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## “Madness, Madness!”

“Madness, madness,” the last line from the classic movie Bridge on the River Kwai, comes to mind as I contemplate the continuing blind fascination with economic statistics by stock and bond market commentators. Every day, the press describes stock and bond market movements as reactions to the statistic *du jour*. As an economist, I have every incentive to keep the curtain drawn on the wizard’s cubicle. Committing the heresy of bad-mouthing economic statistics may get me thrown out of the club of market pundits. Nevertheless, I believe the daily obsession with government economic statistics is at best useless and at worst harmful to investors. Why do I feel the majority of these statistics are worthless?

**1. We have an overload of information.** Economic statistics are released almost every day. Reports on employment levels, wholesale prices, consumer prices, leading economic indicators, capacity utilization, industrial production, gross domestic product, and so on barrage us each month. 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 often 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. The government typically releases the revisions at the time of the next month’s report, however. Commentators usually ignore the revisions, focusing instead on the current month’s report (itself to be substantially revised next month). In addition, even the initial reports are only as good as the government’s measures. There are often “seasonal adjustments” and little-disclosed changes in the make-up and collection methods for the statistics. Relying on the government for your investment advice is a quick way to go broke.

**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”). Just as you cannot tell the players without a scorecard, you cannot make money from economic statistics unless you know whether good news is actually good news or bad news today. Assume that you told stock and bond managers at the beginning of this year that the dollar would collapse in the world currency markets. They would have predicted substantial declines in U.S. stock and bond prices. Instead, we have had a sustained bull market in both stocks and bonds. Even if we were perfectly prescient in predicting the economic statistics, we probably could not make money from them.

**4. Everyone keeps changing their mind 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. Tomorrow, it will be ... well, you get the idea.

**5. The whole 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. Think about that for a moment -- 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 (through a glass, darkly) the past. Investing based upon reported economic statistics is like driving a car while looking in the rear view mirror. In order to use economic statistics to predict the stock market, you have to go two iterations into the future. I know I'm not that smart. Why should I assume others are?

The stock and bond markets tend to discount everything everyone knows about the future, including anything we can glean from economic statistics. Market prices have already discounted today's economic statistic. Unless it substantially differs from expectations, market prices probably discounted it months ago. Investment firms have spent millions on computer models to predict future interest rates. Do you know what the best prediction model turned out to be? The bond market.

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Last month's industrial production or wholesale price index has zero relevance to how much money you will have when you retire or when your kids are ready for college. One of Sigma's primary missions is to help its clients develop rational, long-term investment strategies that do not depend on tomorrow's government report. Sigma also helps its clients with the discipline to stick with their investment plans despite short-term market movements caused by emotional reactions to the white noise of economic statistics. Investing is hard enough without being distracted by nonsense.

William A. Berg, President

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