

The View from the Land of Steady Habits
Investing and Economics

Reasonably well informed investors need to know something about economics in order to understand the broad setting for consumer spending, business profitability, and investor opportunity. This is especially true when it comes to the effects of inflection points on economic performance and investment returns. What happens when economic growth stalls and a recession sets in? What happens when a recession ends and the economy starts to recover? What will consumer and business performance look like at those times? What signals should investors look for to protect themselves from losses or to take advantage of gains in the market?

One of the biggest challenges for investors is finding reasonable forward-looking economic analysis – and for good reason. Economists, in general, are dreadful at forecasting the future, and probably for several reasons.

First, forecasting the economy is like weather forecasting, only harder. The U.S. and the global economy is one vast, chaotic system subject to innumerable influences both fundamental and psychological. Comprehending this system is beyond the reach of the normal human brain, which is accustomed to making judgments on the basis of a small number of factors. The elaborate econometric models economists have built of the economy have had little success in predicting major turning points despite their successes in forecasting results in a steady state environment.

Second, economics is primarily a descriptive science. Ideally, a good description may have predictive value, but producing the description is largely a matter of studying historical data. Much of economics, therefore, is backward-looking, and as a result, economic forecasts on average appear to be heavily influenced by recent past performance. If an inflection point is approaching, economists seem as likely not to see it coming as the lay person.

Third, economic forecasting is heavily influenced by the consensus view. Of course, an economist might object and say that the consensus view is nothing other than the average position of the independent outlooks of each economist. Even if this were true, though, the individual outlooks are, in fact, never completely independent. Each economist's analysis and outlook is influenced by others in the profession. Over the course of time, a common perspective is developed among many economists, and for an individual to see the world differently requires him or her to be at odds with the community. Economists, of course, are as fierce as any group of academics in the defense of their independence and are famous for the variety of opinions they might hold on any subject. Nevertheless, consensus views – or at least widely held views – do evolve that often appear in retrospect to be as mistaken as outlier views.

If economists themselves are not much help to investors, investors are even worse at seeing around the corner. Besides suffering from the same shortcoming in terms of brain wiring and the inability to comprehend and digest a large number of system factors, investors are not necessarily any better than anyone else at seeing new trends or emerging behavior patterns that can signal turning points in the economy. And because negative news tends to dominate the headlines – and for good reason since it is often the most impactful on our society – investors often overlook the quieter and less noticeable signals of new economic activity occurring.

So what's an investor to do? Three things.

First, investors should read and read a lot. Occasionally an economist writes an article or gives a speech or presentation that is so compelling in its grasp of the current situation and in its vision of the future that the reader fortunate to come upon it catches a clear glimpse of the future. Such was the nature of Nouriel Roubini's presentation to an IMF seminar in September 2007, "The Risks of a U.S. Hard Landing and Implications for the Global Economy and Financial Markets." I find it hard to imagine that anyone who had read the transcript of Roubini's presentation in late 2007 would not have been convinced that the U.S. was heading for a recession and potentially a long and severe one. Unfortunately, I have not come across any current analysis that strikes me as cogent and as compelling as Roubini's 2007 view.

A corollary to the advice to read a lot is to read good stuff and a range of authors. This means being serious about the task and not confining oneself to the pop culture money magazines. Also, one must read economists across a range of political/economic persuasions. Neither the Heritage Foundation nor Paul Krugman alone can provide a broad enough perspective.

Second, investors should keep a watch out for signs of the times – local indications of improving or deteriorating economic conditions. Although I do not think investors should try economic forecasting based on what they see going on around them in their communities – our vision is too narrow and too local – local signs are sometimes indications of broader trends. How many acquaintances have had salary or wage freezes imposed on them for this year or been required to take unpaid furlough days? Are more store fronts or office spaces vacant than normal? Are these just local phenomena or should I be looking for economic analysis and forecasts that take these signs of the times into account?

Third, investors should treat consensus economic forecasts with some skepticism. The fact that seventy-five or eighty percent of forecasters see the economy moving in a particular direction at a particular pace does not mean that the consensus forecast has a seventy-five or eighty percent certainty to it. Investors should judge for themselves based on what they believe to be the most plausible outlook and then hedge their bets.

In the end, by being as well informed, observant, and independently-minded as possible, we may not be able to see the economic future any more clearly than the next investor. We may, however, be able to be more prudent investors less susceptible to the fashionable outlooks that can be misleading.

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