

Office and Plant:  
2800 South 61<sup>st</sup> Court  
Cicero, Illinois 60804-3091

(708) 735-8000  
(800) 323-2750



Mailing Address:  
P.O. Box 5137  
Chicago, Illinois 60680-5137

Facsimile:  
(708) 735-8100

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## Prediction – A Game or Science?

People love to predict. If you need confirmation of that assertion, just look at the billions spent wagering on the outcomes of the Super Bowl and hundreds of other sporting events, on political contests and on commodity prices. In each of these cases, the bettor seeks to use his knowledge of the past to predict events in the future. (This kind of betting is thus different from playing games of chance, like slot machines, roulette or coin tossing.)

Prediction can also be a more “dignified” occupation, particularly when it is the product of seasoned observation, like the many, many opinions we are given by media pundits, who sagely tell us why Truman will lose, Reagan has no chance, Perot will end the two-party system, etc., etc. Then, there are the intelligence experts in the government, whose prognostications are supported by billions of dollars of taxpayer investments, and whose product leads our leaders to believe that the USSR was strong in the 1980s and that Saddam possessed weapons of mass destruction in 2003.

The most ubiquitous of the predictors are those who comment on economic issues. Virtually all of the thousands of traded stocks are the subject of analysis by employees of investment entities, each of whom provides recommendations *i.e.*, predictions, to investors. And then we have the innumerable investment advisors, who seek to counsel their clients on the kinds of investments that should prosper. And, at the top of this economic heap are those who dabble in macro issues, like the possibility of recession (or recovery), what will happen to interest rates, the price of energy and the like.

At any given time, when current economic conditions are plain to all, it is common to ask who predicted those conditions (a matter of interest, perhaps) and then to learn what they are predicting for the future (a matter of danger, likely). Thus a recent article in the *New York Times* about Nouriel Roubini, a professor of economics at NYU.

Two years ago, Roubini predicted the housing bust and the oil price shock, with the resulting credit crises, crippling of hedge funds and banks and a worldwide deep recession. Roubini was ridiculed at the time, but the accuracy of (most of) his predictions has brought him to current renown, invited to speak to companies, banking authorities and international

conferences. He currently believes that the mortgage crisis will recur with credit card and auto loans, commercial real estate, corporate debt and other borrowings. He also thinks that a good third of regional banks will go under and government bail-outs will critically expand the national debt.

What to make of Roubini? Maybe less than meets the eye. First of all, he is a well known preacher of gloom and doom. As the saying goes, "Even a stopped clock is right twice a day." Secondly, his analysis was based on events in Mexico, Asia, Brazil, Russia and Argentina in the late 1990s. Those countries typically had large current accounts deficits financed by foreign lenders. This situation is, of course, like what is happening in the U.S. (a matter we have commented on a number of times in these letters). Based largely on these common characteristics, Roubini projected disaster for the U.S. The triggers would be bursting the housing bubble and the increases in oil prices, both of which were not hidden from view two years ago.

Financial sages often point out (as do mutual fund prospectuses) that success in the past does not guarantee the same for the future. Thus, one should investigate whether Roubini brings something new to his analysis that suggests he is on to something. In that regard, his approach seems pretty thin, at least to a layman. Economists have been warning against the mounting U.S. trade and current account deficits for decades – periods of strong and poor economic performance. Thus, the fact that other countries (with economies a fraction of the size of ours) came to grief from these deficits is hardly confirmation of a causal effect of the current U.S. problems. Indeed, the subprime and other lending messes appear to be the result of a lack of discipline and have little to do with our current accounts balances.

Thus, this predictor has the same intrinsic weakness as most others – reliance on the past to predict the future, a very iffy game. (The *Times* pointed out that large groups of economists failed to predict 97% of the 62 economic contractions that occurred worldwide in the 1990s.) On the other hand, ignoring the past would turn economic projection into a game of chance (but one in which the odds would probably be better than 3% of being correct).

Whether Roubini is right or wrong, one can take some comfort in the fact that his advice to the government is essentially to do what they have done – ease interest rates and seek to assist borrowers by developing ways for them to work out their mortgage problems.

Here are some specifics on input costs this month:

- Scrap and Pig Iron. Lo and behold! Scrap prices actually declined this month – #1 dealer bundles and #1 busheling (Chicago) were each down \$40 to \$850 per mt. This followed five months of sharp increases, each to a new record. (In our letter of December, 2004, we called a price of \$435 “astounding”.) Pig iron (Brazilian spot price, cif New Orleans) also declined for the first time in ten months by \$90 to \$840 per mt.
- Natural Gas. Another amazing drop this month from \$12.98 to \$8.86 per mcf in the Nymex contract price. This 32% decline tracked the lower crude prices that we have seen.
- Exchange Rates. The final piece of news was the strength of the dollar. As of this writing, the cost of a euro is \$1.48, down 9 cents, the pound is at \$1.85, off 14 cents, and the Canadian dollar is worth 95 cents, 3 cents less than last month.

Thank you for your comments and suggestions, which are always welcome. This letter will be posted on our website, [www.coreysteel.com](http://www.coreysteel.com) and on the international site, [www.steelonthenet.com](http://www.steelonthenet.com).