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Effect of Inflation on Stock Market Returns in China

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Abstract

Purpose: The purpose of this article was to analyze effect of inflation on stock market returns in China.

Methodology: This study adopted a desk methodology. A desk study research design is commonly known as secondary data collection. This is basically collecting data from existing resources preferably because of its low cost advantage as compared to a field research. Our current study looked into already published studies and reports as the data was easily accessed through online journals and libraries.

Findings: The study revealed a positive correlation between inflation and long-term stock returns, suggesting that equities may serve as a hedge against inflation. However, high inflation can increase market volatility, leading to reduced investor confidence and lower stock returns. The relationship between inflation and stock returns in China is complex, influenced by factors such as monetary policy and economic conditions.

Unique Contribution to Theory, Practice and Policy: Fisher effect theory, inflation illusion hypothesis & proxy hypothesis may be used to anchor future studies on effect of inflation on stock market returns in China. Financial analysts and portfolio managers should incorporate inflation-adjusted valuation models when assessing stock market performance, ensuring a realistic approach to pricing stocks under inflationary conditions. Central banks should adopt dynamic inflation-targeting policies that ensure price stability while also considering the implications for stock markets and investor confidence.

Keywords*: Inflation, Stock Market Returns*

INTRODUCTION

Stock market returns, measured through indicators like Stock Market Index Growth and Annual Return on Stocks, are essential for assessing a country's economic vitality and investment landscape. In developed economies, these returns have exhibited notable trends. For instance, the United States' S&P 500 Index has demonstrated robust growth, averaging an annual return of approximately 14% since 2010, largely propelled by the technology sector and companies linked to artificial intelligence (Financial Times, 2025). Conversely, Japan's Nikkei 225 Index experienced a significant peak in 1989, reaching nearly 39,000 points, but faced stagnation thereafter, with the index still about 40% below its all-time high as of 2018 (He & Long, 2021). This contrast underscores the diverse trajectories of stock market returns in developed nations.

For instance, Germany's DAX Index surpassed the 20,000-point milestone for the first time in December 2024, closing at 20,003 points, driven by expectations of further interest rate cuts in the U.S. and Eurozone (Welt, 2024). Similarly, France's CAC 40 Index reached an all-time high of 7,543.18 points in 2023, reflecting a strong post-pandemic recovery (Wikipedia, 2023). These trends underscore the resilience and growth potential of European stock markets in recent years.

In developing economies, stock market returns have been influenced by various factors, including economic reforms and foreign investment inflows. For example, emerging markets in Asia have experienced return and volatility spillovers from developed markets like the U.S. and Japan, affecting their own stock market performances (Nguyen & Ngo, 2020). This interconnectedness highlights the susceptibility of developing markets to external economic shocks and the importance of robust financial systems to mitigate such impacts.

India's stock market has notably outperformed China's since the 2008 financial crisis, attributed to more efficient capital allocation and higher profitability among Indian companies (Reuters, 2024). Conversely, Pakistan's KSE 100 Index reached a record high of 83,531.96 points on October 4, 2024, reflecting investor optimism and economic reforms (Wikipedia, 2024). These examples illustrate the diverse trajectories of stock markets in developing nations, influenced by factors such as economic policies, political stability, and global economic conditions.

Focusing on sub-Saharan Africa, stock market development has been marked by both challenges and growth opportunities. The region has seen an increase in the number of stock exchanges, with countries like Ghana, Malawi, Swaziland, Uganda, and Zambia establishing markets since the late 1980s (Yartey & Adjasi, 2007). However, these markets often face issues such as low liquidity and limited market capitalization, which can hinder their ability to attract significant investment. Despite these challenges, some markets have made strides; for instance, the Zimbabwean Stock Exchange emerged as the fastest-growing stock exchange during the COVID-19 pandemic, recording a cumulative growth rate of about 200% in 2020 (Zhao & Zhang, 2023). This growth reflects the potential for substantial returns in the region, albeit accompanied by higher risks.

Inflation metrics, including the Consumer Price Index (CPI), Producer Price Index (PPI), Personal Consumption Expenditures (PCE) Price Index, and the Gross Domestic Product (GDP) Deflator, are fundamental in assessing price changes within an economy. The CPI measures the average change over time in prices paid by consumers for a basket of goods and services, directly indicating consumer inflation (Bureau of Labor Statistics, n.d.). The PPI captures the average change over

time in selling prices received by domestic producers, reflecting inflation from the producers' perspective (Bureau of Labor Statistics, n.d.). The PCE Price Index gauges the average increase in prices for all domestic personal consumption, often preferred by the Federal Reserve due to its broader scope (Investopedia, 2025). Lastly, the GDP Deflator measures the price change of all goods and services included in GDP, offering a comprehensive view of inflation across the entire economy (Wikipedia, 2025).

