Business Forecasting: Prediction or Speculation

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Abstract

Business and financial forecasting helps management accountants to develop the best strategies for current and future trends and events. Today, artificial intelligence, forecasting software, and big data are supposed to make business forecasting easier, more accurate, and personalised to each organisation. However, forecasting does not promise an accurate picture of the future, or how your business will evolve, as we have seen with the unexpected shifts in the business climate post Covid-19 lockdowns.

Business leaders and investors had a tough time in 2021 and 2022, with the nastiest surprises coming when something that is taken for granted is suddenly called into question—such as low interest rates, unlimited capital, functioning banks or a lockdown-free existence.

Management accountants need to be well prepared to face whatever *headwinds* 2023 brings.

Introduction

Paul Samuelson, a Nobel-prize winning economist, once joked that the stock market had predicted nine of the last five recessions.

Business forecasting is a practice that helps determine how to allocate resources and plan strategically for upcoming projects, activities, and costs by projecting future developments of a business or industry. Such forecasting enables organisation to manage resources, align their goals with present trends, and increase their chances of surviving and staying competitive.

Business forecasting relies heavily on *analysing trends and patterns of past and present data.* The problem was that in 2021, as the world slowly emerged from Covid-19 restrictions there were significant business surprises that emerged which defied predictions and flummoxed forecasters [i].

The Business Surprises of 2021

The significant business surprises of 2021 were:

Supply-Chain Disruptions

Whilst the onset of the pandemic in early 2020 was strikingly free of serious disruptions, 2021 was marked by extensive shortages and surging supply-driven inflation. The average cost of shipping a 40-foot container across a range of routes reached a peak of US$10,377 in late September 2021, quadruple the level a year earlier.

Disruptions to factories and ports in China and South-East Asia, driven by their governments' efforts to smother Covid-19 outbreaks, did not help matters. But the lion's share of the tumult was attributed to the explosive demand for physical products. Spending on durable goods rose by 34% in America since the beginning of 2020, compared with an increase of about 4% on services.

Chinese Markets Upturned

A regulatory crackdown in 2021 left the *Morgan Stanley Capital International* (MSCI) *China Tech 100* share-price index down by nearly a third that year. The stock price of *Alibaba*, an e-commerce giant, fell by almost 50% over the same period. *Evergrande*, a huge property developer, the most extreme symbol of China's heavily leveraged real-estate sector, defaulted in 2021 — in the face of the Chinese government's efforts to throttle borrowing by developers. The shakedown of both the tech and property sectors in 2021 made clear that investment performance in China can turn on a dime if the government's mood shifts.

The Earnings Bonanza

Analysts and investors expected a revival in earnings in 2021—after all, things could hardly have been worse than 2020—but the scale of the recovery beat almost all projections. The growth in the 2021 year was 45%, stronger even than the 40% rise in 2010, after the global financial crisis.

Public v Private Capital

In 2021, America raised over US$150 billion, more than twice the amount raised in 2020. This boom cast some doubt over the idea that public markets are being inexorably supplanted by private capital. The power of banks over the listing process had signs of ebbing, as more companies going public opted for direct listings, or mergers with special-purpose acquisition companies (SPACs).

Green Finance

Prior to 2021, executives and investors who were keen to appear environmentally friendly had sometimes been objects of derision — and green finance in general was regarded with (often justified) scepticism. But 2021 saw some concrete developments with *Green government bonds* flooding the market — with at least 20 countries issuing such debt that year. In mid-October 2021, the *European Union* issued its first *green bond*, selling €12 billion-worth (UD$13.6 billion) to enthusiastic investors.

Perhaps the most interesting green developments came in 2021 from the private sector. Investment in climate-tech start-ups reached US$60 billion in the first half of 2021, more than triple that in the same period the year before. There was also a huge surge of investor interest in electric-vehicle firms, from *Tesla* to *CATL*, the world's leading battery-maker. Meanwhile, in May 2021 *ExxonMobil* lost a proxy battle against activist investors, who voted more climate-friendly directors to the oil firm's board. Surprisingly, the oil majors were among the companies exploring hydrogen technologies that year.

With so many surprises in 2021, how did the forecasters fare in 2022?

The Business Surprises of 2022

No forecaster could have predicted the 'perfect storm' of trend reversals in 2022. In fact, given how many trends changed direction over the course of 2022, the real surprise is that the investment outlook was not nastier by the end of the year. Here were the most significant trend reversals in 2022 [ii]

End of Cheap Money

Many business forecasters actually thought interest rates would stay near zero for the foreseeable future. Even in 2021, respectable investment houses were publishing articles as to why interest rates will stay low [iii]. Borrowing costs had been falling for decades; the combination of the global financial crisis of 2007-09 and the Covid-19 pandemic seemed to have permanently fixed interest to the floor.

