The Economists Win Another Round

A dwindling number of us of a certain age recall the mainframe era, a time when not everyone capable of getting dressed by themselves in the morning had the equivalent of a 1970s supercomputer on their desks, let alone plugged into their ears and glued to their hands. It was during this border-time with the Pleistocene I formulated Simons' Law and its first corollary: Some numbers drive out no numbers and computer-generated numbers drive out other numbers.

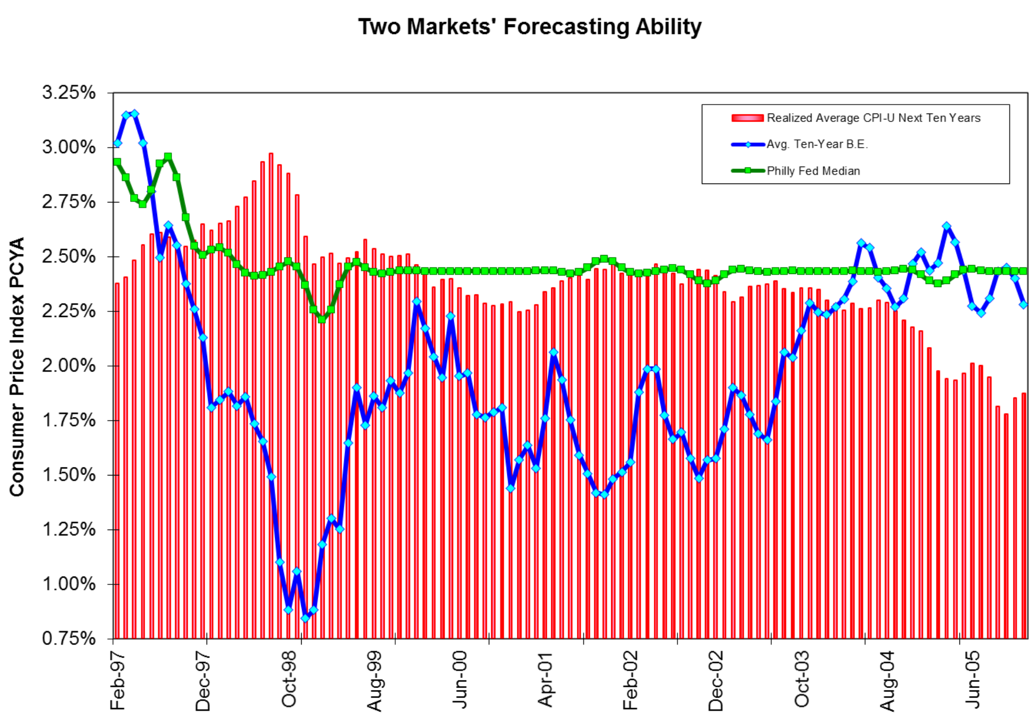
You still see this in action, generally in association with a government grant, for studies such as good-looking people are hired before the alternatives…and that's as far as I am going to take this line of thought.

Implied And Actual Inflation Forecasts

Now let's return to a favorite of mine, one last updated here in January 2015, comparing the median inflation forecasts of economists surveyed by the Philadelphia Federal Reserve (motto: Please stop calling us the Philly Fed) to the inflation forecast implied in ten-year TIPS.

There is a certain conceit, one very much related to Simons' Law, market-derived forecasts are better than professional forecasts. This appeals to our collective sense we are all contrarians, even if we take the bus to the office and then sit in a cubicle all day. If we see the self-proclaimed experts get taken down a peg or two, then we think we are just as good.

I took the economists' quarterly forecasts, knocked them down to a monthly frequency using cubic spline interpolation and matched them to a series of monthly average ten-year breakevens. I then compared those two forecasts to the actual rate of consumer inflation over the next ten years.



Once again, the results are unequivocal. The average forecasting error for the TIPS market of 0.60% represents 25.02% of the realized ten-year forward average of the CPI-U; the comparable numbers for the Philadelphia Federal Reserve panel are 0.22% and 9.07%.

As you can tell by the chart, neither the economists nor TIPS traders standing in 2004-2005 could forecasts the drop in realized consumer inflation in 2014-2015. As a result, both forecasts are skewed high, with the TIPS market's forecast skew coming in at 0.085 as opposed to 0.012 for the economists' forecasts.

One other thing stands out in this chart. Please note how constant the economists' forecasts were for a long period of time. It is as if they pulled a number out of the air – let's hope it was out of the air – and stayed with it through thick or thin. The TIPS market was far more peripatetic. After all, it is composed of traders whose goal is making money from trading the spread between TIPS and conventional Treasuries as opposed to getting the forecast right.