Journal of Accounting and Finance Research

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Journal of Accounting and Finance Research
ISSN:0110-5159
Vol. 2, Issue. 2, 2025

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Article History

Published on:12/10/2025

https://doi.org/10.5281/zenodo.17874464

How to cite in APA format:

Onyango, F. A., & Ngureh, J. (2025). INFLATION AND FINANCIAL PERFORMANCE OF EQUITY MARKET IN NAIROBI SECURITIES EXCHANGE, KENYA. Journal of Accounting and Finance Research, 2(2), 1–14. https://doi.org/10.5281/zenodo.17874464

Abstract:

Purpose: This study examined the effect of inflation on the financial performance of the equity market at the Nairobi Securities Exchange (NSE), Kenya. It focused on how different inflation measures influence market returns within an emerging market context.

Methodology: Guided by Fisher's Hypothesis, the Efficient Market Hypothesis, and the Capital Asset Pricing Model, the study adopted an explanatory research design. A census of all 67 firms listed on the NSE All-Share Index was used, relying on secondary panel data from 2018–2023. Financial performance was measured using the Market Return Index (MRI), while inflation was assessed through the Producer Price Rate (PPR), Wholesale Price Rate (WPR), and Food Price Rate (FPR). Data were analyzed using correlation and random effects panel regression.

Findings: Results showed that all inflation indicators had a statistically significant negative effect on equity market performance. Producer Price Rate ($\beta = -0.382$, $p=0.001$), Wholesale Price Rate ($\beta = -0.283$, $p=0.006$), and Food Price Rate ($\beta = -0.206$, $p=0.033$) were inversely related to the Market Return Index. The model was significant (Prob > chi2 = 0.000) and explained 20.5% of the variation in market performance.

Unique Contribution to Theory, Practice and Policy: The study challenges Fisher's Hypothesis by demonstrating that inflation does not hedge equity returns in Kenya's emerging market. It contributes to theory by revealing inflation as a systematic risk factor. Practically, it recommends inflation-hedging strategies for investors and cost-control measures for firms. For policy, it suggests the need for macroeconomic stability to support capital market resilience.

***Keywords*:** *Inflation, Equity Market, Financial Performance, Nairobi Securities Exchange, Producer Price Index.*

JEL CODES: E31, G10, C33

1.0 INTRODUCTION

1.1 Background of the Study

Financial performance assesses a company's ability to generate profit, manage expenses, and achieve long-term sustainability, providing insight into its economic health (Rinaldo & Endri, 2020). The stock market, a core component of the financial sector, channels capital from investors to productive sectors, fostering economic growth and stability (Bakhtiyarovich, 2021; Zhang, 2018). Market activity affects security prices through supply and demand dynamics, where rising demand increases prices, signaling strong fundamentals (Adeyanju, 2022). Inflation significantly influences equity market performance globally and locally, often increasing volatility and uncertainty in stock returns (Abaidoo & Agyapong, 2024). For instance, Kenya's inflation averaged 6.1% in 2022, up from 5.7% in 2021, negatively affecting investor sentiment and equity returns (Kenya National Bureau of Statistics, 2022; Kirui et al., 2022). Despite these pressures, NSE market capitalization doubled from KES 1.1 trillion in 2012 to KES 2.2 trillion in 2022, reflecting resilience. Comparatively, other emerging markets like Mexico, Argentina, South Africa, Ghana, and Egypt have also experienced equity volatility due to inflation and macroeconomic factors (OECD, 2017; Mhonyera et al., 2023; Seidu & Vasilev, 2024; Maher, 2022). This study seeks to address the research gap by examining the relationship between inflation and financial performance of equities listed on the NSE.

