THE RELATIONSHIP BETWEEN INFLATION AND STOCK PRICES – A CASE STUDY OF THE NAIROBI STOCK EXCHANGE

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ABSTRACT

The relation between stock prices and inflation has intrigued researchers who have attempted to explain how a nominal variable such as inflation should determine a real variable (asset prices). Recent research findings have established the existence of a negative relationship between stock prices and inflation.

These findings contradict the hypothesis by Fisher (1930) who argued that stock prices should be positively related with expected inflation, providing a hedge against rising prices.

This study investigated the relationship between inflation and stock prices at the Nairobi Stock Exchange. The study’s objectives were to specify and estimate the functional relationship between inflation and stock prices at the Nairobi Stock Exchange to assess the validity of the Fisherian hypothesis using the stock prices at the Nairobi Stock Exchange and to draw policy conclusions and recommendations based on the empirical findings.

An empirical investigation is conducted using monthly data on selected stocks from a sample of six companies listed at the Nairobi stock exchange, for the period 2002-2006. The OLS estimation technique was employed to estimate a single equation with the real returns as the independent variable and explanatory variables as actual inflation, expected inflation and information dummy. A specification associated with error correction modeling (ECM) was applied to capture long-run equilibrium after the variables were differenced to make them stationary.