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The perils of prediction

Weekly Digest

Week ending **8 January 2018**

– Andrew Hardy, CFA

As is customary around year end, many in the financial industry will have spent December making forecasts for the year ahead and their output is stuffing our inboxes. So should we read or press delete? For me, the appropriate action depends on how you intend to use the information.

While there is no doubting the amount of effort (and brainpower) that goes into forecasting, as the famous quote goes "prediction is very difficult, especially if it's about the future". Evidence abounds to support this being true across the financial industry; a brief glance through outlooks from previous years certainly supports this case. In fact, the last couple of years have served up several good examples of how difficult it is to predict how markets will move even if you had perfect foresight of upcoming events: most people would have been entirely wrong about the market reaction to the US election or Brexit referendum, for example. Although one might be able to correctly predict how fundamentals change, second guessing investor sentiment is notoriously difficult.

So why continue dedicating so much effort to forecasts? James Montier highlights five common excuses in his excellent book 'The Little Book of Behavioral Investing', the most prevalent of which is that predictors shouldn't be judged on just one forecast, through to the "ceteris paribus defence" that something happened outside of the scope of their model. We are all prone to falling into these types of behavioural traps; recognising them and taking steps to control them should generally lead to better investment outcomes over the long term.

Professional forecasters have poor records across many other industries. Howard Marks of Oaktree Capital has described numerous parallels he sees between the investment industry and professional sports. The published results of their eleven 'experts' for a season of over 250 games in the New York Post's "NFL Bettor's Guide", showed that on average they were right just 51.6% of the time and that their 'best bets' were only right 2.4% more often than other picks.

Despite overwhelming evidence that they are unhelpful, it is bold and specific forecasts that proliferate across the media rather than more realistic ranges of scenarios. That's because we are titillated by bold predictions, and it is tempting, particularly for the inexperienced, to see investing as an exact science but that is far from the truth. While markets and economies tend to track fundamentals reasonably well over the very long term, there are still many other factors that lead to large forecast errors, which are likely to be even more impactful and harder to predict over short time horizons. Hence why a scenario based approach is more instructive.

We shouldn't, however, resign ourselves to failure due to these shortcomings around forecasting. We can and should still work to understand the fundamentals and consider a range of potential future scenarios. Understanding the drivers of investor sentiment and expectations is also helpful as it may guide where risks or opportunities lie. It rarely pays to follow the consensus market view or to invest in a 'sure thing', not because it necessarily turns out to be wrong but because the view is usually priced-in already. Surprises move markets most; by definition they can't be anticipated consistently but they can be prepared for. Genuine diversification and robust portfolio construction is also a powerful defence to avoid a portfolio becoming hostage to a particular scenario and giving us the best chance of achieving our targeted outcomes.

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The **Marketplace**

- Brent crude finished the week at 67.8, up 1.1%.
- Gold was up 1.1% standing at 1,320.5.
- Bitcoin begins the new year with a decline.
- MiFID II comes into effect to increase protection and transparency for investors.
- Global equity indices rise, new records set.

Market **Focus**

US

- The Dow Jones was up 2.3% closing at 25,295.9, ending the week on another all-time high.
- The Nasdaq had a strong week, up 4% and again closing the week at a new all-time high of 6,653.3.
- US manufacturing ISM beat forecasts 59.7 vs 52.5, services PMI was also better than expected at 53.7 vs 52.5.
- Two million jobs were added in 2017, beating estimates of 1.98 million. December payrolls fell short of target at 148,000. Unemployment stands at 4.1% vs an estimated 4.6%.
- VIX volatility index dropped 6.4% to a near all-time low of 9.15 on the 3rd of January.

UK

- Manufacturing PMI slid from 57.9 to 56.3 in December, though Q4 expansion was the highest since Q1 of 2014. Exports seen as the main driver.
- UK Services PMI also beat expectations in December rising to 54.2 from 53.8. Overall economy grew 0.5% in Q4.
- The share price of the struggling construction outsourcing giant Carillion jumped 20% on the back of potential refinancing deals, following a 90% drop last summer.
- The FTSE was up 0.5% on the week, closing at 7,724.2, another record-breaker.
- Next Plc posted better than expected retail results for the Christmas period, boosted by strong online sales. By contrast Debenhams, who have struggled with their online offering had a very weak season and saw their share price falling 24% in a day, further bad news stories emerging..

Europe

- The Eurostoxx50 was up 3% closing at 3,607.6.
- Yields on German 2 year government bonds slowly improving (though still negative) on the back of the ECB scaling back bond buying by a half and inflation expectations.
- Angela Merkel continues to try and form a coalition government.
- Expectations of accelerating Euro area inflation fail to materialise despite strong economic data.

