This study empirically tested the relationship between the stock prices on Nairobi stock exchange and Kenya's macroeconomic variables that included; inflation, exchange rates, current account balance, money supply, budget deficit and treasury bill rates. This was in recognition of the fact that the market efficiency tests done by other researchers examined whether markets incorporate available information, but did not determine what information the market responds to and to how important this was. The objectives of this study were therefore to identify the macroeconomic variables that influence the stock prices and to estimate a long-run relationship between them, utilizing the VAR technique.

Monthly data for the period 1990 to 2002 were used. The model was specified based on the Arbitrage Pricing Theory. Before any analysis of the data was done, stationarity tests for time series data were conducted. By applying the Augmented Dickey Fuller test, it was found that all the variable were I (1) except GDP and current account balance, which were I (2) and I(0) respectively.

Johansen's procedures for cointegration were used and it was found that cointegrating vectors existed. The findings of the study suggest that the stock prices and inflation, exchange rates, current account balance, money supply, budget deficit, treasury bill rates tend to evolve together over time. The relatively small coefficient of the error term in the Vector Error Correction Model (VECM) indicated a slow rate of adjustment to restore equilibrium in the dynamic model.

In order to get a deeper insight of the interrelationships among the variables identified, Granger-Causality analysis was performed. The empirical results show that bi-directional relationship existed between stock prices and inflation, exchange rates, money supply, budget deficit, treasury bill rates and Gross Domestic Product. Unidirectional relationship was found to exist between stock prices and current account balance. Thus, stock prices are caused by inflation, exchange rates, money supply, budget deficit, treasury bill rates and GDP.