

Investment Update



August 2011

Perils and Pitfalls of Forecasting

Even in the best of times, correctly divining future events and how they will pan out in the economy and financial markets is a difficult task. Currently, the job of forecasting seems especially perilous. In today's interconnected world, geopolitical events in Europe, China or the Middle East are just as likely to move U.S. markets as those in our own backyard. Textbook cases often analyze one theoretical event while holding all others constant — commonly referred to by economists as “all else being equal.” However, now more than ever, “all else” does not hold still in the real world, but instead frequently moves at an almost incomprehensible pace.

Casting Issues

Given the difficulty of forecasting, it may not be surprising to learn that a valid field of economic research has developed called nowcasting. In reality, this technique was originally developed due to the considerable lag time in the release of most economic data. Nowcasting attempts to estimate current real time economic variables such as GDP, inflation, unemployment or other information using econometric models that incorporate existing economic data while adjusting for various complications in the data inputs. A number of scholarly white papers extol this approach.

In a similar vein, we also find the backcasting method used. This approach starts at a current event

to determine the past influencing factors, or it works backward from a possible future event to gauge present current conditions. While both nowcasting and backcasting surely have valid uses, a cynic might suggest that these fields were developed because actual forecasting had become so difficult.

Nowcasting takes a situation that has just happened, or that has been occurring over time, and frames it as a prediction of what will happen. Numerous recent examples of nowcasting exist, such as recent predictions of a “lost decade” for equities (been there); a collapse in treasury yields (done that); consumer deleveraging (still watching that movie, but it actually started in 2007); the housing market decline (so 2006); and jobless recovery (true, but the trend in jobless recoveries started more than ten years ago).

Nowcasting often resonates with investors because these investors are feeling a current impact on their portfolio or in their daily lives. However, nowcasting is helpful only to the extent that the analysis is based on new information or how the event may unfold moving forward. Otherwise, it is no more than clever reporting with no predictive value. Those who do not pay close attention to, or are unfamiliar with, how past events have unfolded could easily mistake such reporting for valid forecasting. This could cause unwitting overreaction and more pronounced investment changes than might be warranted.

Other Common Investor Mistakes Related to Forecasting

Whether positive or negative, if investors focus only on information that confirms their view, they may incur a selection bias that leads them to conclusions that would be unsupported by a balanced analysis. A splinter approach to nowcasting, called doomcasting, also has emerged. Doomcasting is the tendency of some commentators to greatly accentuate and perhaps unduly dramatize potential negative outcomes. It always has been the case that bad news sells and that playing on fears captures attention. While identifying risks to markets or economies is important, hyping a low probability event — if its potential impact could be high — can be a disservice to investors. If an investor reacts to the hype by making more pronounced shifts than he or she otherwise would, a costly mistake could result.

The dire forecasts of massive municipal defaults, issued late in 2010, are an example of this trend. The predictions garnered widespread media attention and caused great investor concern, resulting in swift price drops and persistent municipal bond outflows. At the time, we discussed why

we thought the predicted extreme outcome was unlikely, highlighting some of the opportunities that might be created by investors' overreaction. At this writing, defaults are not remotely close to doomcaster predictions; indeed they are running at levels lower than last year.

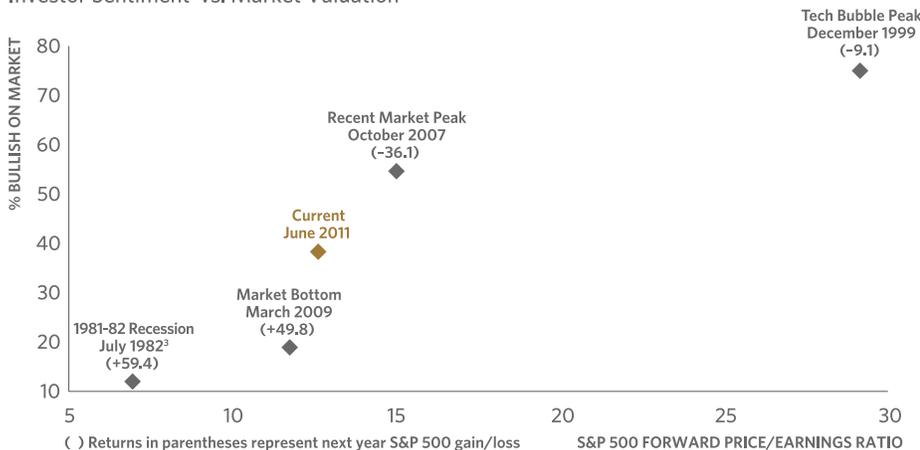
Given the rapid pace of economic and market developments, including some that could greatly impact portfolios, investors can become susceptible to paralysis by analysis. Conversely, they can fall prey to herd mentality, embracing — sometimes unknowingly — pervasively held views. Waiting until every piece of uncertainty is resolved often leaves one waiting at the station long after the train has left. Jumping onto a trend that has long since been fully priced into markets is fraught with risk. As Warren Buffet once said, "The future is never clear, and you pay a very high price in the stock market for a cheery consensus. Uncertainty is the friend of the buyer of long-term values."

Seeing the Forest through the Trees

Mr. Buffet's comment aptly applies in today's environment. Notwithstanding the strong market recovery and modest improvement in investor sentiment since early 2009, great uncertainties remain. If some of the bumper crops of current concerns do not reap a bitter harvest, markets may have room to climb as the outlook and the economic environment even modestly improve. As can be seen in Exhibit 1, danger is often highest when enthusiasm and expectation peak. Conversely, at the nadir of a crisis, opportunity and positive surprises may exist if events unfold more positively than expected.

Exhibit 1 — Low Expectations Create Opportunity

Investor Sentiment¹ vs. Market Valuation²



As of 6/30/11.

Sources: ¹American Association of Individual Investors; ²FactSet;

³BNY Mellon Wealth Management estimate of investor sentiment.

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While we have not been all inclusive in our list of potential forecasting pitfalls, it is clear how easily forecasting errors can put investors off track. If a common denominator exists in these mistakes, it lies in emotional, panicked or knee-jerk reactions to short-lasting or low probability events. The antidote — disciplined decisions reflecting experience, judgment, thorough analysis, and objectivity — does not yield the right forecast in every instance. Over time, however, it comes out far ahead.

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