

## **Dismal Science—Dismal Record**

In 1798, economist Thomas Malthus predicted that the world's population growth would inevitably surpass the growth of the world's food supply, causing mass starvation. At the time, the field of economics was still considered a pure social science similar to sociology and psychology. So, a prediction based on demographics was within the purview of the economist in 1798. It has been said that, a few years after the Malthus prediction, historian Thomas Carlyle referred to Malthus and other economists of that era as "respectable professors of the Dismal Science." Although the Malthus discourse would not be considered an economic forecast today, the label "Dismal Science" stuck, thanks to the historically poor track record of economic forecasters since the nineteenth century.

### **Reign of Error**

Many published studies over the years demonstrate how economists have routinely failed to predict turning points in the economy. William Sheridan, in his book *The Fortune Sellers: The Big Business of Buying and Selling Predictions*, reviewed leading research on the accuracy of economic forecasts since the 1970s. He found that economists had failed to predict the past four most severe recessions and that the consensus forecast had called for economic growth in each case. Sheridan also noted that forecasting skill, on average, is equivalent to guessing. In addition, more powerful computers, more complicated models, and greater amounts of data did not improve the accuracy of the forecasts. Sheridan found no evidence to suggest that forecasting skill has improved since 1970 or that any individual forecaster was consistently more accurate than his peers.

Even with this poor track record, economists are still featured in the financial press. As a group, economists are interesting to listen to, and their observations are very convincing. Unfortunately, they are frequently wrong. Every six months, *The Wall Street Journal* publishes a survey of interest-rate predictions from prominent economists. Recently, noted fixed-income researcher, Jim Bianco, studied over 20 years worth of *The Wall Street Journal's* interest-rate surveys. The study found that professional economists, as a group, successfully predicted the future direction of interest rates only 30% of the time. These results were consistent with an earlier study by bond manager Ronald Ryan, and they are damning. Not only were the professional economists unable to predict the level of interest rates with any accuracy, but also, they could not successfully predict whether interest rates would go up or down during the next six months. In fact, flipping a coin (50% probability) gives you better odds at predicting the direction of interest rates than the pros' 30% success rate.

Despite man's heroic efforts to develop consistent, predictable economic forecasting methods, accuracy remains elusive. Forecasting continues to be difficult in part because the data that economists rely upon is frequently revised and updated. One only has to look back to the 1992 Presidential election to be reminded of how material economic data revisions can be. Recall how Bill Clinton adopted the central campaign theme, "It's the economy, stupid." Clinton successfully hammered away at Bush's supposedly poor economic record and won the election. Two years later, the government revised the 1990-1993 GNP growth by 25% and real disposable income by 70%. *Business Week* reported that while Clinton was criticizing Bush's performance, the economy was actually growing at a healthy 5.7%. It would seem that forecasting inaccuracies are inevitable when the prediction is based upon preliminary and frequently changing data.

### **Fed Versus Wall Street**

We are not suggesting that economic forecasts serve no value. Clearly, these forecasts are vital in setting public monetary policy and in the federal budget process. Our primary concern is in how economic

forecasts are used. Fortunately, the most important consumer of economic forecasts, the Federal Open Market Committee (FOMC), recognizes the weaknesses and limitations that are characteristic of these predictions.

Recently, the Federal Reserve Bank of St. Louis performed several studies on forecast accuracy and concluded that economic forecasts are subject to an inherent range of error. Their study suggests that the standard error for a one-year-ahead forecast is about 1.4 percentage points. This means that forecasted growth (GDP) of 4.5% results in a forecast range between 3% and 6%. Normally, people would interpret 6% growth as robust, while a 3% growth rate would likely create fear that the economic recovery is failing. This forecast range not only creates monetary policy challenges, but the study also suggests that, 33% of the time, actual growth will fall outside of the range of error. It is these economic forecast surprises that Federal Reserve Bank of St. Louis President William Poole said are most important. Poole said, "Forecast errors create risk, and that risk needs to be managed as efficiently as possible. The surprises that create forecast errors also create the need for policy changes that can't be anticipated in advance because the surprises can't be anticipated."

The Federal Reserve's view of economic forecasting is much more realistic and responsible than the typical message you hear from Wall Street economists. Over the years, the role of the Wall Street economist has changed from an internal adviser on trading management to that of a public relations specialist. The primary responsibility of the modern-day Wall Street economist is to burnish the image of his firm. Hopefully, he does this while providing insightful forecasts, but in any event he must keep himself in the limelight.

Unfortunately, it appears to matter very little if Wall Street's economic forecasts are right or wrong. People rarely remember what was actually said. They do, however, recognize that the economist is frequently seen and quoted in the financial press, which further establishes his credentials as an expert and brings recognition for his firm.

The desire for media attention is so great that some economists will seek to differentiate their message by producing forecasts that vary sharply with the consensus opinion. As long as the prediction is not perceived as ridiculous, it will probably garner some press, as there seems to be an ever present constituency for both the overly optimistic forecast and the gloom and doom forecast. Economists risk very little by making these types of predictions. If your forecast happens to be on target, you will receive favorable publicity.

If you are consistently wrong, there will be plenty of company from others whose predictions are also inaccurate. Furthermore, the public is likely to forget a prediction but remember that you have been quoted.

## **Moral For Investors**

Even with the inherent risks and limitations of economic forecasting, many investors and managers base their investment strategies on an economic prediction. This approach is referred to as "top-down" investing. The investment research begins with an expectation for the economy (the top), which determines the economic sectors upon which to focus. The analysis then shifts down to the industry level, attempting to identify the industries that will most benefit from the given economic forecast. After this, individual stocks are selected from the most attractive industries. The obvious problem with a "top-down" approach is that the investment strategy is based upon an economic forecast that has a high probability of being wrong.

Alternatively, a “bottom-up” strategy begins at the stock level. Investments are selected based on the characteristics of the stock, not on an expectation for the economy. At CornerCap, our research employs a “bottom-up” approach. We have found that it is more profitable to identify quality companies that trade at attractive prices for their underlying earnings and cash flows than it is to predict which way the economy might be heading.

We are not the only ones to come to this conclusion. Many renowned investors of the past and present also have questioned the value of economic forecasting. This list of investors includes Ben Graham, who is considered the father of modern security analysis, Phillip Fisher, and John Neff, to name a few. Perhaps the most famous investor today, Warren Buffett, made the following comments in 1994:

We will continue to ignore political and economic forecasts, which are an expensive distraction for many investors. Thirty years ago, no one could have foreseen the huge expansion of the Vietnam War, wage and price controls, two oil shocks and the dissolution of the Soviet Union. But, surprise, none of these blockbuster events made the slightest dent in Ben Graham’s investment principles. . . . A different set of major shocks is sure to occur in the next 30 years. We will neither try to predict these nor profit from them.

So why do “top-down” strategies continue to be so popular? It is simple—they sell! The “bottom-up” approach lacks the marketing sizzle of “top-down” investing. Overlooking the historical inaccuracies of economic forecasting, nervous investors find a sense of security in adopting the predictions of the highly educated, articulate economist. A herd-like mentality is created. Uncertain of the future, the typical investor cannot stand the thought of being wrong and alone. It is much more comforting to be wrong along with the sharpest minds on Wall Street.