Chapter 1

Introduction

1.1 Research Background

Stock market is an important part of the economy of a country. The stock market plays a pivotal role in the growth of the industry and commerce of the country that eventually affects the economy of the country to a great extent. That is reason that the government, industry and even the central banks of the country keep a close watch on the happenings of the stock market. The stock market is important from both the industry's point of view as well as the investor's point of view.

Whenever a company wants to raise funds for further expansion or settling up a new business venture, they have to either take a loan from a financial organization or they have to issue shares through the stock market. In fact the stock market is the primary source for any company to raise funds for business expansions. If a company wants to raise some capital for the business it can issue shares of the company that is basically part ownership of the company. To issue shares for the investors to invest in the stocks a company needs to get listed to a stocks exchange and through the primary market of the stock exchange they can issue the shares and get the funds for business requirements. There are certain rules and regulations for getting listed at a stock exchange and they need to fulfill some criteria to issue stocks and go public. The stock market is primarily the place where these companies get listed to issue the shares and raise the fund. In case of an already listed public company, they issue more shares to the market for collecting more funds for business expansion. For the companies which are going public for the first time, they need to start with the Initial Public Offering or the IPO. In both the cases these companies have to go through the stock market.

The role of Stock Exchanges are varied and highly important in the development of economy of a country. They measure and control the growth of a country.Stock markets are the places, where exactly you do your business. Your stock trading transactions are executed at the stock exchanges through your broker, unless you have a membership with that exchange, which enable you to trade directly.

The topic of this research is to examine and highlight the cointegration of South East Asian stock markets vis-à-vis developed and European stock markets. The assessment of interdependence between stock markets is an important aspect of international portfolio management.

Capital flows are considered valuable for both the source and host country and a swift growth in international investments have recently been observed. Possible reasons for the increase in cross-border investments include, relaxation of controls on foreign exchange transactions and capital movements, decrease in cost of informationdue to improvement in technology and expansion in the multinational operations of major companies, e.g. listing of firm on multiple stock exchanges. These factors affect the co-movement between the stock markets (Kiviaho et al., 2014).

Grubel (1968) found that the risk of a stock portfolio can be reduced by diversifying the portfolio across international stock markets that are not perfectly correlated. These diversification benefits led researchers to scrutinize whether international stock markets are interdependent or not? Low (high) stock markets interdependence/integration implies high (low) diversification advantage for the investors. However, an investor from outside the region would find it easier to invest in an integrated regional stock exchange. In addition to stock investors, managers would need to assess capital investment in different countries. If capital markets are segmented then investment projects with similar risks must be treated in a different way. According to Ologunde et al (2006), the capital market is a collection of financial institutions set up for the granting of medium- and long-term loans. Babalola (2008) is of the opinion that the major significance of the financial system in any economy is its ability to mobilize savings and to efficiently intermediate in financial service delivery so as to create liquidity in the economy, minimize information cost, and create a bridge in assets diversification. Engle and Yoo (1987) and Clements and Hendry (1995) highlighted the importance of examining cointegration among international equity markets. They suggested that cointegration implies a long-run equilibrium relationship between the stock markets.

Under the hypothesis of cointegration, stock market movements have a tendency to trend together in the long-run even though experiencing short-run deviations from the common equilibrium path. A potential cointegration between the markets suggests that markets posit a long-run equilibrium relationship that prevents any one from getting too far out of line, at least for an extended period of time. Earlier empirical evidence indicated low correlation between the stock markets returns (Hilliard, 1979). However, current literature suggests that since the mid-1990s, the correlation between international stock markets have increased (see e.g. Beirne et al., 2010; Kizys and Pierdzioch, 2009; Click and Plummer, 2005). Notably, increased stock market comovement has been observed between the geographically concentrated countries (Lucey and Zhang, 2010).

Previous studies have mainly focused on developed and European markets. However, the studies on interdependence between emerging and developed stock markets are scarce.

