Forecasting

"Forecasts usually tell us more of the forecaster than of the future." - Warren Buffett

Put Forecasting in Its Final Resting Place

DEC 14, 2016

By Barry Ritholtz

One of the things I failed to learn after writing a book was the simple fact that methodically demonstrating a thing with data and evidence doesn't resolve that issue. I shouldn't have been so naive ....

Which is why, despite all of the earlier discussions about the folly of forecasts, I find myself once again compelled to bring up this subject. Blame it on the time of year, when all of the forecasts for 2017 are being rolled out, while the old ones that were so-often wrong are forgotten instead of being reviewed.

So please consider this column a public service. Here is a round-up of some of 2016's forecasts, and a look at why they didn't quite work out as expected:

• Get Ready for $80 Oil: "When oil drilling activity collapses, oil supply goes down too." That may or may not be true, but one thing we know is that oil never got anywhere near $80 this year, peaking at about $53 earlier this week. The error here is assuming you can: Accurately measure a drilling activity slowdown; figure out what that impact will be on supply; and determine how that will affect prices. This forecast, made by Raymond James, tried to thread that needle. It didn't happen.

• The recession of 2016: "Central bank bungles, oil price fluctuations and overregulation indicate contraction." This forecast, published in the reliably ideological Washington Times, commits the classic analytical error of infusing emotional politics into forecasts. The author opposed the Federal Reserve's program of quantitative easing as well as government regulations, so *of course* these things will cause a recession! Only, they didn't. Economic analysis colored by political bias equals awful investing advice.

• Recession sign is in play and has 81% accuracy: Recessions have followed consecutive quarters of corporate earnings declines (whenever that happens) four out of five times, according to JPMorgan Chase & Co. strategists. There are at least two reasons for this: First, as we have discussed before, relying on a single variable to explain a complex system such as the economy is a poor approach to analysis. The world is just not black and white. Second, it confuses correlation with causation.

• Billionaire Sam Zell Says Recession Likely in Next 12 Months: This one blames the Fed and the strong dollar, which fell in the six months after Zell's prediction. We have discussed Zell's call before, but a few words about the halo effect, or the tendency to give people successful in one field more credibility than is warranted in other areas. Although we have to give credit to a billionaires' ability to make money, they probably don't have a comparable ability to foretell recessions.

• Why Gold Will See $2,000: Gold bugs are too easy to debunk. But as a reminder, the market has managed to figure out that China and India are net buyers of gold, and have been for thousands of years. That isn't what is going to drive its price, which never reached more than about $1,375 this year.

• Debate Night Message: The Markets Are Afraid of Donald Trump: "Wall Street fears a Trump presidency.

Stocks may lose 10 to 12 percent of their value if he wins the November election, and there may be a broader economic downturn." So wrote Justin Wolfers in the New York Times on Sept. 30, based on a "close analysis of financial markets during Monday's presidential debate." This looks like another classic error of causation and correlation. This prediction, for all we know, may yet prove true. But we have to note that since the election, the Standard & Poor's 500 Index is up 6 percent.

• This Dow rally will end March 23: This forecast was made on Feb. 16, so at least it didn't have much shelf life. Studies have shown that people prefer false precision to accurate ambiguity. The forecaster who tells you that the future is inherently unknowable, and all forecasts 12 months out are just guesses isn't as well received as someone saying with certainty that the Dow Jones Industrial Average will top 21,000 on the day Donald Trump is inaugurated as president. Why don't investors recognize this? The answer is quite simple: It is just human nature.

Those who make forecasts for a living, or are asked to do so by the news media, should use the opportunity when they make a prediction to point out the absurdity of the exercise. My own 2017 predictions attempt to do just that.

The bottom line remains: forecasts and predictions are exercises in marketing. Outrageous and wrong forecasts are typically forgotten, and when one randomly happens to come true, the guru is lauded as the next Nostradamus. It is an expensive and fatuous practice, and the finance industry should give it a permanent rest.

Our thoughts

As previously shared, we were wrong on Brexit, Trump (reassuring several nervous clients and far more incredulous Chinese and Japanese during our trip to Asia this summer that America wouldn't succumb, this time around, to the populism that was engulfing Europe) and OPEC (the 2 experts we follow were in agreement that OPEC wouldn't cut production so we, unfortunately, held off on adding another E&P stock that met our criteria). Yet our clients profited more than most after these events due to our academic approach to investing. Our Factor driven, Quantitative process doesn't involve macroeconomic or political forecasts.

