

The Canadian Stock Market and Macroeconomic Fundamentals

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This project uses the Present Value Model of Stock Prices as the theoretical foundation and relies on prior research and economic theory to select macroeconomic fundamentals to investigate the long run relationship between the stock market and macroeconomic fundamentals. Two cointegration techniques are applied in order to model the long run relationship between industrial production, money supply, oil price, exchange rate, interest rate, inflation and stock prices in Canada; where the S&P TSX Composite Index is used as a proxy for the stock price. Pairwise Granger causality and an Over-Fitted VAR model are used to test the causality between the stock index and macroeconomic fundamentals. Finally using the VAR model and Random Walk approach an out of sample forecast of the stock index is performed. The results of the cointegration analysis suggest the existence of at least three significant cointegrating vectors, a strong bivariate long run relationship between the stock index and industrial production and a weak long run relationship between money supply, exchange rate, interest rate and inflation. The results of the pairwise causality test suggest that there is one way causality from industrial production to the stock index and the stock index in turn has one way causality towards Exchange Rate, Oil Price and Inflation. The results of the Wald Coefficient Test for causality suggest that there is no causality from macroeconomic fundamentals towards the stock index. Although there is a strong existence of causality from the stock index towards the exchange rate. There is also evidence which suggests that VAR model is superior when compared to the Random Walk Model to forecast TSX when using Industrial Production as a predictor variable whereas the Random Walk Model is superior when using Oil Price as the predictor variable.