Financial performance measures a firm's profitability, efficiency, and value creation for stakeholders (Rinaldo & Endri, 2020; Chouaibi et al., 2022). Key indicators include net income, EPS, ROE, and operating margins (Simanullang & Simanullang, 2023). Equity markets enable trading of shares and other instruments, facilitating capital mobilization and contributing to economic stability (Zhang, 2018; Tursoy, 2015). Investors assess market performance via price movements, liquidity, and market capitalization, with indices like NSE All Share Index and NSE 20 Share Index reflecting overall trends (Patra & Poshakwale, 2016; CMA, 2016). From 2018–2023, NSE indices and company earnings declined, with NSE 20 Share Index profits falling by 28% and bank ROE dropping from 17.5% to 11.2% (Cytonn Investments, 2023; Kenya Bankers Association, 2023). Market capitalization, TRS, and trading volumes serve as performance metrics, indicating investor confidence and market liquidity (Batta, 2014; Wang & Huang, 2012).

Inflation reflects rising costs of goods and services across an economy, typically measured by CPI, PPI, or WPI (Ulla et al., 2017). It manifests as demand-pull inflation, due to increased market demand, or cost-push inflation, stemming from higher production costs (Kwofie & Ansah, 2018). Inflation raises interest rates and reduces real wages, discourages investment, and affects export competitiveness (Amata, 2017; Gu et al., 2021). In Kenya, inflation rose from 5.357% in 2021 to 7.88% in 2023 before declining to 4.4% in 2024, affecting purchasing power and investor returns (CMA, 2019). Globally, high inflation negatively impacts stock market returns in countries like Indonesia, India, and Jordan, reducing real returns and increasing uncertainty (Kalam, 2020; Setiawan, 2020; Chiang, 2023; Sreenu, 2023; Batayneh et al., 2021). Understanding inflation's influence is essential for policymakers and investors to mitigate risks in equity markets.

The NSE is Kenya's principal stock exchange, established in 1954 and regulated by the Capital Markets Authority (CMA) (NSE, 2015; CMA, 2011). Its primary role is to mobilize financial resources for productive businesses (CMA, 2017). The NSE operates on an automated platform, listing various assets for trading, with market performance affected by interest rates, currency value, inflation, and GDP growth (Ali et al., 2022; Joseph, 2012). Ranked second in Africa after Johannesburg, the NSE has experienced cyclical performance, with fluctuations in share prices reflecting investor sentiment and market efficiency (Barnor, 2014; Najaf & Najaf, 2016). Market monitoring allows investors to make informed decisions, with stock volatility influenced by systematic risk, policy changes, and economic conditions (Mwaniki, 2015). The NSE's structure and trading environment are vital for attracting both local and international investors, contributing to Kenya's economic development (NSE, 2016).

1.2 Statement of the Problem

In emerging economies like Kenya, the equity market is vital for financial sector growth, enabling firms to raise capital for expansion and development. However, Kenya's equity market remains underdeveloped, with low market capitalization relative to GDP, limited new IPOs since 2014, and few listed stocks, restricting liquidity (Financial Sector Regulators, 2018). Market concentration is high, with the top five companies controlling about 70% of total market value, increasing susceptibility to financial contagion (Capital Markets Authority, 2018). Historically, the stock market's contribution to GDP has been minimal, around 1%, far below the Vision 2030 target of 10% (Ngugi, Maana, & Amanja, 2013). Inflation's impact on financial performance at the NSE has not been adequately studied (Ngetich, 2023). While inflation reduces purchasing power and affects returns, evidence on its direct effect on firm-level measures such as stock returns and earnings per share is limited (Mutuku & Ngugi, 2021). Existing studies often use generalized econometric models that overlook the NSE's small size and vulnerability to local economic shocks (Wambua & Omondi, 2023; Gichuki & Mwangi, 2020). There is a knowledge gap in localized frameworks linking inflation to firm-level performance, including return on assets, which is necessary for understanding investor behavior on the NSE (Kibet & Otieno, 2021; Kamau & Njoroge, 2022; Mburu & Kimani, 2023).

1.3 Objectives of the Study

General objective

The study aims to investigate the effect of inflation on financial performance of equity market in NSE, Kenya.

Specific Objectives

1. To determine the effect of Producer Price Rate on financial performance of equity market in NSE, Kenya.
2. To establish the effect of Wholesale Price Rate on the financial performance of equity market in the NSE, Kenya.

