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Forecasting the Economic State with Financial Market Information and Term Structure of Interest Rates

ABSTRACT

This study examines whether financial markets, especially excess stock returns, contain information about changes in future values of certain macroeconomic variables. Earlier literature documents that term spreads of interest rates can predict both nominal activity, i.e. inflation, and real activity, i.e. output, consumption and industrial production, in economy. We combine stock returns and term spreads in an economic tracking portfolio framework and show that economic tracking portfolios can forecast changes in future macroeconomic variables, most accurately with 12 month forecasting horizon. The information content of industry stock portfolios depends on the target macroeconomic variable. The importance of term spreads is supported in two ways: first, they improve the performance of the ETP model even though the omission of them from the analysis seems to have only marginal effect; second, the only benchmark model that outperforms the ETP model in some cases uses solely term spreads as explanatory variables.

Key words: *economic tracking portfolios, forecasting, term structure of interest rates*
JEL Codes: C53, E44

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