Markets are Good Forecasters

Many have tried to refute the basic logic that an open and relatively easily accessible market will tend to aggregate public information well, and by extension, be hard to beat (make excess risk-adjusted returns) without inside information. The most rhetorically effective attack on the idea of the "efficient market", which is nonetheless empty in the final analysis, is summarized thus:

As many traders don't attempt to predict future events when judging to buy or sell, and trade merely to buy insurance against a price move, the market 'signal', the information baked into prices, is effectively corrupted. "If everyone in the market isn't at least trying to get it right, then the market is rubbish.", so to speak.

This is something you usually hear Austrian-minded people put forth. Weirdly, those who shout "Free Markets!" loudest, are actually highly skeptical of markets! For these people, financial markets are a sort of Casino for the very rich and intelligent. A madhouse of betting that much of the financial industry is inexplicably focused on. We suspect this rhetoric comes out of a need to discredit markets, as markets are most certainly a challenge to the perma-bear view, the bane of gold bugs and internet crackpots.

For us at NGDP-Advisers, financial markets are a sort of probability aggregating engine. When a particular market rises or falls, we interpret that as a sign the Smart Money has reweighed the probabilities of certain events. Our job, as we see it, is to look at patterns in many markets, across asset classes and countries, and interpret what those patterns imply for the macro economy. This allows our clients to be better-informed about the likely path of the economy, allowing them to make better decisions for their business in advance of macroeconomic moves.

We've essentially staked our business and our credibility on the idea that markets are highly informative, and can tell you far more about the state of the economy and its likely future course than "expert" judgement or overwrought, pseudoscientific forecasting models. We believe this to be true because this approach has proven so useful historically. In 2011, most major business economists were expecting a housing-lead recovery, as low house prices and interest rates, as well as a mysterious force known as "Pent Up Demand" kindled borrowing and consumption spending. These analysts were calling for 10-year interest rates to be in the 3% to 5% range by 2013! When 2013 came and the US economy remained depressed, these analysts simply tacked their old forecast on to the latest historical end point for the data series and repeated the same tired stories.

Market Monetarists, including members of our team were, however, on record saying rates would remain low, and the economy would stay depressed, barring a revolution in the monetary policy framework the Fed and other major central banks were using. We were of course right, and the outlook our members were speaking of in 2011, 2012, 2013, or 2014 would have proven largely accurate as of today's date (late 2016). If we were wrong it was only in that we failed to anticipate how uncreative and timid the Fed would prove to be in the face of low oil prices and innovations in policy approaches by other central banks.

We've been proven right because we respect markets. Markets weren't forecasting a return to the good old days of 5% nominal income growth, so neither did we. We respect markets primary because of two mechanisms at work in financial markets that makes them hard to be consistently beaten:

1. The Wisdom of Crowds, or model averaging

2. The discipline of the payoff

These two mechanisms combine to undermine the seemingly compelling objection to market efficiency laid out in the beginning of this piece. With *Wisdom of Crowds* and the *Discipline of the Payoff*, a big fraction of traders can bet at random, or deliberately bet against rational expectations, and the market should still be a good compiler of publicly available information; should still be more or less efficient, in the sense that there's no reliably easy money to be made from trading. Number two is the most important, so let's get number one out of the way.

We can split traders into two camps. In the first camp, we have people who bet in the market because they think they know something. Some of these people just have a vague idea that prices will go up, so they buy, some are sophisticated traders, buying, shorting, trading options. When we're talking about this first group of ***Predictor*** traders, we're dealing with the *Wisdom of Crowds* phenomenon. The great British polymath, Sir Francis Galton made the Wisdom of Crows concept famous, by observing that the average of bets at a county fair on the weight of a cow was closer to the cow's true weight than any individual bet. This mechanism is at play in financial markets: ask five copper traders to predict the spot price in 6 months and you'll probably be better off averaging all their guesses than going with any one guess, particularly if you repeat the process over and over for years. When someone thinks they can reliably out-forecast a market, they're in effect saying they can outdo the collective wisdom of all the traders in that market. It's quite a strong position to take.

The Wisdom of Crowds gives the market the ability to make solid predictions, given current information. Some events are inherently hard to predict (such as what the hell the Fed was thinking in September, 2008), and markets are wrong all the time, but we're not done yet. Effect number two, the *Discipline of the Payoff* as we've called it here, is what ties it together and makes markets so hard to beat.

Let's say some whale of a trader opens a position merely to hedge against an event which he is exposed to in some other aspect of his business. Let's say this whale moves the market a whole lot and for no rational purpose. Let's assume, conservatively, that his hedging action contains no information about the tails of the distribution for the asset's future price, it's just irrational hedging. By his action of moving the market away from the arguably efficient price, he's created an opportunity for someone else to make money. The people who deny the efficiency of markets are saying no one, out of the thousands of big-time traders in the market, will come in and pick up that easy money.

Markets punish and reward, this is the essence of the *Discipline of the Payoff* effect. It doesn't matter if the asset we were discussing above is a stock that pays dividends, a stock from a speculative, loss-making but potentially successful tech company, a commodity future or a bond. There's a payoff somewhere for that asset. If you don't think so, then we'd love to see your tax returns. You should have all sorts of capital gains to report from your superior trading skills!

If financial markets aren't efficient, if they don't over time punish and reward, then all you've got to do is bet on revision whenever markets move on a clearly identifiable piece of info. Stocks fall on rumors of a Fed rate hike? Buy baby! Random hedging and irrational speculation will move the price back up on average, because traders aren't good a picking up the free money. A simple strategy would be to always bet against big moves, you'll be rich! Of course if you think the implications of this all the way through, you'll realize that were markets inefficient, your actions would tend to make them less inefficient, which over time, and with enough notice by others...would make them efficient! And dear reader and future client, please understand than our use of “you” here is colloquial. We know *you're* smart, as you’re at NGDP-Advisers.com!

This is not to say that markets are always giving clear signals that economists can interpret without effort. A famous example of this is the correlation between US treasuries and the Spain-Germany bond spread from 2012 and early 2013. In this interval, when spreads rose in Europe, Treasury yields in the US fell, though other US assets didn't do anything particularly interesting. It was just an effect of haven-demand: when traders dumped Spanish bonds, they tended to shoulder into the US treasury market, pulling down yields. If you'd been using US treasuries as a shadow forecast of nominal GDP, you'd have been misled, but if you were reading the Market Monetarists, you'd have known the US would be OK. It's also important to point out that markets aren't magic, and are only as good as the traders. The market becomes efficient through the hard work and focus of millions of people. The point isn't that markets are always right about corporate earnings or future commodity spot prices or demand for debt; rather that, without inside information, it's really hard to know when prices have moved away from what’s rational, and to do so consistently throughout a career.