Partner Talk®

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Predictions, Predictions

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> "If you can look into the seeds of time,
> And say which grain will grow and which will not,
> Speak then to me."

In *Macbeth* the above words are spoken by Banquo – Macbeth's friend, then his victim, then his spectral nemesis -- when he and Macbeth happen upon three soothsayers. The soothsayers entice both Macbeth and Banquo, predicting that Macbeth will become King, but Banquo "shalt get kings" through his children. After hearing these prophesies, only Banquo expresses deep doubt, stating that the soothsayers might "win us with honest trifles, to betray's in deepest consequence."

PMA feels similarly about soothsaying. We often state, when asked to predict when the next recession will occur, or what the markets will do the next quarter, that we do not have a crystal ball and do not make fundamental investment decisions based on predictions about the direction of the markets in the near future. Why is that?

There are at least three answers. First, academic studies have demonstrated the futility of trying to "time" the markets – jumping in and out based on guesses of whether the market will soon dip or rise. In fact, such "market timing" is more likely to do more harm than good. Second, PMA believes that in a complex, interrelated world of almost 7.5 billion people, intellectual honesty requires us to admit that predictions about the near term collective decisions of millions of equity owners (in America alone approximately 160 million people invest in equity markets), is futile.

But third, and perhaps most importantly, is the recognition that what causes short term market moves, are surprises. Unexpected good news moves markets up, and unexpected bad news moves markets down. The key word, of course, is unexpected – if the events were expected they would not be surprises and would not have dramatic market effects.

Examples of this abound, but here is a colorful one. In April 2016 one prolific author and investor published a paper titled "50% Returns Coming for Commodities and Emerging Markets?" The paper predicted that emerging market equity investors were "standing at the edge of 40-96% returns over the next two years" and that emerging markets were about "to rocket across the room." CNBC echoed these sentiments in August 2016, publishing an article entitled "Five reasons why it's a good time to invest in emerging markets."

How do these predictions bear out? Year to date through October, emerging markets are down 15.72% percent (measured by the MSCI Emerging Market index), while the S&P 500 is up 3% percent. Over the last 12 months emerging markets are down 12.52% percent, compared to a 7.35% rise for the S&P. Over the last 2 years emerging markets do have a positive return but nothing close to 40%, in fact the emerging market index has over the last two years significantly underperformed the S&P 500 and has also underperformed the MSCI World Ex USA index (includes all countries except the US).

Were there surprises over the last two years that adversely affected the performance of emerging markets? Yes! First, as recognized by the Financial Times, the "dollar remains the single most important consideration for emerging market finances," and during the last two years the dollar has shown unexpected strength. Second, President Trump's initiation of trade tensions with virtually every major worldwide trading partner of the US further adversely affected emerging markets. For example, tensions between the US and Turkey, an emerging market country with a population of 80 million, have been at an all-time high, culminating with the US sanctioning Turkey this past summer amidst a dispute over a botched prisoner exchange. These unprecedented sanctions threw the Turkish lira into a spiral, forcing the Turkish central bank to raise its benchmark interest rate an enormous 625 basis points in an effort to defend its currency. While Turkey's economy is not a large component of the emerging markets indices, the sharp fall in the lira sparked fears of contagion in broader emerging markets. Raise your hand if, in April 2016, you predicted, or even dreamed, that Donald Trump would win the nomination, be elected President and would subsequently throw the economy of a NATO partner into a crisis because it refused to release from its jails one American pastor.[1]

In truth, the more interesting question to long term investors such as PMA, is not what the markets will do the next quarter, but why humanity (exemplified by Macbeth[2]) has such a deep, unquenchable need to be told what will happen in the future. One answer to that question is suggested by New Yorker journalist Kathryn Schulz in her book *Being Wrong, Adventures in the Margin of Error*. Schulz, synthesizing immense quantities of psychological research and philosophical musings, rather persuasively argues that nothing is feared and hated by humanity as much as *uncertainty*. Uncertainty is hated because most people, most of the time, live in a state of self-induced certainty – we are certain that our senses provide us with correct information about the

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[1] Turkey released the pastor on October 12, 2018, presumably in an effort to diffuse tensions with the US.

[2] Macbeth later in the play seeks more prophecies from the soothsayers and demands that they "answer me: though you untie the winds and let them fight against the churches; though the yesty waves confound and swallow navigation up; . . . even till destruction sicken; answer me."

world, we are certain of our most core beliefs, and seek to associate primarily with people who reinforce them, and we are certain of the soundness of our cognitive processes. In short, we live in our own "bubble" of certainty created by all of these (fallible) mechanisms. Accordingly, certainty "feels safe and pleasurable" whereas uncertainty "compels us to face" the "unconsoling fact that nothing in the world can be perfectly known by any mere mortal."

This explanation seems as good as any why there is a never-ending stream of predictions in the financial press about what the markets will "do next" – there is a deep human need for the uncertain future to be made to appear certain, and economic predictions, the more confidently stated the better, is the marketplace's way of satisfying that need. Unfortunately, as stated by Peter Bernstein, investment giant and a founder of *The Journal of Portfolio Management*, we are "stuck with uncertainty." From this fact Bernstein further explicated a fundamental principle with which we deeply agree: "Investment management provides only one dependable way to survive through the uncertainty of the future: diversification."

None of this is to say that PMA does not operate without any assumptions of its own about the future. One important assumption is that the geopolitical entity known as the United States is a wealth producing juggernaut unlike any ever seen in world history. A basis for this assumption is nicely illustrated by two companion pieces included with this month's inserts, both prepared by economist Mark Perry: "Putting America's enormous $19T economy into perspective by comparing US state GDPs to entire countries" and "Understanding America's enormous $19T economy by comparing US metro area GDPs to entire countries." As Perry establishes in the former piece: "the US produced 24.3% of world GDP in 2017, with only about 4.3% of the world's population" while the three largest American states each "would have ranked in the world's top 11 largest economies last year" and together "those three US states produced nearly $6.0 trillion in economic output" which is 1 trillion more than produced by Japan, the world's third-largest economy. In his latter piece which examines the US economy by metropolitan areas, Perry proves that just the "three largest metro areas" together "produced $3.44 trillion in GDP, which was just slightly less than the entire economic output of Germany at $3.64 trillion" and that "each of America's 17 largest metro economies as separate nations are big enough to rank in the world's 50 largest economies."

These types of facts support PMA's belief that the wealth generated by the US economy will, over the long run, be available to owners of the companies that, collectively, comprise its economy. While recognizing that nothing is certain and that we are not in the business of prophesying, that is a "prediction" we willingly make.