



Cracks in the Crystal Ball

One of the mysteries of life in the financial markets is that many people still seem to believe you can build a successful investment strategy around forecasting, despite the road being littered with the corpses of those who got it wrong.

This month, twenty-four out of twenty-seven market economists polled by Bloomberg forecast that the Reserve Bank of Australia would cut its benchmark official cash rate by one-quarter of a percentage point to 4.0%, the third such move since November last year.

The rationale seemed clear enough. The global economy was moderating, local activity was slowing, household spending had eased, employment growth was weakening, inflation pressures had receded, and the strength of the local currency was making life tough for non-commodity exporters and import-competing businesses.

A Bloomberg journalist wrote: "The Reserve Bank of Australia is poised to respond to the nation's weakest job market in almost 20 years by lowering interest rates for a third time tomorrow, the most aggressive rate cuts since the global financial crisis."

In its own preview, the *Sydney Morning Herald's* reporter was even more emphatic: "A betting plunge on financial markets puts an interest rate cut today as good as certain with weak retail sales figures indicating the worst growth on record."

Yet, the central bank confounded market expectations and kept rates on hold. The market reaction was dramatic. The Australian dollar took off like a rocket, hitting its highest levels in six months against the US dollar and rising on the cross rates. Shares eased and bond yields rose.

At this point, the very same economists who had carefully parsed the bank's language going into its decision proceeded to analyze in great detail the wording of the statement announcing that rates would stay where they were for another month.

Actually, there really wasn't that much remarkable about what the RBA said. Essentially, it had decided that, with economic growth close to its long-term trend and inflation on target, the RBA could afford to wait another month to see how events in Europe and elsewhere panned out.

Local bank economists immediately pushed out their expectations for the next policy easing to March. Some had second thoughts altogether and decided the central bank might be done on interest rates for the foreseeable future.

For everyday investors, there are a few lessons out of this episode. The first is that there is very little evidence market professionals—including the ones closest to policymakers—are any better than anyone else in forecasting the prices of securities, commodities, interest rates, or currencies.

Last August, for instance, a global bond fund manager admitted he felt like "crying in his beer" over his call in March 2011 to dump almost all of his flagship fund's US government bond holdings because interest rates were unsustainably low.

The second lesson is that trying to time markets—picking the turn in performance of bonds versus equities or government bonds versus corporate bonds or value stocks versus growth stocks—is a pretty tough job. In fact, few (if any) people seem to get it consistently right.

The third takeout is that it really doesn't matter how strong you think the fundamental case is for an interest rate change or a lower currency or a higher stock price; events have a distinctive and unerring way of messing up your impeccable logic.

An example: In the US in February this year, strategists at some of the world's biggest investment banks capitulated on their bearish forecasts after global stocks registered their best start to a year since 1994. In a summary of recent research, Bloomberg quoted strategists at several banks as admitting they had gotten their timing badly wrong.

The final message is that you don't really need any of this fundamental analysis to build long-term wealth. Markets are unpredictable because news is unpredictable.

This means the best approach is to structure a diversified portfolio that is built according to your own investment goals and risk appetite, both across and within asset classes. Occasional rebalancing of the portfolio ensures you maintain an asset allocation consistent with your risk profile. The rest is all about discipline.

This may not be a particularly exciting investment story. But it's one that works. And it doesn't require you to make forecasts about interest rates, currencies, stock prices, or economies. As we have seen, there are some serious cracks in the crystal ball.

This month's retirement report taken from "Outside the Flags" Vice President, Jim Parker