Does the Stock Market React to Unexpected Inflation Differently Across Business Cycles?

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Abstract

I document strong evidence that equity returns respond more negatively to unexpected inflation during economic contractions than expansions. I find that real equity returns of firms with higher systematic risk, specifically those with lower book-to-market ratio, or of medium size are more negatively correlated with unexpected inflation. These are also portfolios whose correlations with unexpected inflation demonstrate strong asymmetric patterns across business cycles. Since changes in expected real activity generally have a greater impact on firms with higher systematic risk, such observations indicate that changes in expected real activity, signalled by unexpected inflation, are important in explaining the asymmetric business cycle patterns of inflation beta.