

ERSA Research Brief

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Stock return predictability in South Africa: An Alternative Approach

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The financial and real sectors of the economy are inextricably linked; with strong evidence to suggest that there are spillover effects from the stock market to the real economy, with the stock market usually leading the real sector. As such, substantial stock market downturns can negatively impact output. This is of particular concern in an emerging country such as South Africa where maintaining and supporting growth in gross domestic product is critical for the continued development of the country and the allied lowering of poverty levels. Accordingly, for policy makers the ability to forecast market downturns accurately enables them to implement appropriate policies to limit the effects of these stock market downturns on the real economy. Current measures used to forecast share returns such as the Treasury bill yield and dividend-price ratio have limited success in this regard.

The study of Charteris and Strydom (2016) presents a novel approach to forecasting stock market returns on the South African market that links the real and financial sectors directly through consumption, labour income and share returns. They find that the consumption aggregate wealth ratio can predict share returns one quarter ahead and provides a better measure than any of the traditional measures that policy makers currently utilise. Accordingly, these authors recommend that financial economists make use of the consumption aggregate wealth ratio in identifying changing patterns in risk as this is likely to provide a more accurate reflection of future returns. In so doing, this will provide policy makers with the opportunity to implement appropriate monetary or fiscal policy to prevent falloffs in production such as those experienced post the financial crisis of 2007/ 2008.