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A TEST OF THE PROXY-EFFECT HYPOTHESIS: EVIDENCE FROM MALAYSIA

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I. INTRODUCTION

The question of stocks being a better hedge against inflation has been widely researched and documented. The notion that stocks retain real value regardless of the inflation rate fluctuations is consistent with classical investment theories found in Day (1984) and Marshall (1992). However, progressive empirical studies in the developed countries have documented that expected inflation, unexpected inflation and changes in expected inflation were all negatively related to stock returns which appear contrary to both economic theory and common sense.

In the view of Fisher hypothesis, real stock returns are independent of inflationary expectations. This indicates that nominal asset returns should be positively related to both expected and unexpected inflation. The Phillips' curve that shows a negative relationship between unemployment and the inflation rates implies a positive association between inflation ad real economic activity. Therefore, stock returns that were positively correlated with real economic activity are, in turn, expected to show a positive association with inflation. The positive relation between stock returns and unexpected inflation suggests that common stocks are good hedges against unexpected inflation.