3. To determine the effect of food price rate on the financial performance of equity market in NSE, Kenya.

2.0 LITERATURE REVIEW

2.1 Theoretical Review

This study will be underpinned by Fisher's Hypothesis, Efficient Market Hypothesis and Capital Asset Pricing Model.

Open Fishers Theory

Fisher first put forth the Fishers theory in 1930. Fisher (1930) asserted that as equity is a claim on actual corporate assets, it can be utilized as a hedge against inflation. When investors anticipate high inflation, they might diversify their holdings by buying real estate and selling financial assets. According to Grande, Locarno, and Massa (2017), nominal stock prices represent expected inflation, indicating a positive relationship between inflation and stock prices. One drawback of Fisher's hypothesis is that empirical evidence suggests that there might occasionally be a negative relationship between stock market success and the rate of inflation. The rate of inflation affects businesses by raising their operating expenses, which lowers corporate profitability and dividends and, in turn, lowers stock prices, which in turn lowers equity market performance (Oprea, 2014). The purpose of this study is to investigate how the producer price index, which measures inflation, affects the financial performance of the Kenyan stock market on the NSE. It is predicated on Fisher's hypothesis, which holds that stock prices are positively impacted by increasing inflation rates. According to Fisher's hypothesis, the real interest rate stays mostly unchanged whereas nominal interest rates usually fluctuate to reflect shifts in inflation expectations in the context of the producer price rate. As a result, nominal interest rates will reflect changes in the producer price index, which represents changes in prices for goods and services produced within the country, as lenders adjust rates to account for inflation expectations.

Efficient Market Hypothesis

It was Fama who came up with the (EMH) in 1970. According to the EMH, it is impossible to reliably achieve risk-adjusted market outperformance since all relevant market information is reflected in asset values. (Fama, 1970; Malkiel, 2003; Shiller, 2003; Timmermann & Granger, 2004). While the EMH has been widely accepted and supported by empirical evidence in some cases, it has also faced criticism and challenges (Shiller, 2003; Timmermann & Granger, 2004; Lim & Brooks, 2011; Cuthbertson & Nitzsche, 2004). Behavioral finance theories, which incorporate psychological factors and investor biases, have emerged as an alternative explanation for market inefficiencies and anomalies that contradict the EMH (Shiller, 2003; Timmermann & Granger, 2004; Lim & Brooks, 2011; Cuthbertson & Nitzsche, 2004). Nonetheless, the theory is applicable to the present investigation since it lays the theoretical groundwork for comprehending the effect of fluctuating inflation rates on the financial results of the Nairobi Securities Exchange's equity market.

Capital Asset Pricing Model

Researchers Sharpe, Lintner, and Treynor created the CAPM (1964). Using the beta coefficient as a proxy for systematic risk, the CAPM lays out a framework for estimating an asset's expected return (Sharpe, 1964; Lintner, 1965; Treynor, 1962; Fama & French, 2004). The CAPM has faced criticism (Fama & French, 2004; Roll, 1977; Banz, 1981; Reinganum, 1981). Some of the criticisms include the unrealistic assumptions underlying the model, the inability to fully explain asset returns, and the difficulty in determining the appropriate market portfolio (Fama & French, 2004; Roll, 1977; Banz, 1981; Reinganum, 1981). Nonetheless, the model is pertinent to our research since it informs the financial performance dependent variable. Inflation is regarded as a potential risk factor that may influence the expected returns of assets in the equity market (Sharpe, 1964; Lintner, 1965; Treynor, 1962; Fama & French, 2004). By incorporating inflation as a risk factor in the CAPM framework, the study will be able to analyze how changes in inflation rates influence the expected yield on investments within the Nairobi Securities Exchange, consequently shaping the equity market's financial outcomes.

