Predictability of the Buffett Yardstick Ratio

Abstract

This paper tests the "Buffett Yardstick" hypothesis that a country's total market capitalization (total market cap) to GDP ratio – referred to as the Yardstick ratio – can forecast its stock market valuation. According to Buffett's Yardstick Hypothesis, the value of the ratio should be able to explain the state of the economy. Thus, for the ratio to be a reliable economic indicator there needs to be a long run relationship between total market cap and the Yardstick ratio, and as such, a cointegrating relationship, so that we can use the Yardstick ratio to predict a country's total market cap level. We use U.S. data on which we perform the ARDL bounds testing procedure (Pesaran and Shin, 1999; Pesaran et al., 2001), later adding expected market volatility (CBOE volatility index, i.e. VIX) as a regressor within the ARDL model. This gave us results in favour of cointegrating relationship between the two variables, and thus, proof of the explanatory power of the Yardstick ratio, and its validity as an economic indicator.