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Stock prices response to real economic variables: the case of Germany

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Abstract

Purpose

This is a research paper aiming to re-examine Fama's proxy hypothesis which states that inflation is negatively related to real economic activity and the negative relationship between stock returns and inflation reflects the positive impact of real variables on stock returns.

Design/methodology/approach

Two issues are addressed, first if there is a relationship between the real and financial sectors and once this is established the next step is to investigate the type of relationship present. The study uses annual data covering the years 1960-2000, on the German economy, and builds a VAR model to test the hypothesis of the negative impact of real economic activity on stock returns.

Findings

The findings suggest that in Germany employment growth has a negative effect on stock returns and influences positively inflation. The rational lies in the fact that employment growth forecasts inflation which is expected to erode firm's profits. This is expressed through falling stock returns.

Research limitations/implications

Germany is the largest economy in the European Union, the findings suggest that over the period under examination, the economy operated close to its potential level of output



It adds to the understanding and knowledge on a debate that is as current as ever from the point of view of the macroeconomist as well as the politician.

Keywords

- Stocks and shares
- Germany
- Economic cycles

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