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Industrial Effects, Macroeconomic Conditions, and Financial Analyst Forecasts

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The top-down stock valuation approach suggests that security markets reflect what is expected to happen in the economy. According to this approach financial analysts should incorporate economic conditions, industrial conditions, and firm-specific fundamental information into their forecasts on firm's profitability. The existing literature shows that there are two major ways to forecast earnings. One is from financial analyst earnings forecast database, such as IBES analyst data (Ramnath et al, 2008). In this line of study industrial effect and macroeconomic conditions have been widely discussed in firm-level earnings forecasts. The other method uses statistical methods as a base to forecast earnings (Hou et al., 2010). However, one of the problems associated with this method is that some variables are omitted, since it does not control for industrial and macroeconomic factors simultaneously.

This study tries to provide a comprehensive study on the relationships between firm-specific earnings forecasts, industry effects, and change in macroeconomic conditions. The firm and business segment data used in the analysis come from the Compustat annual fundamentals and Compustat segments. The macroeconomic indicators are drawn from the Federal Reserve Economic Database (FRED). The financial analyst forecasts data are drawn either from IBES analyst database or from the estimates from Hou et al (2010). More specifically, the hypotheses tested in this paper are as follows:
H1: Financial analyst's forecasts incorporate expectations on macroeconomic conditions after we control firm-specific fundamental information for each industry.
H2: Financial analyst's forecasts change as macroeconomic conditions changes in each industry.
We also compare the effects of changes in macroeconomic conditions on earnings forecast from two methods in each industry. This paper will contribute to the literature by helping investors and management understand earning forecast better since earnings forecast is an important tool for them.