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Taking the Pulse of the Real Economy Using Financial Statement Analysis: Implications for Macro Forecasting and Stock Valuation

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ABSTRACT

In this study, we hypothesize and find that financial statement analysis of firm profitability drivers applied at the aggregate level yields timely insights that are relevant for forecasting real economic activity. We first show that focusing on the 100 largest firms offers a cost-effective way to extract information embedded in accounting profitability data of the entire stock market portfolio. We then show that accounting profitability data aggregated across the 100 largest firms have predictive content for subsequent real Gross Domestic Product (GDP) growth. We also show that stock market returns have predictive content for future real GDP growth, while their predictive power varies with the length of the measurement window with annual stock market returns being the most powerful. Importantly, we find that the predictive content of our indices of aggregate accounting profitability drivers is incremental to that of annual stock market returns. An in-depth investigation of consensus survey forecasts shows that professional macro forecasters revise their expectations of real economic activity in the direction of the predictive content of aggregate accounting profitability drivers and stock market returns. Although macro forecasters are fully attuned to stock market return data, their forecasts of real GDP growth can be improved in a statistically and economically significant way using our indices of aggregate accounting profitability drivers. Our findings suggest that professional macro forecasters and stock market investors do not fully impound the predictive content of aggregate accounting profitability drivers when forecasting real economic activity. In additional analysis, we examine the association between stock market returns and the portion of subsequent real GDP growth that is predictable based on our indices of aggregate accounting profitability drivers but that is not anticipated by stock market investors. We find that this portion is positively related to stock market returns, suggesting that the macro predictive content of aggregate accounting profitability drivers is relevant for stock valuation. Overall, our study brings financial statement analysis to the forefront as an incrementally useful tool for gauging the prospects of the real economy that should be of interest to academics and practitioners.

JEL Classification: *E01; E32; E60; M41*.

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Data Availability: *Data are available from public sources indicated in the text*.

Keywords: accounting, financial statement analysis, macro forecasting, stock valuation, macroeconomics

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