Asian Journal of Advances in Research

5(1): 1128-1132, 2022

WILL COVID-19 PANDEMIC ALIGN STOCK RETURNS TO GDP GROWTH IN KENYA?

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AUTHOR'S CONTRIBUTION

The sole author designed, analyzed, interpreted and prepared the manuscript.

Received: 20 July 2022
Accepted: 25 September 2022
Published: 15 October 2022

Review Article

ABSTRACT

Many countries are experiencing slow economic growth and reduced activity at the stock market. Stock markets always provide the vital role of acting as a leading indicator for economic growth. Even though there is no consensus on whether the two variables are positively or negatively correlated from previous studies, there is unanimity to the fact that stock market returns greatly affect economic growth of a country like Kenya.

This review offers an intensive and extensive literature review of how stock market returns will correlate to economic growth in this period and factors that might influence the resultant behavior. The review also investigates whether factors Kenyan Stock returns are going to be aligned to the GDP influenced by factors such as foreign investments, disposable income, dominant stocks and investor sentiments.

This review established that the growth in Kenya's GDP, like that of many countries, will follow stock market returns in slowing down in response to the pandemic. This is attributed to reduced propensity to invest caused by reduced disposable income job losses and negative investor sentiments. The study advices stakeholders to pay keen attention to the Kenyan stock market returns in order to project economic growth if the market is devoid of interferences. The government is urged to cushion businesses and employers from the harsh economic tides in order to avail disposable income to as many people as possible who will in turn invest in stocks.

Keywords: Attention theory; cyclical movement; disposable income; dominant stocks; investor sentiment; globalization.

1. INTRODUCTION

The COVID-19 pandemic has had a lot of negative effects on various spheres of life. The economy and to an extension the stock markets, this pandemic has left devastating effects. According to Baker et al. [1]. "no previous infectious disease outbreak, including the Spanish Flu, has negatively impacted the stock market as forcefully as the COVID-19 pandemic".

In the home stretch, a UNDP [2] report the pandemic has devastating social, economic and political crises which will leave lasting effects both in Kenya and around the globe. The article also notes that the Kenyan economic situation is further blighted by earlier locust invasion in large parts of the country.

According to Trading Economics [3], "the Nairobi 20 decreased 863 points or 32.26% since the beginning of 2020, according to trading on a Contract For Difference (CFD) that tracks this benchmark index from Kenya". Furthermore, the Capital Markets Authority (CMA) quarterly statistical report alludes those shocks triggered by COVID-19 pandemic

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sparked off panic selling by foreign investors, Okoth [4].

The central bank of Kenya left its benchmark interest rate unchanged at 7% during its July 2020 meeting. Policymakers said that the package of policy measures adopted since March to cushion the impact of the coronavirus pandemic were having the intended effect and added that it will be reinforced by implementations of fiscal measures announced in the FY2020/21 government budget. The Committee noted that the inflation rate remains well anchored and it is projected to remain within the target range of 2.5-7.5% in the near term. Policymakers underscored the uncertainty regarding the increasing rate of coronavirus cases. The Committee said that they will continue to monitor the impact of the policy measures so far, developments in both the global and domestic economy and will take any measures if needed.

This study looks at the important aspect of whether stock investors will react to the circumstances availed by the COVID-19 pandemic and whether the results shall mirror those of the economy. We aim to achieve this by deducing evidence from relevant theories and empirical literature.

2. STOCK RETURNS, STOCK PRICES AND THE LOCAL GDP

The most comprehensive economic indicator is Gross Domestic Product (GDP), which measures the value of all goods and services produced in a country during a specific period thus providing a basic measure of growth or contraction in an economy. The GDP therefore affects the stock market because a stock's price generally reflects expectations of a company's future profitability while it's returns shows the rate of growth. When an economy is healthy and growing, businesses are more likely to report better earnings and growth-aggregate corporate earnings rise when the economy grows or vice versa.

In a theoretical environment of closed economy, stock price increases should exactly match real GDP growth. Part of the GDP of a country is derived from a company’s profits, Earnings Per Share (EPS), which greatly determines the price of a company’s stock. However, this only works in a state of autarky which does not apply to the Kenyan stock market which is composed of both local and foreign companies.

