Inflation News and Stock Returns: a Sectorial Analysis of the Spanish Case

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The aim of this paper is to study the relationship between unanticipated inflation news and stock returns, focussing our analysis on the sector of activity. Using event-study methodology, we analyze the short run response of daily stock prices in the Spanish market to the announcements of inflation news on a sectorial level.

Firstly, we examine the behaviour of the abnormal returns during an event window, which contains two days before, the announcement day and two days after, and also depending on the sector of activity. We only observe significantly abnormal returns for several sectors in the pre-announcement period.

Secondly, assuming that responses to positive and to negative unexpected inflation news could be compensated each other in the previous analysis, we control for the state of the economy and the direction of the news. We observe significant responses of abnormal returns to the unexpected inflation component for many sectors in certain scenarios.

We try to explain these results using a different combination for each sector of the "behavioural finance" hypothesis (BFH) (Veronesi, 1999) and the "flow-through" hypothesis (FTH) (Estep and Hanson, 1980). Evidence in favour of the BFH is only found in sectors of low "flow-through" capability, that is, abnormal returns of these sectors react to the unexpected component of the inflation rate according to this theory. In the case of sectors with a high ability to transfer inflationist shocks to prices, abnormal returns are independent of the unexpected inflation rate. Anyway, the signs of the coefficients are not always those expected according the BFH, that is, results for

sectors that can be considered as high “flow-through” capability are consistent with the FTH.

Thus, we make two contributions to the literature. The sectorial analysis is our main contribution, in contrast with previous literature focused on the global stock market response. Second, this paper enriches the understanding of the relationship between unexpected inflation news and stock abnormal returns analyzing the Spanish market case using event-study methodology.