

What Is the Opposite of Confirmation Bias?

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CIO Weekly Perspectives



Shannon L. Saccocia, CFA, Chief Investment Officer—Private Wealth

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Many investors say they anticipate a soft landing for the U.S., but market swings suggest they are seizing on any excuse to position against that thesis.

There is a decisive and growing consensus in favor of a U.S. economic soft landing.

Or rather, that's the impression left by most comments in the financial press, or in sell-side and buy-side notes.

If instead you take your cue from the markets, you'd think investors are convinced the U.S. will tip into recession next year—except when they seem to be on high alert against a return to rising inflation.

It's rare to see market participants betting so erratically against their stated convictions. Why might it be happening, and how might investors respond?

Behind the Curve

Investors spent much of the summer pricing as if the U.S. Federal Reserve was falling behind the curve, inviting a recession due to its hesitancy to cut rates far or fast enough.

In equities, the broadening in equity market performance we have been writing about for much of the year hasn't really gained traction: Rallies in small caps, cyclical names and value stocks keep petering out. In rates, yields fell and curves steepened dramatically over

the summer; and even after the Fed gave them a 50-basis-point cut in September, futures markets responded by pricing for yet another in November.

All this happened despite U.S. inflation being above target (albeit declining), unemployment being low (albeit rising), and the economy growing at a rate of 3%—a long way from zero. So, perhaps it's no surprise that just the potential for a reversal of one of those data trends was enough to trigger a sharp turn in market positioning.

When the September U.S. payrolls report revealed a quarter-of-a-million new jobs and a tick down in the unemployment rate, futures completely abandoned their expectations for 50 basis points in November. They took a further 25 basis points out of their pricing for 2025. The two-year yield soared at a pace reminiscent of the start of the rate-hiking cycle in 2022.

Data releases sowed yet more confusion last week: When September inflation came in above expectations at the same time as (hurricane-affected) initial jobless claims spiked back to summer 2023 levels, bond prices seesawed violently. No wonder last week also saw the Merrill Lynch Option Volatility (MOVE) Index, a kind of “fixed-income VIX” that tracks the implied volatility of the U.S. Treasury market, experience one of its biggest one-day jumps since the pandemic.

In our view, these moves are symptomatic of a market careering from hard-landing to no-landing with each new data point, without bothering to stop at soft-landing—even though it is arguably the best explanation of the data and, in many cases, the core scenario in investors' outlooks.

Rare

We think these data reinforce the soft-landing thesis.

The mixed jobs-market picture does not show the type of supply-and-demand mismatch that would precipitate significant wage inflation, in our view. Nor does it suggest a universal acceleration of firing or slowdown in hiring. Instead, we believe it depicts the complexities of overlapping jobs recessions and recoveries happening across different sectors, as set out by Claudia Sahm, the ex-Fed economist and originator of the Sahm Rule.

Reluctance to fully embrace the soft-landing assumption is understandable, however. It's a difficult feat for a central bank to pull off, especially when high inflation, combined with an inflation-targeting mandate, makes it risky to give a slowing economy the monetary support it needs.

It is generally accepted that rate hikes were followed by soft landings in 1965, 1984 and 1994. Three instances are rare enough, but in 1965 and 1994 the Fed had the advantage of relatively benign inflation. And while inflation was higher during the mid-1980s hiking cycle, so was unemployment—there was a clear need to respond with rate cuts to support growth.

It is hard to put a lot of faith in those historical soft-landing models today, when inflation has been high and remains above target, but unemployment is low.

Psychological Reflex

To Erik Knutzen and Jeff Blazek's list of current sources of market volatility—geopolitics, the U.S. election, the turn in the business and monetary-policy cycles, crowded trades—we can therefore add a strange psychological reflex that is moving prices.

Because so few are confident in their core economic scenario, each new economic data point is an opportunity to fuel doubts and succumb to one's dominant fear, whether it be recession or inflation. In an odd mirror-image of confirmation bias, everyone seems to want to be convinced they are wrong.

As Erik and Jeff suggested, this is why maintaining moderate exposures right now is not an expression of timidity, but of discipline. It is difficult to feel completely comfortable with the assumption that the Fed has perfectly navigated the narrow channel between recession and inflation. But confidence is not the same as complacency, and a dispassionate assessment of economic data must admit the possibility that they can support one's thesis.

Until we see clear evidence otherwise, we think the U.S. is heading for a soft landing, and market dynamics alone will not pull us away from that conviction, in either direction.

In Case You Missed It

- U.S. Consumer Price Index: +2.4% year-over-year, +0.2% month-over-month (core consumer price index +3.3% year-over-year, +0.3% month-over-month) in September
- U.S. Producer Price Index: +1.8% year-over-year, +0.0% month-over-month in September
- University of Michigan Consumer Sentiment: -1.2 to 68.9; one-year inflation expectations +0.2% to 2.9% in October

What to Watch For

- **Thursday, October 17:**

- European Central Bank Policy Meeting
- U.S. Retail Sales
- NAHB Housing Market Index
- Japan Consumer Price Index
- China Q3 GDP
- **Friday, October 18:**
 - U.S. Building Permits
 - U.S. Housing Starts

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