Weekly Digest

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Unreliable Narrators

One well-known literary artifice is that of the Unreliable Narrator, (usually) the first-person storyteller who deceives the reader either deliberately or through incompetence. Such a narrator can lead the reader to all sorts of supposedly valid conclusions about the characters or the direction of the plot, before the truth is finally revealed. The reality is often shocking, but sometimes a surprise happy finale is revealed.

We, as humans, are particularly susceptible to the influence of narratives, because they help us to make sense of the world. Trader-turned-writer Nassim Taleb discussed the idea of the "narrative fallacy" in his seminal book "The Black Swan", opining that flawed stories from the past shape our views of the world as it is now, and also help to determine our view of the future. The theme was subsequently taken up by Daniel Kahneman in "Thinking, Fast and Slow". Our intuitive "System 1" brain is only too eager to join the dots and turn a murky picture into a high definition vision, while our lazy "System 2" brain remains reluctant to conduct the deeper analysis that could either confirm or deny the truth of the proposed narrative. Many narratives, Kahneman believes, would fail the "System 2" analysis on account of the facts that are missing. Narratives are often built with a specific purpose that deliberately excludes plenty of relevant material.

Economist and market historian Robert Shiller is the latest big shot to add to the literature, with his book "Narrative Economics", published in 2019. This, in turn, extends George Soros's theory of "reflexivity", in which Soros posited that how investors view markets affects how they invest, which, in turn, affects the markets, and so on. Shiller's theory is that as any particular narrative becomes dominant, it will affect behaviour and thus feed back into economic activity, which will itself affect policy. In the same vein, Goodhart's Law, proposed by Charles Goodhart, a former member of the Bank of England's Monetary Policy Committee, states that any when any measure becomes a target, it no longer has any use as a measure because economic actors will find alternative ways to conduct their business. Physicists have a similar theory that merely observing an object changes its state.

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At any one time there are any number of competing narratives for us to choose from, whether it be from an investment perspective, politics, daily life, or the outcome of the Euro 2020 football championships. On the latter, you would get a very different perspective from media in, say, Italy, than from the back pages of the UK press. Even so, when the trophy is presented, the sports journalists will be almost unanimous in their declaration of the inevitability of the recipient – even if it's Wales! (I mean, how could a team with a midfield trio of Gareth Bale, Aaron Ramsey and Daniel James fail to conjure up some match-winning goals between them?)

Amongst investors and economists right now, the big alpha male scrap for narrative dominance is between the inflationists and the deflationists. The inflationists definitely gained the upper hand earlier in the year, a development that was evident in the sharp rise in expected rates of inflation and bond yields. Talk of an inflationary commodity super-cycle became commonplace, and images of the 1970s were summoned from the archives. However, in recent weeks, the narrative has shifted back to one that favours a less inflationary outcome. Indeed, so powerful has this shift been that last week's higher-than-expected US consumer price data ruffled no feathers at all.

Admittedly some of that insouciance is down to the fact that investors, in aggregate, were already positioned for the "shock" reading, which itself supports the theory of reflexivity. And by pushing bond yields higher in anticipation of higher inflation, the market had already undertaken the function of tightening liquidity conditions by raising the cost of debt capital and mortgage rates, thus dampening future inflation risks.

Obviously one could tie oneself in knots trying to navigate every twist and turn in this plot. That might be fine for nimble traders and hedge funds, but hardly suits balanced portfolios that are invested for the long term. Thus we continue to rely on hard data as well as an asset allocation process that attempts to find the correct balance between risk and reward. This uses a combination of objective historical modelling and more subjective opinions as to where we are heading. And that, of course, inevitably does involve the use of some long-term narratives.

What other strong narratives are there today that are worth bearing in mind from an investment perspective? We might as well start with COVID. The dominant narrative is that the vaccine beats the virus, but that we will have to learn to live with it. Thus, so long as this holds, new variants, short-term spikes in cases and delayed re-openings should not derail the recovery, although we might be held at a stop signal for a while. Even so, recalling the Stockdale Paradox that I wrote about at the beginning of the year, I would caution against pinning one's hopes of a return to normality to any specific date. I know he's not asking for my advice, but Boris Johnson's biggest mistake (in this regard, at least) is to continue to carve dates into stone. I understand that it allows people and businesses to make plans, but it doesn't half leave him a hostage to those dates in a situation that remains incredibly dynamic.

The other compelling narrative that is dominating the investment industry is ESG – the application of Environmental, Social and Governance factors to all investment assets and the people who run them. That includes us, and I am planning that when I take my annual break from these commentaries during the summer one of my colleagues will provide an in-depth analysis of our initiatives. It is already clear, though, that ESG is a major force behind, for example, the pursuit of lower carbon emissions, with capital for "polluters" becoming more costly.

Related to ESG is the political shift towards more socially inclusive agendas, and this in turn is propelled by the new-found belief amongst supra-national organisations such as the OECD and the IMF, as well as many finance ministers (with an eye on re-election), that these can be financed with fiscal deficits. Indeed, G7

leaders fully endorsed this path in Cornwall at the weekend. These deficits could be financed by central bank purchases if necessary, under the (heavily disguised) banner of Modern Monetary Theory, as well as by more redistributive tax policies. There has already been some evidence of the potential influence of the latter, seen in capital gains tax-related selling of assets in the United States to avoid payments at higher rates in the future.

And while we're on tax, don't tell me that the UK's Stamp Duty holiday has not contributed to at least some distortion in the residential market. House price rises of 10% a year put a smile on the face of homeowners, and possibly lead to increased consumption owing to the wealth effect, but they also make life even more difficult for first-time buyers. And when the holiday ends, there will no doubt be much angst about the inevitable slowdown, which will then pose another conundrum to the Bank of England in terms of timing its policy tightening. Nothing is straightforward!

On the geopolitical front, it is the deterioration of relations between the US and China that dominates. Remember that the narrative used to be that China's entry into the world economy was positive, and it certainly was a major contributor to the disinflationary forces of the past few decades. No more. It is now viewed as the aggressor, and not without some justification, especially since President Xi's pivot towards a more pure form of communist leadership, and the extension of his term in office (never a positive sign when it comes to leaders). The stand-off between the two countries is at least partly responsible for some of the current supply-chain bottlenecks, but will also massively influence future investment plans, such as moving component manufacturing back on-shore to the US.

There is no shortage of other potential narratives to relate, whether at the macro level or down to the business model of the smallest companies, and I might well return to this theme. I was once myself involved in a (very) small private company, and even at the time I knew that the narrative of the business plan was a lot more compelling than its precarious finances and its position in an industry notorious for consuming investors' capital without giving much by way of return. Its demise was as predictable as you might expect, but at least the return on social and intellectual capital more than made up for the financial losses, and I ended up meeting people and going to places that I would otherwise have not. At least that's the narrative I have constructed to justify my long written-off investment!

Last week’s Economic Highlights

FTSE 100 Weekly Winners

Company	Change
Auto Trader Group PLC	11.3%
BT Group plc	8.4%
Intermediate Capital Group plc	6.1%
Pennon Group Plc	5.8%
Rightmove plc	5.3%
DS Smith Plc	4.7%
Flutter Entertainment Plc	4.4%

FTSE 100 Weekly Losers

Company	Change
J Sainsbury plc	-4.9%
Ashtead Group plc	-3.4%
Barratt Developments PLC	-3.3%
Anglo American plc	-2.9%
Taylor Wimpey plc	-2.9%
Ferguson Plc	-2.6%
Persimmon Plc	-2.5%

FTSE 100 Index, Past 12 months

Source: Factset

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