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Forecasts of Economic Growth from the Bond and Stock Markets

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Forecasts of Economic Growth from the Bond and Stock Markets

Although both stock and bond market data contain information relevant for predicting GNP growth, the bond market delivers more accurate predictions. While yield curve measures are able to explain more than 30 per cent of the variation in economic growth over the 1953–89 period, stock market variables explain only about 5 per cent. Furthermore, forecasts based on the yield curve compare favorably with forecasts from leading econometric models, whereas forecasts from stock market models do not.

Inasmuch as firms' earnings are positively correlated with economic growth, one might expect that stock prices would contain information about real economic activity. But variations in stock prices can reflect both changes in expected economic growth and changes in the perceived risk of stock cash flows. Investors' changing perceptions about the riskiness of cash flows can confound the information about expected economic growth.

A yield-based forecast for the third quarter of 1989 through the third quarter of 1990 suggests a slowing of economic growth, but not zero or negative growth.

THE LINK BETWEEN ASSET markets and real economic growth was formalized by Irving Fisher.[1] Fisher suggested that, in equilibrium, the one-year interest rate reflects the marginal value of income today in relation to its marginal value next year. The intuition is straightforward. If a recession is expected next year, there is an incentive to sacrifice today to buy a one-year bond that pays off in the bad times. The demand for the bond will bid up its price and lower its yield. The theory implies that current real interest rates contain information about expected economic growth.

1. Footnotes appear at end of article.

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Similarly, the price of a share of stock is the discounted value of expected cash flows. The strength of the economy determines the magnitude of these cash flows. The price of equity thus reflects expectations of real activity, and changes in the value of equity partially reflect revisions in these expectations.

This article measures the relevant information contained in the bond market and the stock market for forecasting real economic activity. Traditionally, the stock market is assumed to contain important information about the future path of economic growth. The Standard & Poor's 500 stock price index (S&P 500) carries an important weight in the Department of Commerce's widely quoted index of leading indicators. Indeed, many forecasters predicted a recession for 1988 solely on the basis of the stock market crash in October 1987. The results presented here suggest that the bond market reveals more information about future economic growth than the stock market. The bond market forecasts also compare favorably with the predictions of seven major econometric forecasting services.

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