (both countries) and Volcker-disinflation dummy (US only) included; coefficients suppressed for clarity. Significance: $^{*}p < 0.10$, $^{**}p < 0.05$, $^{***}p < 0.01$.

2.2 Mortgage rates do not explain the sentiment slump

Mortgage rates do not have a measurable relationship with sentiment once inflation is included in the model. The coefficient on the change in the mortgage rate is small and statistically insignificant in both Australia and the United States, regardless of whether inflation is measured quarterly or year-ended.

This suggests that the apparent link between interest rates and sentiment largely reflects their co-movement with inflation. When inflation rises, central banks tend to raise interest rates; but in these regressions it is inflation, not the mortgage rate itself, that is associated with weaker sentiment.

The result is robust to alternative measures of borrowing costs. In Australia, replacing the standard variable mortgage rate with mortgage interest charges from the Selected Living Cost Indexes does not restore a mortgage-rate channel, and leaves the inflation coefficient large and significant. This contrasts with Bolhuis et al. (2024), who argue that borrowing costs help explain the recent weakness in US sentiment.

The distribution of the sentiment decline also points away from a mortgage-specific explanation. Both the ANZ–Roy Morgan and Westpac–Melbourne Institute surveys show large falls in sentiment across age, income and housing-tenure groups. The post-2022 decline is not concentrated among mortgage holders. This is more consistent with a broad cost-of-living shock than with a channel operating mainly through mortgage repayments.

Household survey evidence points in the same direction. HILDA data show that financial satisfaction has fallen since 2022 across mortgagors, renters and outright owners, including after adjusting for household income and demographic characteristics. The decline is therefore not concentrated among households with mortgages, which is more consistent with a broad cost-of-living shock than with a mortgage-specific channel.

2.3 The sentiment response to inflation builds over several quarters

The baseline regressions estimate the average within-quarter relationship between inflation and sentiment. But the recent puzzle is dynamic: inflation slowed through 2024 and 2025, while sentiment remained very weak. This suggests that households may respond to inflation over several quarters, not only to the latest inflation print.

1 Adding year-ended growth in total real household disposable income strengthens the inflation coefficient to around −0.86 in Australia and softens it modestly to around −0.43 in the United States, with both estimates significant at the one-per-cent level. This suggests that the inflation result is not simply capturing contemporaneous real-income growth. However, both household spending growth and disposable income growth are growth-rate controls. They do not capture the level of real income relative to where households expected it to be. A cumulative shortfall in real incomes could therefore still appear as an inflation effect in these regressions. I return to this interpretation in Sections 3 and 4.

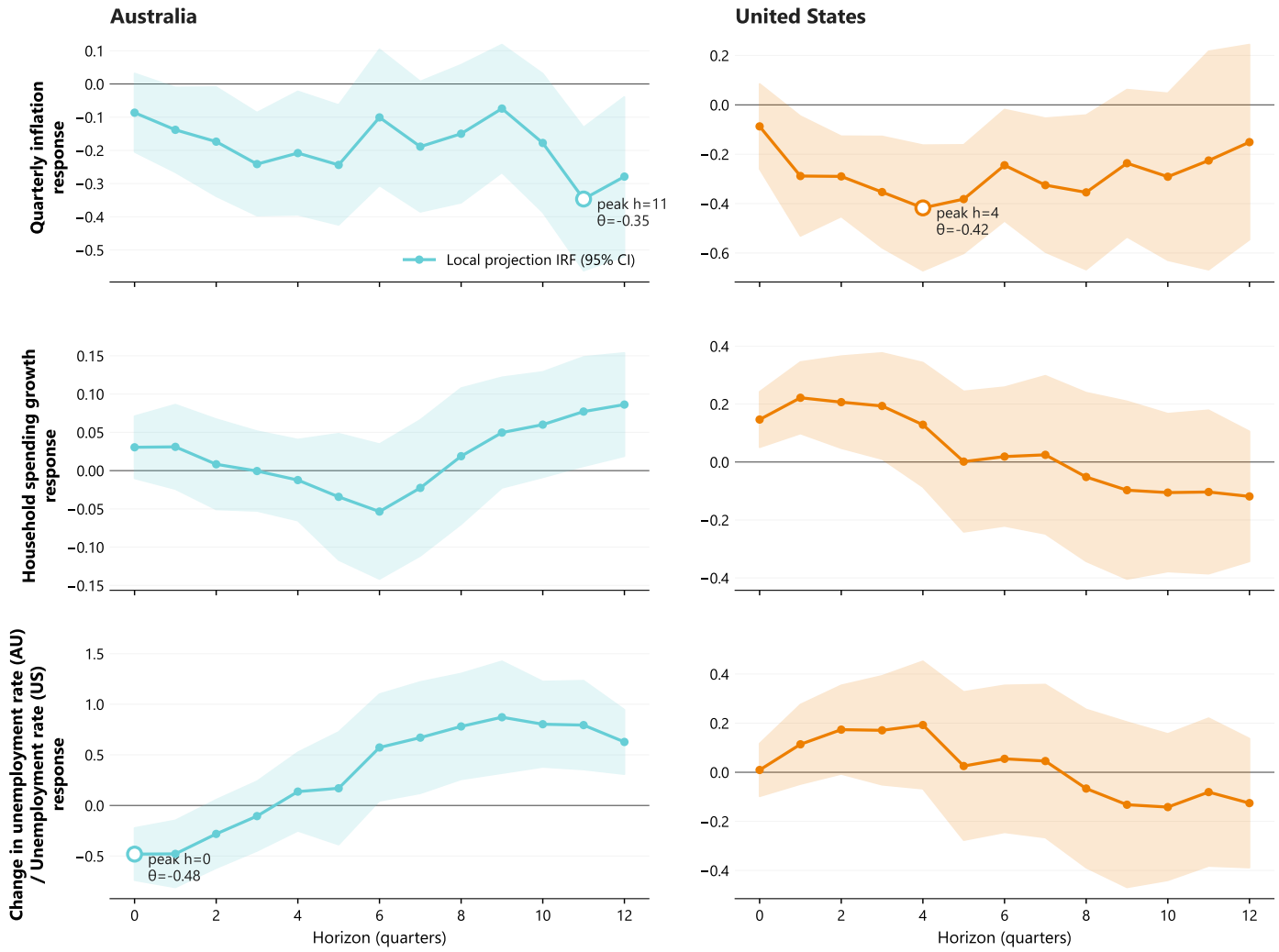
To trace this dynamic response, I estimate local projections (Jordà, 2005). The specification relates sentiment at horizon h to an inflation shock today, controlling for lagged sentiment, lagged inflation and lagged macroeconomic conditions:

