

The Silliness of Sanctimonious Economic Forecasts

by Frank K. Martin¹

Charlie Munger, Warren Buffett's deadpan, mince-no-words sidekick, frequently splices his point-blank utterances with the noun "silliness." The clever and no doubt intentional use of the childish word embellishes its impact because it doesn't seem to fit the man any more than a tutu would fit Ben Bernanke, the "reserved" chairman of the Fed.

Silliness, as Munger uses it, is a profoundly adult word. During an interview in the spring 2009 *Stanford Lawyer*, Munger was asked if the current crisis is "worse than the Great Depression." He stuck his nose into an uncertain future only so far as a man as wise as Munger could: "The economy hasn't contracted as much as during the Great Depression, but the malfeasance and *silliness*, the triggering events for today's crisis, were much greater and more widespread. In the '20s, a tiny class of people were financial promoters, and a tiny class of people were buying securities. Today, it's deep in the whole culture, and it is way more extreme. If sin and folly get punished appropriately, we're in for a bad time."

Moving from the moralist to the pragmatists, on Thursday, June 11 the *Wall Street Journal* released its latest survey of 52 economic forecasters. The consensus opinion: The recession will end in August, with growth returning in the third quarter. Inflation will remain benign, with the consumer price index staying below the Fed's target of 2% throughout 2010. The employment rate will peak at 9.9% by December of 2009, dropping back to 9.4% by the end of 2010. Housing prices won't stop declining until the first half of 2010 but a near unanimous 92% of the economists opined that an end to the decline in house prices "isn't a prerequisite for a sustained recovery." You can take that to the bank ... or can you?

Despite the sanctimoniousness of these consensus forecasts, Charlie Munger would surely snort that such exactitude is nothing short of silliness. George Bernard Shaw may have only added to the falderal when he turned a memorable phrase on the apparent inability of economists to reach a consensus: "If all the economists were laid end to end, they'd never reach a conclusion." Any study of past forecasts would, for good reason, suggest that economic forecasts in general are (1) much more alike than different and (2) almost invariably wrong. Further, any differences in opinion among the prognosticators are insignificant compared with the variance between the consensus forecast and the future reality.

Why the variance? Macroeconomic forecasting is simply too complex and interactive for even the greatest minds to synthesize the myriad and ever-mutating moving parts. This is not conjecture. The abysmal history of past forecasts should leave no doubts as to the efficacy of the assertion. In those rare instances where the consensus forecast has been close to the mark, one must give credit where credit is due: luck. In the face of such cold realities, the profession defaults to a function within its capabilities (and one that has as good a chance of being right as most others): simple extrapolation. Since most forecasters use the same data, Shaw inadvertently, I presume, put form before substance. Moreover, the

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economists who sing for their supper, employees of corporate or government entities, dare not drift too far from the mean at the peril of exposure to reputational risk and its natural consequence, heightened job insecurity. There is no economic upside incentive to do so. Some forecasters from academia are more than willing to accept reputational risk for a fleeting chance at fame. Nouriel Roubini, recent Nobel Prize winner Paul Krugman, and newcomer historian Niall Ferguson are but a few of the better known. Sad to say, the half-life of celebrity status for economic scholars is short. Examine the roster. You will find few, if any, old, bold forecasters from academia.

The weakness in extrapolation is that such modeling seldom neatly accommodates major structural changes in key economic variables. Moreover, the combination of chaos theory and non-linear systems results in huge variances in final outcomes resulting from minor differences in input assumptions. Think only of the almost incomprehensible consequences that arose from the simple assumption that house prices moved only in one direction.

Flash back to September 11, 2008, to put your finger on the pulse of what 51 economists foresaw only four days before the Lehman Brothers bankruptcy and almost two months before Barack Obama was elected president. The excuse that they were blindsided does not hold water. Early-warning signs of sweeping structural change brought on in part by the “ledger d’main” at the financial industry’s highest levels had been looming larger and larger for years.

The economists were gloomy, predicting four straight quarters of GDP growth below 2%, with the annualized rate of 0.7% in 2008’s fourth quarter and recovering slightly in the first quarter of 2009 to 1.3%. Those surveyed saw a 60% chance of outright recession with the economy disgorging jobs at the rate of 19,000 per month for the next 12 months and unemployment hitting 6.4% by mid-2009. Two-thirds of the forecasters said a second fiscal stimulus package, then under debate by Congress, wasn’t “the right move.” Most favored extending or making permanent the Bush tax cuts. Paul Ashworth of Capital Economics wrapped it up by concluding: “You can’t afford to bail out the financial system and the real economy at the same time.”

Now in June 2009 let the harsh facts speak for themselves. Fourth-quarter 2008 real GDP declined by 6.3% from the prior quarter and slumped an additional 5.7% in 2009’s first quarter. For convenient comparison purposes, the September consensus data are shown in brackets. [September GDP growth forecasts were a positive 0.7% and 1.3%, respectively]. On November 28, 2008, the national Bureau of Economic Research said the U.S. is in recession, and it began in December 2007. [Those surveyed in September forecast a 40% probability of outright recession.] The average monthly increase in the ranks of the unemployed from the end of September 2008 through May 2009 was 615,000, and the unemployment rate stood at 9.4% at the end of May. [The September consensus estimate of additions to the ranks of the unemployed was an average monthly increase of 19,000 over the next 12 months, totaling 228,000. The unemployment rate was forecast to be 6.4%.] In the months of September and October 2008 alone the number of unemployed skyrocketed by 399,000, almost double the September forecast for the coming year! To put an exclamation point on the variance, the ranks of the unemployed have increased by 4.9 million from September through May.

The only rational conclusion one can draw from this latest round of prognostications is that they will be wrong, unless, perchance, they might in the long term be proven right in proposing, assuming Ashworth spoke for the majority, that “You can’t afford to bail out the financial system and the real economy at the same time.” Given the unprecedented macroeconomic experimentation under way, the smart money has to be betting that the disconnect between the forecasts and the future reality will not only be wrong but wrong in a big way. Will the forecasters prove to be wildly optimistic or excessively pessimistic? To dignify that impossible question with a response is, in the inimitable words of Charlie Munger, pure silliness. Investors take note.