Then in 2022, with persistent high inflation, America's *Federal Reserve* embarked on its swiftest *quantitative tightening (QT)* cycle since the 1980s, raising the target range for its benchmark interest rate by more than four percentage points, to 4.25-4.5%. Other central banks followed in its wake. The Fed's governors now think that its rate will finish 2023 above 5%, before settling down to around 2.5% in the longer run. The era of free money appears to be over (at least for the foreseeable future).

Death of the Long Bull Market

From the post-financial crisis depths of 2009 to its peak at the end of 2021, the *S&P 500 index* of leading American shares rose by 600%. In October 2022 the long-Bull Market finally ended. The S&P 500 fell by a quarter to its lowest point and remains down 20% in early 2023. *MSCI's* index of global shares fell by 20%. Stocks were not the only asset class to have been decimated[iv]. Share prices have fallen in part because interest rates have risen, raising the returns on bonds and making riskier assets less attractive by comparison. Whether or not prices fall further, the *"bull market in everything"* appears to have come to a close.

Evaporating Capital

Capital was not just cheap in the last years of the bull market; it was seemingly everywhere. Around the world, Central Banks' *quantitative easing* (QE) programmes, devised during the financial crisis to stabilise markets, went into overdrive during the pandemic. Together, the Central Banks of America, Britain, the Euro area and Japan pumped out more than US$11 trillion of newly created money, using it to vacuum "safe" assets, such as government bonds, and depress their yields.

This pushed investors in search of returns into more speculative corners of the market. In turn, these assets boomed. In the decade to 2007, American firms issued US$100 billion of the riskiest high-yield (or "junk") debt per year. In the 2010s they averaged $270 billion. In 2021 they hit $486 billion.

In 2022 capital abundance turned to capital scarcity. The US Fed and the Bank of England put their bond-buying programmes into reverse; the European Central Bank prepared to do likewise. Liquidity drained away, and not just from the risky end of the debt market. Initial-public offerings (IPOs) smashed all records in 2021, raising US$655 billion globally. Now, in 2023, American IPOs are set for their leanest year since 1990. The value of mergers and acquisitions also fell, albeit less dramatically.

End of Corporate Debt Monsters

Awkward questions are now being raised about what happens next with the mountain of debt that companies have amassed in recent years. Since 2000, non-financial corporate debt has gone up from 64% of GDP to 81% in America and from 73% to 110% in the Euro area. All told, American, British and Euro area public companies now owe creditors almost US$19 trillion, with a further US$17 trillion owed by unlisted firms.

Just how wobbly is this pile?

A case in point is the *Citrix* fiasco. When investment bankers agreed in January 2022 to underwrite the leveraged buy-out of Citrix, a software company, by a group of private-equity firms, returns on safe assets like government bonds were negligible. Yield-hungry investors were desperate to get their hands on any meaningful return, which the US$16.5 billion Citrix deal promised. Lenders including *Bank of America, Credit Suisse* and *Goldman Sachs* were happy to dole out US$15 billion to finance the transaction.

Nine months later the banks tried to offload the debt in a market gripped not by greed but by dread—of stubborn inflation, a war in Ukraine and recession. Struggling to find takers, they palmed off US$8.6 billion of the debt at a discount, incurring a US$600 million loss. They are still nursing the remaining US6.4 billion on their balance-sheets.

Citrix is a particularly shocking example of a broader shift in corporate debt markets that most financial forecasters missed. Western central banks are now pushing interest rates to levels not seen in 15 years and shrinking their balance sheets. Those that bought corporate bonds during the pandemic in order to stave off a wave of bankruptcies have been selling them or have already done so. All this is draining the market of liquidity as investors abandon riskier assets like corporate debt in favour of safe *Treasury bonds*—now that these suddenly promise decent returns. The result is plummeting prices of corporate bonds, especially for less creditworthy businesses [v].

Value Beats Growth

The bull run was a dispiriting time for “value” investors, i.e., those who hunt for stocks that are cheap relative to their underlying earnings or assets. Low interest rates and QE-fuelled risk-taking put this cautious approach firmly out of fashion. Instead, “growth” stocks, promising explosive future profits at a high price compared with their (often non-existent) current earnings, stormed ahead. From March 2009 to the end of 2021, MSCI’s index of global growth stocks rocketed by a factor of 6.4, more than twice the increase of the equivalent value index.