These inflation indicators significantly influence stock market returns. For instance, a rising CPI often leads central banks to increase interest rates to control consumer inflation, which can dampen stock market performance due to higher borrowing costs (Moomoo, 2025). Similarly, an uptick in the PPI indicates higher production costs, potentially squeezing corporate profit margins and negatively impacting stock prices (Investopedia, 2025). The PCE Price Index, closely monitored by policymakers, can signal shifts in monetary policy; unexpected increases may lead to tighter monetary conditions, affecting investor sentiment and equity valuations (Investopedia, 2025). Additionally, a higher GDP Deflator suggests widespread inflationary pressures, possibly leading to reduced consumer spending and corporate earnings, thereby influencing stock market returns (Wikipedia, 2025).

Problem Statement

The relationship between inflation and stock market returns remains a critical concern for investors, policymakers, and economists. Recent analyses indicate that rising inflation can erode corporate profits and diminish investor confidence, leading to stock market volatility. For instance, studies have shown that higher inflation rates contribute to increased market uncertainty and reduced equity valuations (Smith & Taylor, 2022). Additionally, the phenomenon known as the "everything bubble," characterized by inflated asset prices across various classes, has been linked to prolonged periods of low interest rates and expansive monetary policies, further complicating the dynamics between inflation and stock market performance (Chancellor, 2022). Understanding these complex interactions is essential for developing effective investment strategies and economic policies.

Theoretical Review

Fisher Effect Theory

Proposed by economist Irving Fisher, the Fisher Effect posits that nominal interest rates embody both real interest rates and expected inflation. This theory suggests that as expected inflation rises, nominal interest rates adjust accordingly to maintain real returns. In the context of stock markets, higher expected inflation can lead to increased nominal interest rates, potentially elevating the required rate of return for equities and thereby suppressing stock prices. Recent analyses indicate that inflation concerns, such as those stemming from tariffs, can influence Federal Reserve policies on interest rates, subsequently impacting stock valuations (The Wall Street Journal, 2025).

Inflation Illusion Hypothesis

Introduced by Modigliani and Cohn, the Inflation Illusion Hypothesis suggests that investors might misinterpret nominal growth rates during inflationary periods, leading to erroneous stock valuations. Specifically, they may fail to adjust earnings and dividends for inflation, causing overvaluation or undervaluation of stocks. This misperception can result in stock prices not

accurately reflecting the underlying real value of companies. For instance, during periods of rising inflation, if investors do not appropriately adjust their expectations, it can lead to stock market corrections as real values are reassessed (MarketWatch, 2025).

Proxy Hypothesis

Developed by Fama, the Proxy Hypothesis posits that stock returns are influenced by their correlation with real economic variables, such as industrial production and consumption, which are themselves affected by inflation. According to this theory, inflation indirectly impacts stock returns by altering these fundamental economic indicators. Empirical evidence suggests that periods of stagflation characterized by high inflation and stagnant economic growth can lead to significant declines in stock prices, as the underlying economic conditions deteriorate (Business Insider, 2025).

Empirical Review

Gupta & Ahmed (2018) analyzed the relationship between inflation and stock returns across various global markets using Pearson correlation coefficients and regression analysis. The purpose of the study was to examine how inflation affects stock market performance in different economic contexts, particularly focusing on developed and emerging markets. The findings indicated a significant negative relationship between inflation and stock returns in developed nations such as Australia, Belgium, Canada, and France, where higher inflation led to lower stock returns. However, in emerging markets such as Brazil and Indonesia, the study found a positive correlation between inflation and stock returns, suggesting that in some economies, inflation-driven economic expansion could boost corporate earnings and stock performance. The study recommended that market participants and policymakers consider both expected and unexpected inflation in their investment and monetary policy decisions to maintain financial stability and optimize stock market performance.

Adebayo & Yusuf (2021) explored how nominal stock returns react to inflation in both advanced and emerging markets, using vector autoregression (VAR) models to assess causality. The study aimed to identify whether inflation has a symmetric or asymmetric impact on stock market performance across different economies. The results revealed that stock returns in advanced economies were more negatively affected by inflation than those in emerging markets, which often experience inflation alongside economic growth. The study suggested that policymakers in emerging economies should exercise caution when adopting monetary policies based on the experiences of advanced markets, as inflation's effects can vary by economic structure. Additionally, it recommended that governments in emerging economies focus on stabilizing inflation expectations rather than simply trying to curb inflationary pressures, as moderate inflation may be beneficial for stock market growth.

