

THE IMPACT OF MACROECONOMIC VARIABLES ON ISLAMIC STOCKS MARKET PERFORMANCE IN MALAYSIA

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ABSTRACT

This study examines the relationship between macroeconomic variables and the performance of Islamic stocks in Malaysia, focusing on the FTSE Bursa Malaysia Hijrah Shariah Index. By analyzing the effects of interest rates, inflation, gross domestic product (GDP), and foreign direct investment (FDI), the research addresses existing gaps in understanding how these factors influence Shariah-compliant equity markets. The study adopts a quantitative design using 15 years of quarterly data (2009–2023), yielding 60 observations. An Autoregressive Distributed Lag (ARDL) model is applied to assess both short- and long-run dynamics, complemented by diagnostic tests to ensure validity and reliability. The results show that GDP exerts a statistically significant negative influence on Islamic stock market performance in both the short and long run, whereas interest rates, inflation, and FDI exhibit no significant effects. These findings offer important implications for investors, policymakers, and other stakeholders, supporting more informed decision-making and contributing to efforts to strengthen the resilience of Malaysia's Islamic capital market.

Keywords: *Islamic stock market; FTSE Bursa Malaysia Hijrah Shariah Index*

INTRODUCTION

In recent decades, Islamic finance has become an important segment of the global financial industry, promoting ethical investment practices consistent with Shariah principles. Unlike conventional equities, Islamic stocks are governed by strict criteria that firms must satisfy to qualify for inclusion in Shariah-compliant indices. As noted by Buyondo (2024), Islamic finance provides a distinct approach to wealth management by prohibiting Haram activities such as *riba* (interest), *maysir* (gambling), and *gharar* (excessive uncertainty), while emphasizing risk-sharing and profit-sharing arrangements. These principles shape the structural foundation and investment strategies of Islamic financial markets, leading to the development of dedicated Islamic stock indices that screen firms according to Shariah guidelines. As a result, investors are able to allocate funds to companies that do not engage in prohibited activities.

In Malaysia, the Islamic stock market has emerged as a significant segment of the financial landscape, driven by a growing demand for Shariah-compliant investment opportunities. As one of the most prominent Islamic stock indices in the region, it offers a key measure of the overall performance and growth of Malaysia's Islamic capital market. In the context of stock markets, macroeconomic factors such as inflation, interest rate, total Gross Domestic Product (GDP), and Foreign Direct Investment (FDI) play crucial roles in shaping investor behavior and market performance. These variables, which reflect the broader economic environment, are traditionally associated with stock market movements. According to Ligocka (2024), the significance of macroeconomic factors and their interrelations increases with heightened volatility and instability in stock markets.

This study examines the influence of inflation, interest rates, GDP, and FDI on the performance of Malaysia's Islamic stock market, as proxied by the FTSE Bursa Malaysia Hijrah Shariah Index, using 15 years of data from 2009 to 2023. The research seeks to address the limited empirical understanding of how macroeconomic conditions affect Islamic equity markets in the Malaysian context. By analysing these relationships, the study aims to provide insights into how shifts in economic fundamentals shape the behaviour of Shariah-compliant investments. The findings are expected to inform investors and policymakers, contributing to more effective decision-making within Malaysia's Islamic finance sector.

Background of Study

Macroeconomics plays a critical role in understanding the performance of economies by analyzing key factors such as economic production, exchange rates, interest rates, inflation, and the balance of payments (World Bank Group, 2023). These variables form the foundation of economic activity, influencing national and global financial stability. Effective macroeconomic management through effective monetary and fiscal policies is crucial for achieving poverty alleviation, social equity, and sustainable development. It integrates various policies, resources, and technologies to enable economic progress, highlighting its importance to a country's overall growth and stability.

For a nation, macroeconomic stability provides the groundwork for long-term economic development. Proper macroeconomic policies enhance investor confidence by reducing uncertainties and creating favorable conditions for investment and growth. The lack of effective macroeconomic management could hinder poverty reduction and social equity, underscoring the necessity of well-crafted policies to maintain economic equilibrium (World Bank Group, 2023). In the context of stock markets, macroeconomic variables significantly shape investor sentiment and market performance. These variables influence critical aspects of market dynamics, including corporate profitability, investment opportunities, and risk assessment. Vaswani & Padmaja (2023) highlighted that stock market gains strongly correlate with macroeconomic indicators such as industrial production, inflation, and interest rates. This connection underscores the importance of macroeconomic analysis for Islamic finance, where market dynamics are guided by ethical principles and investor behavior aligns with broader economic trends.

Interest rates play a fundamental role in shaping economic activity by influencing borrowing costs, market liquidity, and investment decisions. In Malaysia, the interest rates rose from 3.44% to 5.32% between 2021 and 2023 as Bank Negara Malaysia (BNM) sought to stabilize the ringgit and contain inflationary pressures arising from a weak exchange rate and widespread subsidies (OctaFX, 2023). Interest rates serve as a crucial monetary policy tool, directly affecting consumer spending, corporate investment, and overall market conditions.