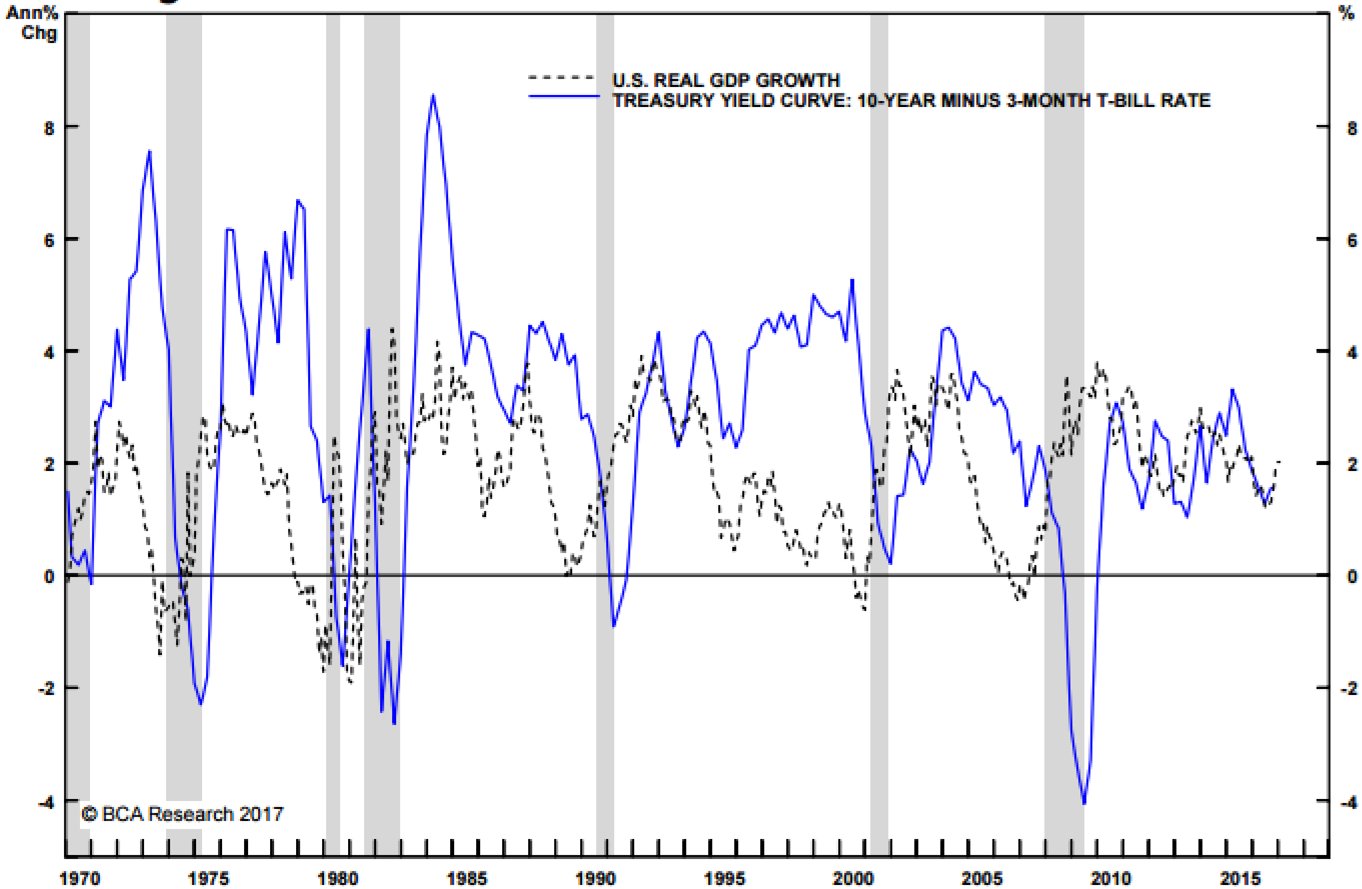
However, Mr. Market is schizophrenic. His overreaction to the latest headlines will occasionally provide opportunity. If corporate insiders within a segment of the market are buying, it is important to understand the risks from following their lead, and for that a base forecast is needed. Ours comes from BCA Research. Although we don't rely on their, or anyone else's, market calls, their track record on the economy, interest rates, etc. is better than most. So here is a portion of their 2017 Outlook:

We do not expect a recession in the next year or two, absent some new major negative shock. But by the time we get to 2019, the recovery will be ten years old and normal late-cycle pressures should be increasingly apparent. The labor market already is quite tight, with wages growing at their fastest pace in eight years, according to the Atlanta Fed's wage tracker ....