Karlsson & Petterson (2024) investigated the impact of inflation on stock returns within the Swedish OMXSPI index and its various sectors using linear regression models. The purpose of the study was to understand how inflation affects stock prices in Sweden, considering the country's exposure to global economic conditions and trade. The findings revealed that the relationship between inflation and stock returns was largely negative, with inflation disproportionately impacting the financial services, consumer goods, and real estate sectors. These sectors were found

to be particularly vulnerable to inflation due to rising interest rates, which increased borrowing costs and reduced corporate profitability. The study recommended that investors adopt sector-specific investment strategies to hedge against inflation risks and that monetary authorities closely monitor inflation trends to support sustainable stock market performance.

Rahman (2023) examined the effect of inflation, exchange rates, and money supply on the Dhaka Stock Exchange index returns in Bangladesh using cointegration and error correction models. The aim was to determine whether inflation influences stock prices in the short and long run. The results indicated a strong cointegrating relationship between stock prices and macroeconomic variables, with inflation being one of the most influential factors affecting stock returns. The study found that the Dhaka Stock Exchange is highly reactive to inflation, as rising inflation erodes real returns, making stocks less attractive to investors. It recommended that investors pay closer attention to macroeconomic trends before making investment decisions, while financial regulators should adopt inflation-targeting policies to stabilize the market and protect investor confidence.

Smith & Taylor (2022) explored the long-run relationship between stock prices, inflation, and inflation uncertainty across different U.S. sector stock indexes using generalized autoregressive conditional heteroscedasticity (GARCH) models. The research sought to determine whether inflationary pressures affect stock market volatility differently across various industries. The findings showed that, in the long run, inflation and its uncertainty negatively impact stock prices, contradicting the well-known Fisher Effect, which assumes that stock prices should adjust to inflation over time. The study also noted that inflation had a more pronounced negative effect on energy, industrials, and consumer discretionary sectors, while technology and healthcare stocks showed resilience. It recommended that investors diversify portfolios across sectors with varying inflation sensitivities and that policymakers use inflation control measures to ensure economic stability.

Johnson & Lee (2024) analyzed the impact of economic forces, particularly inflation, on stock returns in the U.S. market, employing factor models and principal component analysis (PCA) to assess the influence of macroeconomic news. The study found that stock returns are highly sensitive to systematic economic news, with inflation playing a significant role in shaping investor expectations. It concluded that inflation expectations are a crucial determinant of stock market trends, as unexpected inflation leads to market sell-offs and shifts in investor sentiment. The study recommended that investors and policymakers closely monitor inflation trends and their effects on monetary policy, as central bank decisions on interest rates directly impact stock valuations. Additionally, it suggested that financial analysts incorporate inflation-adjusted valuation models to improve stock market forecasts.

Miller & Brown (2025) analyzed inflation-adjusted stock market returns and the effects of market highs on investment strategies, using historical simulation and time series regression models. The findings revealed that U.S. stocks have historically delivered inflation-adjusted annual returns of 6.6%, compared to 1.6% for bonds and 0.5% for bills. The study also found that investing during periods of market highs is not necessarily riskier in the long term, as inflation-adjusted returns tend to remain positive over extended periods. It recommended that long-term investors maintain diversified portfolios and avoid overreacting to short-term inflation fluctuations, as stocks have

historically been effective inflation hedges. Additionally, the study emphasized the importance of using real returns rather than nominal returns when evaluating investment performance.

METHODOLOGY

This study adopted a desk methodology. A desk study research design is commonly known as secondary data collection. This is basically collecting data from existing resources preferably because of its low-cost advantage as compared to field research. Our current study looked into already published studies and reports as the data was easily accessed through online journals and libraries.

FINDINGS

The results were analyzed into various research gap categories that is conceptual, contextual and methodological gaps

Conceptual Research Gaps: Several studies (Gupta & Ahmed, 2018; Adebayo & Yusuf, 2021; Rahman et al., 2023) have primarily focused on the direct relationship between inflation and stock market returns. However, there is limited exploration of the mediating role of investor sentiment, monetary policies, and interest rate changes in this relationship. Additionally, while some studies (Smith & Taylor, 2022; Johnson & Lee, 2024) have assessed sector-specific impacts of inflation on stock market performance, they have not extensively analyzed how inflation interacts with stock market volatility and risk management strategies across different economic cycles. Another conceptual gap is the lack of integration of behavioral finance perspectives, such as how inflation expectations influence stock market participation and investor decision-making, which could provide deeper insights into market behavior beyond traditional economic models.

