HSBC Global Research

7 June 2024

The Major bond letter

#50. Narrative fallacy

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Rates

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Steven Major, CFA
Global Head of Fixed Income Research
HSBC Bank Middle East Ltd, DIFC

Ever looked at the news and come away confused? Noticed how sometimes the headlines seem contradictory? You would certainly not be alone.

The title of this bond letter comes from Nassim Nicholas Taleb's *The Black Swan (2007)*[1]. Narrative fallacy is a cognitive bias in humans where, when trying to simplify a complex situation, we attach meaning or cause to something in error. It's when we use a flawed story from the past to inform our view of the future. Taleb critiqued this bias with coverage over a key event in the Iraq war (2003); we come across it all of the time in the bond market, especially around data releases, key decisions, and bond auctions.

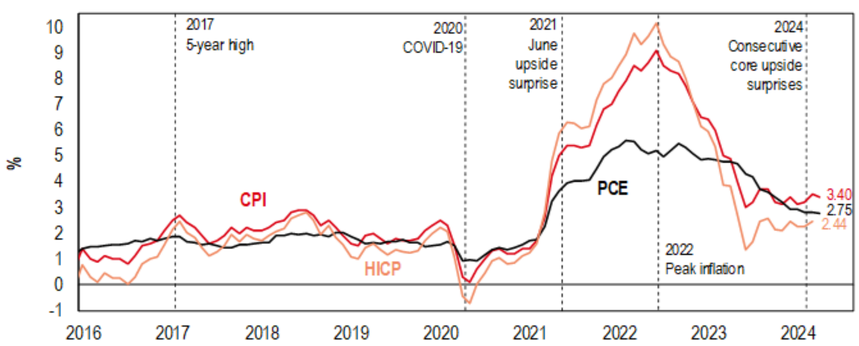
A hypothetical example in recent weeks would be "yields rise on US inflation upside surprise" followed shortly after by "rate cut probabilities increase as inflation miss not as bad as it could have been". We have totally made this up but could point to countless examples in the news flow, which we are all consuming every day. The point is that yields could have moved for any number of reasons other than inflation.

We are not criticizing journalists, who are anyway fully aware[2], and unlike when Taleb made his observation, today some of the commentary may well have been written with the help of Artificial Intelligence (AI). When a machine produces text in response to a market move, it draws on a data release or event in justification. Errors will come if humans don't spot them.

Investors are in any case better served by keeping a distance from the echo chamber of commentary solely based on the latest data release. There can be too much fuss over a 0.1% miss versus expectation on the latest inflation print. Much ado about nothing.

Our chart shows all key measures of inflation have been moving in the right direction. The reversal of the inflation surge has been symmetrical. True, not quite back to target, but focusing on the last few yards after running a mile means we might be missing the runner coming up fast on the outside.

A range of US inflation measures have fallen



Source: Bureau of Labor Statistics, Bloomberg, Bureau of Economic Analysis, HSBC

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Central banks do not base policy decisions on a single data release. Triggers and catalysts for a change in market direction anyway often come from exogenous events: a dramatic slowdown overseas, something geopolitical, a restructuring event, or something that exposes an imbalance in the system born out of previously excessive accommodation.

The explanation for higher yields is imbedded in the rise in real yields which are better explained by fiscal largesse, immigration, and AI/technology (see *The Major bond letter #49. No regrets*, 20 May 2024). There may also be concerns about central banks and their inflation targets, which could be a source of risk premium reflected in forward real yields, but this has not been evident in inflation expectations. Real yield is elevated because of real activity.

The Fed's dual mandate requires them to maximise employment and stabilise prices. Another less discussed objective is to moderate long-term interest rates. As with other central banks, there is also the requirement to monitor financial stability. All this suggests the narrative could shift away from inflation to something else, and we suggest a few examples.

First, the US real economy appears to be cooling. Data surprises have been on the downside which suggests a transition in the narrative towards something other than inflation. If (or when) a recession starts, it will not be confirmed for many months after it started. We won't see it in real time, which means all the charts we look at to monitor the variables will have to be updated.

Second, it was only four years ago when the Fed introduced flexible average inflation targeting (FAIT), and we wouldn't be surprised if something similar comes out of the next review in 2025. What if today we knew that, whilst the target for inflation was still 2.0%, it would be allowed to move in a range of 2.0-3.0%? Presumably markets would be less sensitive to small moves away from expectations.

Third, on a related point, with such a huge stock of debt - and in the absence of a better plan - the most likely outcome is financial repression. This is when inflation runs above interest rates, so that in real terms the debt is reduced over time. At 2% inflation, it takes 35 years to halve the debt, whilst at 3.0% it's about 10 years less.

Fourth, what about financial instability? With so much leverage in the system there is always the risk that market focus will shift to another deleveraging episode. It was just over a year ago that US regional banks were dominating the narrative. Short-dated yields were as much as 200bp lower than their recent peak (see *The Major bond letter #48. Triple top*, 29 April 2024)

Finally, there is the rarely mentioned objective to moderate long-term interest rates. This is sufficiently ambiguous to mean just about anything that would allow intervention in times of volatility. Increased Treasury supply risks turning each auction into a major event, with plenty of discussion around the minutiae of the results.

Our discussion of narrative fallacy in this bond letter is about seeing the wood for the trees. The narrative will likely change[3] from an obsessive focus on inflation and move to the real economy and/or financial stability.

When the narrative changes so will the direction of the market. But even with falling yields there will still be plenty of noise around each data release, as one comment contradicts another, even though it is based on the same information.

[1] Taleb, Nassim Nicholas. *The Black Swan: The Impact of the Highly Improbable* (p. 74), Penguin Books, 17 April 2007
[2] See, for example, Fox, Justin. *Why Stock Prices Fall, Rise or Both*, Bloomberg, 25 August 2015
[3] Shiller, Robert J. *Narrative Economics*, Princeton University Press, 1 October 2019

Previous editions of 'The Major bond letter'

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#2. *How to spice it up in a dull market*
#3. *New year, old narrative*
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