## EXECUTIVE SUMMARY

The purpose of this paper is to investigate the underlying relationship between stock returns and inflation in Hong Kong. Hong Kong is one of the emerging Pacific Basin stock markets. These markets have attracted international investment because of the remarkable economic growth in the region and their gradual opening up to overseas investors in their liberalization process. The markets are expected to provide additional diversification to international portfolios.

Since stock prices reflect firms' future earnings potential, an economic downturn predicted by a rise in inflation will depress stock prices and hence returns. A higher current inflation is associated with expectations of lower future output, whose impact is captured (negatively) in current stock returns, thereby producing a negative stock return-inflation correlation in actual data. However, little is known about the relationship between inflation and stock returns for relatively small markets. The purpose of this paper is to empirically examine the relationship of Hong Kong stocks and inflation for

the period between 1990-2000.