CHAPTER I

INTRODUCTION

1.1.   Research Background

The topic of this research is about the economic studies regarding stock returns volatility in relation to the economic cycles. In making investment decision, it was believed the investor will make use all of the available information they can gathered and take this into account to make a logical and rational decision before investing and that would be one of the reason why investor should understand and examine the nature of stock returns toward the economic condition of the country, how the stock returns behave during bad economic conditions, whether it will decreases or increases on the post or pre or even during the crisis. That's why in this research, the researcher will focus more into analyzing the conditions of stock returns in accordance with the global economic shocks.

In this research primarily the researcher will investigate the response of stock markets of Asian countries and how it behaved toward the global economic shocks or global crisis. The research of stock returns related to the global crisis phenomenon has been conducted in several countries. Recent studies of Herwany and Febrian (2013) has shown   relationship of Indonesian Financial Industry with the same industry of US, UK, Tokyo, Hong Kong, Singapore, and Kuala Lumpur Stock and from the pre and post period of economic crisis which includes the year2nd January

2007 until 30th December 2010. This study has found that Indonesian market were associated with these 6 markets. Regardless Indonesian stock prices are less affected by the pressures of economic crisis compared to the other market.Based on this previous research, Indonesian, US, and several asian countries have become interesting countries that need to be analyzed by the researchers and by using these countries as the samples, it would help researcher to understand how the relationship of each country would effect the condition of other country during crisis. In this research these problem will be conducted thoroughly.

Another important consideration is regarding the global market condition especially throughout globalization era, in which the market changing rapidly over a period of time. According to Michie (2006, p.297-298) history book of The Global Securities Market, the market condition were very different compared to the condition from twentieth century in which the government give big intervention and control in financial markets. Ever since the year of 1900, the goverment intervention was minimized and also with the globalization, and development of new technology which offer efficiency and instant communication, the stock market have been evolving both advances and reversals.

Based on Liaw's book of Capital Markets (2004, p.471-472), in the early 1990's crisis has been occured, and most countries have implemented economic policy to prevent the problems, having deregulation, maintained restrictions and many other kind of measurement from each countries. In this research, comparison between Asian countries will be conducted. As the financial crisis that were happened

since early 1990's have influenced the developing nations of East and Southeast Asia especially in 1997 and 1998, that's why to understand how these global phenomenon influence, this research will be focused on 5 countries which consist of Indonesia, Hong Kong, Malaysia, Japan, and US.

Researcher use the US market because it is known as the biggest market and every changes will surely effect other countries in different way. While the east Asian market is one of the growing market and potential market in the eyes of investor to widen their international portfolio. The researcher would like to examine how crisis influenced the developing countries (Indonesia and Malaysia) also the developed countries (Hong Kong and Japan).

In this research, global phenomenon consist of three major crisis that has happened since the year of 1997 until 2013, there are consist of financial crisis, Sub-prime Mortgage crisis, European Debt Crisis. Asian Financial Crisis began in early July 1997. According to Kanaoka (2012) Asian financial crisis was triggered by illiquidity in Thailand, with Thailand currency experienced sharp devaluation and later peaked in 1998. Based on Pretorius and Beer (2014) found that unsustainable exchange rate arrangements and budget deficits, also asset price bubbles, increasing in credit growth,economic fragility and political uncertainty also played roles that provoked the instability in the financial market and become the key cause of the crisis.

Han (2014) explained the Global financial crisis began by the breakdown of Sub-prime Mortgage industry, where many banks and hedge funds invested heavily

and in which resulted to worldwide credit crunch and credit freeze. US banking system become the main center of the crisis. On September 2008, the crisis reach its peaked when Lehman Brothers bankrupt. The collapsed of Lehman Brothers resulted to great losses on other firms and with international financial linkages, global financial crisis was transmitted throughout the countries.

Akram et al. (2011) identified European Debt Crisis was basically the result of negligence and inefficiency of Greek government. Greece experience the fall of budget deficit and public debt, and there were several causes as why this debt crisis happened. Tuan and Linh (2014) listed several causes of debt crisis, there are inefficiency of an economic model heavily based on bank and financial services, and overload debt obligation from the global financial crisis in 2008, and the role of emergence of the Euro, etc.

These three major crisis will be analyzed in this research as these are the main interest of many researcher to see how these global economic events influence the cyclical nature of the stock return. The periodical samplings provided by Lukanima and Swaray presented in table 2.1, divided the events that happened since 1990 and to fulfill the objectives of the research, by examining three major crisis, the researcher found that these classifications which consist of eight periods will give more insight and detailed information regarding the condition of each countries during each period.