$$S_{t+h} = \alpha_h + \theta_h \Delta p_t + \beta_h X_t + \rho_h S_{t-1} + \phi_h \Delta p_{t-1} + \Gamma_h X_{t-1} + \varepsilon_{t+h}, \quad h = 0, 1, \ldots, 12, \tag{2}$$

where X_t includes household spending growth, a labour-market control and the change in the mortgage rate. The COVID and Volcker dummies are also included as exogenous controls.[2][3]

I estimate separate local projections for inflation, household spending growth and unemployment. This makes it possible to compare the persistence of the inflation response with the response to more conventional macroeconomic shocks.

Figure 3: Local-projection responses of sentiment to macroeconomic shocks



Notes: each panel plots the coefficient on the named shock at horizon h from a lag-augmented local projection that includes sentiment$_{t-1}$, shock$_{t-1}$ and X_{t-1} for every continuous control X. Shaded band is a 95% HAC confidence interval; hollow markers indicate the most negative significant horizon for each inflation panel. Sources: ABS; RBA; ANZ–Roy Morgan; FRED.

2 Equation (2) is a reduced-form local projection rather than a structural identification scheme. The coefficient θ_h captures the response of sentiment to movements in inflation that are orthogonal to past sentiment, past inflation and past values of the controls. A causal interpretation requires assuming that contemporaneous movements in inflation are not themselves driven by contemporaneous innovations in sentiment. I therefore interpret the results as conditional reduced-form responses, with the main object of interest being the shape and persistence of the response rather than a precise structural magnitude.

3 ADF tests fail to reject a unit root for the Australian sentiment index and for Australian and US year-ended inflation over the full sample. These series are bounded and so cannot be true unit-root processes, but they are highly persistent and contain structural breaks. The lag-augmented form of equation (2), which includes S_{t-1}, helps absorb this persistence. As a further check, Appendix C re-estimates the impulse responses using $S_{t+h} - S_{t-1}$ as the dependent variable. The inflation response is very similar. In Australia I use the change in the unemployment rate in the local projection and distributed-lag specifications because the unemployment rate in levels fails standard stationarity tests over the Australian sample. In the United States the unemployment rate is stationary in levels and is used directly.

The inflation response is hump-shaped in both countries (Figure 3, top row). In Australia, the contemporaneous response is close to zero. The effect then builds over the next year, reaching around −0.24 standard deviations after three to five quarters, and remains negative at longer horizons. In the United States, the response is also small on impact and peaks after about four quarters, at around −0.42 standard deviations.

This persistence is specific to inflation. Unemployment has a more immediate and transitory relationship with sentiment, especially in Australia. Household spending growth has little dynamic relationship with sentiment in either country. These results suggest that sentiment does not simply track short-run movements in activity. Inflation appears to leave a longer shadow.[4]

These dynamics identify the shape of the response, not the mechanism. A slow-building sentiment response is consistent with households gradually absorbing price increases and updating their views about the cost of living. It is also consistent with a more mechanical real-income channel: if prices rise faster than nominal incomes, the cumulative shortfall in purchasing power grows over time. As a robustness check, Appendix B re-estimates the inflation response using a vector auto-regression. The hump shape and persistence are similar.

2.4 The inflation–sentiment relationship holds across advanced economies

The Australia and US results could reflect country-specific factors. To test whether the relationship is more general, I extend the analysis to a quarterly panel of 13 OECD economies: Australia, Belgium, Canada, France, Germany, Italy, Japan, Korea, the Netherlands, Norway, Spain, Sweden and the United States. The United Kingdom is excluded because of unemployment data gaps. The sample runs from 1980 Q1 to 2023 Q3 and uses harmonised OECD data.

