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## Madness, Madness II

In October 1995 our newsletter "*Madness, Madness!*" described the ongoing insanity of everyone trying to predict the stock market using reported economic data. As we wrote then, "the daily obsession with government economic statistics is at best useless and at worst harmful to investors."

Obviously, no one was listening, for the intense focus on what Alan Greenspan and the Federal Reserve are going to do next has reached new heights. We have been tempted several times to write a follow-up newsletter -- one draft from last December tied interest rate speculation to the popularity of the Elmo doll and was tentatively titled "*Tickle Me Alan.*" The recent nattering about what the Fed will do at its next meeting in July finally has pushed us over the edge.

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To restate our case:

**1. We have an overload of information.**

Economic statistics are released every day. Their movements and interrelationships are often contradictory, leading to unfounded euphoria one day followed by equally unfounded despair the next.

**2. The statistics are suspect.** The government subsequently revises the statistics, sometimes substantially. If the revised information were available at the time of the initial report, the market's interpretation might be substantially different. There are also "seasonal adjustments" and little-disclosed changes in the make-up and collection methods for the statistics.

**3. The perception of the financial markets about what is a good or bad statistic is not stable.** One day, the stock market perceives a statistic indicating economic strength as being good ("this will lead to strong earnings"). The *very next day*, another statistic indicating economic strength may make the stock market go down ("this will lead to inflation"). It makes us feel dumb, but we would not have made money trading on economic statistics this year even if you gave us the statistics in advance of the announcement -- so what good are they?

**4. Ever changing minds about what the key statistic is.** In the late 1970's and early 1980's, it was the money supply. Then it was the inflation statistics. Then it was the leading economic indicators. Now, it doesn't matter what the statistic is -- all that matters is how it might relate to what the Federal Reserve might do at its next meeting. Statistics we've never heard of result in triple digit moves in the Dow Jones Industrial Average.

**5. The basic logic of predicting the stock market with economic statistics is flawed.** The index of leading economic indicators is used to predict the economy. The stock market has the best predictive record among all of the index's components. *The stock market predicts the economy, not the other way around.* The stock and bond markets are forward looking, discounting all expected future information. Economic statistics are backward looking, reflecting only (and perhaps incorrectly) the past. In order to use economic statistics to predict the stock market, you have to go two iterations into the future.

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**6. Who cares about the Fed anyway?** In the old days, the Federal Reserve would act and the markets would follow. The world has changed, however, with free flows of capital across national borders, instant electronic transmission of information and 24 hour financial market trading. For the last several years, any moves by the Fed have followed trends already established in the markets. In other words, if the Fed tightens in July, it will probably be after an existing upward movement in interest rates -- a reflection of what has already happened, not of what will happen.

As money managers, we have accountability in that we regularly report our performance to our customers. Economic pundits, however, have no accountability -- nobody keeps track of their predictions and, in any event, they always manage to fudge things just enough that they can claim to be right no matter what happens. Surely some of these people must know how fruitless their explanations are. Why do they do it? Because they want to sound smart. When asked about stock market action today, saying something like "early optimism about the impact of the GNP deflator on wage pressures in the cyclical industries gave way to later concern over compression in the yield curve" sounds a heck of a lot better than answering "Brownian motion."

Hug your kids, read the classics, host a Three Stooges film festival, become a Civil War buff, do anything other than take up brain space worrying about tomorrow's release of economic data. Ultimately, speculation about economic statistics in general and Federal Reserve actions in particular are like wondering whether UFO's really crash-landed at Roswell, New Mexico 50 years ago. It might be interesting, but it won't help make you rich.