

thebigpicture

guideposts for the private investor

Week Commencing 24 January 2005

Publishing and Subscription Information

thebigpicture guideposts for the private investor is published by *thebigpicture* Economics (ABN 71 040 787 936). The author, John A Robertson, while working in Australia, London and New York, has over 20 years experience in international financial and commodity markets, corporate strategy, financial and business evaluation and government policy. He has been Chief Economist and a director of a leading Australian investment bank. He has been a top-rated institutional equity analyst and has marketed investment advice in all the major international financial centres.

To subscribe to the newsletter, go to www.thebigpicture.com.au or send an e-mail to: admin@thebigpicture.com.au.

Newsletter subscribers may also subscribe to *thebigpicture* premium content which includes tailored analysis and seminars on economics, business and policy issues affecting investment decision-making. Further information can be seen at www.thebigpicture.com.au.

◆◆◆◆◆◆◆◆◆◆

thebigpicture Economics
ABN 71 040 787 936
PO Box 333, Malvern
Vic 3144

FORECASTERS ARE ONLY HUMAN

Forecasting financial and economic variables is a dangerous profession. The complexity of markets conspires with the competence of forecasters and limitations imposed by their own thought processes to frequently produce inadequate results. Looking at alternative scenarios to the ones forecast can often provide insights into the market processes.

Regrettably, forecasters are only human. They have a natural tendency to optimism, usually assuming progress and discounting stagnation: markets should rise; incomes should grow; and, profits should expand.

So, over the past decade, international forecasters have continued to tip a Japanese economic recovery where more objective evidence has suggested many obstacles to this happening. Similarly, when there is evidence of growth slowing it is never by much. Almost inevitably, a 'soft landing' dominates forecasters' initial thoughts until recession hits. Wishful thinking too often overrides analysis.

There is also a marked reluctance to move very far from history. The consensus is often nothing more than last year's outcome extrapolated to the year ahead, perhaps modified for some known events. A year of strong growth will typically be extrapolated until evidence mounts that a change in direction has occurred.

Turning points are notoriously hard to forecast but getting them right sets the men from the forecasting boys. It takes some skill to see the bigger picture and courage to take a view contrary to the consensus.

When everyone is absolutely sure a market is set to rise and, by definition, there are no further buyers to push prices higher, they will fall. Similarly, when everyone is convinced that there is no bottom (and, by definition, there is nothing left to sell) a rise is inevitable. Unfortunately, forecasters find it hard to divorce themselves from the crowd they are judging and are prone to join them at precisely the wrong moment.

Future levels are also difficult to gauge because people react to the emerging consensus and forecasters do not usually take account of this in framing their views. Accepting forecasts that an exchange rate is likely to rise, for example, encourages people to buy the relevant currency pushing it above prior forecasts. Reacting to forecasts of weakening economic activity, business might cut back investment spend making the initial consensus forecast too optimistic.

For investors, there is frequently little connection between macroeconomic forecasts and forecasts of business profitability which drives equity markets. This is partly because macroeconomists are often more interested in exchange rates and interest rates and have little training in company analysis. Often, too, company analysts are being guided by the companies they follow. Relationships can be put at risk if their forecasts depart too much from those in the corporate handout. Hence the spectacle of earnings downgrades as the economy weakens and upgrades as growth accelerates.

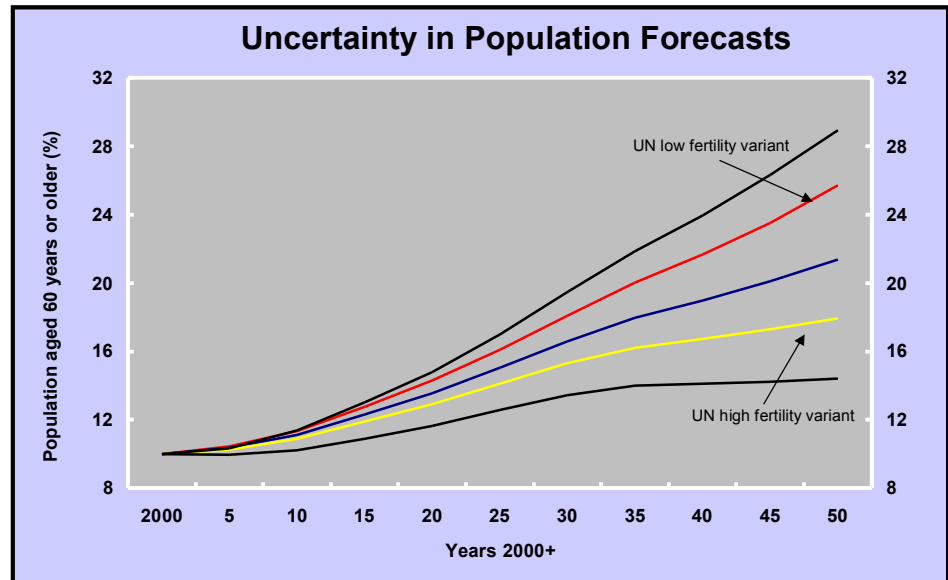
Recent issues of *thebigpicture* have reviewed economic and business conditions largely

