EQUITIES

Are Stocks Real Assets? Sticky Discount Rates in Stock Markets

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Local stock market investors seem slow to adjust nominal discount rates in response to news about the path of future local inflation. The authors document two symptoms of nominal discount rate stickiness in stock markets.

First, over short horizons — those of less than one year — the nominal returns on a country's value-weighted stock market index do not increase after a country-specific increase in past inflation. As a result, country-specific inflation lowers local real stock returns roughly by the deviation of that country's rate of inflation from the global average.

Second, over the same horizons, local stock returns do not respond contemporaneously to country-specific inflation surprises either. As a result, local investors in the local stock market tend to earn low real returns as the local economy transitions from a low- to a high-inflation equilibrium. While sticky prices in product markets can explain incomplete pass-through of surprise inflation to nominal stock returns, it cannot account for incomplete pass-through of expected inflation.

The pass-through of local inflation to nominal discount rates used by local stock market investors is slow and incomplete, but there is no evidence of nominal stickiness in T-bill and bond markets after changes in inflation. The nominal returns on local short-term and long-term government bonds respond immediately after changes in inflation. So do exchange rates. As a result, an increase in the local rate of expected inflation shrinks the local equity premium over bills and bonds, but not the equity premium on a basket of foreign stocks, because the local currency depreciates.