

Chapter 5

Market Fundamentals and Stock Pricing in Nigeria: Further Evidence from Micro and Macro Analysis

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ABSTRACT

This chapter investigates the relationship between stock pricing and behaviour of the stock market on one hand and micro and macroeconomic fundamentals in the Nigerian economy on the other from 1980-2009 using both primary and secondary data. Results from the primary survey indicate that the key drivers of share prices were neither broad macroeconomic indicators nor key indicators of the health of the firm. Prices were clearly shown to be much above levels that could have been determined by such indicators as posted profits of firms, amounts paid out as dividend and its regularity. Secondary data analysis equally show that the relationship between actual levels of the all share price index for the period of our analysis and during the financial crisis were not driven by “expected” variables. While its fundamental values are driven by monetary and relative price variables, actual values are driven by external sector variables and prices.

INTRODUCTION

The role of financial markets in economic development has received considerable attention in the literature starting from Schumpeter’s work in 1911. There is no gainsaying the fact that without the capital market, the financial system

of any country will be grossly incomplete. The primary role of a capital market is the provision of medium to long term finance for development. Stock markets help to allocate and reallocate the ownership of the economy’s capital resources. In this way it plays an important role in distributing the economy’s wealth (Owolabi & Ajayi, 2013;

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Ulici, 2012; Ndako, 2010; Agu & Chukwuma-Agu (2010), Ajadi, 1984). According to Olarotimi (2008) absence of an effective and efficient capital market that mobilises and allocates the surplus funds to the deficit units of the economy could mean that such funds would remain idle and thus unproductive. However, in the past few years, developments in our national and global finance and economics have led to renewed interest in stock market outcomes. For example, when on March 10, 2000, the technology-heavy NASDAQ composite peaked at 5,048.62, very few expected what was to follow the next couple of months. Even though such high movements were quite contrary to the trends in the rest of the US economy (particularly given that the Federal Reserve had raised interest rates six times over the same period and that the rest of the economy was already beginning to slow down), the fall still caught many analysts and stakeholders unprepared. The bubble burst that followed (generally known as the dot-com bubble crash) wiped out about \$5 trillion in market value of technology companies between March 2000 and October 2002. Many other (non-technology) stocks followed in the wave of weak confidence in the market and lost values. A number of reasons have been given for that particular market crash, but as in many other times, such reasons often relate to market-specific occurrences and are weakly related to the overall question of what causes stock market crash and how these can be prevented. Consequently, the question of what causes a particular market crash remains a context-specific one that must be answered for all dips in the market.

Investors sometimes, albeit temporarily, show excessive optimism and pessimism which end in pulling stock prices away from their long term trend levels to extreme points. Just before a major burst, experience has shown, the market will always look so promising and attract some late comers who are also somewhat new and inexperienced in the business. Unfortunately, they are the most vulnerable in crisis times. However, even for the

more mature investors, there is evidence that following the market is a very demanding job and no one actually ever does a perfect job of correctly predicting its direction. In particular, the cause of bubbles remains a challenge to most analysts, particularly those who are convinced that asset prices ought not to deviate strongly from intrinsic values. While many explanations have been suggested, it has been recently shown that bubbles appear even without uncertainty, speculation, or bounded rationality. For instance, in their work, Froot and Obstfeld (1992) explained several puzzling aspects of the behavior of the United States stock prices by the presence of a specific type of bubble that they termed “intrinsic bubbles”. Bubbles are often identified only in retrospect, when a sudden drop in prices appears. Such drop is known as a *crash* or a *bubble burst*. To date, there is no widely accepted theory to explain the occurrence of bubbles or their bursts. Interestingly, bubbles occur even in highly predictable experimental markets, where uncertainty is eliminated and market participants should be able to calculate the intrinsic value of the assets simply by examining the expected stream of dividends. Clearly, the existence of stock market bubbles is at odds with the assumptions of Efficient Market Theory (EMT) which assumes rational investor behaviour. Often, when the phenomenon appears, pundits try to find a rationale. Literatures show that sometimes, people will dismiss concerns about overpriced markets by citing a new economy where the old stock valuation rules may no longer apply. This type of thinking helps to further propagate the bubble whereby everyone is investing.

The growth in stock markets in the emerging economies has reflected the increased demand for such transactions and the lower costs of investing in international markets. According to International Finance Corporation (1999), from 1989-1998 the number of developing countries with actively trading stock markets increased from 31 to 78, the number of domestic companies listed on emerging market stock indices rose