“For investors, there is frequently little connection between macroeconomic forecasts and forecasts of business profitability which drives equity markets.”

(Continued on page 3)

THE WEEKLY CHART SPOT

“Naturally, analysts gravitate toward the medium outcome as the basis for other forecasts and for framing policy but that might not be any more likely than a large range of other possibilities.”



Source: United Nations

The world's population is aging. However, the extent of the change is uncertain despite the resources put into modeling global demographic forces. At the heart of the uncertainty are the assumptions being made by forecasters about fertility rates.

The United Nations has led the modeling of global demographic changes. Its most widely used projections show global population increasing from 6.1 billion in 2000 to 8.9 billion in 2050, an average 0.7% annual growth rate compared to 1.7% in the prior fifty years.

Within this trend is a rapid increase in the average age of the population from 26.4 years in 2000 to 36.8 in 2050. These changes imply that 21.4% of the population will be aged 60 years or older in 2050 compared with 10.0% in 2000. This is the UN's 'medium' fertility variant.

In making its projections, the UN has assumed in its "medium" variant that there would be a gradual recovery in fertility rates among the developed countries. This assumption has been subject to some debate among demographers, one reason the UN also considered alternative scenarios for fertility. Under the alternatives, fertility is assumed to level off at half a birth below and half a birth above the assumed rate in the "medium" variant providing the low and high fertility variants, respectively, illustrated in the chart.

Under all scenarios, the average age of the population and the proportion of people above 60 in the population rises. However, in the high fertility variant, the proportion rises to only 17.9% in 2050. In the low fertility variant, the proportion increases more substantially to 25.7%.

The chart also shows two standard deviations around these base case limits. That puts a plausible outcome somewhere in the range from 14.4% to 29.0%. The upper limit of the anticipated proportion of older people is twice the lower limit.

Naturally, analysts gravitate toward the medium outcome as the basis for other forecasts and for framing policy but the medium variant might not be any more likely than a large range of other possibilities. However, the difference for policy and business planning could be considerable. ■

ALTERNATIVE SCENARIO ONE CONT'D

(Continued from page 3)

lar. Exporters are shocked at the prospect.

10. Australian profit levels continue to set new records supporting higher market values despite more ominous clouds

on the horizon: sooner or later Australia's Reserve Bank will have to join the Federal Reserve in signalling that inflation pressures are becoming intolerable. ■

FORECASTERS ARE ONLY HUMAN CONT'D

(Continued from page 1)

using consensus forecasts as the basis for the outlook focussing on what they say about the guideposts which have been described in these newsletters. So, what might be different in the year ahead?

The starting point is a global economy which the consensus suggests is going to grow slightly less quickly in 2005, perhaps at 4.3% rather than the 5.0% pace reached in 2004, according to the International Monetary Fund.

At well above the average rate of growth for the past 20 years, the putative 2005 growth rate would be no shabby outcome. The world's economic forecasters are saying that times have been better than usual and are likely to stay that way.

While implicitly acknowledging that last year's outcome was implausibly strong as a continuing rate of expansion, however, they have not dared to suggest a radical departure from what has gone before.

There are two alternative growth scenarios:

- we are getting the direction wrong, growth does not slow and the momentum is maintained; or,
- growth does slow but the natural tendency to conservatism has led forecasters to underestimate the change in momentum.

How could these alternatives happen? For each case, **thebigpicture** offers ten points of difference. ■

Alternative Scenario One: A Growth Roller Coaster

Forecasters are anticipating that global growth will be slightly slower in 2005. thebigpicture presents ten feasible points of difference from the consensus which might lead to outcomes better than the current consensus and a growth roller coaster.

