Publication: The Straits Times, p A19
Date: 27 December 2010
Headline: Why market predictions for 2010 failed

Why market predictions for 2010 failed

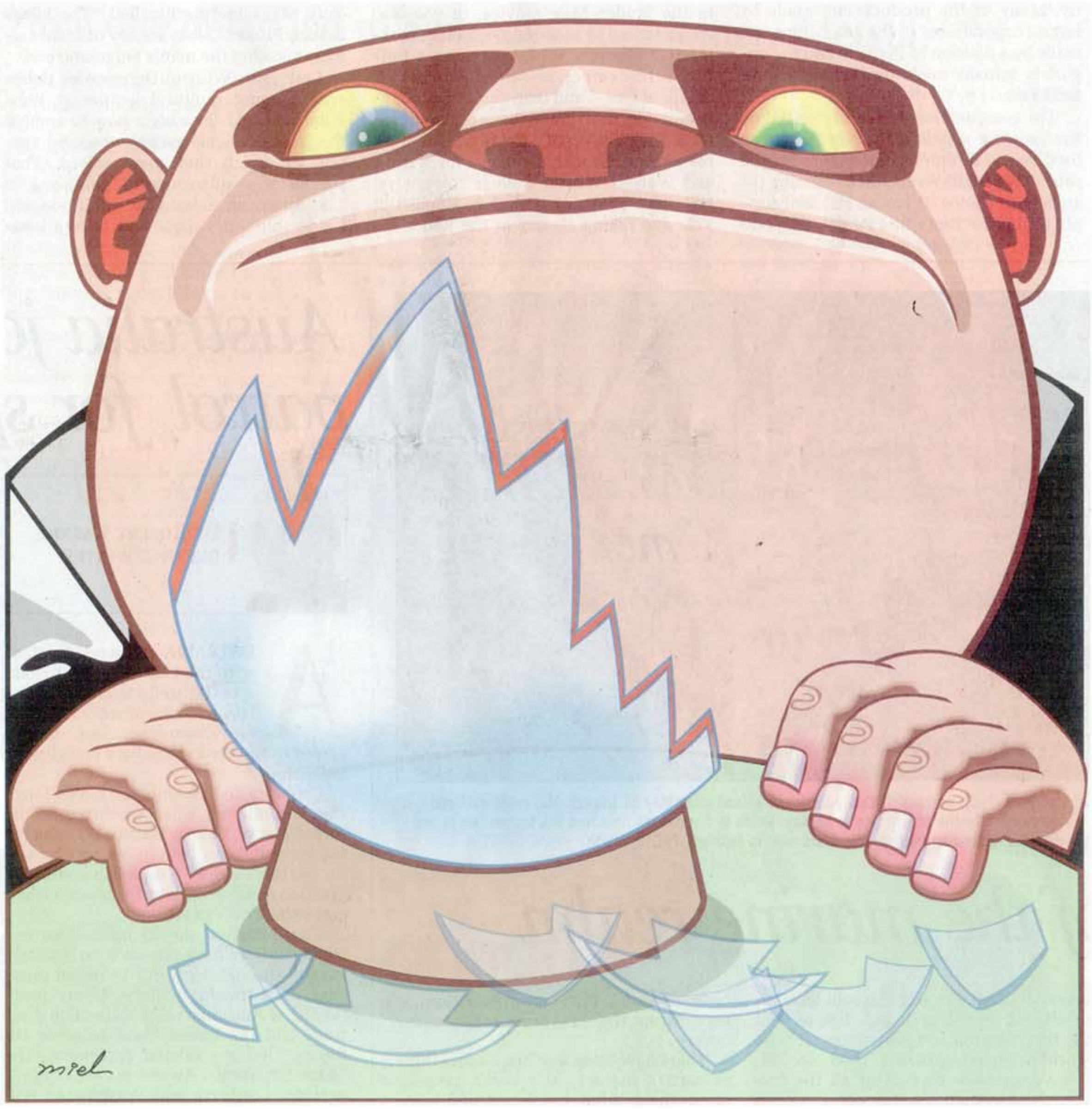
By Bernard Lee
For The Straits Times

TOP market strategists are fond of publishing their market predictions at the beginning of each calendar year. One of Wall Street's favourites is Blackstone vice-chairman Byron Wien who publishes a list of "10 Surprises" for the financial markets. Mr Wien's predictions, a tradition he started during his days as chief strategist at Morgan Stanley, have enjoyed a credible track record.