Although Islamic finance prohibits *riba* (interest) in line with Shariah principles, Malaysia's dual banking system means Islamic financial markets remain indirectly exposed to interest rate fluctuations (Harun et al., 2024). Factors such as competitive pressures and market dynamics further influence this exposure, particularly in the early development of Islamic banking (Seho et al., 2020). Changes in interest rates can indirectly affect Islamic stock performance by shaping market liquidity, consumer demand, and corporate profitability. Moreover, investors may adjust their portfolio allocations in response to changing interest rates, impacting the demand for Shariah-compliant equities (Sholikah & Safitri, 2024).

Inflation reflects the general rise in prices and the corresponding decline in purchasing power, serving as a key economic indicator influencing monetary policy and

living costs (Zhubi et al., 2024). In Malaysia, inflation has fluctuated significantly, ranging from deflation at -1.14% in 2020 during the pandemic to 2.49% in 2023 as the global economy recovered. The rise in 2022 was driven by higher commodity prices, a strong US dollar, and geopolitical tensions from the Russia-Ukraine conflict, while government interventions such as subsidies and price controls helped moderate inflationary pressures in 2023 (The Star Online, 2023; 2024). Managing inflation is critical for ensuring economic stability, as excessive inflation can erode savings, increase borrowing costs, and reduce household purchasing power.

In the context of Islamic stocks, inflation significantly affects firm profitability and investor behavior. Rising costs can pressure Shariah-compliant firms, particularly in sectors like energy and construction, where price volatility is high (Belanova, 2023). Moreover, reduced consumer spending can lower corporate revenue. Nevertheless, Islamic stocks often serve as a hedge against inflation due to their ties to real assets, particularly during periods of moderate, stable inflation (Selmi et al., 2023; Umar et al., 2020). For investors and policymakers, understanding the relationship between inflation and Islamic stock performance is essential for maintaining portfolio stability and ensuring long-term market resilience.

Gross Domestic Product (GDP) represents the total market value of goods and services produced within a country, serving as a key indicator of economic health and growth potential (Orabi, 2023). In Malaysia, GDP has shown notable recovery in recent years, increasing from RM1.42 trillion in 2020 to RM1.82 trillion in 2023, reflecting economic resilience following the pandemic. The removal of COVID-19 restrictions, combined with government stimulus programs, contributed to this growth by supporting businesses, boosting employment, and strengthening consumer confidence (Kismawadi, 2024; Ministry of Finance Malaysia, 2024). Positive GDP growth also enhances Malaysia's ability to attract foreign investment and strengthens its global competitiveness (Yusuf et al., 2020).

In relation to Islamic stock market performance, GDP plays a vital role by shaping investor sentiment and market opportunities. Economic expansion increases consumer purchasing power, driving demand for goods and services, which can positively impact the revenue and stock performance of Shariah-compliant companies (Olokoyo et al., 2020). Conversely, unexpected GDP declines can introduce uncertainty and negatively affect market stability. Therefore, understanding the relationship between GDP and Islamic stock performance is essential for assessing market prospects and guiding investment decisions.

Foreign Direct Investment (FDI) refers to cross-border investment activities that involve the acquisition, establishment, or operation of businesses, either fully funded by foreign capital or in collaboration with domestic investors (Halim, 2021). FDI plays a vital role in promoting global economic integration by enhancing financial market efficiency, reducing information asymmetry, and stimulating economic growth (Haryono & Atika, 2023). In Malaysia, FDI has grown substantially in recent years, rising from RM140.94 billion in 2020 to RM263.13 billion in 2023, reflecting the country's attractiveness to foreign investors amid global recovery efforts. Notably, Malaysia secured significant investments in the electrical and electronics (E&E) sector in 2022, aligning with global technological trends (Malaysian Investment Development Authority, 2023). However, competition from regional economies such as Indonesia, Thailand, and Vietnam continues to challenge Malaysia's ability to sustain high FDI inflows (Jhek, 2024).

FDI contributes directly to Malaysia's economic development by fostering job creation, facilitating technology transfer, and strengthening both industrial and service sectors. It expands market size, improves efficiency, and enhances access to international markets, thereby boosting the nation's competitiveness (Haryono & Atika, 2023). For a highly trade-dependent economy like Malaysia, FDI remains a critical pillar supporting

long-term economic growth and resilience in an increasingly competitive global environment.

In the context of Islamic stock market performance, FDI plays a dual role. The inflow of foreign capital enhances market liquidity, promotes investor confidence, and supports the expansion of Shariah-compliant businesses (Rasyidin et al., 2023). However, FDI can also introduce risks such as financial instability, contagion effects, and intensified competition, requiring Islamic firms to balance international competitiveness with adherence to Shariah principles (Haryono & Atika, 2023). Thus, effectively managing FDI is essential to maximize its benefits while safeguarding the stability and resilience of Malaysia's Islamic financial sector.