2.2 Empirical Review

Several studies have examined the influence of macroeconomic variables on stock market performance, providing a foundation for analyzing the effects of producer, wholesale, and food price rates on the Nairobi Securities Exchange (NSE). Akech (2020) explored macroeconomic determinants of NSE performance from 2010 to 2019, highlighting the relevance of producer price rates (PPR) in shaping stock market outcomes. Khan and Khan (2018) investigated Pakistan's Karachi Stock Exchange, analyzing interest rates, inflation, exchange rates, and GDP growth, showing that macroeconomic factors significantly affect stock prices. Similarly, Innocent, Shukla, and Mulyungi (2018) studied Rwanda's equity market, finding that exchange rates, GDP growth, inflation (CPI), and lending rates influence market capitalization and returns, demonstrating the importance of localized empirical studies for understanding stock market dynamics. These studies provide a comparative backdrop for examining the PPR's effect on the NSE's financial performance.

Regarding wholesale price rates (WPR), Tripathi and Seth (2020) analyzed India's equity market, showing that interest rates, inflation, currency movements, and GDP growth affect market volatility and returns, while highlighting the role of foreign direct investment. Etale and Eze (2019) examined Nigeria's stock market, demonstrating that macroeconomic shifts including WPR impact returns and volatility in both the short and long term. Locally, Owino (2019) investigated Kenyan equities using longitudinal data from 1993 to 2013, revealing that interest rates, inflation, exchange rates, and GDP growth significantly affect NSE indices. These studies underscore the importance of isolating WPR to understand its specific impact on NSE financial performance.

Food price rates (FPR) have also been linked to equity market outcomes. Deepika, Mundukur, and Paul (2021) studied India, showing that commodity prices, production, and demand affect stock market performance. Avgerinopoulou (2018) examined the UK stock market, employing co-integration and impulse response models to demonstrate the effects of CPI, interest rates, exchange

rates, and industrial output on stock returns. Endri et al. (2019) focused on food and beverage firms, revealing correlations between profitability, liquidity, leverage, and stock returns. These findings suggest that FPR influences equity performance, motivating the present study to specifically examine how food prices affect the NSE's financial outcomes.

3.0 RESEARCH METHODOLOGY

This study adopted an explanatory research design to examine the causal relationship between inflation and financial performance of the Nairobi Securities Exchange (NSE) (Thyer, 2010; Andrew, Pedersen & McEvoy, 2011). The target population consisted of all 67 firms listed on the NSE All-Share Index as of December 2023, with annual panel data collected over five years (2018–2023) (Jani, 2014). Due to the manageable population size, a full census of all listed firms was conducted, ensuring comprehensive and valid results (Lavrakas, 2011). Secondary panel data were sourced from NSE Annual Reports, CBK Annual Reports, Economic Surveys, and World Bank data, capturing variables such as producer, wholesale, and food price rates (Wooldridge, 2010). Data analysis was conducted using STATA 18.0, applying descriptive statistics to summarize key characteristics and inferential statistics, including Pearson correlation and panel regression analysis, to test hypotheses and examine relationships between variables (Brooks, 2008; Timoneda, 2021). Panel regression modeled financial performance as the dependent variable with producer, wholesale, and food price rates as independent variables, controlling for time and entity effects.

4.0 RESEARCH FINDINGS AND DISUCSSION

4.1. Descriptive Analysis

Table 1presents the descriptive summary for the study variables covering 6 years for 67 firms resulting in 402 observations.

Table 1: Descriptive Statistics

Variable	Obs	Mean	Std. Dev.	Min	Max
MRI	402	1.539	2.365	0	10
Stock Prices	402	208.179	598.763	.17	4100.57
Trading Volume	402	138262.94	881298.41	0	13959200
Market Volatility	402	-6.951	37.127	-87.143	511.429
Food Price Rate	402	209.707	22.538	180.515	246.295
Source: Research Data (2025)					

The descriptive summary indicated that Market Return Index recorded a mean of 1.539 with a standard deviation of 2.265 with a range of 0 to 10. This implied that in the period 2018 to 2023, on average, the NSE listed firms did not perform strongly with a number of firms reporting stagnation although there were some variations as shown by the standard deviation. Further, stock prices showed averaged 208.179 with a high standard deviation of 598.763 with ranges spanning between0.17 and 4100.57. This showed that there were very high variations in the prices of stock

probably due to the differences in size of firms. Trading volume averaged 138262.94 with a high variation of 881298.41 and ranging between 0 and 13959200. This implied that in the period 2018-2023, trading volume varied highly across the firms. Market volatility averaged -6.951 with a standard deviation of 37.127 with ranges between -87.143 and 511.429. This implied that the stock price for the firms had high volatility. Further, food price rate averaged 209.707 with a standard deviation of 22.538 and ranging between 180.515 and 246.295. This implied that there was moderate variation in food prices nationally.

