Can Common Stocks Provide a Good Hedge Against Inflation? Evidence from the Emerging Markets

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Abstract


This study focuses on the long-debated question that whether common stocks can provide a good hedge against inflation. We try to answer this question by investigating the relationship between stock prices and inflation using share price indices and consumer price indices data of eight representative emerging countries. Cointegration methods are employed to tackle with the non-stationarity property of data as well as estimate the Fisher coefficients in the vector-error-correction system.

On balance, cointegration analysis on these markets suggests a positive relationship between stock prices and goods prices over the long run. Estimates of the long-run elasticities of stock prices with respect to good prices exceed unity and range from 1.172 to 3.154. Moreover, the lower bound of the 95% confidence interval for the Fisher coefficients are greater than unity. We thus concludes that common stocks in these markets do provide not only a complete, but also a good hedge against inflation in the long term.
Time path for the response of stock prices to innovations in consumer prices validates the dichotomy in time-related response patterns of stock prices to inflation; namely, a blip of negative responses at the beginning changes to a positive response over a longer period of time. This reconciles the stock return-inflation puzzle. Stock prices in these emerging markets appear to reflect a time-varying memory associated with inflation shocks that make stock portfolios a reasonably good hedge against inflation in the long run.

Keywords: Common Stocks, Inflation, Hedge, Emerging Markets, Cointegration, Time Response.
I, Guo Haizhen, hereby states that this thesis represents my own and original work, apart from the sections where origins are clearly stated. All the materials in this thesis have never been previously included (partially or wholly) in a thesis, dissertation or report submitted to this University or to any other institution for a degree, diploma or other qualifications.

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