1. In the USA, after a long lull, investment spending begins to better reflect the financial capacity of business. The restrictions imposed by Sarbanes Oxley and the recently displayed risk aversion among corporate managers are progressively cast off. Managers begin expanding their businesses more aggressively.
2. In Asia, where investment spending outside China has also been relatively weak, the cycle starts to turn more noticeably aided by the momentum which has come from China's industrialisation.
3. The Chinese authorities show that they are no better at controlling a growing economy through monetary policy than anyone else. Ominously, growth does not slow significantly. It heads higher. For the time being, this means a stronger global economy.
4. Stronger investment outside China brings more buoyancy to commodity markets. Commodity prices have been strong but not especially so when viewed against other cycles. Now, things change. The cycle seems set to

be driven higher.

5. Oil prices are caught up in the general commodity price buoyancy. Prices move past \$60 a barrel. Pressures to commercialise alternative fuel sources rise.
6. Stronger investment spending in the USA (with still relatively subdued growth rates in Europe and Japan) highlights that the US economy is one of the most vibrant parts of our economic world. Investment funds begin to flow more strongly toward the USA.
7. Stronger than anticipated growth rates suggest that the US budget deficit is likely to be lowered (at least relative to GDP) more quickly than earlier forecasts had suggested. Fears that the deficit was going to pull the rug from under the currency dissipate. The US dollar is rising.
8. The Federal Reserve, already committed to raising interest rates in a measured fashion, keeps to a schedule of 25 points a month until the third quarter when there are two 50 point hikes. Inflation is now a worry. Higher rates are good for the dollar.
9. The Australian dollar – never quite able to shake off its commodity tag – rises through 80 cents. As usual in foreign exchange markets, traders think that the current direction will prevail forever. Some talk of parity with a rising US dol-

(Continued on page 2)

“Turning points are notoriously hard to forecast but getting them right sets the men from the forecasting boys. It takes some skill to see the bigger picture and courage to take a view contrary to the consensus.”

ALTERNATIVE SCENARIO TWO: A SLIPPERY SLIDE

Global growth expectations for 2005, only slightly below the 30 year record growth rate set in 2004, might be too optimistic. *thebigpicture* presents ten feasible points of difference from the consensus which might lead to a slippery slide toward a more pessimistic growth outcome.

1. The Iraqi insurgency becomes more intractable for the USA with the two most senior officials of the newly elected administration murdered. Iraqi security forces are unable to cope requiring the US to significantly boost its troop numbers. Meanwhile, a direct link between Osama bin Laden and senior members of the Saudi royal family becomes public after a major terrorist attack on the US mainland. The US Congress makes anti-Saudi sanctions, including restrictions on capital flows, a condition of further funding for US efforts in Iraq.
2. In the USA, as markets sag over mounting concerns about capital flow disruptions, consumer confidence slips and job growth, already meagre by past standards, begins to stall. Growth seems to be slipping away faster than expected.
3. The effects of the Federal Reserve increasing interest rates by 75 points since the beginning of the year are showing. There is debate among the potential successors to Alan Greenspan about the correct course of action but discussion leads to indecision. Without a reassuring new appointment, business and consumers worry about the outlook. Their confidence slips further.
4. The US dollar is pressured by these events. There is a commitment to domestic spending reductions (detrimentally affecting economic activity) by the administration but the international spend related to Iraq is an offset.
5. A falling US currency is hindering the growth prospects of Japan and

Europe. Their growth outcomes are coming in much lower than had been expected because once again forecasters have underestimated how important structural conditions (including the prospect of falling population) are in determining growth.

6. Pressure is applied to Chinese authorities to revalue their exchange rate as part of a global adjustment. They also attempt to slow the pace of domestic growth by constraining monetary conditions but they are human and go too far (just like monetary authorities anywhere else trying for a 'soft landing'). Chinese growth begins to slow more dramatically than had been anticipated.
7. Fears of non-oil commodity shortages evaporate and some prices drop rapidly. Resource sector investments seem suddenly unattractive and the Australian dollar drops precipitously. Sixty cents becomes a reasonable target according to the traders quoted in the press.
8. The Australian Reserve Bank had been following the rises in US interest rates earlier in the year. These rises and the sharp change in conditions are having an effect. Consumer confidence is dented especially since housing prices seem to be weakening. Employment growth dries up and the first signs of rising unemployment become evident.
9. The government must revise its budgetary position. Spending cuts must be made to deliver the promised budget surpluses.
10. Australian business profitability begins to slip back from its record levels and profit warnings from Australian companies become more frequent. The Australian market which had risen to 4500 falls 10% in a fortnight signalling a change in conditions. ■

"At well above the average rate of growth for the past 20 years, the putative 2005 growth rate would be no shabby outcome. The world's economic forecasters are saying that times have been better than usual and are likely to stay that way."