

Extrapolative Investor Demand and Reflexivity in Credit Booms and Busts

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Abstract

We quantify the price effects of extrapolation—investors’ tendency to extrapolate past trends into the future—and reflexivity—a feedback loop between extrapolation and prices—by heterogeneous investors on credit prices. Our demand system motivated by a micro-founded model captures the reflexivity of extrapolative demand: When credit spreads decrease, extrapolative investors increase demand for higher-yield bonds, further compressing credit spreads and intensifying demand for these bonds. Our findings indicate that extrapolative demand and reflexivity account for 10–22% of variation in aggregate and individual credit spreads. Mutual funds with larger size, capital inflows, and high-yield strategies are major extrapolators, fueling credit overheating, while insurance companies are not. These demand-driven changes in aggregate credit spreads also predict future GDP growth.

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