Historically, most recessions were triggered by tight monetary policy with a flat or inverted yield curve being a reliable indicator (Chart 16). Obviously, that is extremely hard to achieve when short-term rates are at extremely low levels. However, if the Fed raises the funds rate to around 3% by the end of 2019, as it currently predicts, then it will be quite possible to again have a flat or inverted curve during that year.

CHART 16

No Sign Of A U.S. Recession



NOTE: SHADING DENOTES NBER-DESIGNATED RECESSIONS.

The recent environment of modest growth has kept inflation low and forced the Fed to maintain a highly accommodative stance. As spare capacity is absorbed, the Fed will be forced to tighten, raising the odds of a policy overshoot. And this is all without taking account of the potential threat of a trade war. ...

The global economy still has lots of problems, and we are a long way from boom-like conditions. The IMF predicts that 2017 growth in the euro area and China will be below the 2016 level, and forecasts for the U.K. have been revised down sharply since the Brexit vote. On a more positive note, the firming in commodity prices should help some previously hard-hit emerging economies. Overall global growth may not pick up much over the coming year, but it would be a significant change for the better if we finally stop the cycle of endless forecast downgrades. ...

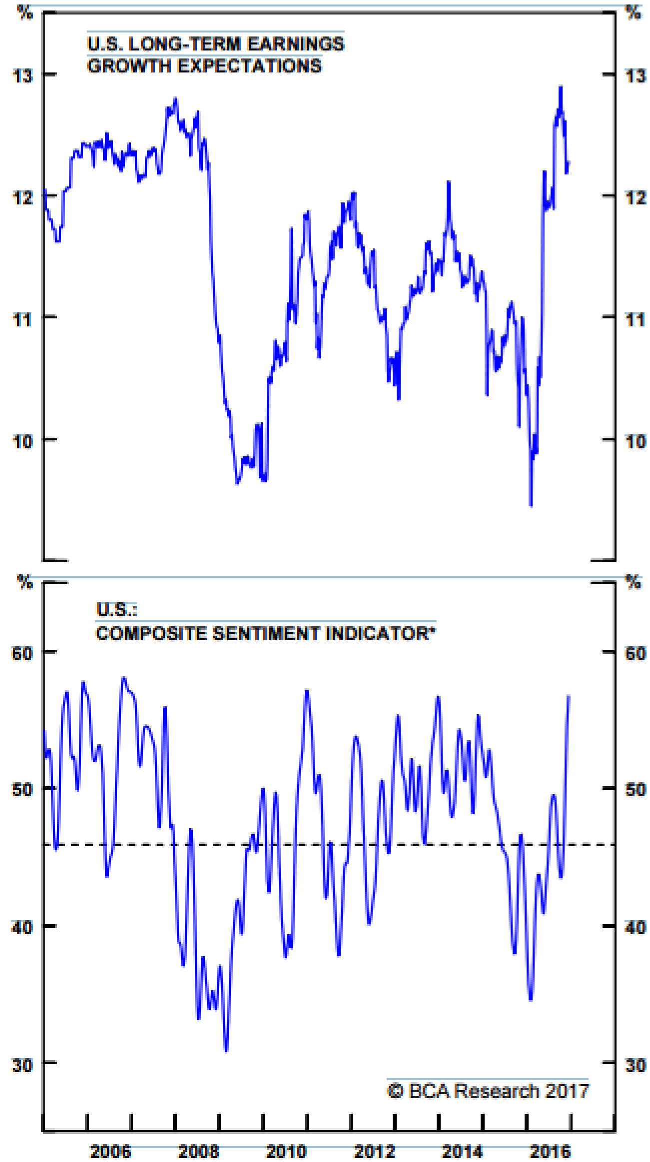
The late-2016 sell-off in bonds was violent and yields rose too far, too fast. So we recently shifted our tactical bond recommendation from underweight (short duration) to neutral. ... The underlying story for bonds – especially in the U.S. – is bearish. The prospect of fiscal stimulus, rising short rates and a pickup in inflation suggests that U.S. yields will be higher over the next 12 months. Although yields may decline somewhat in the very near-term, we doubt the move will be significant enough or last long enough to warrant an overweight position. ...