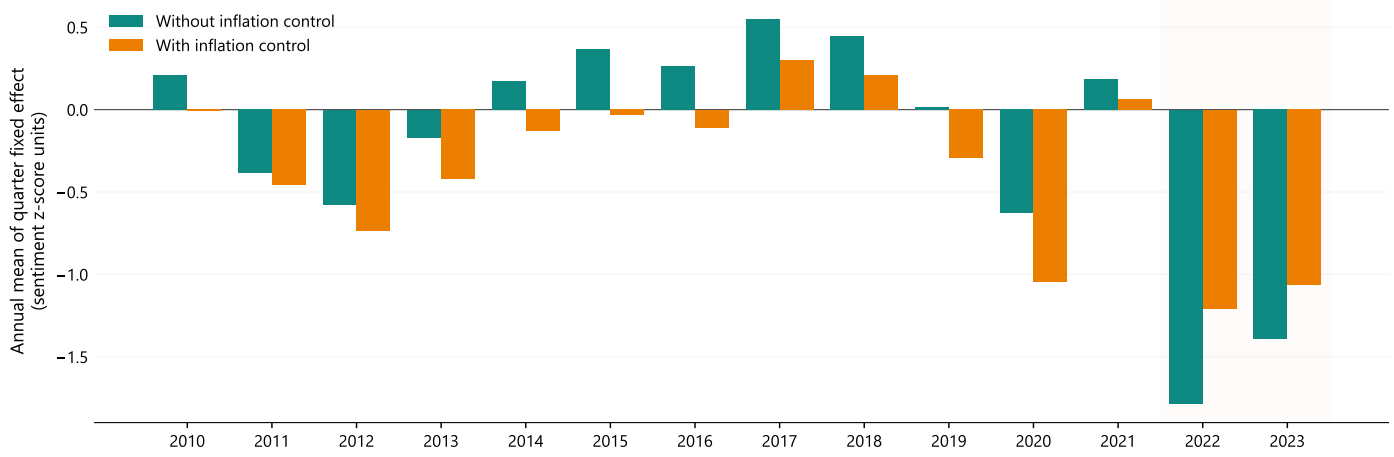
I estimate two country and quarter fixed-effects regressions:

$$S^{z}_{i,t} = \alpha_i + \delta_t + \beta_1 \, \Delta \ln c_{i,t} + \beta_2 \, u_{i,t} + \varepsilon_{i,t} \quad \text{(Spec A)} \tag{3}$$

$$S^{z}_{i,t} = \alpha_i + \delta_t + \beta_1 \, \Delta \ln c_{i,t} + \beta_2 \, u_{i,t} + \beta_3 \, \pi^{\text{cpi}}_{i,t} + \varepsilon_{i,t} \quad \text{(Spec B).} \tag{4}$$

The dependent variable is standardised sentiment. The controls are real consumption growth and the unemployment rate. Spec B adds year-ended CPI inflation. Country fixed effects absorb permanent cross-country differences in average sentiment. The quarter fixed effects capture the common component of sentiment across advanced economies after controlling for domestic economic conditions.

Figure 4: Annual mean of OECD-panel quarter fixed effects, with and without inflation control



Notes: annual mean of the quarter fixed effects from a country + quarter fixed-effects regression of sentiment z-score on real consumption growth and the unemployment rate (left bars, Spec A) and the same model with year-ended CPI added (right bars, Spec B), pooled across the 13 OECD economies listed in the text. Panel area shaded from 2022 onwards. Source: OECD harmonised data via FRED.

4 A distributed-lag specification gives the same message from a different angle. Appendix A asks how far sentiment falls when inflation is held one percentage point higher for several consecutive quarters. The cumulative response reaches around −0.7 to −0.9 standard deviations after eight quarters in both countries. This is consistent with households reacting to the cumulative effect of a sustained inflation episode rather than only to a one-quarter surprise.

Before 2022, the common quarter effect is small. From 2022 onwards, it falls sharply. Without an inflation control, the common shock averages about −1.8 standard deviations in 2022 and −1.4 standard deviations in 2023. Adding inflation reduces these averages to about −1.2 and −1.1 respectively. Inflation therefore explains around 30 per cent of the common post-2022 decline in sentiment across this group of advanced economies.

The international evidence supports the single-country results. The post-2022 sentiment slump is not unique to Australia or the United States. It appears across economies with different institutions, labour markets and household balance sheets, and a meaningful share of the common decline is explained by inflation.

3. Why has sentiment fallen since 2022?

Section 2 showed that inflation is a strong predictor of consumer sentiment in both Australia and the United States. This section asks whether that relationship can help explain the unusually large fall in sentiment since 2022.

A simple explanation is that households feel worse off after a large increase in the price level. Even once inflation starts to fall, prices do not return to their old path. If nominal incomes have not fully caught up, households may still feel poorer than they expected to be. This means the effect of the post-2022 inflation shock may persist even after year-ended inflation has eased.

There may also be a reference-point issue. The long-run estimates in Table 1 use data going back to the 1970s. Over that full period, inflation was often higher than it was immediately before the pandemic. Against a long-run benchmark that includes the 1970s, the post-COVID inflation boom in Australia and the United States is not historically exceptional.

But that is probably not the benchmark that households today have in mind. Households have lived for two decades in a low-and-stable inflation regime. Against that reference point, the post-2022 inflation shock looks much larger.

To allow for this, I re-estimate the simple sentiment model with a post-1993 indicator and an interaction between that indicator and inflation. This allows the inflation–sentiment relationship to differ between the pre-targeting and inflation-targeting periods. Australia formally adopted inflation targeting in 1993. For the United States, I use the same date as a practical marker for the low-and-stable-inflation regime.

The inflation–sentiment relationship is much stronger in the inflation-targeting era. In Australia, the pre-1993 inflation slope is close to zero. The post-1993 interaction is negative and statistically significant, taking the inflation-targeting-era slope to about −0.41 standard deviations for each percentage point increase in inflation. In the United States, the pre-1993 slope is already negative, but it becomes larger after 1993, with a post-1993 slope of about −0.45.

