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Impact of Inflation on Stock Market Returns: An Empirical Study

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ABSTRACT

This study examines the empirical relationship between inflation and stock market returns, with a focus on the Indian financial market. Inflation, a key macroeconomic indicator, significantly affects investor sentiment, purchasing power, and corporate profitability—all of which have a bearing on equity markets. The purpose of this research is to analyze whether inflation exerts a positive, negative, or neutral impact on stock market performance, both in the short and long term.

The study uses secondary data from sources such as the Reserve Bank of India (RBI), National Stock Exchange (NSE), and other financial databases. Statistical techniques including correlation analysis, regression analysis, and time-series models have been employed to determine the strength and direction of the relationship between the Consumer Price Index (CPI) and stock market returns (Nifty 50 index).

Preliminary findings indicate a moderate negative relationship between inflation and stock returns in the short term, suggesting that rising inflation may erode real returns and investor confidence. However, the long-term impact appears less significant, possibly due to market adjustments and inflation-hedging behaviors by investors.

This research contributes to a better understanding of inflation's role in investment decisions and can guide policymakers, investors, and financial analysts in strategy formulation during inflationary periods.

This thesis explores how behavioral finance principles influence individual investment decisions, challenging the traditional notion that investors are fully rational. It highlights the impact of psychological biases such as loss aversion, overconfidence, mental accounting, and herd behavior on consumer preferences for products like mutual funds, SIPs, insurance, and stocks.
The study is based on primary data collected from 50 digitally active young Indian investors (mainly aged 18–35), who are increasingly turning to digital media and social networks for investment advice. Results show that emotional and social triggers, rather than purely logical analysis, often guide investment behavior.

Keywords: inflation, stock market return

I. INTRODUCTION

In today's globalized and interconnected economy, financial markets play a crucial role in mobilizing savings, channelling investments, and promoting economic development. Among various economic indicators, inflation stands out as a significant macroeconomic variable that has widespread effects on businesses, consumers, and investors alike. Simultaneously, the stock market acts as a barometer of a nation's economic health, reflecting investor confidence and corporate performance. Understanding the relationship between inflation and stock market returns is vital for effective financial decision-making, risk assessment, and policy formulation.

Inflation, defined as the sustained increase in the general price level of goods and services in an economy over time, affects the purchasing power of money and alters the cost of capital, input prices, and consumer demand. For investors, particularly equity investors, inflation introduces uncertainty about future cash flows and real rates of return. A key concern is whether stocks can serve as a hedge against inflation, preserving real wealth during inflationary periods, or whether inflation erodes equity returns, discouraging investment in stock markets.

The relationship between inflation and stock market returns has been widely debated in financial literature and practice. Classical economic theory, particularly the Fisher Effect, suggests that nominal stock returns should adjust to reflect expected inflation, making equities a natural hedge. However, empirical findings have been mixed. Some studies reveal a negative correlation, where rising inflation dampens stock returns due to reduced profit margins and tightening monetary policies. Others argue for a positive or neutral relationship, depending on the country's economic environment, inflation expectations, and the ability of firms to pass rising costs onto consumers.

In the context of developing economies like India, where inflation is often more volatile due to supply-side constraints, structural issues, and policy lags, the inflation-stock market dynamic becomes even more complex. Indian investors have witnessed periods of high inflation alongside stock market volatility, raising important questions about the impact of macroeconomic instability on equity performance. Moreover, with an increasing number of retail investors participating in stock markets and growing integration with global financial systems, there is a need to revisit and reassess the inflation-return relationship using recent data and robust analytical methods.

This study aims to explore the empirical relationship between inflation and stock market returns, focusing specifically on the Indian equity market. The research will investigate whether inflation influences stock returns significantly and whether equities can serve as a reliable hedge in the face of inflationary pressures. The analysis will consider short-term and long-term effects, using statistical tools such as correlation and regression analysis to draw meaningful insights.

The findings of this study are expected to contribute to academic literature and offer practical implications for investors, financial analysts, fund managers, and policymakers. For investors, understanding this relationship is crucial for portfolio management and asset allocation during inflationary cycles. For policymakers, it provides inputs on how inflation-targeting policies may indirectly influence capital markets and investment behavior.

By shedding light on this important macro-financial linkage, the study not only addresses a critical gap in current research but also supports informed financial decision-making in an environment marked by economic uncertainty and fluctuating inflationary trends.

II. CONCLUSION

The relationship between inflation and stock market returns is complex and multifaceted, influenced by a variety of economic, financial, and behavioral factors. This study has offered empirical evidence highlighting this interplay within the Indian context. Effective investment and policy decisions must account for inflation dynamics to foster market stability and growth. Continuous research and adaptive strategies remain essential as economic conditions evolve.

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