4.2. Correlation Analysis

Correlation analysis measured the direction and strength of the relationship between financial performance measured by market return index and the inflation variables, producer price rate, wholesale price rate and food price rate. Table 2 presents the findings.

Table 2: Correlation Results

Variables	(1)	(2)	(3)	(4)
(1) Market Return Index	1.000			
(2) Producer Price Rate	-0.187	1.000		
	(0.001)			
(3) Wholesale Price Rate	-0.217	0.191	1.000	
	(0.008)	(0.046)		
(4) Food Price Rate	-0.099	-0.052	-0.072	1.000
	(0.047)	(0.381)	(0.383)	
Source: Research data (2025)				

The findings revealed that the correlation between Market Return Index and Producer Price Rate was weakly negative and significant (r=-0.187, P=0.001). This implied that as producer price rates increase, market return index decreases. These findings align with the findings by Khan and Khan (2018) who found that macroeconomic factors significantly relate with stock prices. The correlation between Wholesale Price Rate and Market Return Rate was also found to be weakly negative and significant (r=-0.217, P=0.008). This implied that an increase in wholesale price rate is associated with a decrease in market return index. This aligns with Tripathi and Seth (2020) who found a significant correlation between market volatility and macroeconomic factors.

Further, the association between Food Price Rate and Market Return Rate was found to be weakly negative and significant (r=-0.099, P=0.047). This implied that as inflation rate that is Food Price Rate increases, Market Return Index decreases. This concurred with Avgerinopoulou (2018) who found a connection between the UK economy and stock market.

4.3 Random Effects Analysis

Based on the Hausman test, the random effects model was selected. The results of the random effects analysis were presented in Table 4.9

Table 4.9: Random Effects Results

Market Return Index	Coef.	St.Err.	t-value	p-value	[95% Conf	Interval]	Sig
Producer Price Rate	-.382	.118	-3.24	.001	-.612	-.151	***
Wholesale Price Rate	-.283	.102	-2.77	.006	-.483	-.083	***
Food Price Rate	-.206	.097	-2.13	.033	-.395	-.016	**
Constant	.134	.098	1.37	.172	-.058	.327	

Mean dependent var	0.019	SD dependent var	1.100
Overall r-squared	0.205	Number of obs	110
Chi-square	27.298	Prob > chi2	0.000
R-squared within	0.173	R-squared between	0.174

*** p<.01, ** p<.05, * p<.1

Source: Research data (2025)

The findings revealed that R squared was 0.205. This implied that 20.5% of the variations in Market Return Index (financial performance) of NSE listed firms is explained by the predictor variables, producer price rate, wholesale price rate and food price rate. The findings also showed a Prob > chi2 of 0.000 meaning that the independent variables producer price rate, wholesale price rate and food price rate jointly have a significant effect on the dependent variable (financial performance). The findings further revealed that the effect of producer price rate on market return index is negative and statistically significant at 1% confidence level (β=-0.382, p=0.001). This implies that a one-unit increase in producer price rate is associated with 0.382 units decrease in market return index. This means that higher producer price rates are associated with lower market returns. These findings concurred with the findings by Innocent, Shukla, and Mulyungi (2018) who established that macroeconomic variables including inflation significantly affect the stock performance in Rwanda. Findings also complement the findings by Akech (2020) who affirmed that macroeconomic factors particularly price related ones significantly affect the stock performance at NSE. Findings also showed that there is a negative and statistically significant effect of wholesale price rate on market return index at 1% confidence level (β=-0.283, p=0.006). This implied that market return index decreases by 0.283 units when wholesale price rate increases by one unit. These findings agreed with Etale and Eze (2019) who found that the selected macroeconomic factors including inflation rates are significantly related with stock market performance. This also concurred with Owino (2019) who found that the NSE 20-share index, inflation, and the rate of 91-day Treasury bills in Kenya; the rate of inflation, amount of money (M3), industrial production index, and FTSE 100 index significantly affected the performance of NSE equities securities. It was further revealed that the effect of food price rate on the market