Using these inflation-targeting-era slopes reduces the post-2022 sentiment gap materially. The remaining shortfall falls to −1.11 standard deviations in Australia and −1.26 standard deviations in the United States, compared with unconditional gaps of more than −1.5 standard deviations in both countries. On this basis, around 30 per cent of the post-2022 sentiment shortfall in each country is explained by allowing households' inflation reference point to reflect the low-inflation regime they had actually experienced before the shock.

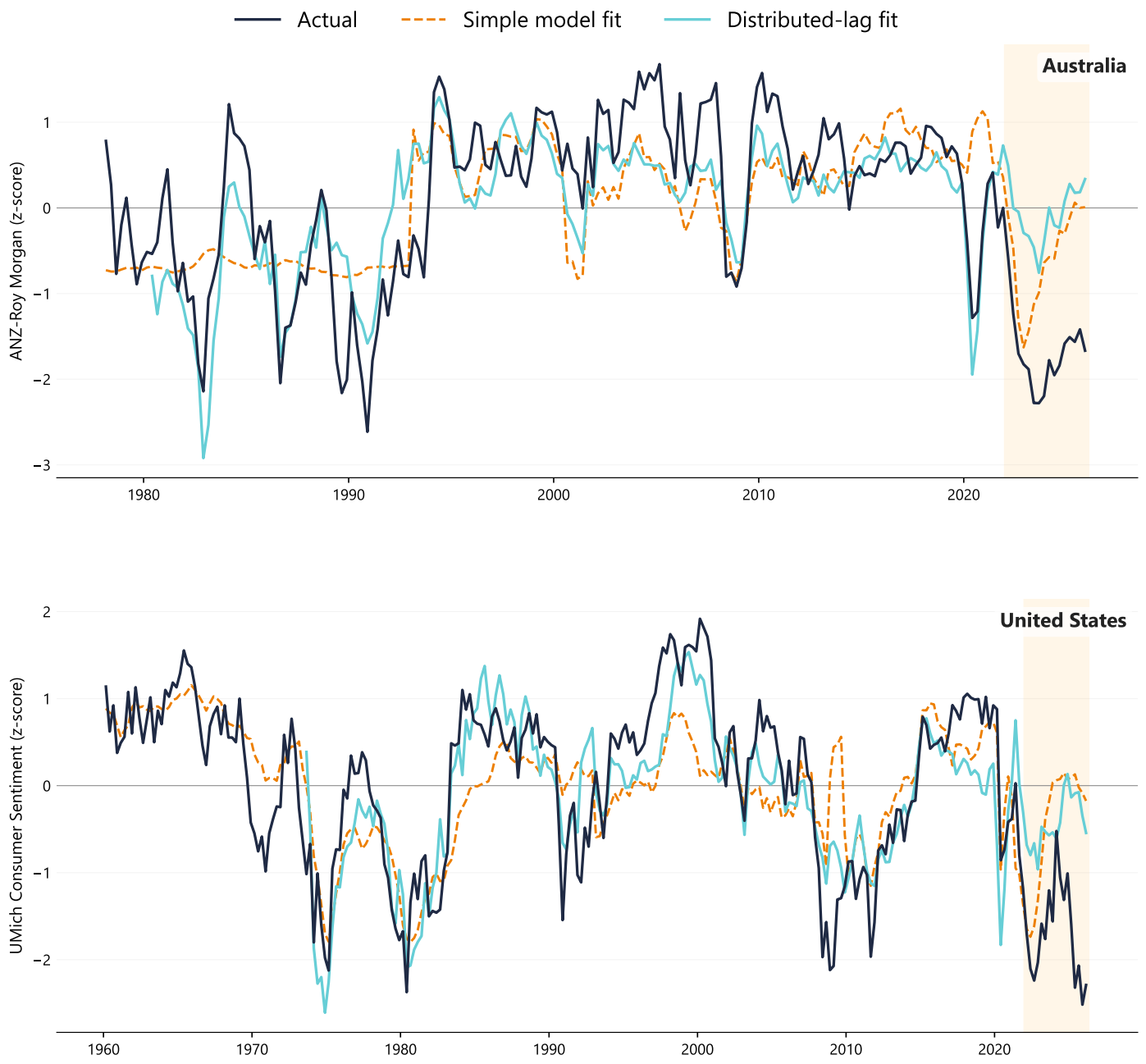
This also helps explain why sentiment was not as weak in the 1970s and 1980s, even though inflation was often higher than it is today. In a high-and-volatile-inflation regime, a 7 per cent inflation print may have been less surprising. In a low-and-stable-inflation regime, the same print is a much larger shock.

The inflation-regime adjustment does not explain the entire fall in sentiment. But this is consistent with the persistence results in Section 2.3. Sentiment appears to respond not only to current inflation, but also to the cumulative price-level shock. Once the low-inflation reference point and these persistence dynamics are taken into account, much of the post-2022 sentiment puzzle becomes less puzzling.

4. What weak sentiment is telling us

The main policy lesson is that weak sentiment is not just a response to current economic conditions. It reflects the cumulative effect of the post-2022 inflation shock. Prices rose quickly, the price level stayed high, and real incomes have not fully recovered. Even as inflation has slowed, many households are still living with the loss in purchasing power created by the earlier price surge.

Figure 5: Consumer sentiment and the model fit, simple model versus distributed-lag model, inflation-targeting era



Notes: actual sentiment with two in-sample fitted values, both estimated on the full sample using an intervention-analysis specification that includes a 1993-onwards indicator together with its interaction with inflation. Dashed line: simple specification, with sentiment regressed on year-ended inflation and the unemployment rate. Solid line: distributed-lag specification, adding eight lags of every continuous regressor. Shaded area: 2022 onwards. Sources: ABS; RBA; ANZ–Roy Morgan; FRED.