Analysts' expectations of long-run earnings growth for the S&P 500 universe have risen to 12%, which is at the high end of its range over the past decade (Chart 27). ... surveys show an elevated level of optimism on the part of investors and traders.

The outlook for earnings is the most critical issue when it comes to the longrun outlook for stocks. Low interest rates provide an important base of support, but as we noted earlier, rates are more likely to rise than fall over the next couple of years, possibly reaching a level that precipitates a recession in 2019.

Investors are excited about the prospect that U.S. earnings will benefit from both faster economic growth and a drop in corporate tax rates. We don't disagree that those trends would be positive, but there is another important issue to consider. One of the defining characteristics of the past several years has been the extraordinary performance of profit margins which have averaged record levels, despite the weak economic recovery.... The roots of this rise lay in the fact that businesses rather than employees were able to capture most of the benefits of rising productivity. This showed up in the growing gap between real employee compensation and productivity. As a result, the owners of capital benefited, while the labor share of income – previously a very mean reverting series – dropped to extremely low levels. The causes of this divergence are complex but include the impact of globalization, technology and a more competitive labor market.

CHART 27
Too Much Optimism On Wall Street?



*BASED ON ADVISOR, INDIVIDUAL INVESTOR AND TRADER SENTIMENT. SHOWN SMOOTHED EXCEPT FOR LATEST DATAPOINT.

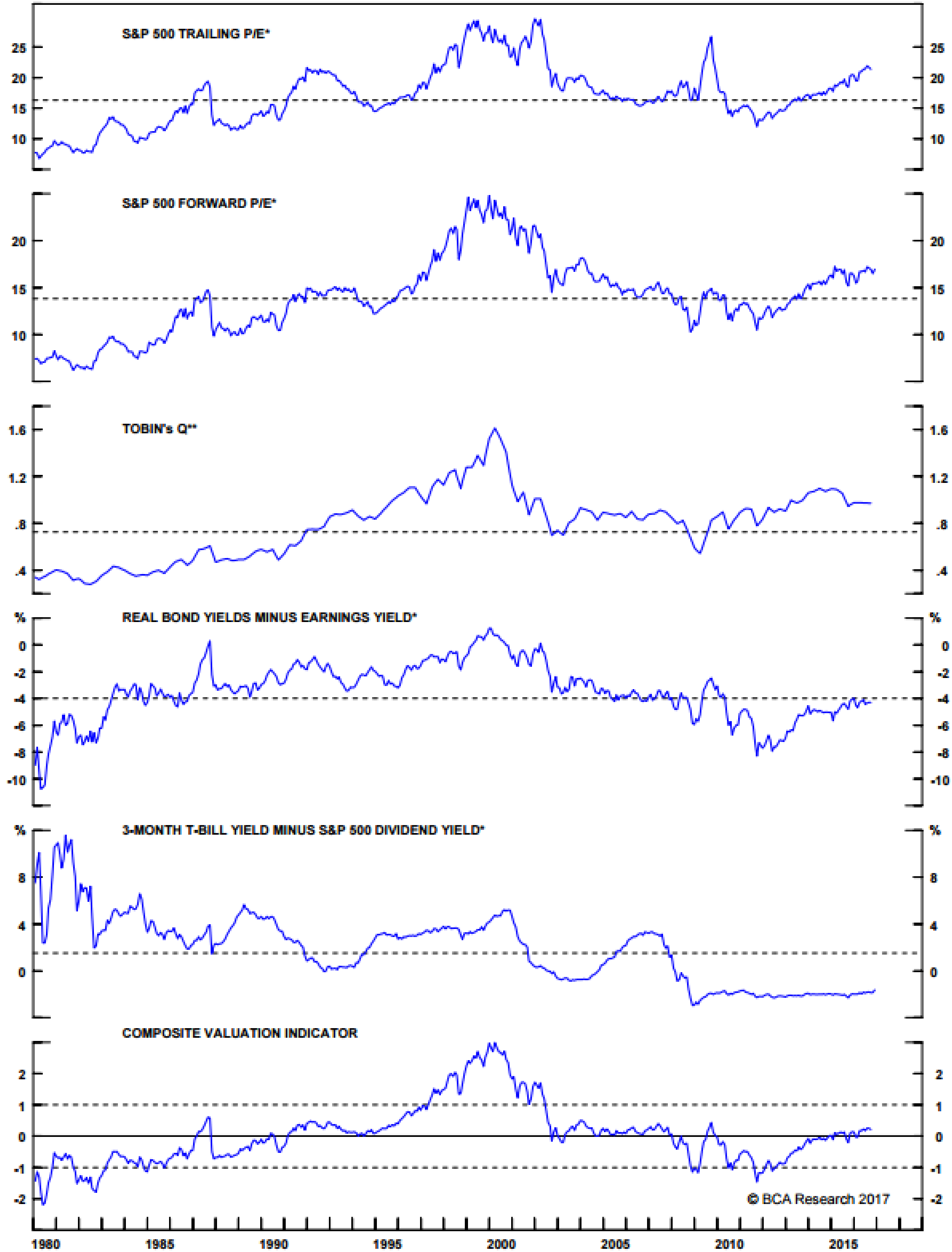
With the U.S. unemployment back close to full-employment levels, the tide is now turning in favor of labor. The labor share of income is rising and this trend likely will continue as the economy strengthens. And any moves by the incoming administration to erect barriers to trade and/or immigration would underpin the trend. The implication is that profit margins are more likely to compress than expand in the coming years, suggesting that analysts are far too optimistic about earnings. Long-term growth will be closer to 5% than 12%. The turnaround in the corporate income shares going to labor versus capital represents another important element of our theme of regime changes.