Islamic stocks refer to equities that comply with Shariah principles, which prohibit investment in sectors such as alcohol, gambling, and interest-based financing, while promoting ethical and socially responsible business practices. The global Islamic investment industry has grown substantially, with Shariah-compliant assets surpassing US\$2 trillion and the number of Islamic equity funds expanding from nine to over six hundred (Buyondo, 2024; Parvin et al., 2024). This growth reflects the increasing international adoption of Islamic finance, even in major financial hubs such as New York, London, and Hong Kong.

The performance of Islamic stocks is closely linked to macroeconomic stability, particularly factors such as inflation and GDP growth, which shape investor sentiment and market dynamics (Karyatun et al., 2021). Islamic equities have gained popularity for their ethical foundation, diversification potential, and historical resilience, with Shariah-compliant stocks outperforming conventional counterparts by an average of 167.2% (Belanes et al., 2024; Parvin et al., 2024). Malaysia's Islamic stock market not only contributes to local economic development but also attracts international investors, enhancing market liquidity, financial resilience, and the country's position as a global leader in Islamic finance.

The performance of stock markets is often influenced by various macroeconomic variables, which can significantly impact investment behavior, market trends, and economic stability. In conventional finance, variables such as interest rates, inflation, total GDP, and FDI have been widely studied for their effects on stock performance. According to Keswani et al. (2024), macroeconomic factors, including GDP, interest rates, and inflation, significantly influence the stock market. However, within the Islamic finance framework, the impact of these macroeconomic indicators remains relatively underexplored, particularly given the unique Shariah-compliant principles that guide the sector. Shariah-compliant stocks have grown significantly, attracting both Muslim and non-Muslim investors as a viable alternative to conventional investments, noted for their ethical and socially responsible foundation (Ali et al., 2023). Despite the growth of Shariah-compliant investments, a significant gap remains in understanding how macroeconomic factors specifically influence the performance of Islamic stocks, as represented by the FTSE Bursa Malaysia Hijrah Shariah Index, given that Islamic finance prohibits activities involving *riba* (interest) and speculative transactions, which creates a unique set of dynamics distinct from conventional stocks. This unique set of dynamics highlights a pressing need to investigate the effects of these macroeconomic variables on Shariah-compliant investments, particularly in Malaysia, where the FTSE Bursa Malaysia Hijrah Shariah Index serves as a critical benchmark within the well-established Islamic finance sector.

However, limited research has specifically examined how these macroeconomic factors interact with the performance of this particular index, indicating a lack of comprehensive analysis in this area.

Moreover, previous research has primarily focused on conventional stock markets, leaving a gap in the understanding of how these macroeconomic factors influence Shariah-compliant investments, particularly in Malaysia, where the Islamic stock market is a significant segment of the financial landscape. As the Islamic finance sector gains increasing attention from both local and international investors, it becomes crucial to explore how macroeconomic variables interact with Islamic stock market performance to inform better investment strategies and policies. In fact, Islamic stock indices are considered to be more strategically positioned and robust during financial crises in comparison to their conventional counterparts (Belanes et al., 2024). In addition, the efficacy of Shariah compliance in Islamic investing as a safeguard against financial crises (Ghallabi et al., 2024). This underscores the need for a comprehensive analysis of emerging markets like Malaysia, as the relationship between macroeconomic variables and the performance of the Islamic stock market is a complex and nuanced issue that warrants thorough investigation.

Focusing on Malaysia, where the FTSE Bursa Malaysia Hijrah Shariah Index represents the top 30 Shariah-compliant companies, this study seeks to bridge the knowledge gap regarding the impact of macroeconomic variables on Islamic stocks. The FTSE Bursa Malaysia Hijrah Shariah Index is particularly significant as it reflects the performance of large-cap, Shariah-compliant companies in Malaysia's stock market, offering insight into the health and growth potential of the Islamic finance sector. According to Qoyum et al. (2024), Malaysian stock market data show that Islamic stocks exhibit greater resilience and efficiency compared to conventional stocks, with reduced volatility attributed to the financial ratio screening rigorously applied by Shariah-compliant firms. This screening process promotes sound financial practices, discourages excessive risk-taking, and aligns with principles of stability and ethical responsibility, distinguishing Islamic stocks from their conventional counterparts. Understanding the impact of each macroeconomic variable, such as interest rates, which may affect investment and borrowing decisions, inflation, which impacts purchasing power, total GDP, generally linked to stock market performance, and FDI, which signals international investor confidence and enhances market liquidity, is therefore crucial for comprehending how these variables shape the dynamics of Shariah-compliant investments in Malaysia.

