

The Tortoise and the hare

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Wild Rides or Wild Guesses?

“The experts said 2014 would be wild. They were right. They think 2015 will be wilder.” So said the Wall Street Journal as the New Year got underway. But were the experts really right about last year? You be the judge.¹

One of the best performing asset classes in 2014 was government bonds. With inflation and expectations for future inflation low, yields on many longer-dated bonds fell toward record lows throughout the year. Yields fall as prices rise.

For example, the return for investors in US Treasuries that mature in 10 years or more was above 20% last year, eclipsing the gains in shorter-dated bonds and in equities. The 10-year bond ended the year at just above 2%.

Yet a year before, the consensus forecast from economists polled by Bloomberg was for Treasury yields to rise rapidly in 2014 to 3.44%. Likewise, the yield on the 30-year bond ended at 2.75%, defying economists' forecasts of 4.25%.²

UK government bonds also had their best year since 2011. Gilts returned 14% as the Bank of England kept interest rates at record lows. The 10-year bond ended the year at 1.76%, down from 3% in January and again at odds with expectations of a rise.

In Australia, Bloomberg in February found 11 institutions predicting the central bank would raise its benchmark rate. It turned out cash rates remained unchanged all year and Australian government bond yields fell from above 4% to below 3%.³

It wasn't just the bond market that confounded forecasters in 2014. Economists surveyed by the Wall Street Journal in January 2014 expected oil to end the year at about \$US95 a barrel, up from \$US92. But oil prices collapsed 46% over 2014, the steepest decline in six years to end just above \$50 a barrel.⁴

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The US share market fooled some analysts as well. The consensus forecast for the S&P 500 from a Bloomberg poll of 20 analysts was for a modest 5.5% gain in 2014. The market ended up by more than 11% or nearly 14% including dividends.

In Australia, analysts got it the other way around, predicting a much better year for local shares than eventuated. In January, a Sydney Morning Herald poll said the local benchmark S&P/ASX 200 index was tipped to “rocket” 8.5% to more than 5900 by the end of the year. As it turned out, the price-only index gained just over 1%.⁵

But even if you had picked bond and equity movements in 2014, you also had to manage currency risk. And it was an extraordinary year for the US dollar, which posted its best year in nearly a decade. Bloomberg data showed the greenback climbed against all of its major peers last year.

A year before, there was a consensus view that the US dollar would strengthen. But few picked the extent. The mean estimate in a poll of 46 analysts by Bloomberg in late 2013 was for the US dollar to rally 7% against the euro in 2014. As it turned out, the US currency put on 12%. Against the commodity-driven Australian dollar, the US dollar gained 8.3%.⁶

Why did so many forecasts go awry in 2014? The simple answer is things happened. Inflation was much lower than many expected. The slump in commodity prices, particularly for oil and bulk commodities like iron ore and coal, surprised many. This hurt the resource-heavy Australian market in a relative sense.

Geopolitically, it was a turbulent year, though the actual effect on markets was hard to discern. The militant group Islamic State rampaged through Syria and northern Iraq, triggering US-led military reprisals. War broke out in Gaza between Israel and Hamas. Relations between Russia and the

West deteriorated over the Ukraine. The Ebola virus ravaged parts of West Africa, raising global health concerns.

Economically, the US recovery accelerated. Growth in the third quarter reached its quickest pace in 11 years and the Federal Reserve wound up its asset buying program in anticipation of an eventual increase in official interest rates this year.

Europe, in stark contrast, continued to struggle economically. The single currency zone grappled with the threat of deflation, triggering market expectations by year end of radical policy action by the European Central Bank.

Japan’s recovery showed signs of stalling toward the end of the year, triggering promises of another near-\$30 billion stimulus package by Prime Minister Shinzo Abe’s re-elected coalition government.

China, too, flagged more stimulus as industrial activity there slowed and the property market weakened. December quarter growth was estimated at 7.3%, undershooting the official 7.5% target and marking the weakest annual expansion in 24 years.

Even so, Chinese stocks climbed toward 5-year highs to end up more than 50% for the year and topping the league table for international stock markets in 2014.

So were the forecasters right after all? Was 2014 a “wild” year? The short answer to that question is another question: compared to what? Ask yourself when haven’t markets had something to worry about? When has there ever not been uncertainty?

The world is a big and ever-changing place. Economies wax and wane. There is always geopolitical conflict somewhere. “News”, which is journalistically defined as both noteworthy and unexpected events, is always happening.

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The prices of securities respond to news. To accurately and consistently predict prices, then, you need to be able to anticipate everything that might influence them. And the fact is no-one has been shown to be able to do that (at least no-one human).

So the task for investors as each and every year begins is to take every forecast with a large grain of salt. At best, these forecasts are assumptions. They're based on a whole lot of other variables going according to plan. We saw how bonds confounded forecasters last year. So investors who avoided them missed an excellent return.

We saw how the US equity market continued to reach new highs despite some expectations of more modest gains and how Chinese stocks defied gloomy economic numbers. We noted how oil prices slumped despite rising unrest in the Middle East. And we saw how the strength of the US dollar surprised many. The news is important, for sure. But even if you had a crystal ball to see

events before they happened, you would still have to predict how the market would react. And, as we have seen, that is not always obvious. What matters ultimately for individuals as investors is what is going on in their own lives and whether their portfolios are sufficiently diversified to get them to where they want to go. There will always be parts of the market that do better than others. The challenge is we don't know which. And you probably aren't sufficiently diversified if nothing in your portfolio stank.

Ultimately, wild rides aren't made easier with wild guesses.

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