None of this means that the stock market faces an imminent plunge. Poor value and over-optimism about earnings raises a red flag over long-term return prospects, but says little about near term moves. As we all know, market overshoots can move to much greater extremes and last for much longer than one can rationally predict. And the fact remains that the conditions for an overshoot could well persist for another 12 months or even longer.

Optimism about the economic benefits of the new administration's policies should last for a while as proposals for tax cuts and increased fiscal spending get debated. Meanwhile, although the Fed plans to raise rates again over the next year, the level of interest rates will remain low by historical standards, sustaining the incentive to put money into stocks rather than interest-bearing assets. ...

CHART 29

The U.S. Market Is Modestly Expensive



*HORIZONTAL LINE DENOTES LONG-TERM AVERAGE, 1955-2016.
**NONFINANCIAL CORPORATE MARKET VALUE OF EQUITIES DIVIDED BY BUSINESS NET WORTH.

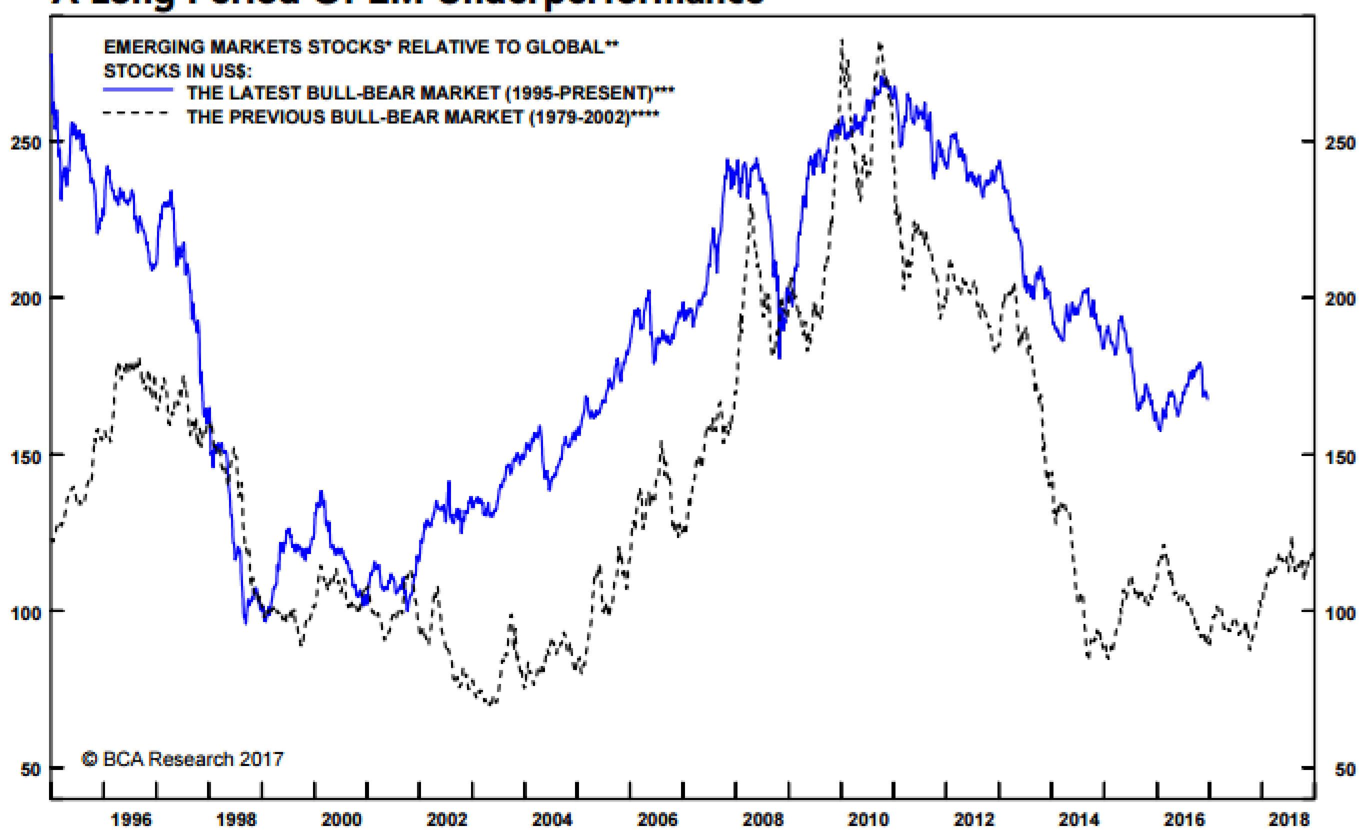
The U.S. market is only modestly overvalued, based on an average of different measures. It is expensive based on both trailing and forward earnings and relative to book value, but cheap compared to interest rates and bond yields. A composite valuation index based on five components suggests that the S&P 500 currently is only modestly above its 60-year average (Chart 29). Valuation is not an impediment to further significant gains in U.S. equities over the coming year although it is more attractive in other markets. ...