One of the variables is interest rates influencing the Islamic stock market. Despite extensive research on the relationship between interest rates and Islamic stock market performance, the findings remain contradictory and inconclusive. Some studies assert that interest rates negatively impact the Islamic stock market (Garnia et al., 2021; Rachmawaty, 2024; Rahayu et al., 2021; Sheikh et al., 2020; Sriwanti et al., 2023). Conversely, other studies indicate a positive relationship between interest rates and Islamic stock markets (Amal & Musthofa, 2023; Amijaya et al., 2020; Dewi et al., 2022; Hasan et al., 2022; Khan et al., 2020; Nugroho et al., 2023). These mixed findings emphasize the need for further investigation to provide a clearer understanding of how interest rates influence Islamic stock market performance, particularly in the context of Malaysia.

Malaysia's highly regulated and well-developed Islamic finance sector provides a unique context for examining the interplay between macroeconomic variables and the performance of Shariah-compliant stocks. The stringent Shariah-compliant standards applied to the top 30 companies on the FTSE Bursa Malaysia Hijrah Shariah Index not only enhance their ethical foundations but also influence their responsiveness to economic changes. Despite the existing knowledge on conventional stock performance, there remains a significant gap in empirical evidence regarding how macroeconomic factors specifically

affect Shariah-compliant stocks in Malaysia. Addressing this gap is essential for developing a deeper understanding of the resilience and efficiency of Islamic investments, particularly as the sector continues to attract both local and international investors.

This research aims to explore the intricate dynamics between macroeconomic variables and the Islamic stock market performance in Malaysia. The main objective of this study is as follows is to analyze the relationship between macroeconomic variables and Islamic stock market performance in Malaysia. To achieve this, the research will focus on specific objectives that address key macroeconomic factors, including interest rates, inflation, total GDP, and FDI. These specific objectives are:

- i. To analyze the relationship between interest rates and Islamic stock market performance in Malaysia.
- ii. To analyze the relationship between inflation and Islamic stock market performance in Malaysia.
- iii. To analyze the relationship between total GDP and Islamic stock market performance in Malaysia.
- iv. To analyze the relationship between FDI and Islamic stock market performance in Malaysia

LITERATURE REVIEW

The performance of stock markets has long been a focus of financial research, particularly regarding the influence of macroeconomic variables such as interest rates, inflation, GDP, and FDI on investment decisions and market behavior. In emerging markets like Malaysia, this relationship is especially relevant given the presence of a significant Islamic stock market, which operates under Shariah principles promoting ethical and socially responsible investments. Prior studies, including Elshabouny (2024), have highlighted the sensitivity of Malaysia's stock market to macroeconomic fluctuations, underscoring the need to examine these dynamics within a Shariah-compliant framework.

This literature review explores the macroeconomic factors influencing stock market performance, with particular attention to Malaysia's Islamic stock market. As a global hub for Islamic finance research (Mohamad, 2024), Malaysia offers a unique context to assess how macroeconomic shifts affect Shariah-compliant investments. The review integrates theoretical perspectives, including the Efficient Market Hypothesis (EMH) and Arbitrage Pricing Theory (APT), with empirical findings to provide a conceptual basis for understanding how Islamic stocks respond to macroeconomic changes. This serves to frame the study's objectives and guide its investigation into the interaction between macroeconomic conditions and Malaysia's Islamic stock market performance.

Efficient Market Hypothesis (EMH)

The Efficient Market Hypothesis (EMH) is a financial theory that suggests that asset prices in financial markets reflect all available information at any given time, making it impossible for investors to consistently achieve returns that outperform the market average (Neifar & Gharbi, 2023). According to the EMH, prices of securities adjust instantaneously to reflect new information, thereby ensuring that the market is "efficient." The theory assumes that all investors have access to the same information and that any new information, whether public or private, is quickly incorporated into stock prices. This results in stock price movements being unpredictable and essentially following a random walk, with future price changes being independent of past movements. Therefore, the EMH suggests that it is impossible to consistently achieve superior returns without taking on additional risk (Liu et al., 2022).

There are three forms of EMH, including weak, semi-strong, and strong, which differ in terms of the types of information that are assumed to be reflected in stock prices. The weak form suggests that all past market data, such as historical prices, are reflected in stock prices (Elangovan et al., 2022). The semi-strong form posits that all publicly available information, including news, earnings reports, and economic indicators, is reflected in stock prices. The strong form asserts that all information, including insider knowledge, is fully reflected in the prices (Bonga et al., 2023). According to EMH, any deviation from the fair value of a stock is purely the result of randomness or market inefficiencies, and any observed short-term profits or abnormal returns are considered the result of luck or risk-taking behavior rather than skill (Fianto et al., 2023). In the long run, any abnormal returns would be offset by higher levels of risk.