Surprisingly, market views of many seasoned forecasters, including those of Mr Wien, did not do so well this year. I attempt a review of their predictions at the beginning of 2010 and how the world has turned out in the final weeks of the year. In general, due to fundamental changes in the economy, there has been a less-than-stellar performance by market strategists this year.

To be fair, making predictions is a far more hazardous business than commenting on such predictions with the benefit of hindsight. Nonetheless, it may still be useful to understand the dynamics behind why many predictions made by top market strategists failed to materialise.

I will go through five key predictions made at the start of the year and explain why each was on or off target.



■ **Prediction 1:** The United States economy will resume growth, and the US unemployment rate will drop. The Fed funds rate will move away from its near-zero range and the yield on 10-year US treasury bonds will move back to typical ranges of above 5 per cent. Foreign central banks start to show reluctance in buying US treasuries. The Standard & Poor's (S&P) 500 Index will rally but may not hold onto its gains. The US dollar strengthens.

■ **Outcome:** The US economy continued to stagnate and US unemployment stayed at historical levels. The Fed funds rate is still in its near-zero range, with the Fed having to resort to another round of quantitative easing. The yield on the 10-year US treasury has been hovering at the unusually low range of above 3 per cent for most of the year. Yet, there is no obvious sign that foreign central banks have other credible alternatives besides buying US treasuries. The S&P 500 Index has been trading range-bound between 1,050 and 1,250, but is now approaching its year-to-date high. Despite its many ups and downs, the US dollar currency index has been trading in a range around 80 for most of the year.

■ **Analysis:** In short, the US is spending too much while not producing or investing enough, especially on longer-term investments such as education and infrastructure. For now, "printing money" is used to sustain a consumption-driven economic growth strategy. The real surprise here is that foreign central banks continue to buy large amounts of US treasuries.

Despite talk of reserve diversification, foreign central banks have no obvious alternatives besides gold, but the continuous rise in gold prices also makes it a risky alternative.

That is not to say that one should write off the US economy despite all its well-known problems. Its venture capital culture, research and development innovation and the Silicon Valley remain the envy of the world.

However, it is also true that the country's economic engine is increasingly driven by its well-educated, foreign-born citizens, who are ready for a much higher degree of global mobility than their US-born counterparts. Accordingly, it will be increasingly difficult for the US to implement policies that assume some degree of economic hegemony.

■ **Prediction 2:** An improving US economy will energise the Obama administration. Mid-term election results, while unimpressive, will not cause outright embarrassment to the Democrats. The Obama administration will be able to push through an energy policy agenda. Financial services legislation, like the health care Bill, should pass with some positive outcomes.

■ **Outcome:** The Obama administration is clearly losing momentum in its policy agenda. It suffered from a disastrous mid-term election, while President Barack Obama's own approval rating is now slipping to the mid-40s. Surprisingly, the administration even failed to leverage the worst environmental disaster in US history to push through a meaningful climate or energy policy agenda. While the Dodd-Frank banking reform legislation was finally passed, there are plenty of noises questioning the competency of those responsible for its implementation. In the meantime, other countries are also beginning to question US leadership in the Group of 20 (G-20) process for global financial regulatory reforms.

■ **Analysis:** The US political system, almost by nature, tends to avoid making tough but necessary decisions on economic issues, because of their potential unpopularity in elections. At the same time, populist policy implementation with even the slightest hint of egalitarianism often creates more problems than it solves in today's global financial markets. It is not yet obvious that the financial reform legislation will have meaningful positive impact. Likewise, the consensus-driven nature of the G-20 process is increasingly dysfunctional: The G-20 will work only under a credible leader. Unless the US puts its own house in order, other countries may not be inclined to listen to its preaching.

■ **Prediction 3:** Global growth will be driven by economic recovery in the industrial world. Some predicted that Japan would stand out as one of the best performing major industrialised markets in the world as its currency weakened and its exports improved. The Nikkei 225 would also surge ahead.

■ **Outcome:** Instead of Japan, China is now the engine of global growth. China is proceeding with the initial stages of internationalising the yuan while allowing limited flexibility in its exchange rate policy. It is also increasingly assertive in its foreign policy. In contrast, the Japanese economy continues to stagnate, with the Nikkei 225 flat for the year.

