CHAPTER ONE

1.0 INTRODUCTION

1.1 The Impact of Macroeconomic Variables on the performance of the Kuala Lumpur Stock Exchange (KLSE)

Over the last twenty years there has been increasing evidence in the finance literature that speaks against the constant expected returns hypothesis. Whether this has been in the form of variance tests (Shiller (1981)), long horizon regressions (Fama and French (1989)), variance ratios (Poterba and Summers (1988), contrarian strategies (Debondt and Thaler (1985) and Lo and Mac-Kinlay (1990)), short horizons vector auto-regressions (Campbell (1991)), fundamental and non-fundamental factors (Marzio and Fabio (1994)) or any of the many approaches used by researchers, the general conclusion is that expected stock returns are time varying, that is, that assets returns are to some extent predictable (Patelis (1997)). This conclusion seems to hold across international stock markets and across different time horizons (M. H. Pesaran and A. Timmermann (1995)). Variables identified by these studies which are important predictors of stock market returns include interest rates, monetary growth rates, changes in industrial production and inflation rates.

All of the above studies recognise the importance of causal relations and discuss them in one way or another. Most of the studies examining the relationship between stock market returns and fundamental economic activities were done in the United States context using data on the New York Stock Exchange and data on the US economy and these studies are well documented. However, the impact of economic factors on the stock markets in relatively less developed Asian countries (For example Korea, Taiwan, Singapore, Hong Kong, Malaysia, China)

is less well documented. Specifically, little research has been done on how stock market indices in less developed countries respond to changes in fundamental economic variables.

Thus my study is focussed on understanding the impact of macroeconomic variables (namely money supply, interest rate, the general price level, international reserves and industrial) on the performance of the Kuala Lumpur Stock Exchange.

1.2 Significance of the Study

They are four primary contributions of this study:

Firstly, this research extends the previous research done in this area in the United States to Malaysia. Furthermore, this study could also serve as a basis for future research on the impact of other variables (for example dividend yield) and their impact on the KLSE.

Secondly, this study is focussing on systematic or market variables and not company specific variables. There is a current interest on market risk especially in light of the recent economic crisis. According to the Capital Asset Pricing Model, the only relevant risk of a security is its market risk as measured by beta. Given the fact that market risk cannot be diversified by holding the market portfolio, understanding market risk is of crucial importance as all stocks will rise and fall simultaneously with the market. This is so because diversification eliminates company specific or unsystematic risk only leaving investors exposed to market risk (Radcliffe, 1998). Thus portfolio managers must understand the impact of macroeconomic variables on the stock market performance and eventually on the returns of the portfolios they manage. Macroeconomic variables are systematic variables and as such through their impact on the stock market as a whole, they have a direct influence on market risk (Radcliffe, 1998).

Thirdly, the successful forecasting of macroeconomic policy variables can lead to the formulation of effective trading strategies. For example, an expansionary monetary policy is likely to improve liquidity and lower interest rate which will lead to a bull market. Thus buying securities which are positively correlated with the market will eventually lead to positive returns when the market eventually swings upwards to the extent that this information is not already impounded in the securities prices and the fact that increase in money supply leads the stock market. Another example of a trading strategy is to trade in the KLSE Composite Index Futures. An investor can buy futures if he expects the market to rise due to an increase in Bank Negara Malaysia's international reserves for example and liquidate them to close his position when the market turns up.

Fourthly, the study can help in understanding and comparing the impact of macroeconomic variables in developing markets (taking the KLSE as a model) as opposed to their impact on developed, well-organised and efficient markets like the U.S. stock market.

1.3 Scope of the Study

The scope of study was limited to the followings: -

As there are many factors that can affect the performance of the Kuala Lumpur Stock Exchange, like the imposition of capital controls in September 1998, fears of asset deflation and currency turmoil similar to Thailand's financial and economic woes (Kuala Lumpur Mutual Fund Report, 1999), Black Monday crash on 19th October 1987, dividend yield among others, it is not possible to investigate all the factors affecting the KLSE in one study. Therefore, only some of the pertinent variables like the money supply, interest rate, industrial production, inflation and

international reserves have been chosen as key macroeconomic variables affecting the KLSE Composite Index.

The study covers the period between January 1983 to June 1999. Historical data on the money supply (M2), the 1-month interbank money market rate, the CPI, KLSE Composite Index and growth in industrial production was gathered on a monthly basis for the period January 1983 to June 1999 (198 observations per variable). Similarly monthly data for the same period was gathered on the stock of international reserves held by Bank Negara Malaysia. Thus the sample was restricted to the above period for the current research.

1.4 Limitation of the study

The research has been done using secondary and historical data drawn from Bank Negara Malaysia's Monthly Statistical Bulletins and Quarterly Reports. However one of the major limitations of historical information is that it quickly becomes out of date in a dynamic environment. Thus to the extent that the findings of this study are used for understanding the reasons for fluctuations in the KLSE Composite Index, historical data might be appropriate.

If the findings of this study are to be used for predictive purposes then knowledge of the variables which impact the KLSE Composite Index might be useful to predict movements in the KLSE Composite Index.

1.5 Organisation of the Study

Chapter one introduces the reader to the main focus of the study, that is, the impact of macroeconomic variables on the performance of the KLSE. Chapter one also discusses the significance, the scope and the limitation of the study.

Chapter two reviews the relevant literatures on the impact of macroeconomic variables on the KLSE. The findings of previous researchers on this topic are reviewed to throw light on the hypotheses to be tested in this study.

Chapter three discusses the research methodology which includes the definition of concepts, the theoretical model, the hypotheses, the various measures used, the research sample, the data collecting methods and the techniques of data analysis.

Chapter four provides analysis of the research findings which includes the testing of the hypothesis by means of factor analysis, correlation analysis and regression analysis.

Chapter five provides a summary of the research findings and conclusions. In addition, recommendations for future research and the implications of the study for future research are also discussed.