ABSTRACT

The role of investor sentiment in depicting their emotions as a key pillar of behavioral finance is vital to study its impact on the relationship between stock returns and macroeconomic variables. The current study used secondary time series data on a monthly basis from January 2006 to December 2020 to investigate the effects of macroeconomic variables such as inflation, interest rate, exchange rate, foreign direct investment, financial development, and investor sentiment on stock market returns. The study adds to the existing literature by introducing financial development as a macroeconomic variable in the context of the Pakistani economy, as well as presenting another concept of investor sentiment as a moderating variable in order to understand how it influences the relationship between financial development and stock market index returns, while controlling for other macroeconomic variables. The research considers two different models. The first model on individual basis examines the impact of macroeconomic variables on stock returns, whereas in second model investor sentiment is taken as moderating variable by creating one interaction variable with financial development. This research done also examined the connections by employing ARDL (Autoregressive Distributive Lag) testing approach to co-integration and error correction model (ECM) respectively. The findings from ARDL and ECM showed significant positive impact of interest rate but significant negative effect of financial development and investor sentiment on stock returns in short run, while interest rate, inflation, exchange rate and sentiment of investor has significant influence on returns of stock market in long run. In second model on short run basis negative significance of investor sentiment on association between stock returns and financial development was observed, which turns to insignificance over the long run. The negative coefficient of ECM shows 72% of the stock market index returns (KSE-100) are corrected. The research findings recommend that monetary authorities should reduce the interest rate in order to boost up the stock market and the economy as well. This policy should also include reduction in inflation coupled with stable exchange rates, provision of capital to the private sector at lower rates and attracting foreign direct investment. It also proposes that policy makers in the Government as well as investors in the stock exchange to keep a close eye on the investor sentiment as well in devising efficient and making prudent investment decisions.

Keywords: Macroeconomic variables, Stock market returns, Investor sentiment.