Keeping in view the growth and importance of these markets, this paper aims to determine the extent of integration and interaction between the selected Southeast Asian, developed and European stock markets through co-integration and causality analysis. Cointegration tests are important for several economic reasons. First, Southeast Asian markets can be of interest for regional diversification for local investors. Second, due to increasing interest and investment of international investors in these markets, fluctuations in regional and international equity markets may make these markets vulnerable to international shocks. Third, an insight into the relationship between local and global markets can be utilized by investors for potential benefits and by policy makers for regulatory framework.

The particular aspect of asset markets examined here is the correlation between returns in international equity markets. Portfolio selection models, and their success in real world applications, depend crucially on asset market correlations. In terms of risk reduction, the coefficient of correlation is the most important input into any asset allocation model. There are a number of accepted stylised facts regarding stock market co-movements. Firstly, correlations are generally lower between international than domestic markets. This has been the driving force behind the wealth of literature advocating international diversification from Grubel (1968) to the present day. Secondly, correlations tend to increase in times of large shocks to returns such as a stock market crash, e.g. see King and Wadhwani (1990), Longin and Solnik (1995) among others. Despite their undoubted importance, very little is known about what factors influence the underlying co-movement between two markets. Karolyi and Stulz (1996) observe that 2 “the determinants of the levels and dynamics of these covariances have been little studied from an academic or from a practical perspective”.

1.2 Research Scope

This research will be multifaceted if there is no restraint of the research. This research decided research scope as restraint. The scope of this research is the research only will investigate the relationship between developed, European, and Southeast Asian Stock Market. Here is the explanation of each part on the research.

1. Researcher will use the stock exchange of USA (S&P500) and UK (FTSE100) as the developed country data.
2. Researcher will use the stock exchange of DJ STOXX 600 as the representation of European country data.
3. Researcher will use the stock exchange of Indonesian (JKSE), Malaysia (KLCI), Thailand (SET) and Philippines (PSE) as the Southeast Asian emerging country data.

4. This research will investigate the long-run relationship between the developed, European, and Southeast Asian stok exchange, and investigate its short-term dynamics.

1.3 Research Problem

1. Is there any causal relationship among the emerging Southeast Asian stock market?
2. Does the stock market of Southeast Asia interlinked with the developed market?
3. Does the developed stock market links with each other?

1.4 Research Objectives

1. To examine the linkage among the emerging Southeast Asian stock market.
2. To investigate the relationship between Southeast Asia stock market and the developed market.
3. To investigate the relationship between the developed stock markets to each other.

1.5 Research Contribution

The results of this study are expected to provide benefits, especially investors in taking investment decisions in the stock market. The benefits of this study can be described as follows:

1. For Investor, the results of this study are expected to be useful information for investors as consideration and reference in investment decision making.
2. To Author, this research is expected to make a better knowledge and understanding to the author about the relationship between developed market and Southeast Asia's market.
3. The Readers, this research can help readerto acknowledge about price international stock market, especially the developed market, European market, and Southeast Asia's market.
4. For Next Researcher, the results of this study are expected to provide insight and reference for next researchers who are interested to conduct studies in the same field.

1.6 Originality of the Writing

This research followed the preceding research that has been done before in other country's stock market and using different type of data. All of the writing in this research was collected, analyzed, explored, and premeditated thoroughly by the researcher.

1.7 Writing Structure

This research is divided into 5 chapters, which are:

Chapter I: Introduction

This chapter provides the research background, problem statement, scope of the study, research objective, benefits of the research, originality of the writing,and writing structure.

Chapter II: Theoretical Background

This chapter consists of concept and theory that is relevant with the problem statement of this research. This chapter will be divided into three part, the first one is about the literature review, the second one is about the previous study done by other researcher or other related study with the topic that became a reference in this research,and lastly is about the hypothesis development that will represent the findings of the research of the study in detail.

Chapter III: Research Methodology

This chapter contains the data collection method, research variables, and data analysis method.

Chapter IV: Data Analysis

This chapter contains the analysis of the collected data and the interpretation of the result of the data analysis.

Chapter V: Conclusion

This chapter contains the conclusion, managerial implication, limitation of the research, and the suggestion for future research.