Stock prices and returns are part of the GDP and are not expected to outgrow the GDP. Stock prices are an indication of growth in sales of companies' proceeds and services. From the supply side, it indicates a growth in supply supported by a stable demand. This therefore raises a fundamental question as to whether the prevailing economic situation supports production and to how much disposable income is available to consumers. Another important factor that can dictate this movement is the consumer behavior, how does the pandemic affect consumption? Sectorial mix of our local companies can also lend a bearing to these movements, which sectors do most companies fall, do they produce essential/basic goods and services or luxury goods?

3. STUDY OBJECTIVES

This study aims to establish whether the COVID-19 pandemic will affect the relationship between stock returns and the GDP growth of Kenya.

To inform stakeholders on the factors that shape the relationship between stock returns and the country's GDP.

4. RESEARCH QUESTIONS

How do local stock returns align to the GDP? Which factors influence stock returns in the COVID-19 pandemic era?

5. THEORETICAL REVIEW

This research lends heavily from the investor attention Theory, the classical growth theory and the Arbitrage pricing theory.

6. INVESTOR ATTENTION THEORY

Merton's (1987) theory predicts that attention could increase market valuations directly by alleviating informational frictions that prevent investors from holding lesser-known assets and vice versa. This theory helps us understand investors' reactions to market news and global information that advice their actions especially during this pandemic era.

7. THE ENDOGENOUS GROWTH THEORY

It is anchored on classical growth theory that states that the economic growth decreases with increasing population because increased GDP stretches population which in turn reduces the GDP. This theory views economic growth to be generated by internal forces as opposed to external forces. This means that investments and innovation by locals are key determinants to the growth of GDP. We infer to this theory to point that GDP can also be strained if production reduces against an already stretched population like it can be witnessed during this period.

8. ARBITRAGE PRICING THEORY

It was developed by Stephen Ross in 1976 as an improvement of the CAPM theory used in Asset pricing. According to APT stock returns can be forecasted with the linear relationship of its returns and the macroeconomic factors that affect the asset's risk. The APT theory supports the assertion that stock returns are determined by several factors that also determine the economic growth rate thus building the link between the two variables.

9. LITERATURE REVIEW

There are several studies conducted by various researchers to establish the relationship between stock returns and economic growth. A few were however selected to support this study.

Barra [5] conducted "a study to establish whether there is a link between GDP growth and Equity returns using data collected from selected developed countries between 1958 and 2008 generated several findings. Long real earnings growth fell behind long term GDP growth following cyclical patterns". The study points that stock prices are affected by investor expectations and the cyclical movements. Following this pattern, we expect the Kenyan stock market to be depressed following low economic activities that have lowered investors' expectations.

Reddy [6] added "another vital parameter by studying the impact of Inflation and GDP on annual Indian Stock Returns between 1997 to 2009 using regression analysis". Stock returns were found to positively correlated with RGDP in a significant way but negatively with inflation. Inflation reduces the expected and real rate of returns of investors besides eroding their disposable income. Listed companies are also adversely affected by inflation. The Kenyan Economy is expected to experience higher levels of cost-push inflation due to the COVID-19 pandemic which eventually lowers investment returns.

Moller (2017) studied "the cylindrical consumption and time-variation in expected stock returns. The findings indicate that cylindrical consumption is negatively related to future stock returns". These findings suggest that investors require high expected returns to invest in the stock market when cylindrical consumption is low as experienced during bad economic times. We can therefore deduce that stock returns and GDP of an economy both undergo cyclical movements in a financial period. This can be attributed to the varied nature of disposable income available to investors as well as the changing production and demand.

Oswake and Ananwude (2017) followed by "an empirical study to explore short run and long run between stock market development and economic growth in South Africa and Nigeria from 1981 to 2015. The GDP was used to represent economic growth while stock market development was represented by the market capitalization to GDP and stock value traded ratio using ARDL co-integration model using data from world bank". The study found positive correlation between the two variables in both countries which is consistent with certain theories. However, the research proposed can be improved by use of monthly data. This study is significant since the Kenyan stock market is closer to the two markets.

Schwab (2018) used "the findings from studies of three largest economies in the world: the U.S., Germany, and Japan and compare the performance of their stock markets to the growth in their respective GDP. The growth in the Japanese stock market and the economy has moved in opposite directions in recent years, though it is closely linked to the performance of global financial stocks, making keeping an eye on financial conditions more useful to investors than just watching GDP". The German stock market also falls off tune with its GDP but syncs well with the global Auto market. This is because its economy is dominated by the motor vehicle sector. The US stocks also mirrors the global technology industry more than its local GDP. These findings suggest that these stock markets in developed economies corelate more with the dominant sector of their local economy. This can be attributed to dominance of the markets by the respective sectors. We can therefore expect Kenya stock market to be shaped by dominant sectors. However, in the COVID-19 pandemic era, the stock markets are expected to shape up to the dominant stocks such as Safaricom. Being a small economy, the Kenyan economy does not contribute significantly to the global economy.