This year, rising interest rates turned the tables. With rates at 1%, to have $100 in ten years’ time you must deposit $91 in a bank account today. With rates at 5%, you need only put away $61. The end of cheap money shortens investors’ horizons, forcing them to prefer immediate profits to those in the distant future. That ‘Growth’ stocks will be out, and that ‘Value’ will be back in vogue was missed by most financial forecasters.

Crypto Implodes (Again)

Those who think crypto is only good for gambling and dubious activities such as money laundering could not hope for a better example than the fall of the crypto exchange *FTX;* supposedly the industry’s respectable face, run by *Sam Bankman-Fried*, a 30-year-old philanthropist and political donor. Yet, in November 2022, the firm collapsed into bankruptcy with some US$8 billion of customer funds missing. American authorities now call it a “massive years-long fraud”. Mr Bankman-Fried has been arrested and faces criminal charges (he has pleaded not guilty). If convicted, he could spend the rest of his life in jail.

Whatever Mr Bankman-Fried’s fate, FTX investors and the financial consultants who advised them, have already gone through the *five stages of ‘crypto grief*’ [vi]. The first of these stages, according to psychology textbooks, was *denial*— giving a range of arguments about why things weren’t as bad as they seemed are floated—from the debatable (“crypto is here to stay”), to the self-serving (now is actually the *perfect* time to invest) and even some unhinged responses. In the second stage people progress from denial to *anger*— where Bankman-Fried is viewed as more villain than victim. The third stage is *bargaining*— if only the industry had been better regulated, the FTX scandal would not have happened. The fourth stage is *depression*— where people feel betrayed by the Founder, whom they had regarded with a zeal usually reserved for religious leaders. Now they must reckon with a traitorous apostle in Bankman-Fried. The last stage of grief is *acceptance*— as many as 1 million people lost US$8 billion between them on FTX alone.

FTX's downfall marked the bursting of crypto's most recent bubble, and the outing of dubious financial forecasting speculators. At its peak in 2021, the market value of all cryptocurrencies was almost US$3 trillion, up from nearly US$800 billion at the start of the year. It has since fallen back to around US$800 billion. Like so much else, the debacle's roots lie in the era of cheap, abundant money and the anything-goes mentality it created.

Bailouts for Everyone

When times are tight, governments have long sought to provide safety nets or stimulus in bad times. But over the past 15 years, they have become far more willing to shore up vast swathes of the economy. When industries, companies or people get into trouble, fiscal help is never far away. Gains are privatised, but a growing share of losses or even potential losses are socialised. We have truly entered an era of *"bail-outs for everyone"* [vii].

When the Covid-19 pandemic arrived, bailouts moved from the financial economy to the real one. During the lockdowns that followed, governments handed out trillions of dollars of support, guaranteed vast amounts of corporate lending, and banned evictions and bankruptcies. Unlike in previous crises, rates of poverty, hunger and destitution did not rise and in some places actually fell. Across the rich world, disposable incomes rose. Most firms that shut their doors subsequently reopened them.

With this success behind them, politicians have set new expectations of what the state can and should do. This is visible in the smaller bailouts, guarantees and rescues that have mushroomed since the start of the 2010s. The Italian government, for instance, has set up schemes to deal with banks' non-performing loans, to get the private financial sector to lend again. The British government has offered banks vast guarantees to get them to offer bigger mortgages. The value of bank deposits insured by America's government has risen by 40% in the past five years.

In August, President Joe Biden announced that he would spend hundreds of billions of dollars to bail out Americans holding student-loan debt. Around the same time, he expanded loan guarantees for clean energy. Australia and New Zealand have offered citizens cost-of-living payments to deal with high inflation. Poland has introduced a moratorium on mortgage debt. Romania is doing something similar. It is only a matter of time before the next intervention comes along.

There are downsides, however, aside from the potentially monumental fiscal costs. While a given intervention—a bank bail-out, say, or stimulus cheques in a pandemic—may be justifiable in its own right, lots of interventions together may strangle an economy. Capitalism produces innovations and higher incomes through creative destruction. Things that do not work stop, and things that work should be given the opportunity to start. An economy-wide safety net slows this down.

For now, however, governments are unlikely to change course. So long as they are not directed at banks, bailouts are popular. When the next recession hits, as it may well soon, people and companies will surely expect another round of furlough schemes, additional benefits, and stimulus cheques. When the next industry fails, expect a big rescue package. We are all bankers now.

Summary

Every year comes with its own unexpected twists for businesses and financial markets, but in the two years post-Covid-19 the world has been jam-packed with them. These unexpected developments have taken investors, companies and financial analysts by surprise — leaving business and financial forecasters to be mere speculators, rather than confident forecasters of developing trends.

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