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Forecasting is hard

By Robert Teitelman

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For David Levy, 55, forecasting is a family business. His grandfather, Jerome Levy, turned from physics and business to economics early in the 20th century. After World War II, his father, S. Jay Levy, began an economic forecasting service. David joined the business in the mid-'70s, and in 1986 Jerome's other son, legendary Wall Streeter Leon Levy, funded the Jerome Levy Economics Institute of Bard College, which provided a home for economist Hyman Minsky, the famed student of financial crises, until his death in 1996. Then, in 2001, Jay and David spun the forecasting unit out as the for-profit **Jerome Levy Forecasting Center LLC**. Over the years, David Levy has made some prescient recessionary calls, including an early recognition of the credit bubble. But he is also a sophisticated observer of the limitations and challenges of the prediction game.

The Deal: *So what's the forecast?*

David Levy: By 2011, we think there's a 60% probability of recession, maybe a bit more. One of the biggest variables is we don't know what's going to happen with fiscal policy. What increases the risk is the phenomenal fear about government debt, which causes us to back away from safety nets, or aggressively do something to stabilize housing. There's a reluctance to help out state and local governments. ... Now probably not very much will happen before the [midterm] elections. One of the biggest questions is about the expiring Bush tax cuts; it looks like there's momentum to put off the issue, or wait another year, or just raise taxes on the wealthiest.

We also have uncertainties in terms of politics and budgetary policies in other countries. We have questions about banking crises, [which are] still ahead of us in Europe, and sovereign debt problems. There are huge problems for the mortgage industry. So there's enough of a crisis that no matter who's elected, Tea Party or otherwise, they have to do something.

We have a pervasive need for balance sheets to shrink. We've seen credit shrink in the private sector dramatically. A lot of this is debt being written off, though some is lack of borrowing, so that it has actually caused total debt to shrink despite huge increases in federal debt. The economy remains heavily dependent on government deficits to keep it out of a Great Depression. To our clients interested in acquisitions, our general theme is keep your powder dry. The best opportunities are definitely going to come, but there's no rush. Doses of deflation and problems likely in the next 12 to 15 months are going to make it difficult to price assets, and then great times for buying will come. Unless you have an overwhelming case, I would be patient and look for more of a buyer's market.

What kind of time frame are we talking?

I distinguish between when the economy gets back to prosperity and what's an attractive time for investors. The latter is going to take time. We'll see the bottom, say, next year or so, but we'll go through multiple business cycles before this gets cleaned up. We'll go through some up years, but generally we'll see a difficult period of chronically high unemployment in which business becomes increasingly conservative and cautious. That said, the time when assets become most attractive is not when people are just gloomy and pessimistic, but the most scared. You could have some period of extended liquidity problems in some markets, plus the shock of another recession, plus some deflation. These bottoms aren't necessarily V-shaped. We use the analogy of sliding down a steep mountain, then bouncing through the foothills. For markets like housing, we've seen the worst of the steep slide, and we've bounced a little, but we're now in the foothills, some of which could be big. The opportunity is to those who recognize this as a finite period, that it's going to take more than one business cycle to work through.

Why is forecasting so difficult?

One of the ways forecasting in the modern way tries to deal with uncertainty is to look at the past and try to match patterns without having a sufficient understanding of cause and effect. How many times do people say, "Well, in the last eight or nine recessions, this happened or this happened, and therefore we expect it to happen again?" Or that the history of V-shaped recoveries is always a steep fall and a steep rise. This is pure pattern matching. Why did this recession happen? Why is it different or similar to other recessions? It also affects the debate over fiscal policy. People look at Greece and say, "Look, it's 100% debt-to-GDP. We're going to be next because we're heading to 100%." A more scholarly version of that is [Kenneth] Rogoff and [Carmen] Reinhart [in "This Time Is Different: Eight Centuries of Financial Follies"] looking at many countries over many years, putting a big data set together and saying there's a strong tendency for countries, when debt goes up, to get into trouble. But there are many differences between countries. If you look at countries that look a lot like the U.S., Britain or Japan, you find they can have a lot more debt-to-GDP.

One of the things that makes forecasting hard is the uncertainties. But it's also very difficult to understand the system you're forecasting. In economics, the main education people have is the neoclassical paradigm, with its different schools of thought, which has very little financial dimension. There's interest rates and the money supply, but there's no balance sheet, debt service, no bank crises -- it's missing all the things that happened, so it's difficult to explain what's been going on. That stuff is relegated to noise.

Hyman Minsky was interesting because he had enormous respect for the uncertainties. He described processes that would move an economy that was prosperous and thriving over a long period of time to riskier and riskier positions. What Minsky was saying was that Keynes raised a series of critical issues: that there was a lot of uncertainty and that the future is not a probability function we can predict; that there are time dynamics so the world isn't just a set of simultaneous equations that will adjust when a shock hits; that the situation may play out in ways economists don't recognize and you might not get to equilibrium; and that there's a financial structure where things happen. Minsky developed an understanding of a set of processes that led a prosperous economy to create a self-fulling prophecy. But he would not have much opinion on what's going to happen next year.

How do you approach forecasting?

Our clients basically want to know we're going to help them make better decisions. Our incentive is to try to be right about things we feel we have strong convictions about or at least when there's uncertainty to refine issues and air those uncertainties. I think a lot of people feel pressure to generate a GDP forecast, which is an obsolete way of doing things.

It's a tricky business. People who have been around want to make a prediction their own by understanding the process and finding it intellectually persuasive. A layperson may read a book or hear a speech and say, "That guy is brilliant. He's been right before." But people who have been at this a while know to be suspicious, even [of] someone with a good record. The starting point is, can you really explain the past and present in an adequate way, and can you use that to provide persuasive argument to at least limit the possibilities of what can happen so you can come up with a means of making decisions?

What kind of toll does forecasting take?

Anyone who has done this for a long time goes through emotional learning experiences. There's a strong natural tendency if you have a forecast and the facts go against it to be very reluctant to want to use, even manipulate, those facts to make your argument.

I learned at least 25 years ago that I'll get a gnawing feeling in my gut, a sense of anxiety, when what I'm saying in my public view and to clients is not consistent with what I'm feeling inside. I've learned to listen to that because it's too unpleasant having those feelings. Any kind of prediction with consequences, you have to rein in your emotions and question yourself. That's why it's good to have people who ask hard questions and criticize. It's very, very tough otherwise.

The Predictors

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