As you know, valuation is not the only consideration when it comes to investing. Nonetheless, the direction of monetary policy also would support a better outlook for Japan and the euro area given that the Fed is raising rates while the ECB and BoJ are still implementing QE policies. Exchange rate moves complicate things a bit because further gains in the dollar would neutralize some of the relative outperformance when expressed in common currency. Even so, we would expect the euro area and Japan to outperform the U.S. over the next 12 months. The one important qualification is that we assume no new major political shocks come from Europe. A resurgence of political uncertainty in the euro area would poses the greatest threat to the peripheral countries, which partly explains why they are trading at more attractive valuations than the core. ...

The global underperformance of EM has lasted for six years and may be close to ending. But the experience of the previous cycle of underperformance suggests we could have a drawn-out bottoming process rather than a quick rebound (Chart 32). Emerging equities look like decent value on the simple basis of relative price-earnings ratios (PER), but the comparison continues to be flattered by the valuations of just two sectors – materials and financials. Valuations are less compelling if you look at relative PERs on the basis of equally-weighted sectors ....

CHART 32

A Long Period Of EM Underperformance



*SOURCE: MSCI Inc. (SEE COPYRIGHT DECLARATION).
**SOURCE: THOMSON REUTERS / IBES.
***REBASED TO 100 AT JANUARY 1999.
****REBASED TO 100 AT JANUARY 1983.

More importantly, the cyclical and structural issues undermining EM equities have yet to be resolved. The deleveraging cycle is still at an early stage, the return on equity remains extremely low, and earnings revisions are still negative. The failure of the past year's rebound in nonoil commodity prices to be matched by strong gains in EM equities highlights the drag from more fundamental forces. ...