This helps explain why sentiment has remained weak despite low unemployment and resilient household spending. The effect of an inflation shock builds over four to five quarters and fades only gradually. Households do not appear to reset their expectations as soon as inflation slows. They continue to respond to the higher level of prices and to the time it takes for incomes to catch up.

The regressions cannot cleanly separate two possible channels. One is a cumulative real-income channel: households feel worse off because prices are permanently higher relative to where they expected them to be. The other is a broader dislike of inflation itself: rising prices are visible, frustrating, uncertain and often seen as unfair (D'Acunto et al., 2023; Shiller, 1997; Stantcheva, 2024). Both interpretations point in the same direction. A temporary fall in inflation is unlikely to be enough to restore confidence if households still feel that the price shock has not been absorbed.

This also means that renewed inflation shocks can have larger effects when they arrive before households have recovered from the previous one. Higher fuel prices or further supply disruptions could extend the sentiment slump, even if the labour market remains strong. The ongoing weak readings on sentiment indicators are consistent with this pattern: households are not only responding to new price pressures, but to new pressures layered on top of an unresolved earlier shock.

Taken together, the results suggest that sentiment should be read less as a real-time measure of activity and more as a measure of the cumulative impact of price inflation. Sentiment is likely to recover only gradually, as inflation stabilises, real incomes recover, and households regain confidence that the period of rapid price increases is over.

Appendix A. Cumulative effect of sustained inflation

The local projections in Section 2.3 show how sentiment responds to a one-time inflation shock. This appendix asks a related question: how much does sentiment fall if inflation is held one percentage point higher for several consecutive quarters?

To estimate this cumulative effect, I use a distributed-lag specification with eight quarterly lags of each continuous regressor:

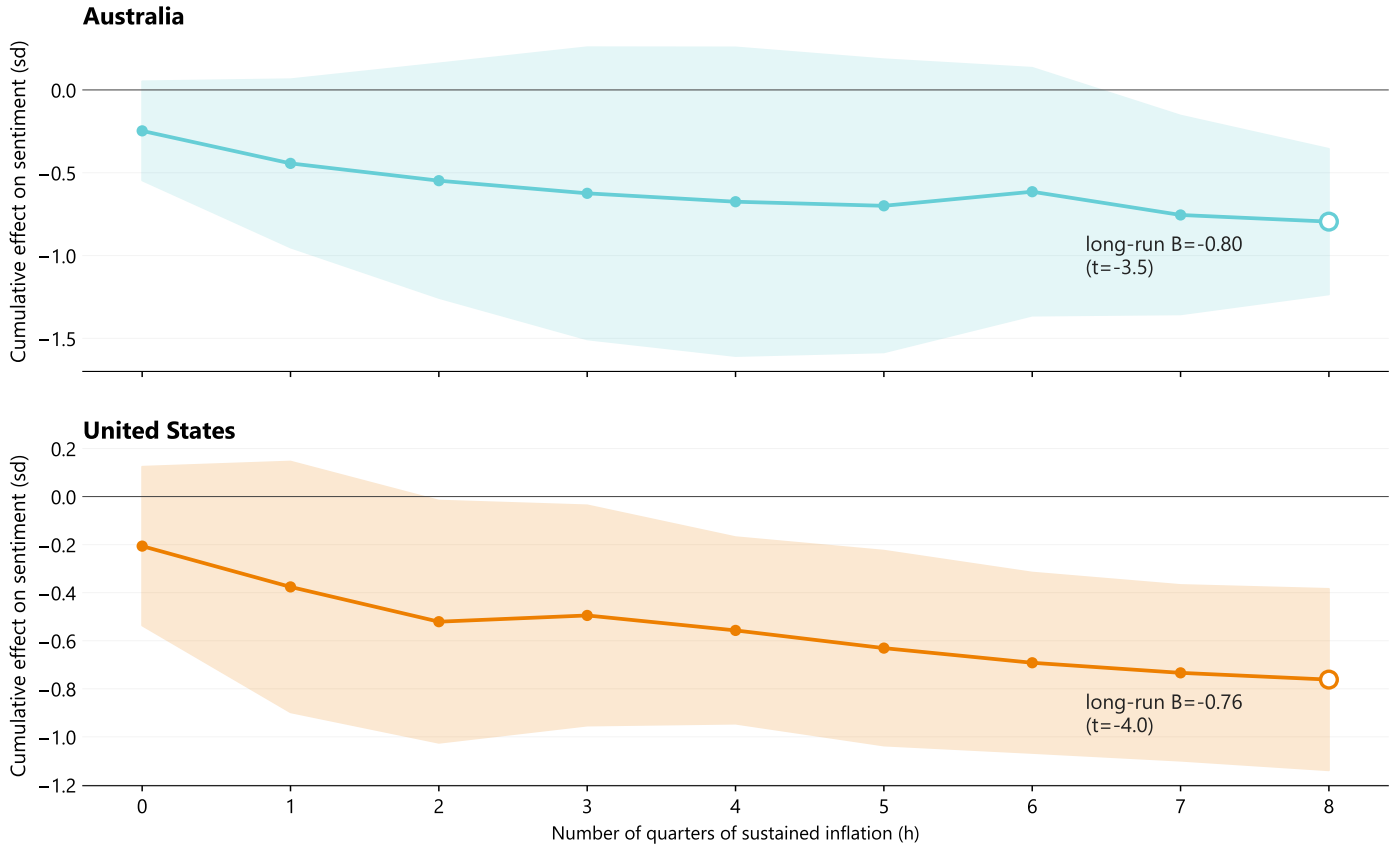
$$S_t = \alpha + \sum_{j=0}^{8} \beta_j \, \Delta p_{t-j} + \sum_{j=0}^{8} \gamma_j \, \Delta \ln c_{t-j} + \sum_{j=0}^{8} \delta_j \, \tilde{u}_{t-j} + \sum_{j=0}^{8} \phi_j \, \Delta i_{t-j} + \psi_1 \, covid_t + \psi_2 \, volcker_t + \varepsilon_t. \tag{5}$$