return index is negative and statistically significant at 1% confidence level (β=-0.206, p=0.033). This means that when food price rate increases by one unit, market return index decreases by 0.206 units. This was supported by Deepika, Mundukur, and Paul (2021) investigated the impact of agricultural products and other commodities on the dynamics of the Indian stock market and found that the influence of elements like commodity pricing, production patterns, and market demand on the overall performance of the Indian stock market was significant.

D. Hypotheses Testing

The study was guided by the following hypotheses:

H_{01}: Producer Price Rate has no significant effect on the financial performance of equity market in the NSE, Kenya.
H_{02}: Wholesale Price Rate has no significant effect on the financial performance of equity market in the NSE, Kenya.
H_{03}: Food price rate has no significant effect on the financial performance of equity market in NSE, Kenya.

The first null hypothesis was that Producer Price Rate has no significant effect on the financial performance of equity market in the NSE, Kenya. The results revealed that the effect of producer price rate on market return index is negative and statistically significant at 1% confidence level (β=-0.382, p=0.001). Therefore, the null hypothesis was rejected. Hence, producer price rates significantly affect financial performance of equity market in NSE, Kenya and the effect if negative. The second null hypothesis was Wholesale Price Rate has no significant effect on the financial performance of equity market in the NSE, Kenya. The findings showed that there is a negative and statistically significant effect of wholesale price rate on market return index at 1% confidence level (β=-0.283, p=0.006). The null hypothesis was hence rejected and it was confirmed that wholesale price rate has a significant negative effect on the financial performance of equity market in NSE, Kenya. The third null hypothesis was Food price rate has no significant effect on the financial performance of equity market in NSE, Kenya. Findings confirmed that the effect of food price rate on the market return index is negative and statistically significant at 1% confidence level (β=-0.206, p=0.033). Based on this, the null hypothesis was rejected. Therefore, food price rate has a negative effect on the financial performance of equity market in NSE, Kenya.

5.0 CONCLUSIONS

Based on the findings, the study concluded that inflation, measured through producer, wholesale, and food price rates, exerts a significant and negative effect on the financial performance of the equity market at the Nairobi Securities Exchange. The regression analysis demonstrated that all three inflation indicators had a statistically significant inverse relationship with the Market Return Index. This robustly rejects all three null hypotheses, confirming that rising inflationary pressures in the production, wholesale, and consumer food sectors erode market returns. The findings contradict the traditional expectation of Fisher's Hypothesis in this context, indicating that equities

on the NSE do not act as an effective hedge against domestic inflation. Instead, inflation functions as a key systematic risk factor, undermining investor confidence, elevating operational costs for listed firms, and ultimately suppressing overall equity market performance. This underscores the pronounced sensitivity of the NSE, as an emerging market, to domestic price-level instability.

6.0 RECOMMENDATIONS

The study recommended that investors and portfolio managers should incorporate explicit inflation-hedging strategies into their asset allocation for the NSE. This includes diversifying into asset classes with different inflation sensitivities to mitigate the identified negative impact. Secondly, the management of listed firms must adopt proactive, strategic cost management and dynamic pricing models to preserve margins during periods of high input cost inflation. For policymakers, specifically the National Treasury and the Central Bank of Kenya, the findings underscore the critical macroeconomic imperative of maintaining price stability, as this is a fundamental prerequisite for a deep and resilient capital market. Finally, the Capital Markets Authority should enhance financial literacy and investor education programs to raise awareness about the distinct impacts of various inflation measures on equity valuations, thereby fostering more informed investment decision-making.

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