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Industry Portfolios, Economic News and Business Conditions: Evidence from the Finnish Stock Market

In recent years, the effects of fundamentalmacroeconomic news on stock prices have received considerable attention in the research literature of financial economics. However, most previous studies implicitly assumes that the investor's reactions to economy-wide news is constant over different stages of the business cycle, although a more realistic model allows the investor's responses to news vary depending on business conditions. The implication of this potential asymmetry is straightforward; if the same type of news is considered good in some states and bad in other states, the estimated news effects in previous studies will be biased towards zero.

The purpose of this paper is to investigate monthly stock price reactions across different industries to macroeconomic news conditional on the state of the economy over the period 1987:01-1995:06. Residuals from a vector autoregression (VAR) model are used as macroeconomic news variables. Business conditions are classified in three discrete economic states (i.e., high, medium, and low) depending on the level of the industrial production relative to the fitted trend. This paper extends previous studies from general price index to more disaggregated data. Industry grouped data is especially important in the Helsinki Stock Exchange since the general price index can give biased results due to the fact that Nokia Corporation (a large telecommunications firm) dominates the aggregate stock market. Moreover, publication lags in economic statistics are also considered.

The results suggest that stock price responses to news are not constant, but vary depending on business conditions. For example, industrial production, real money supply, and interest rate news may sometimes cause a positive reaction to stock prices and at other times a negative reaction. When the economy is strong, higher than expected industrial production and real money supply decreases stock prices while in weak conditions the responses are positive. For the interest rate news, the signs are reversed.

Overall, the results show that when the estimations are made conditional on the state of the economy, stock prices respond to a larger set of economic news and a stronger relationship between news and stock prices is evident. The results are in line with McQueen and Roley's (1993) study. Therefore, Finnish stock markets do not behave differently than their counterparts in the United States despite the use of empirical expectation proxies and one-month event windows.