In the context of this study, the EMH provides a theoretical framework for understanding how macroeconomic factors, such as interest rates, inflation, GDP, and FDI, affect Islamic stock market performance. According to the EMH, stock prices should reflect all available information, and changes in macroeconomic conditions should be quickly absorbed by stock prices, ensuring that they are efficiently priced. For example, as new data about inflation or GDP growth becomes available, Islamic stock prices should adjust to reflect this information, and investors will base their decisions on the most up-to-date information available (Kalumbu et al., 2023). This implies that market participants do not have the ability to "beat the market" consistently, as stock prices already reflect all available information about macroeconomic variables.

However, there are challenges to the application of EMH, especially in the context of Islamic finance. One key issue is the potential for costs associated with obtaining and processing information, which may prevent the market from being perfectly efficient. As noted by Ryczkowski & Zinecker (2022), the existence of costs to acquire information can disrupt the efficient flow of information, meaning that investors who spend resources gathering and analyzing data may not always receive compensation for these efforts. This challenges the notion of perfect efficiency and suggests that information asymmetry could exist, leading to market inefficiencies.

Additionally, while EMH has been widely studied in conventional stock markets, research on its applicability to Islamic stock markets is relatively scarce. Bugar et al. (2021) highlight that the distinctive characteristics of Islamic finance, such as the prohibition of *riba* (interest) and speculative practices, could result in different market dynamics compared to conventional markets. This could potentially lead to variations in how macroeconomic variables are reflected in Islamic stock prices, thereby challenging the traditional view of market efficiency. Moreover, as Othman and Al-Kassab (2022) suggest, macroeconomic variables such as interest rates and inflation can significantly impact stock prices. These effects may be more pronounced or manifest differently in Islamic stock markets due to the unique ethical constraints that guide investment decisions in Islamic finance.

The EMH also aligns with the idea that macroeconomic variables, which are considered explanatory variables in this study, play a key role in influencing stock prices. These variables including interest rates are believed to have a linear relationship with stock prices, often exerting a negative impact, particularly in response to changes in economic conditions (Othman & Al-Kassab, 2022). The expectation is that competition among profit-maximizing investors ensures that these fluctuations in macroeconomic factors are fully reflected in stock prices, as suggested by the EMH.

Arbitrage Pricing Theory (APT)

The Arbitrage Pricing Theory (APT), introduced by Ross in 1976, is an asset pricing model

that extends beyond the Capital Asset Pricing Model (CAPM) by addressing its limitations and offering a more flexible framework for understanding how various systematic factors influence stock returns (Magani & Ochieng, 2020). Unlike CAPM, which assumes that stock returns are determined by a single macroeconomic risk factor, APT posits that multiple systematic risk factors collectively affect asset prices. This model is grounded in the principle that stock returns can be forecasted through a linear relationship between expected returns and several macroeconomic factors, each representing a source of systematic risk (Gupta et al., 2023; Lone et al., 2024).

APT emphasizes that any mispricing of assets will be corrected through arbitrage activities, ensuring that asset prices align with their expected values based on these systematic risk factors. This process highlights the dynamic adjustment of asset prices in response to underlying economic conditions, reflecting the broader market's efficiency (Magani & Ochieng, 2020). In essence, APT provides a multi-factor approach, accommodating a variety of macroeconomic influences such as inflation, interest rates, and currency exchange rates, which have been empirically shown to significantly impact stock returns (Noorie et al., 2020; Rosdiana & Sohilauw, 2024).

In the context of Islamic finance, APT offers a valuable framework for analyzing the performance of Shariah-compliant securities. Similar to conventional stocks, Islamic stocks are influenced by macroeconomic factors, including inflation and interest rates, which tend to generate negative investor sentiment when they rise (Daariy et al., 2023; Hasan et al., 2022). However, Shariah-compliant securities are uniquely characterized by ethical investment principles, which prioritize broader economic and social conditions over company-specific factors (Bassar et al., 2021). This distinction underscores the importance of using APT to capture the nuanced relationship between macroeconomic variables and Islamic stock performance. While previous studies have extensively applied APT to conventional stock markets, limited attention has been given to its relevance in Islamic markets. By examining multiple macroeconomic variables, this study leverages APT to investigate the linear relationship between these factors and the performance of the Islamic stock market in Malaysia. This approach aligns with the APT framework and fills a gap in existing literature, as the model's applicability to Shariah-compliant securities remains underexplored (Hasan et al., 2022).

By focusing on macroeconomic variables as systematic risk factors, this study contributes to a deeper understanding of how Islamic stock prices respond to economic changes. The integration of APT into the analysis highlights its robustness in explaining stock market behavior, offering insights for policymakers and investors seeking to optimize strategies in the Islamic finance sector.

