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10 reasons why economics is an art, not a science

By Barry Ritholtz, Published: August 9, 2013

"Why did God invent economists?"

"To make weathermen feel good about themselves."

That's a quip from David Rosenberg, former chief economist at Merrill Lynch who is now working at Gluskin Sheff, the wealth management shop. He delivered it during a meteorological presentation to a room full of asset economists during the annual Shadow Federal Reserve and Fishing Trip, where I was last week. David Kotok hosts this shindig every year at Leen's Lodge in Grand Lake Stream, Maine. Known informally as Camp Kotok, it runs during the weeks before the Fed's big Jackson Hole conclave.

It is much more than just fishing and drinking: Plenty of economic debate goes on among the economists, Fed researchers, money managers and academics in the woods of Maine. (To get in, you must bring a case of wine, and woe to the attendee who pours substandard vino.) Spend a few days with a dozen or so economists, and you may have to reconsider your views on economics.

Through some quirk in my calendar, I have been spending an inordinate amount of time with economists. Over the past few months, I have attended numerous dinners (usually a table for eight), listened to their debates on economic policy, spent time in canoes fishing with them. Chatham House Rules prevents me from naming names, but among the dismal scientists were the chief economists of major Wall Street firms, government entities and Ivy League college professors. And a Nobel laureate or two thrown in for good measure.

As an investor, I spent much of this time seeing what I could learn from these students of the economy. The good news is that economists are intelligent, engaging and often charming folks. The bad news is their work is often of little use to investors.

Longtime readers know this is an area of interest to me. Way back in 2009, I gave 10 reasons why economists missed the crises. In the intervening years, I have watched the field of economics with a growing skepticism.

My conclusions? Here are some decidedly biased, anecdotal observations:

1) **Economics is a discipline, not a science.** Physics can send a satellite to orbit Jupiter, tell you exactly when it will arrive and the altitude it will orbit at. Economics can barely describe what happened yesterday — and without any particular precision.

2) **Markets are frequently ahead of, and often out of sync with, the economy.** I have been trying to figure out why investors seem so obsessed with economic data. We know that during recessions, corporate earnings often fall 20 to 30 percent. However, the timing is the tricky part, and by the time we know a recession has started, it is too late.

Take the 2007-09 recession. It began in December 2007 and ended in June 2009. Markets act as a future discounting mechanism, often leading the economic data. The Standard & Poor's 500-stock index peaked in mid-October two months before the recession formally began. By the time the NBER, the group that formally dates these things, made its official announcement in December 2008, markets had fallen more than 30 percent. For investors, waiting for the official announcement was of little use.

3) **Models are of limited utility.** As statistician George Box has noted, "All models are wrong, but some are useful." That was the professor's way of explaining that models are imperfect depictions of reality. It's best not to become overly reliant on them. Several analysts have told me that if the Fed cannot model something, then to the Fed, it does not exist. Think about the absurdity of that view — and its impact on policy.

Perhaps the best-known model-dependent economic data point is the NonFarm Payrolls report, which is released on the first Friday of each month. To put into context how silly the excitement around this number is, consider the total U.S. labor pool: It contains about 150 million people. Each month, 4 million or so folks leave their jobs (retire, quit, get fired). At the same time, about 4 million people start jobs. The net difference between people leaving jobs and starting new ones — about 150,000 — is the monthly NFP number. That is a 0.1 percent of the total labor pool — a rounding error.

This number is revised the month afterward, and then revised again the month after that. It is benchmarked a year later, and ultimately reweighted once the decennial census is completed. Much of the time, the final number looks nothing like the

original data released each month. So why do investors spend so much time worrying about it, other than the fact that other investors seem to worry about it?

4) **Contextualizing data often leads to error.** What I mean is that everything economists consider gets forced into their intellectual framework. The imperfect lens of economic theory is less than an ideal way to view the world. Thus, the output of those who see the world this way is similarly imperfect — and as we have seen, occasionally fatally so.

5) **Narrative drives most of economics.** Everything seems to be part of a story, and how that story is told often leads to critical error. Think about phrases like "stall speed," "second half rebound," "muddle through," "Minsky moment," "austerity," "escape velocity," etc. All of these lead to rich tales often filled with emotional resonance — but not a lot of insight.

6) **Economists are loathe to admit that "they don't know."** This trait is common in many professions, but I suspect the modeling issue may be partly to blame. Whenever I see a forecast written out to two decimal places, I cannot help but wonder if there is a misunderstanding of the limitations of the data, and an illusion of precision. Only the people who understand both the data and its limitations will not get lost in the illusion of precision.

7) **A tendency to confuse correlation with causation.** This is one of the oldest statistical foibles, and yet economics remains rife with it at the highest levels. Look no further than the Fed's obsession with the wealth effect for a classic correlation error.

8) **The peril of predictions.** Another brain teaser: Why are Wall Street economists so married to making forecasts? They are mostly miserable at them; as I have discussed previously, forecasts are especially problematic for investors.

9) **Extrapolating current circumstances to infinity: Economists suffer from the recency effect, just like everyone else does.**Their experiences with typical recession cycles in the postwar era left many of them blind to the fact that something unusual was occurring. This left them unable to understand how and why the post credit-crisis era was so different from their prior experiences. These are not your run-of-the-mill recessions. They tend to be more protracted and painful; and their recoveries are weaker and take longer to occur.

10) **Sturgeon's Law: Not every economist is a prize winner.** There is a wide dispersion of talent in economics, and following Sturgeon's Law — "90 percent of everything is crap" — many among the rank and file simply are not great analysts.

And on a side note: I am not trying to draw a distinction between different groups of economists, say, between the macro and micro or among various schools (Monetarists, Keynesians, Austrians). I don't find it compelling. In 2009, Nobel laureate Paul Krugman asked "How Did Economists Get It So Wrong?" He wondered how "the profession's blindness to the very possibility of catastrophic failures in a market economy" could ever have occurred.

This is likely to be the biggest issue affecting your long-term financial health. It helps explain why the average 401(k) has returned only 3 percent annually over the past three decades, despite markets' returns running triple that amount. Psychology is the root cause of getting greedy at tops and panicking at bottoms, neither of which leads to good investment results.

The field of behavioral economics is still relatively young. It has only recently figured out that Homo Economicus — humans as rational and narrowly self-interested actors — is not how people behave in the real world. Economists are just starting to get at these questions of why people make such bad financial decisions, and how we can prevent these behaviors in the future.

Perhaps one day the answer to the question "Why did God invent economists?" will be: "To help us stop making so many bad financial decisions."

Ritholtz is chief executive of FusionIQ, a quantitative research firm. He is the author of "Bailout Nation" and runs a finance blog, the Big Picture. Follow him on Twitter: @Ritholtz.

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