
Research in economics and finance documents a puzzling negative relationship between stock returns and inflation rate in markets of industrialized economies. The present study investigates this relationship for the developing markets of Peru and Chile. Fama’s model of linkages between inflation and real economic activity constitutes the theoretical framework of this paper. The study tests whether the negative relationship between equity returns and inflation is a result of a ‘proxy effect’, namely, a negative relationship between inflation and real economic activity. The evidence for Peru and Chile does not provide strong support for Fama’s hypothesis. It is shown that the negative relationship between the real stock returns and unexpected inflation persists after purging inflation of the effects of the real economic activity. The long-run equilibrium between stock prices and general price levels is weak, as indicated by the findings of the Johansen and Juselius co-integration tests. However, in both economies, stock prices and general price levels seem to show a strong long-run equilibrium with the real economic activity. These findings suggest that in the long-run, Fama’s propositions A and B are supported for Peru and Chile. The disparity between traditional regression and co-integration test results suggest that it may be prudent to re-examine the proxy effect in the framework of a long-run relationship before denying its validity.