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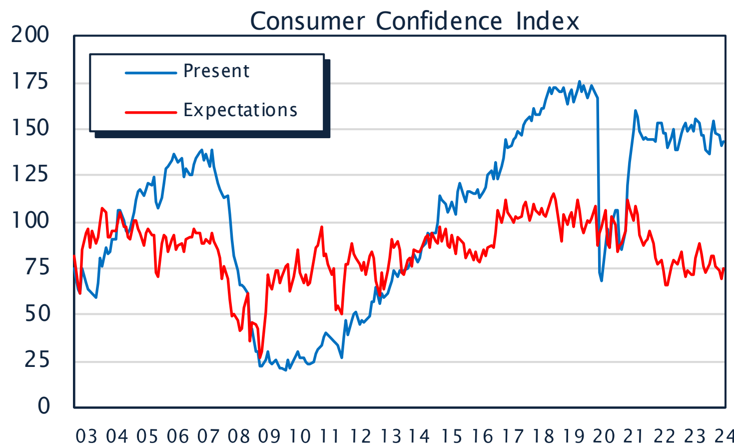
INVESTMENT UPDATE

You may have picked up on the fact that most Americans have a far more negative impression of the health of the US economy than what the actual data shows, and that gap between perception and reality doesn't appear to be closing. There's been a lot of discussion, and some actual research, into trying to explain why the US public feels so bad when most measures of economic health are so strong. We'll take a closer look at this topic in this month's *Investment Update.*

Positive consumer sentiment is, of course, critical for the long-term health of any economy; we know from decades of data that consumer behavior—whether to save or spend, and how much of each—is tied to a household's confidence in the future. And while surveys of consumer sentiment and confidence are considered "soft data" (as compared to "hard data," such as measures of inflation or unemployment), the historic correlation between how we feel and how that translates into economic growth is strong. In some ways, the argument is circular—when we're confident that our employment is secure and alternative jobs are readily available, we tend to spend more. These things go hand in hand.



But over the past few years, our behavior has diverged from our avowed feelings. We're spending, unemployment is low, the economy is healthy, but surveys show that sentiment and confidence are lagging. In May, a Harris poll showed some shocking numbers: More than half (56%) of Americans surveyed believe that the US is currently in recession (it is not, nor is it close to one), 49% believe the stock market is down so far in 2024 (it was up more than 12%, year-to-date, at the time of the survey), an equal percentage believe that US unemployment is at a 50-year high (it has been at or below 4% for the longest period in more than 50 years), and 72% said that inflation is rising (it is not). As the kids say, the results are pretty wild.

Various explanations for this disconnect from reality have been offered, including the idea that we're in a "vibecession," a term coined by author Kyla Scanlon to describe the dour mood that's pervading the American psyche. In her estimation, much of the problem stems from the recent run-up in inflation, made worse by policymakers' slow response and the resultant persistently high level of interest rates—both of which are still suppressing the typical household's free cash flow. High prices and high interest rates have a real, measurable effect on consumers, and that may psychologically overwhelm the positive data that matters to economists. According to Scanlon, inflation and high rates are hurting now, but more than that, they point to continued pain in the future, as even policymakers don't seem to know how long the current situation will continue.

This dovetails with consumer sentiment surveys, which ask for people's estimation of both current and future conditions. As the chart on this page shows, consumer confidence plummeted during COVID, especially for the "present" measure, but recovered fairly quickly, although it still sits below the pre-COVID level. In contrast, the "expectations" measure of sentiment held steady throughout COVID, but has been dropping for the past three years, and currently sits at its lowest level in more than a decade. It seems reasonable to assume that persistently elevated inflation—and the high rates that are necessary to bring inflation down (and compensate bond investors for that inflation) are weighing on households' expectations for what's ahead.

Greg Ip of the Wall Street Journal has referred to something similar—the idea of "referred pain." Here, non-economic reasons for pessimism are the culprit. Ip points to culture war issues, continuing wars in Ukraine and the Middle East, growing fear of the impact of artificial intelligence on job security, and other factors. Together, uncertainty about the future and a lack of control over how the world is changing can certainly affect people's level of optimism. Others have pointed out that the COVID pandemic showed just how fragile our existence could be, and has left psychic scars in the minds of the US population.