As in Section 2.3, $\tilde{u}_t$ is the change in the unemployment rate for Australia and the level of the unemployment rate for the United States. The cumulative inflation coefficient is

$$B_h = \sum_{j=0}^{h} \beta_j,$$

which gives the estimated effect on sentiment of inflation being one percentage point higher for h consecutive quarters. Confidence intervals are calculated using the joint HAC variance–covariance matrix of the lag coefficients.

Figure 6: Cumulative effect of sustained inflation on consumer sentiment, by horizon



Notes: cumulative inflation coefficient $B_h = \sum_{j=0}^{h} \beta_j$ from a distributed-lag specification with eight lags of each continuous regressor: quarterly inflation, household spending growth, unemployment and the change in the mortgage rate. For Australia the unemployment measure is the change in the unemployment rate; for the United States it is the unemployment rate in levels. Shaded band: 95% HAC confidence interval, using a four-quarter lag truncation. Sources: ABS; RBA; ANZ–Roy Morgan; FRED.

Figure 6 shows that the cumulative effect of inflation builds steadily over time. After eight quarters of inflation being one percentage point higher, sentiment is around 0.8 standard deviations lower in both countries: −0.80 in Australia and −0.76 in the United States.

This cumulative effect is larger than the contemporaneous relationship in Table 1. That is consistent with the main result in Section 2.3: sentiment does not respond only to the latest inflation print. It appears to absorb the effect of a sustained inflation episode over several quarters.

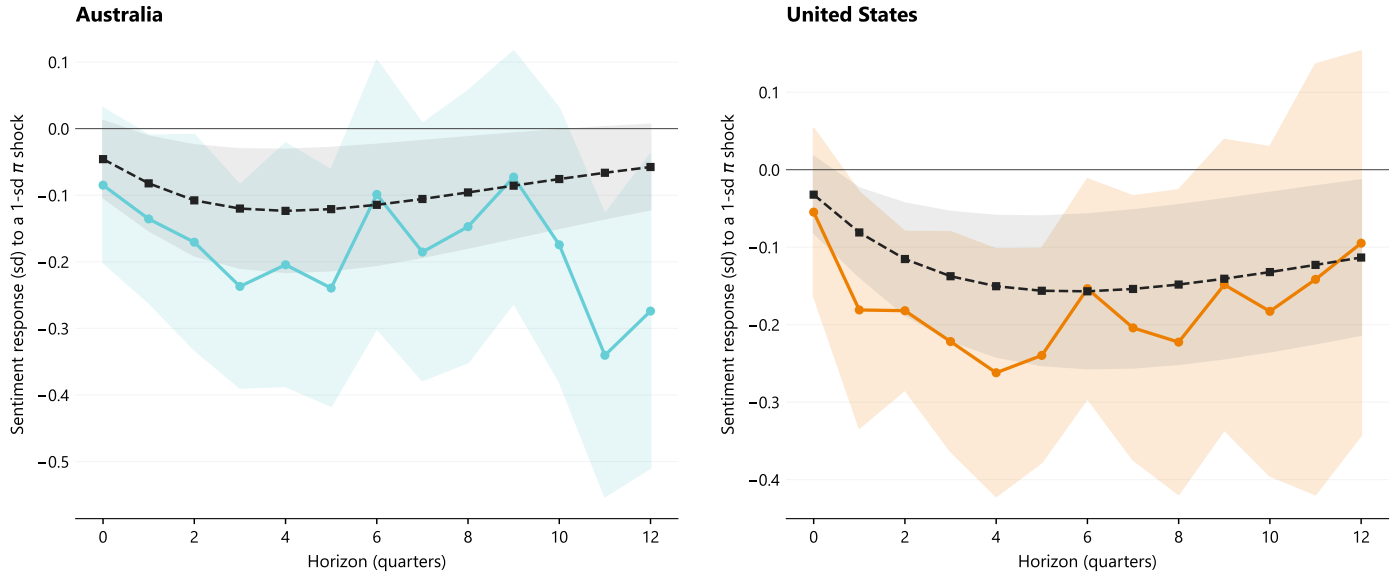
This object is different from the local-projection impulse response in Figure 3. The local projection asks how sentiment responds to a one-time inflation shock. The distributed-lag estimate here asks what happens when inflation remains elevated. The two approaches point to the same conclusion: inflation has a persistent effect on sentiment, and that effect accumulates when price growth remains high.

Appendix B. VAR estimates

As a robustness check, I re-estimate the inflation impulse response using a VAR(1) with Cholesky identification. Sentiment is ordered last, so macroeconomic shocks can affect sentiment within the same quarter, while sentiment does not contemporaneously affect the macro variables.

This specification is more restrictive than the local projections in Section 2.3: the VAR imposes a common dynamic structure across horizons, while the local projection estimates each horizon separately. The purpose of this exercise is to check whether the shape of the response is sensitive to the local-projection specification.