Another study which lends vital knowledge to our study was done by Adoms et al. [7] to determine "the relationship between capital market and economic development in emerging African economies of Kenya, Nigeria and South Africa from 1990 to 2018". The study found significant relationship between capital markets and economic development in conformity with other studies. The study also plays major role in establishing that the Kenyan stocks also correlated with the local GDP like their African peers.

Papakyriakoua et al. [8] used "event-study methodology to investigate the impact of terrorist attacks in G7 countries on international stock markets and the role of investor sentiment. The study found that stock markets decline significantly on the event day and on the following trading day. The study also analyzed the investor sentiment following the attacks, based on the content of country-level news stories and social media sources, and found that indices in countries associated with higher declines in the post-event sentiment, exhibit significantly higher economic losses. These findings can be attributed to panic on investors brought about by uncertainties" [9-13].

In analyzing the effects of the pandemic in the US stock markets, Baker et al. [1] noted that previous pandemics left only mild traces on the U.S. stock market. The study also identified government restrictions on commercial activity and voluntary social distancing, operating with powerful effects in a service-oriented economy, contributing factors to the U.S. stock market responding more sensitively to COVID-19 than to previous pandemics. Baker et al. [1] therefore adds other factors such as social distancing that also contribute to declining stock market activities in Kenya just like the US markets.

Liu et al. (2020) applied "the advance study method and regression to evaluate the short-term impact of the coronavirus outbreak on 21 leading stock market indices in major affected countries. Their results indicate that the stock markets in major affected countries fell quickly after the virus outbreak with Asian countries experiencing more negative abnormal returns as compared to other countries. The study attributed part of this fall to investors' pessimistic sentiment on future returns and fears of uncertainties". This study therefore agrees with Papakyriakoua et al. [8] to a great extent on how investors response to sentiments and uncertainties. A similar behavior can therefore be replicated in Kenya in response to the uncertainties brought about by the COVID-19 pandemic.

10. RESEARCH METHODOLOGY

This study used qualitative approach where secondary data sources such as empirical studies, news bulletins and pertinent literature were used to arrive at scientific conclusions using source triangulation.

11. CONCLUSIONS

This study establishes a positive correlation between stock market returns and the Kenyan Economy as presented in the form of GDP. This implies that the stock market performance can inform the performance of the GDP. Being part of the GDP of an economy stock can either out-perform or under-perform the former depending on the perception of investors and the disposable income available. Investors with more disposable income invest more just like those who expect to get higher returns. The COVID-19 pandemic has reduced the disposable income available to investors due to job losses, salary cuts and closures of certain sectors like education and hospitality leading to reduced activities in the stock market. The Kenyan stock returns will be endogenous and more aligned to the GDP if foreign capital injection and investment are reduced. However, it is not easy to establish how the market will relate to the global economy because we do not have a clear dominant stock/sector. These factors play a major role in shaping the economy and stock returns especially during uncertainties such as the COVID-19 pandemic and will hence greatly influence the performance of stocks in Kenya. Globalization also plays a role in determining the Kenyan stock market returns especially during this COVID-19 pandemic when international trade has reduced.

12. POLICY RECOMMENDATIONS

This study finds that the economic growth of a developing country like Kenya, can easily mirror its stock market returns if it is well insulated from external shocks. The government through the capital markets authority should invigorate the stock market to provide the important capital required to run companies and by extension, the economy.

Many companies are not listed in the stock market which reduces the influence of the market on the economy. Policy makers should reduce bureaucratic requirements to encourage listing of more companies at the NSE.

Some Alternative investments such as real estate despite generating high returns, suffer from high illiquidity and can therefore not avail speedy capital during the COVID-19 pandemic period.

Investment analysts should properly study the market and give accurate information on the state of the economy which should in turn be reported objectively by the media especially during the COVID-19 era since investor sentiments affect market returns.

This study also recommends that the Central of Kenya should maintain stable macro-economic rates such as lending rate to shield the economy from other unsystematic factors.

COMPETING INTERESTS

Author has declared that no competing interests exist.

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