Dimensional

OUTSIDE THE FLAGS

Cracks in the Crystal Ball

Jim Parker
Vice President

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KEY TAKEAWAYS

- At the turn of the financial year, the media is filled with articles making forecasts for the economy and markets in the coming 12 months.
- An analysis of forecasts for 2022/23 made by a panel of top Australian economists showed most of their calls were well wide of the mark.
- The takeaway is to take forecasts with a pinch of salt and stick to your plan as all those expectations are already reflected in prices.

A standard media device at the start of a financial year is a "lookahead" on the outlook for the coming 12 months. As a reflection on the anxieties of the day, these articles are usually reasonably accurate. But as a forecast of the future, not so much.

The financial year outlook articles are put together by journalists based on interviews with market economists and analysts, who are asked to provide estimates for economic growth, inflation, interest rates, shares, bonds and currencies in a year's time.

The resulting stories are usually an interesting read. But there is a fundamental problem with this approach in terms of its reliability: The economists' forecasts rest on a whole bunch of assumptions that can quickly exceed their use-by date when events change or when at least one of the variables undershoots or overshoots their expectations.

One only has to look at the past three years or so to see examples. Carefully made projections for 2020 were made quickly redundant by Covid. Two years later, Russia's invasion of Ukraine upended another set of economic and market assumptions. And remember when we were told that the upsurge in inflation was likely to be a transitory phenomenon?[1]

Making accurate predictions is tough at the best of times, but nailing year-end forecasts for interest rates, shares, currencies and other variables in the face of wars, pandemics and the biggest inflationary breakout in four decades is a nigh-on impossible ask.

Just how hard can be seen by looking back at the forecasts published in the Australian media this time a year ago.

The Conversation academic website each year surveys a panel of academic, market and industry economists for their outlook for a series of economic and market variables for the coming year. In mid-2022, the panel comprised 22 experts.[2]

The consensus forecast for the Reserve Bank of Australia's official cash rate was a rise from its then rate of 0.85% to *peak* at 3.1% by August this year. Well, we're now in July and the rate is already at 4.1%, with market expectations of one or two further increases by year end.[3]

For headline inflation, the panel on average expected it to moderate to 4.8% by the end of the 2022/23 financial year. The most recent monthly inflation indicator for May from the Australian Bureau of Statistics had annual inflation at 5.6%.[4]

On the economic outlook, the panel saw a 40% chance of a recession in the US in the coming two years and a 20% chance of one in Australia, most likely starting in August 2023. While the US economy has slowed, authorities there recently *upgraded* estimates of GDP growth for the first quarter of this year from 1.3% to 2.0% - still a fair way from recession.[5]

In Australia for the same period, annual GDP growth was 2.3%, a marked slowdown from 2.7% at the end of 2022, but still well short of recession.[6]

Unemployment was also seen by the panel as likely to *increase* over 2022/23 from 3.9% to 4.2%. In actual fact, the jobless rate has *fallen* in that period to be at 3.6% by May this year.[7]

On financial variables, the consensus was a slow and modest recovery in the Australian dollar to around 72 US cents. In fact, the currency *declined* over the financial year from around 69 US cents in mid-2022 to close to 66 cents by June 30 2023.[8]

On equity markets, the panel expected the Australian share market to *fall* 2% over the financial year. The reality was the Australian market, as measured by the S&P/ASX 300 index on a total return basis, *climbed* by more than 14% in 2022/23.

What happened? The economists undershot their expectations for inflation, GDP growth, interest rates and share markets, while overshooting expectations for unemployment and the Australian dollar. In essence, they underestimated the strength of the economy.

To be fair, it's a tough business, forecasting, even for the experts. So much can go wrong if one variable (like inflation in this case) turns out to be stickier than assumed. But it's a reminder to the rest of us not to put too much weight in these articles about the year ahead for economies and markets.

It's also a reminder that basing your investment strategy on these forecasts is unlikely to be a successful or sustainable strategy. Instead, accept that the market already does a pretty good job of incorporating all those opinions and expectations for the future and that as events occur, market prices will change.

No-one can predict the future and there will always be uncertainty. The potentially higher returns on offer from shares and other assets are the trade-off for the uncertainty.

At the end of the day, having an appropriate asset allocation for your own risk appetite and personal goals, staying diversified and remaining disciplined are the best alternative to relying on a cracked crystal ball.

1. 'Recent Trends in Inflation', RBA Governor Philip Lowe, 16 November 2021.
2. 'How the Conversation's Panel Sees the Year Ahead', *The Conversation*, 30 June 2022.
3. ASX 30-Day Interbank Cash Rate Futures Implied Yield Curve, as of 30 June 2023.
4. Monthly Consumer Price Index Indicator, *Australian Bureau of Statistics*, 28 June 2023.
5. 'US Weekly Jobless Claims Post Biggest Drop in 20 Months as Economy Shows Stamina', *Reuters*, 30 June 2023.
6. Australian National Accounts, *Australian Bureau of Statistics*, 7 June 2023.
7. Labor Force Australia, *Australian Bureau of Statistic*s, 15 June 2023.
8. Historical Exchange Rate Data, Reserve Bank of Australia.

RISKS

Investments involve risks. The investment return and principal value of an investment may fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original value. Past performance is not a guarantee of future results. There is no guarantee strategies will be successful.

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