Figure 7: Local-projection and VAR(1) impulse responses of sentiment to an inflation shock



Notes: response of standardised sentiment at horizon *h* to a one-standard-deviation inflation shock. Solid line: lag-augmented local projection. Dashed line: VAR(1) Cholesky impulse response, with sentiment ordered last.

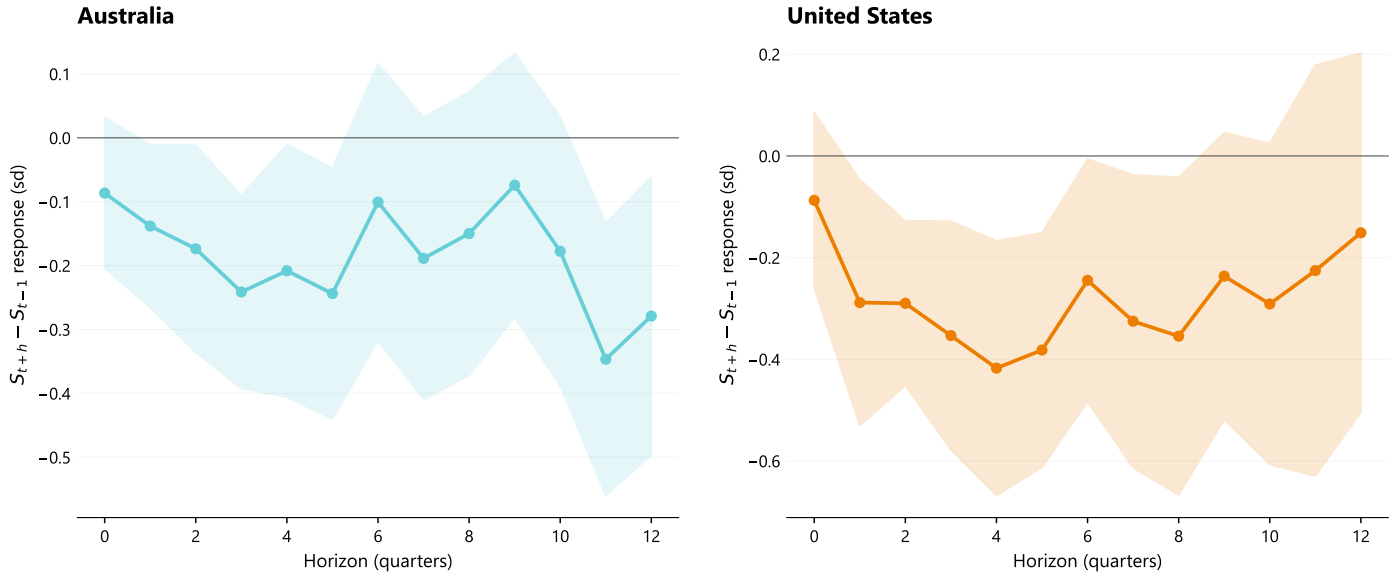
The two approaches produce the same qualitative result (Figure 7). In both countries, an inflation shock is followed by a negative and persistent decline in sentiment. The response peaks after around three to five quarters and then fades gradually. The VAR response is somewhat smaller, reflecting the additional structure imposed by the model. But the timing and persistence are very similar. This supports the main conclusion from the local projections: inflation has a delayed and persistent relationship with consumer sentiment.

Appendix C. Sentiment in differences

The local projections in Section 2.3 use sentiment in levels. This is natural because sentiment is a bounded survey index, but the series is highly persistent, especially around large shocks such as the pandemic. As a robustness check, I re-estimate the local projections using the change in sentiment as the dependent variable.

Specifically, I replace the left-hand side of equation (2) with $S_{t+h} - S_{t-1}$. This transformation removes the persistent level component of sentiment while leaving the rest of the specification unchanged. The regression still controls for lagged sentiment, lagged inflation, lagged macroeconomic conditions and the same dummy variables as in the baseline local projection.

Figure 8: Local-projection IRF with first-differenced sentiment as the dependent variable



Notes: each panel plots the response of $S_{t+h} - S_{t-1}$ to a one-percentage-point inflation shock at horizon h, with shaded 95% HAC confidence bands using a four-quarter lag truncation. The specification otherwise matches equation (2): same lagged sentiment, lagged shock and lagged control set; same dummies; same sample. Sources: as for Figure 3.

Figure 8 shows that the inflation response is very similar to the baseline result. In Australia, the response is small on impact, builds over the next three to five quarters, and remains negative at longer horizons. In the United States, the response again peaks after around four quarters and remains negative through much of the following year.

The main result is therefore not driven by treating sentiment as stationary in levels. Whether sentiment is measured in levels or changes, inflation has a delayed and persistent relationship with consumer sentiment.

Appendix D. Salience-weighted inflation

A possible explanation for the inflation–sentiment link is that households respond especially strongly to prices they see often, such as groceries and fuel (D'Acunto et al., 2023). If this is right, a price index that over-weights frequently purchased items should explain sentiment better than the standard expenditure-weighted CPI.