1.2. Research Scope

In order to give clearer direction for the research, it needed to be set some restrictions or limitation of the study that need to discuss. The limitations are set so the study did not deviate from the problems that actually want to be solved by the research, so the research has set the limits to be discussed as the following issues:

1. This research is focused on examining the cyclical nature of stock return and understands the co-integration of US and other four Asian countries which consist of Indonesia, Hong Kong, Malaysia, and Japan.

2. The data that will be used in this research are focusing on examining the condition of the market prior crisis that has been happened from the period 1997 until 2014 which consist of three major crisis (asian financial crisis, sub-prime mortgage crisis, and European debt crisis).

1.3. Research Problem

This research seeks to examine the cyclicality nature of stock returns in relations toward the economic cycles that happened on the US and four Asian stock markets. There are several questions that has been addressed and used as a guidance to develop this research. This research will relate the global economic phenomenon from 1997-2014. This research is focusing on Asian markets and discussed several issues, consist of:

1. How global economic conditions effect stock return?

2. How global economic conditions effect risk premium?

3. How the impact of good nor bad news (asymmetric information) effect the volatility of stock?

4. Is there any co-integration between US market and four Asian markets during the global economic events?

1.4. Research Objectives

The main purpose of this research is to examine the nature of stock returns in relations toward the economic cycles. This research will focus on Asian stock markets. There are some others objectives that hopefully can be reach or answer after the research has been conducted, such as;

1. To analyze the effect of global economic conditions to stock return.

2. To investigate the effect of global economic conditions to risk premium.

3. To examine the impact of good nor bad news (asymmetric information) effect to the volatility of stock.

4. To analyze the co-integration between US market and four Asian markets during the global economic events (financial crisis).

Another purpose of this research is to analyze the comparison condition of stock return volatility when a country faced crisis. By making comparison, it will give understanding how each market behave when they deal with this condition and

how is the risk premia during bad and good conditions. Hopefully the readers can get better understanding of the correlation between global economic events with stock return volatility, risk premia, and asymmetric information.

1.5. Research Contribution

Hopefully, this research will give positive advantages and provide contribution to both academic and managerial.

1.5.1. Academic Contribution

This research can be means as media to exercise the application of theory and science that has been obtained. By testing the behavior of stock during economic crash, especially in Asian countries, hopefully this research can contribute to broaden knowledge and give better understanding about the correlation of global economic cycles toward stock return volatility.

1.5.2. Managerial Contribution

This research could help financial analysts who invest in Asian stock markets. It can help them to get better understanding about how the global economic cycles influence the volatility of the stock return, help to measure the risk in the market and help to decide to make international portfolio by considering the behavior of the stock return.

1.5.3. Contribution to Investor

This research could help the investor who interested to invest in Asian stock markets and try to broaden their portfolio. This research will help to utilize the information regarding the behavior of stock in several countries and give material for consideration for the investor in their trading strategies and in making investment decisions.

1.6. The Originality of the Writing

This research is carried out based on the previous research or a replication study from previous research that has been done before, which is the replication of the existing journal of Economic Cycles and Stock Return Volatility. According to the recent studies by Lukanima and Swaray (2013), they managed to examine the economic cycles and stock return volatility by using three main variables consist of stock return volatility, risk premium, and information asymmetry. By applying the EGARCH-M models it helps the researcher to examine the co-cyclical nature of stock returns of several countries. Based on the research from period 1990-2011 and with the economic events that have happened during those period, researchers has reach a conclusion that good economic conditions tend to be associated with increases in risk premium, but overall risk is decreases and on the other hand the impact of bad news associated with the increases or decrease in volatility persistent. While the bad

economic condition resulted to the decreases in risk premium, but there's increases in the overall risk.

This previous research is use as the main journal by the researcher to develop this research and in order for this research to not deviate from the problems that would like to be discussed about the stock returns relation toward economic cycles in which focuses on their main variables consist of stock return volatility, risk premium, and information asymmetry. This study will use the same method and type of data that used in the main journal. Some research related with this topic also used to broaden sources and to deepen knowledge about the nature of stock returns and economic cycles.

1.7.   Systematic of the Writing

The writing in this research divided into five chapters, consist of:

Chapter I: Introduction

This chapter divided into seven parts which are consist of the research background, research scope, research problem, research objectives, research contribution, the originality of the writing and the systematic of the writing.

Chapter II: Theoretical Reviews

This chapter consist of description used as the relevant thoretical background to this research, literature review of previous researchs, and hypothesis developments.

Chapter III: Research Methodology

This Chapter describe the research design and it is consist of research design, sample,identifications of research variables, process of collecting data or data collection technique, and data analysis technique.

Chapter IV: Data Analysis

This chapter describes data of US market and four Asian countries from period 1997 until 2013 consist of calculation and data analysis and the description of the result obtained in this research.

Chapter V: Conclusion

This chapter consist of conclusion of the study, limitation of the research, and suggestions for further research.