EUREKA report

Forecasting for Dummies

By Alan Kohler
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PORTFOLIO POINT: Anyone who claims to know where the market is heading should be politely ignored. We need to wait for some clarity.

So it's now official: this has been the worst year ever for Australian equities. Sharemarket funds have, on average, fallen 39% in 2008, more than in 1930. What's more, there are few signs that next year's stockmarket performance will be much better, although it is very unlikely to be much worse.

We rang some experts last week and they predicted an average rise in the local sharemarket next year of 26%. In my view that's either the sterile output of a spreadsheet model, or wishful thinking. But it depends a bit on how you look at that prediction: as a statement that the market has now bottomed, or a prediction that the market will rally next year.

These are two different questions. There almost certainly will be a rally next year and maybe it will be 26%, but that doesn't mean the market has bottomed.

A few random things to think about: China is now suffering deflation (the CPI fell in November for the second month in a row); banking activity in the US is declining again; the auto industry bailout is likely to be less than half what the car companies actually need ($US15 billion versus the $US34 billion requested); US payrolls now seem to be falling at the rate of 600,000 a month; newspaper job ads in Australia point to employment growth here falling to zero within four months.

But the main reason the sharemarket has probably not bottomed and will continue to be volatile is not these symptoms of a grinding economic slowdown. The main reason is events. We saw one of them last week with the uncovering of the incredible Bernard Madoff fraud. It seems he has been running a Ponzi scheme for decades and has ripped off about $US50 billion – more than the Enron fraud.

As with the collapse of Lehman Brothers, the consequences of this are unpredictable. Some hedge funds have already been forced to close as a result and other major institutions are struggling with immense losses. In a wider sense, a bit more confidence has been lost in institutional savings and more people will be moving their money into safe havens such as gold and US Treasuries.

The devastating crisis engulfing the Storm financial planning group in Queensland is another such event. There does not yet seem to have been any fraud associated with Storm but its crisis is likely to have a much bigger impact than that of Westpoint simply because the timing is different.

Investor confidence is already battered; another debacle right now involving outrageous financial planning commissions, too much leverage and ruination for thousands of small investors will damage confidence even further and make investors less likely to take advice just when they need it most.

The combination of events like Madoff and Storm and the fact that the global economy is in recession and the Australian economy is now slowing rapidly – and the likelihood that this is a once-in-a-century cyclical downturn – means that valuation alone is not a guide for when it is a good time to buy shares again.

Valuation is relative. Compare the market's price/earnings multiple to the average of the last couple of decades and it looks pretty good value; compare it to all of history and it looks worse value, but still OK; compare it to other bear markets in history and it doesn't look like very good value at all. But compare it to the Great Depression and the market looks terrible value.

Then again, although experts keep saying that this is the worst economic downturn since the Great Depression, it is not even close to that yet. Unemployment is rising rapidly around the world, but it is nowhere near the levels of recent recessions let alone 1930s Depression.

But this is certainly the messiest, most chaotic financial crisis I have ever seen, and possibly the worst since 1930. Will it turn into the deepest economic recession since then? It is impossible to know.

Taking risk and being comfortable with uncertainty is one of the hallmarks of a good investor. But trying to create the illusion of certainty where it doesn't exist is the hallmark of a fool who is about to be parted from his money.

The question of why wasn't this downturn predicted has a simple answer: it couldn't have been. It is an event without precedent and was not predictable.

But it follows that its course from here is also unpredictable. Anyone who claims to be able to predict it, and makes forecasts about what the market will do next year or the year after, should be politely ignored.

There are times when it's good to buy stocks with your ears pinned back, and to even borrow to do so. This is not one of those times.

This is a time to be very careful and to protect what you have. This doesn't mean, as a few correspondents and bloggers have been writing lately: "Kohler has gone bearish". It means I think we should all wait for some clarity.

This might mean that the market moves decisively up or down, although it's unlikely to be up. It certainly requires a banking system that works properly again without government guarantees, and a credit market that operates freely to provide businesses with capital.

Most of all it requires less leverage – among households, businesses and banks. That is going to take a while to achieve.

Yes, the market will probably bottom well before the *Wall Street Journal* has a headline that says "US Banks Now Safe Again!" or Barack Obama comes out with a megaphone and blares out that everything's OK now, folks.

And even then you shouldn't believe them.

Here is a series of links sent in by a reader to statements by the world's leaders during the early stages of this crisis, in which they all said their particular nation was "well placed" to get through it without losing too much skin – including, God help them, the Icelanders.

- **New Zealand:** http://www.beehive.govt.nz/feature/new+zealand+well-placed+deal+global+slowdown
- **Iceland:** http://www.iht.com/articles/ap/2008/06/24/business/EU-FIN-ECO-Iceland-Economy.php
- **United Kingdom:** http://news.xinhuanet.com/english/2008-04/09/content_7942597.htm
- **Spain:** http://www.reuters.com/article/companyNews/idUSMDT00505020080402
- **Ireland:** http://www.4ni.co.uk/northern_ireland_news.asp?id=80181
- **Canada**: http://www.cbc.ca/money/story/2008/05/12/flaherty.html
- **Sweden:** http://www.thelocal.se/14544/20080924/
- **Australia:** http://www.reuters.com/article/telecomm/idUSSYD14684920080327

Notice they all used the phrase "well placed" and they were all wrong about it. It won't be the last time they get this crisis wrong.