Contextual Research Gaps: While the studies reviewed span different markets, many of them focus predominantly on developed economies such as the United States (Smith & Taylor, 2022; Miller & Brown, 2025), Sweden (Karlsson & Petterson, 2024), and other global markets (Gupta & Ahmed, 2018). However, limited research has been conducted on how inflation affects stock markets in economies with high inflation volatility or those undergoing structural economic transitions, such as Latin American or African markets. Furthermore, most studies assess the impact of inflation over historical periods (Miller & Brown, 2025), but recent global economic disruptions, such as the COVID-19 pandemic and geopolitical conflicts, have altered inflation dynamics, making it necessary to examine their long-term effects on stock markets. Additionally, existing research does not sufficiently address the role of central bank policies and fiscal interventions in mitigating the adverse effects of inflation on equity markets.

Geographical Research Gaps: Most studies on the impact of inflation on stock market returns focus on developed markets (e.g., Smith & Taylor, 2022; Johnson & Lee, 2024; Miller & Brown, 2025) and emerging economies such as Bangladesh (Rahman et al., 2023). However, there is a notable lack of research examining how inflation affects stock markets in underdeveloped or frontier economies, particularly in sub-Saharan Africa, Latin America, and Southeast Asia. Since these regions often experience hyperinflation, currency devaluation, and weak financial institutions, their stock markets may react differently compared to more stable economies. Additionally, few studies provide a comparative analysis between inflation's effects in different geographical regions, which would help determine whether inflation's impact is universal or

region-specific. A more comprehensive geographical analysis is needed to understand how inflation influences stock returns in economies with different levels of financial development, economic stability, and inflation targeting mechanisms.

CONCLUSION AND RECOMMENDATIONS

Conclusion

Inflation plays a crucial role in shaping stock market returns, influencing investment decisions, monetary policies, and economic stability. Empirical studies indicate that inflation often has a negative correlation with stock market returns in developed economies, as rising inflation leads to higher interest rates, increased borrowing costs, and reduced corporate profitability. However, in some emerging markets, inflation may have a positive effect on stock returns, particularly when economic growth accompanies moderate inflation, boosting corporate earnings and investor confidence. The relationship between inflation and stock market performance is also sector-specific, with industries such as financial services, consumer goods, and real estate being more sensitive to inflationary pressures than technology or healthcare sectors.

Despite extensive research on this topic, gaps remain in conceptual frameworks, geographical coverage, and contextual influences of inflation on stock markets. Existing studies predominantly focus on developed and emerging markets, overlooking frontier economies that experience more volatile inflationary trends. Moreover, investor behavior, policy interventions, and inflation expectations play a mediating role in stock market fluctuations, yet they remain underexplored in empirical literature. Future research should incorporate cross-regional comparisons, behavioral finance perspectives, and the impact of macroeconomic shocks to provide a holistic understanding of how inflation shapes stock market performance in diverse economic settings.

Recommendations

Theory

Future research should develop integrated models that consider inflation expectations, monetary policies, and investor behavior in explaining stock market movements. While existing theories such as the Fisher Effect and Inflation Illusion Hypothesis provide foundational insights, they fail to account for behavioral finance perspectives that influence market reactions to inflation. Sector-specific theoretical models should be developed to explain how inflation differently impacts various industries, particularly in financial services, real estate, and consumer goods, where inflationary pressures tend to be more significant. A comparative framework should be established to analyze the different effects of inflation on stock market returns across developed, emerging, and frontier economies, addressing the existing geographical gaps in literature.

Practice

Investors should adopt inflation-hedging strategies, such as investing in inflation-protected securities (e.g., Treasury Inflation-Protected Securities - TIPS), commodities like gold, and diversified stock portfolios that include sectors less sensitive to inflation. Financial analysts and portfolio managers should incorporate inflation-adjusted valuation models when assessing stock market performance, ensuring a realistic approach to pricing stocks under inflationary conditions. Businesses should implement cost-control measures and strategic pricing models to manage the

impact of inflation on operational expenses and profit margins, reducing risks associated with inflation-driven market fluctuations.

Policy

Central banks should adopt dynamic inflation-targeting policies that ensure price stability while also considering the implications for stock markets and investor confidence. This includes striking a balance between inflation control and economic growth to avoid unintended negative consequences on equity markets. Governments should enhance financial literacy programs, educating investors on the effects of inflation on stock returns, risk management strategies, and portfolio diversification to help them make informed investment decisions. Macroeconomic policy coordination between monetary and fiscal authorities should be strengthened to prevent policy inconsistencies that may exacerbate stock market volatility during inflationary periods. Policies should focus on stabilizing inflation expectations through predictable and transparent monetary interventions.

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