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STOCK MARKET RETURNS AND INFLATION: Sri Lankan Evidence

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ABSTRACT

This paper investigates the relationship between stock returns and inflation in Sri Lanka using monthly and quarterly data for the period January 1985 to August 1996 with a view to provide empirical evidence on the generalized Fisher Hypothesis which states that nominal stock returns are positively related to expected inflation in a one-to-one correspondence. The results indicate that both lagged inflation and expected inflation are significantly positively related to stock returns in a manner predicted by the Fisher Hypothesis suggesting that stocks in Sri Lanka, different from evidence in most other countries including the U.S., are an effective hedge against expected inflation. Stock returns and unexpected inflation have negative relation indicating that stocks do not appear to be hedges against unexpected inflation.