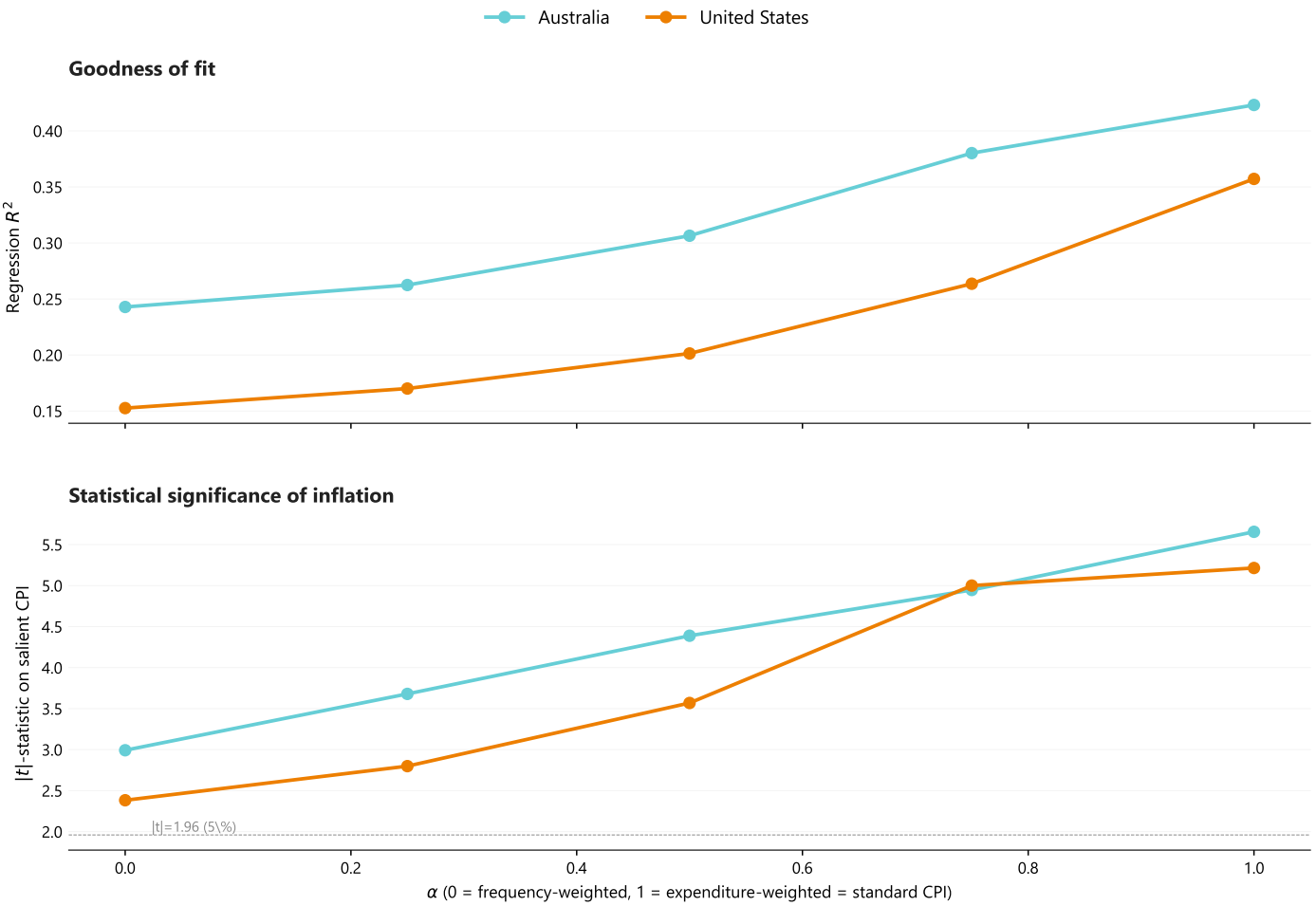
To test this, I construct salience-weighted CPI measures that vary between two extremes. At one end, prices are weighted mainly by purchase frequency, giving more weight to items such as food and fuel. At the other end, prices are weighted by their standard expenditure shares, which gives the usual headline CPI. I index this weighting by α, where $\alpha = 0$ is closest to a frequency-weighted CPI and $\alpha = 1$ is the standard expenditure-weighted CPI.

For Australia, I use three broad components: food, motor-vehicle fuel and the rest of the CPI. For the United States, I use food, gasoline, electricity, rent, shelter and core services. Purchase frequencies are stylised: food and fuel are treated as weekly purchases, housing and utilities as monthly purchases, and the residual or services components as less frequent purchases. I then re-estimate the sentiment regression across the full range of α values.

Figure 9 does not support the frequency-based salience hypothesis. In both countries, the regression fit improves as α rises. In other words, the standard expenditure-weighted CPI explains sentiment better than a CPI that over-weights frequently purchased items. In Australia, the regression R^2 rises from 0.24 under the frequency-weighted measure to 0.42 under the standard CPI. In the United States, it rises from 0.15 to 0.36.

The same conclusion holds in the distributed-lag specification from Appendix A. Replacing headline inflation with the salience-weighted CPI does not improve the dynamic fit. The fit again improves as the index moves toward the standard expenditure-weighted CPI. This suggests that, in the macro time series, sentiment is better explained by broad consumer price inflation than by a narrow index of frequently purchased items.

Figure 9: Sentiment regression fit and inflation t-statistic by salience-weighting parameter α



Notes: the salience-weighted CPI blends expenditure weights and purchase-frequency weights. Lower values of α place more weight on frequently purchased items; α = 1 gives the standard expenditure-weighted CPI. Coefficients are from regressions of standardised sentiment on the salience-weighted CPI, household spending growth, Δunemployment rate, Δmortgage rate and a COVID dummy. AU sample 1979–2025; US sample 2008–2025. Sources: ABS; BLS; ANZ–Roy Morgan; University of Michigan.

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