All these explanations have some element of the truth, but none really get to the root of the problem, particularly when it appears that so many people's pessimistic view of the future

may be based on misinformation they're getting today. We recognize that the topic of misinformation is fraught these days, and the mere mention of it elicits emotional responses from both sides of the political spectrum. We're not interested in politics, and have no interest in "choosing sides;" we're simply interested in the reasons for the current level of pessimism surrounding the current state of the US economy.

Fortunately, two researchers have taken a quantitative approach to explain the disconnect, and have found some interesting conclusions. Ben Harris and Adrian Sojourner, both of the Washington DC-based Brookings Institution (a think tank that's widely considered to be bipartisan when it comes to US politics), recently published a piece examining the relationship between economic fundamentals and economic news from 1980 to late 2023. To measure the sentiment of economic news, they used the San Francisco Fed's Economic News Sentiment Index, which measures how negative economic news reports are across 24 major US newspapers. This index examines the text of articles and op-eds relating to US economics, and assigns a score.

The authors then constructed a model, using four economic variables (US GDP, unemployment, CPI, and equity prices) to predict where the sentiment index should be based on the actual state of the US economy according to these variables. The authors noted that while four variables is fairly narrow, they didn't achieve meaningfully better results by adding more variables; these four proved to have good predictive value (when both back- and forward-tested), and they favored the "simple analytic framework" of these four major economic data series.

Here's what they found: First, to nobody's surprise, news sentiment is more positive when inflation is low, unemployment is down, stock prices are high, and economic growth is strong. Secondly, the model did an excellent job of predicting the sentiment index from 1988 to 2016 based on economic data. There were strong and weak economic periods, and for the most part, the news flow fairly represented the strength and weakness that was occurring. Any deviations between the Fed's economic sentiment index and the model were small, and were distributed roughly evenly between the model being lower or higher than the sentiment index. In short, the Fed's consumer sentiment index accurately reflected economic news, as reported, from 1988-2016. Further, when back-tested for the 1980-1988 period, the model once again performed well in predicting the tone of the news.

But then something happened. Using the same data from '88-'16 and the same methodology, the model in 2017 began showing a higher and more one-sided error, with the Fed's news-based sentiment index consistently lower than what the economic data-driven model predicted. The discrepancy between actual and predicted sentiment was wide in the 2018-2020 period, and got even wider in the 2021 to 2023 period. In other words, there has been a growing bias towards overly-negative reporting among economic news since 2016.

The conclusion to the study is that economic news became systematically more negative after 2016, and that negative bias has been growing ever since. In every year since 2017 (including every quarter from the first quarter of 2022 through the second quarter of 2023), economic news sentiment was consistently biased downward. Based on this study, Brookings estimated that inflation would have to rise by approximately 200 basis points, or for GDP to drop by 3%, for the data to be bad enough to validate consumer surveys during this period.

What's not entirely clear is why inaccurate, overly negative news isn't more carefully scrutinized—after all, it's easy enough to check the facts. Yet research has shown that people have their own biases, and one prominent study showed that social media users become more pessimistic in their outlook when exposed to narratives claiming that an economic recession is imminent. Worse, the same study showed those users' pessimistic attitudes continued to spread among their social media followers. In this way, false, overly-negative news is magnified and transmitted through social media channels.

It's tempting to blame society's ills on social media, and we're reluctant to jump to conclusions. At the same time, there's little doubt that opinions about certain issues are more polarized than ever, and that social media allows individuals to insulate themselves from news sources that don't feed their personal narrative of "the facts." Unfortunately, there are bad actors around the world who have powerful reasons to feed disinformation and foment outrage and misunderstanding. And we know this isn't a US-only phenomenon—the voters in 2022's presidential election in the Philippines were flooded by a torrent of misinformation that completely whitewashed the brutal history of the winning candidate's father (Ferdinand Marcos). We'd like to think we're the only country this is happening to, but it's a global issue.

What's this all have to do with the bond market? A misinformed public will not be making rational investment decisions, which leads to mispricing across markets. If the volume of bad decisions is large enough (think "meme stocks"), we could see market dislocations and possible opportunities for better-informed and more rational investors. We're not seeing widespread evidence of that in our markets, but it's not unthinkable that it could happen in the future.

But being well-informed isn't important just so we make good investment decisions; people need accurate information to make informed decisions about how to manage the myriad details of their lives. Glomming onto misinformation hurts us as a society, makes us less effective at addressing vital issues, and (at its worst) can lead to deep fissures in our social fabric.