Research Framework

The research framework of this research provides a structured approach to understanding the interrelationships between macroeconomic variables and the performance of the Islamic stock market in Malaysia. It serves as a blueprint that guides the research process, linking the independent variables and dependent variable in a systematic manner. It outlines the key components and theoretical underpinnings that guide the analysis, as detailed below:

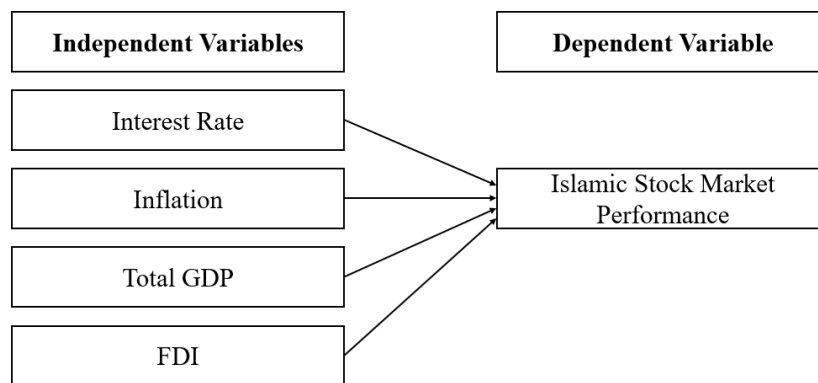


Figure 1: Research Framework

The relationship between interest rates and Islamic stock market performance has produced mixed results in empirical studies, reflecting the complexity of this macroeconomic factor. While many studies highlight a negative relationship, others report positive effects, and some conclude there is no significant relationship at all. These varying outcomes emphasize the need to contextualize the findings within specific markets, time periods, and methodological approaches.

Several studies report a significant negative impact of interest rates on Islamic stock markets. Rachmawaty (2024) found that interest rates significantly and negatively impact the Islamic stock market, based on ordinary least squares (OLS) analysis using data from 2012 to 2023. Similarly, Rahayu et al. (2021), employing panel data regression and a fixed-effects model from 2014 to 2020, concluded that higher interest rates adversely affect Islamic stock performance. Garnia et al. (2021), Sheikh et al. (2020) and Sriwanti et al. (2023) also identified a significant negative relationship between interest rates and Islamic stock markets. Rising interest rates increase interest expenses, which can erode company profit margins and reduce sales, ultimately impacting stock prices (Karyatun et al., 2021). Additionally, higher interest rates typically reduce investment attractiveness and market liquidity, further driving down Islamic stock prices (Hasyim et al., 2024). Increased borrowing costs and negative investor sentiment associated with higher interest rates tend to result in lower stock returns.

In contrast, some studies suggest a positive relationship between interest rates and Islamic stock prices. Amal & Musthofa (2023) reported a significant positive impact of interest rates on Islamic stock performance using the OLS method. Subagio and Rahayu (2024) also observed a positive effect, with interest rates acting as a parameter in exchange rate differentials, contributing to profitability. Dewi et al. (2022) found a significant positive relationship between interest rates and Islamic stock markets during the COVID-19 period, using linear regression. Khan et al. (2020) similarly reported that interest rates had a positive effect on Islamic stock indices in Malaysia and Indonesia during pre-crisis, crisis, and post-crisis periods. Moreover, some studies also states that there is a significant and positive relationship between interest rates and Islamic stock market (Amijaya et al., 2020; Hasan et al., 2022; Nugroho et al., 2023). All these studies suggest that in certain contexts, higher interest rates can boost investor confidence and, in turn, enhance the performance of Islamic stocks.

Conversely, other studies suggest no significant relationship between interest rates and Islamic stock market performance. Karyatun et al. (2021) found that Interest rates have no influence on Shariah- compliant equities. This highlights the distinction between Islamic

finance and conventional markets, interest rates are not directly related to the Islamic stock market because in Shariah, interest rates are prohibited. Islamic banking is not founded on an interest rate system, rather, it is exclusively focused on assets (Almaida et al., 2024). Nawindra & Wijayanto (2020) noted that Interest rates have no short-term impact on Islamic stock prices, but they become significant in the long term. Amin and Sholahuddin (2023) argued that investment in Islamic stocks is more dependent on income than on interest rates, based on secondary data from 2019 to 2022. Similarly, Cahyanti et al. (2024), Hasibuan et al. (2023) and Widarjono et al. (2021), also observed that interest rates did not significantly influence Islamic stock prices. These findings suggest that the prohibition of *riba* in Islamic finance may lead to a different response to interest rate changes, making Islamic stocks less sensitive to conventional monetary policy adjustments compared to their conventional counterparts. Based on the diverse empirical evidence, the following hypothesis is proposed:
 H_1 : Interest rates do not have a significant negative impact on the performance of Islamic stocks market in Malaysia.

H_a : Interest rates have a significant negative impact on the performance of the Islamic stock market in Malaysia.

Inflation

Inflation's relationship with Islamic stock market performance has been a subject of diverse findings in empirical research. Some studies suggest inflation positively influences Islamic stock indices, others indicate a negative relationship, while some conclude that inflation has no significant effect. This variation in results underscores the complexity of inflation as a macroeconomic factor and its contextual dependence on specific markets, timeframes, and methodological approaches.

