

FORECASTING

by [Steve Brown](#)

In May of 1968, the U.S. Navy lost a submarine as it was going in for repairs to Newport News, VA. While many commanders suggested the best way to find the missing sub was by using instinct, Navel Officer John Craven came up with a different solution. He gathered estimates from a diverse group of experts and asked them to answer 3 questions: 1) what was the cause of the malfunction, 2) what was the sub's speed at the time of trouble, and, 3) what was the sub's angle of decent. Craven then took all the estimates and averaged them to project where the sub could be located. Using Craven's data, the Navy found the ship 220 yards from where he had predicted it would be.

Interestingly, no single estimate given to Craven was accurate, but the collective judgment was. This case study was in the back of our minds when we heard of a mid-sized bank that does quarterly polling on 25 of its line personnel (regardless of title). The bank uses the data to form its interest rate consensus and offers small prizes for those that end up closest to reality. In addition to creating an inexpensive rate forecast, the process serves to get the whole bank talking about interest rates and gives each employee a sense of ownership in the process. This bank claims great accuracy. We will quickly add that we have tracked the top 40 market economists for a long time and have not been impressed by any single forecaster's accuracy. In fact, a substantial number don't even get the direction right.

Because of our research, we adopted a "group" methodology as well. We average the top 40 economists and combine it with forward market rates. We publish this data monthly in our ALCO economic update. In using a methodology like this, it is important not to throw out the outlier predictions, as these extreme forecasts are often what give the average its accuracy. We highlight these forecasting methods as a better alternative to using the forecast of a single source (such as a local University or broker-dealer).

If you are interested in seeing both the forward rates and the compilation of economist predictions of rates to aid in your planning, simply let us know and we will sign you up for our complementary Monthly ALCO package. This package is concise and timely and is delivered via e-mail on approximately the 3rd day after the end of the month. In addition to economist surveys from around the nation, the package also has narrative on recent activity in securities, loans, CDs and capital.

Of interest to many banks, the package also contains average loan pricing by maturity and sector. This gives banks a data point of where certain par priced loans were originated during the prior month. Similar to the Craven analysis, data is gathered from loan pricing from around the country, bringing you the collective pricing insight of a large group of community banks.

While we are sure you get many sources of information each month to share internally, when it comes to forecasting, sometimes having a collective insight produces a superior result.

BANK NEWS

Home Construction

Over the weekend builders increased their giveaways in an effort to move homes and decrease their inventory overhang. Lennar is offering interest rates on loans starting at 2.88% for the first year,

Ryland will cover the down payment and closing costs, KB will cover the down payment and Hovnanian is offering to waive all loan closing fees.

Sector Loan Risk

Moving companies are one group of customer banks should be closely monitoring. These companies are in particular distress, as a result of higher gas prices and ongoing housing softness. Some companies report business is down as much as 60% from the same time last year (recall that this is also peak moving season). Meanwhile, continue to monitor contractors closely, as layoffs of carpenters has surged 25% just in the past 90 days. Contractors are obviously getting more serious about staying afloat during this difficult economic period.

Municipal Bankruptcy

It is official - the long awaited and often debated bankruptcy of the city of Vallejo, CA has occurred. The city of 120k people is the largest city in CA ever to seek bankruptcy protection. High employee costs and falling tax revenue were the primary catalysts that led to the filing.

Longer Recession

The world's richest man and investing expert Warren Buffett, said he believes the U.S. is in a recession and that it will be longer and deeper than many people think.

JP Morgan

The Bank announced some of the deepest cuts in its investment banking that Wall Street has seen in a while. 200 executives were let go this week with many more to go in the coming months. All told, JP Morgan is expected to layoff 10% to 20% of its investment banking workforce in a massive downsizing. Almost 50% of the M&A group is rumored to be on the chopping block.

JP Morgan on Staffing

The Bank reports that by year-end 2008, bankers will outnumber tellers as it beefs up its selling staff. For 2007, tellers outnumbered bankers at branches on a 3 to 2 basis.

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