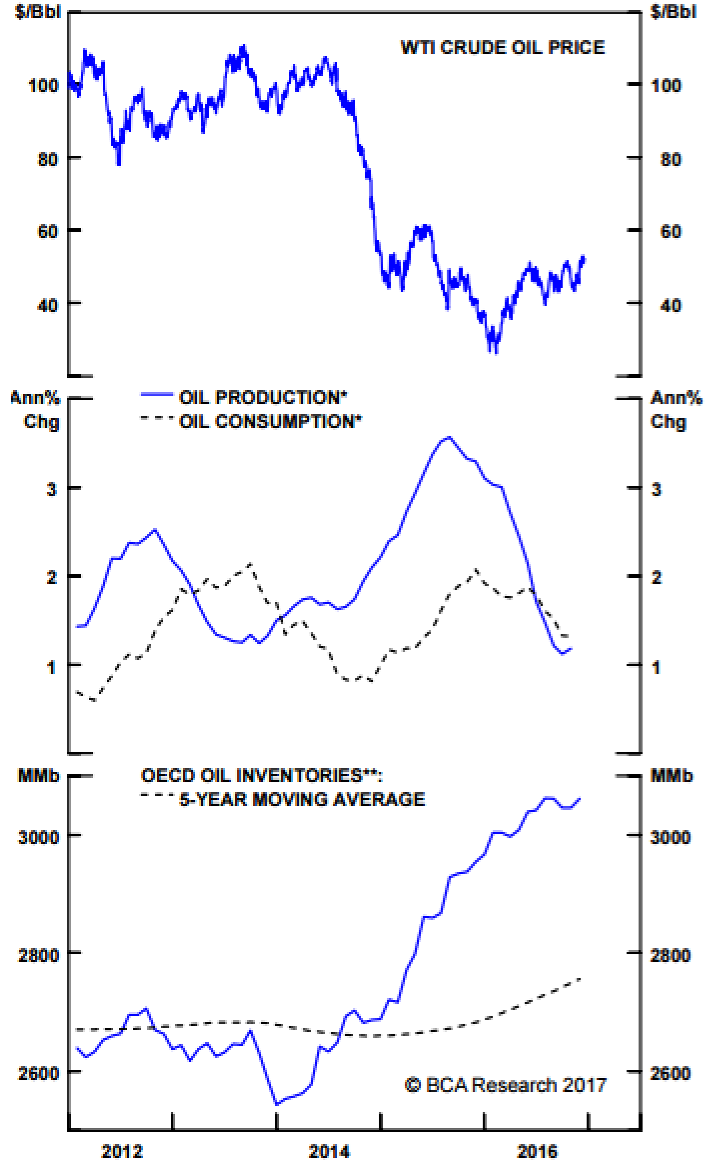
On a longer-term basis, one likely long-lasting effect of the retreat from globalization is that "small is beautiful." Companies with large global footprints will suffer relative to domestically focused firms. One way to position for this change is to emphasize small caps at the expense of large caps, a strategy applicable in almost every region. Small caps are traditionally domestically geared irrespective of their domicile.

In the U.S. specifically, small caps face a potential additional benefit. If the new administration follows through with promised corporate tax cuts, then small caps will benefit disproportionately given that the effective tax rate of multinationals is already low. Moreover, small companies would benefit most from any cuts in regulations.

We have moved our forecast up to an average of $55/bbl following the recent 1.8 million b/d production cuts agreed between OPEC, led by Saudi Arabia, and non-OPEC, led by Russia. The economic pain from the drop in prices finally forced Saudi Arabia to blink and abandon its previous strategy of maintaining output despite falling prices. Of course, OPEC has a very spotty record of sticking with its plans and we expect that we will end up with a more modest 1.1 to 1.2 million b/d in actual output reductions. Yet, given global demand growth of around 1.3 million b/d and weakness in other non-OPEC output, these cuts will be enough to require a drawdown in inventories from current record levels.

CHART 35

Oil Market Trends



*ANNUAL GROWTH OF 12-MONTH MOVING AVERAGE.
**SOURCE: OECD.

Even with the lower level of cuts that we expect, OECD oil inventories could drop by around 300 million barrels by late 2017, enough to bring down stocks roughly to their five-year average level (Chart 35). That is the stated goal of Saudi Arabia and the odds are good that the level of compliance to the cuts will be better than the market expects. ...

We expect U.S. shale-oil production to bottom in the first quarter of 2017, followed by a production increase of around 200,000 b/d in the second half. However, that will not be enough to drive prices back down.

The bigger risk to oil prices over the next year or two is for a rise, not a decline given the industry's massive cutbacks in capital spending. More than $1 trillion of planned capex has been cut for the next several years, which translates into more than seven million b/d of oil-equivalent (oil and natural gas) production that will not be developed. And increased shale production cannot fully offset that. In addition to meeting demand growth, new production also must offset natural decline rates, which amount to 8% to 10% of production annually. Replacing these losses becomes more difficult as shale-oil output increases, given its very high decline rates. Shale technology appears to be gaining traction in Russia, which could end up significantly boosting production but capex cuts will constrain the global supply outlook until after 2018.