Several studies have found a positive and significant relationship between inflation and Islamic stock markets. Sya'bani & Fathoni (2022), analyzing data from Indonesia from 2011 to 2020 using panel data regression, reported that inflation positively and significantly impacts Islamic stock markets. Similarly, Alfajriyani and Musthofa (2023) found a positive and significant effect of inflation on Indonesia's Sharia stock indices during the 2019 to 2022 period. Amijaya et al. (2020) employed the Vector Error Correction Model (VECM) and revealed that inflation significantly influences the Jakarta Islamic Index (JII) in the long run using monthly data from 2011 to 2018. Nurwulandari (2019) also observed a positive and significant impact of inflation on stock prices in the Indonesian Sharia Stock Index using the Fixed Effect Model for 2014 to 2018. Gulzar and Kalim (2022) reported a significant positive impact of inflation on Islamic stock indices, suggesting that rising inflation could reflect increased nominal revenues for companies. These studies highlight the possibility that inflation could improve Islamic stock performance by increasing nominal values of company revenues and profitability in certain contexts.

Conversely, numerous studies suggest a negative relationship between inflation and Islamic stock market performance. Saputra et al. (2024) observed a significant negative impact of inflation on Indonesia's Islamic bank stock prices using panel data regression for 2021 to 2023. They noted that inflation affects operational costs and asset-based financing, making stocks less attractive to investors. Hasibuan et al. (2023) found a significant negative effect of inflation on the Indonesian Shariah stock index, emphasizing that high inflation reduces profitability and decrease investor interest, leading to lower demand for shares. Similarly, Fitriansyah and Darwanto (2022), employing vector error correction modeling (VECM), concluded that inflation has a significant negative influence on the Indonesian Sharia Stock Index. Huda et al. (2023) also reported a significant negative effect of inflation on the Indonesian Islamic stock market over both the short and long term, analyzed using

VECM with data from 2012 to 2021. Mashudi et al. (2020) analyzed secondary time series data on macroeconomic variables from January 2018 to August 2019 (20 months) and found that the inflation factor had a considerable negative impact on Indonesia's stock market index. Moreover, Primartha and Diana (2021) examined data from January 2017 to October 2020 using multiple linear regression analysis and found that inflation had a significant negative impact on Jakarta Islamic Index. Astuti (2021) further explained that inflation increases production costs, reduces company profits, and ultimately results in stock price declines. All these findings suggest that high inflation often disrupts market stability, decreases investor confidence, and negatively impacts Islamic stock markets.

Other studies indicate that inflation does not significantly affect Islamic stock indices. Nida et al. (2023) and Nugroho et al. (2023) reported that inflation does not significantly affect the Indonesian Sharia stock market, with the latter focusing on data from 2017 to 2021. Similarly, Sriwanti et al. (2023), covering data from 2016 to 2020, and Katmas and Indarningsih (2022), using data from 2015 to 2020, reported no significant relationship between inflation and Indonesian Sharia stock index in both the short and long term. Pardiansyah et al. (2024), using time series data (monthly) from the period 2016 to 2021, also concluded that inflation does not significantly influence the Indonesian Islamic stock index in the short or long term. Aziz et al. (2020) further indicated the absence of a volatility spillover impact of inflation on Malaysia's Islamic stock indexes, based on data from December 2010 to September 2019. These findings align with the principle that Islamic finance operates under Shariah, which avoids interest-based activities and may shield Islamic stocks from conventional inflationary effects.

Based on the mixed findings in the literature, this study proposes the following hypotheses:
 H_2 : Inflation do not have a significant positive impact on the performance of Islamic stocks market in Malaysia.

H_a : Inflation have a significant positive impact on the performance of the Islamic stock market in Malaysia.

Gross Domestic Product

Gross Domestic Product (GDP), representing the total economic output of a country, is a critical macroeconomic indicator that influences stock market performance. GDP's relationship with Islamic stock market performance has been widely studied, yielding mixed findings. While several studies suggest that GDP positively impacts Islamic stock markets, others highlight negative effects, and some find no significant relationship. These varied results underscore the complexity of GDP's influence, especially within the context of Islamic finance, where economic principles align with Shariah compliance.

Many studies have reported a positive and significant relationship between GDP and Islamic stock market performance. Yusof et al. (2020) demonstrated that GDP positively affects the Hijrah Shariah Index in Malaysia, applying Ordinary Least Squares Regression on data from 2007 to 2018. Similarly, Islam et al. (2023) found that GDP significantly enhances Islamic stock returns in Bangladesh using multiple regression analysis on data from 2010 to 2021. Mawardi et al. (2019) and Septiarini et al. (2020) also identified a significant positive impact of GDP on the Indonesian Sharia stock index, with data spanning May 2011 to November 2017 and 2016 to June 2019, respectively, suggesting that economic growth improves corporate profitability and investor confidence. In Malaysia, Roslan and Hussin (2019) highlighted that GDP has a significant positive effect on the FTSE Bursa Malaysia Emas Shariah Index, based on data from the first quarter of 2007 to the fourth quarter of 2017. Positive relationship between GDP and Islamic stock reflecting the alignment between economic development and Islamic stock market growth. Prasetyo &

Hariyani (2022) further emphasized that GDP positively influences the Jakarta Islamic Index (JII) in Indonesia, using data from 2013 to 2020, supporting the view that robust economic output drives higher corporate earnings and investment activity, thereby boosting Islamic stock prices.