Asia

- The Nikkei was up 0.9% at 23,714.5.
- MSCi China Index is at its highest in 10 years.
- The Hang Seng was 3% up finishing the week at 30,814.6, a near all-time high.

Past performance is not indicative of future returns.

Source: Bloomberg. Returns in local currency unless otherwise stated.

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Asset Class/Region	Currency	Currency returns			
		Week ending 5 Jan. 2018	Month to date	YTD 2018	12 months
Developed Market Equities					
United States	USD	2.6%	2.6%	2.6%	22.6%
United Kingdom	GBP	0.5%	0.5%	0.5%	11.3%
Continental Europe	EUR	2.7%	2.7%	2.7%	13.0%
Japan	JPY	3.5%	3.5%	3.5%	23.4%
Asia Pacific (ex Japan)	USD	3.1%	3.1%	3.1%	37.6%
Australia	AUD	0.9%	0.9%	0.9%	11.1%
Global	USD	2.5%	2.5%	2.5%	23.3%
Emerging markets equities					
Emerging Europe	USD	4.5%	4.5%	4.5%	24.6%
Emerging Asia	USD	3.8%	3.8%	3.8%	44.6%
Emerging Latin America	USD	5.0%	5.0%	5.0%	26.5%
BRICs	USD	4.9%	4.9%	4.9%	44.6%
MENA countries	USD	1.2%	1.2%	1.2%	0.7%
South Africa	USD	0.4%	0.4%	0.4%	36.3%
India	USD	1.1%	1.1%	1.1%	38.3%
Global emerging markets	USD	3.7%	3.7%	3.7%	39.2%
Bonds					
US Treasuries	USD	-0.4%	-0.4%	-0.4%	1.6%
US Treasuries (inflation protected)	USD	-0.2%	-0.2%	-0.2%	2.4%
US Corporate (investment grade)	USD	-0.4%	-0.4%	-0.4%	5.3%
US High Yield	USD	0.7%	0.7%	0.7%	7.4%
UK Gilts	GBP	-0.4%	-0.4%	-0.4%	2.7%
UK Corporate (investment grade)	GBP	0.0%	0.0%	0.0%	5.4%
Euro Government Bonds	EUR	0.1%	0.1%	0.1%	1.0%
Euro Corporate (investment grade)	EUR	0.2%	0.2%	0.2%	2.8%
Euro High Yield	EUR	0.6%	0.6%	0.6%	6.9%
Japanese Government	JPY	-0.1%	-0.1%	-0.1%	0.4%
Australian Government	AUD	0.3%	0.3%	0.3%	3.7%
Global Government Bonds	USD	-0.2%	-0.2%	-0.2%	6.3%
Global Bonds	USD	-0.1%	-0.1%	-0.1%	7.0%
Global Convertible Bonds	USD	1.8%	1.8%	1.8%	10.4%
Emerging Market Bonds	USD	0.2%	0.2%	0.2%	7.0%

Source: Bloomberg. Past performance is not indicative of future returns

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Asset Class/Region	Currency	Currency returns			
		Week ending 5 Jan. 2018	Month to date	YTD 2018	12 months
Property					
US Property Securities	USD	-2.2%	-2.2%	-2.2%	-0.8%
Australian Property Securities	AUD	-0.7%	-0.7%	-0.7%	0.6%
Asia Property Securities	USD	4.1%	4.1%	4.1%	28.2%
Global Property Securities	USD	-0.2%	-0.2%	-0.2%	13.7%
Currencies					
Euro	USD	0.2%	0.2%	0.2%	13.6%
UK Pound Sterling	USD	0.3%	0.3%	0.3%	9.2%
Japanese Yen	USD	-0.5%	-0.5%	-0.5%	1.9%
Australian Dollar	USD	0.6%	0.6%	0.6%	7.1%
South African Rand	USD	0.4%	0.4%	0.4%	10.0%
Swiss Franc	USD	-0.2%	-0.2%	-0.2%	3.5%
Chinese Yuan	USD	0.3%	0.3%	0.3%	5.9%
Commodities & Alternatives					
Commodities	USD	1.0%	1.0%	1.0%	5.1%
Agricultural Commodities	USD	1.0%	1.0%	1.0%	-5.7%
Oil	USD	1.1%	1.1%	1.1%	18.9%
Gold	USD	1.1%	1.1%	1.1%	11.9%
Hedge funds	USD	1.1%	1.1%	1.1%	6.8%

Source: Bloomberg. Past performance is not indicative of future returns

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