CHAPTER 1

INTRODUCTION

1.1 Introduction

The relationship between stock returns and inflation has been an intriguing anomaly for researches. Research in economics and finance documented a puzzling relationship between stock returns and inflation. In general, there are two main streams of hypothesis or analysis in explaining the relationship between stock returns and inflation. Each has its own assumptions and interpretations in elaborating the relationship, which is either a positive, a negative or no relationship.

1.2 Relationship between Stock Returns and Inflation

One of the main objectives of this study is to investigate the relationship between stock returns and inflation in Malaysia. The Malaysia stock exchange market is different from those newly emerging markets, which had been characterized as suffering from high and volatile inflation like Korea and Mexico during the late 1980s. It would be of great interest to examine the study on Malaysia, where the inflation and stock market are under the supervision of local government and authorized bodies such as the Kuala Lumpur Stock Exchange (KLSE) and Security Council (SC).

This study empirically investigates the relationship between stock returns and inflation, which falls under two streams of thought.

(i)   The "Fisher Hypothesis" (1930) or the classical view on stock returns and inflation, which suggests that there is a positive relationship between stock returns and inflation in the long run static equilibrium. Nominal stock returns vary one-to-one with inflation but the real stock returns are invariant to inflation or general price.

(ii)   The modern and post- Keynesian theory concentrates on the dynamic adjustment process of the economy which shows that stock returns are negatively related to inflation in a shorter-term equilibrium as compared with the long run static equilibrium under the Fisher Hypothesis (1930).

The second main objective is to chart the movements of nominal and real stock returns by applying Elliott Wave Theory under technical analysis. The reason for employing the charting method is to find out the influence of inflation on stock returns, which further enhance the consistency of the econometric results.

1.3   Chapter Summary

This study starts out with an introductory chapter covering the relationship between nominal and real stock returns with inflation in a general view. Economists are still puzzled on the positive and negative relationship between stock returns and inflation as many empirical results suggest varied conclusions.

The second chapter is the literature review, which consists of a few well-known authors with their own theories and hypotheses. The core

discussion in this chapter refers to the classical view on stock returns and inflation in 1930 and post -Keynesian view on stock returns and inflation from 1970 till 2001.

Chapter Three focuses on the two main streams of thought which are Fisher Hypothesis (1930) in the long run static equilibrium and Nelson Analysis (1976) in the shorter-term equilibrium. The case of Malaysia is then analyzed to determine which stream of thought it falls under.

The penultimate section then moves on to decompose the stock returns into real stock returns. Technical analysis, or to be more specific Elliott Wave Theory, is then applied to identify the impact of inflation on nominal and real stock returns. The final chapter ends with a brief summary to conclude the relationship between stock returns and inflation. In particular, a weak positive relationship is found and inflation is proven to be a weak variable in influencing the stock returns.