■ **Analysis:** Judging by the number of China-related headlines appearing on the front pages of the Financial Times this year alone, one may be forgiven for suggesting that we are already in the era of the G-2. On a purchasing power parity basis, a further appreciation of the yuan by 30 per cent to 40 per cent upon its full convertibility is not entirely out of the question. In short, the real economic strength of China is still understated by published statistics. The high savings rate in China is a cultural artefact that will not be changed overnight. Eventually, full convertibility of the yuan may be the only real solution to global payment imbalances and excessive domestic speculations, in terms of offering the Chinese population alternative ways to park their savings. While China is still a long way from Japan in terms of its per capita gross domestic product (GDP), it will close the gap gradually, as the latter is undergoing a significant demographic transformation.

■ **Prediction 4:** The Middle East will remain as the world's leading hot spot while civil unrest in Iran could reach a crescendo. Pakistan may also become another hot spot in the region because of weak government.

■ **Outcome:** Instead of Iran or other well-known hot spots in the Middle East or central Asia, the Korean peninsula is now the world's most dangerous flashpoint. At the same time, Japan's defence policy focus is shifting south.

■ **Analysis:** North Korean leader Kim Jong Il may not be as delusional as he likes the rest of the world to believe: He, too, may harbour insecurity that his battle-hardened generals may not be too keen to listen to his 28-year-old, Swiss-educated son who was recently made a four-star general. China is now caught between a rock and a hard place. If the North Korean regime collapses, the flood of refugees and a possible takeover by the South Koreans may mean American troops on its doorstep. In short, China does not want to lose North Korea as a geopolitical buffer zone. Therefore, a Chinese takeover should not be written off completely, in the event that the North Korean regime does implode – after all, no North Korean general can ignore the simple fact that the country depends on China for most of its energy and food supplies. The pragmatic foreign policy question is whether China can handle the situation with sufficient finesse so that the final solution will look palatable to the rest of the world, especially to China's important allies and neighbours in East and Central Asia.

■ **Prediction 5:** No major trouble in Europe. While balance-sheet issues related to a number of European governments were subjects of heated debate, few predicted the ferocity of the European sovereign debt crisis.

■ **Outcome:** A few hedge fund managers began questioning the viability of the euro several years ago. However, the market in general was caught by surprise by the euro and sovereign debt saga.

■ **Analysis:** Greece is often called the tip of Europe's iceberg. There is no lack of estimates on the amount of recapitalisation required to "fix" the various financial problems in the many nations caught in the sovereign debt crisis. The fundamental issue is that the euro imposes a uniform set of monetary policies on a collection of countries with wildly different economic conditions. A similar scenario existed in the US for parts of the 20th century, but it worked out because there is only one federal government, which can make certain economic adjustments by differential fiscal spending. On the other hand, the inability to sustain differential fiscal spending among European Union countries has precipitated the sovereign debt crisis.

ONE key underlying theme is that the driving forces behind the above outcomes fall under the description of "extreme scenarios" – scenarios hard to predict at the beginning, based on known factors. These are now setting new paradigms in the global economy.

Whenever no comparable historical data or scenarios are available, inferring the future from the past may suffer from significant "model calibration bias". That is probably why even market forecasters with successful track records could not predict how 2010 would pan out.

An alternative approach is to develop a structural description that fits the dynamics of the global economy. This kind of war game approach can then be used to derive possible "unknown-unknown" scenarios (in the famous words of former US defence secretary Donald Rumsfeld). Certain central banks and supranational organisations are known to deploy such sophisticated and expensive techniques to study significant policy questions, such as the possible alternatives to the euro and the eventual convertibility of the yuan. Needless to say, most of us will not have access to such sophisticated models and their insights.

So what is the moral of the story for the savvy finance professionals of 2011?

This has been the first year in which decoupling is no longer just a debate, and when there is clear evidence that the global economy is going through some rapid and probably fundamental transformations. Predicting market behaviour may be extremely arduous even for a seasoned maestro. Under these circumstances, a healthy dose of common sense and scepticism, along with some back-to-basics reasoning, may be far more trustworthy as guides to the 2011 markets than any heavy reliance on models and historical data.

The writer is deputy director of the Sim Kee Boon Institute for Financial Economics at the Singapore Management University.