Contrary to the above findings, some studies suggest that GDP negatively impacts Islamic stock market performance. Nasution et al. (2023) found a significant negative effect of GDP on the Jakarta Islamic Index over the period 2016 to 2022, using a quantitative approach with path analysis. Similarly, Masrizal et al. (2020) observed that GDP, proxied by the Industrial Production Index (IPI), negatively affects Islamic indices in the long term, based on Vector Error Correction Model (VECM) estimation. Yurista and Ayuningtyas (2019) reported that GDP negatively impacts Shariah stock prices in Indonesia, attributing this to inefficiencies in translating economic growth into higher investor returns. Muharam et al. (2019) also noted a significant negative relationship, suggesting that certain sectors might not benefit equally from GDP growth, leading to declines in Islamic stock market performance.

Other studies conclude that GDP does not significantly influence Islamic stock market performance. Muttaqi & Surur (2024) found no significant effect of GDP on Islamic stock prices in either the short or long term, using the VAR/VECM method with a data time frame from 2016 to 2020. Similarly, Bakhri et al. (2023) and Surono et al. (2022) reported no significant relationship between GDP and Islamic stock indices, indicating that GDP growth does not always translate into increased investment activity in Shariah-compliant markets. Fajri et al. (2020), Wijayanti et al. (2024) and Zulkarnain & Sufyati (2024) argued that GDP had no significant effect on the Shariah stock price index. These studies further highlighting the mixed results surrounding GDP's impact on Islamic stocks.

Based on the above findings, the hypothesis for this study can be formulated as follows:

H_3 : GDP do not have a significant negative impact on the performance of Islamic stocks market in Malaysia.

H_a : GDP have a significant negative impact on the performance of the Islamic stock market in Malaysia.

Foreign Direct Investment

The relationship between foreign direct investment (FDI) and the performance of Islamic stock markets has been widely studied, resulting in mixed findings. Some studies highlight a positive and significant effect, attributing this to the role of FDI in enhancing capital availability and market efficiency. Conversely, others find a negative relationship, suggesting that FDI may increase market volatility or lead to resource misallocation. There is also evidence indicating no significant relationship, implying that FDI flows might not directly influence Islamic stock market performance due to structural or institutional factors. These varied outcomes reflect the complex interplay between FDI and market dynamics.

Several studies have found that FDI positively influences the Islamic stock market. Ansari et al. (2022) showed that foreign portfolio flows, including FDI, have a significant lagged positive effect on Islamic stock returns. This relationship indicates that FDI contributes to increased liquidity and confidence in the market. Similarly, Suwanhirunkul (2022) highlighted a positive contemporaneous relationship between capital flows and shariah-compliant stock returns, suggesting that FDI enhances market performance through improved investment opportunities. Hermuningsih et al. (2023) further confirmed that foreign investments significantly and positively impact the prices and volume of shares traded in Indonesia. Additional studies, such as Setiaji and Wijayanto (2019) and Asrofillah et al. (2022), also emphasized the positive role of FDI in boosting capital market returns.

On the other hand, some research identifies a negative relationship between FDI and the Islamic stock market. Tawfik et al. (2024) found that FDI, alongside institutional investments, negatively affects shariah-compliant stocks, possibly due to market distortion or dominance by foreign investors. Makau (2021) similarly concluded that FDI negatively impacts stock prices. Idenyi et al. (2016) supported this view by demonstrating that FDI negatively influences stock market growth in both the short and long run, highlighting potential vulnerabilities caused by over-reliance on foreign capital. Aditty & Rahman (2022) also found evidence of a negative relationship using VECM analysis, emphasizing the risks associated with FDI in stock market performance.

Other studies report no significant relationship between FDI and Islamic stock markets. Halim (2021) observed that foreign investment flows through the Jakarta Composite Index (JCI) have no substantial effect on the Indonesian Shariah Stock Index (ISSI), indicating that FDI may not be a primary determinant of Islamic stock market performance. Similarly, Pratama (2024) concluded that there is no relationship between foreign investors and Indonesian capital market. Sia et al. (2023) and Ponco (2024) further reinforced these findings, stating that FDI does not significantly affect Islamic stock market performance in both short and long-term analyses. Muharam et al. (2019) extended this view, showing that FDI does not significantly influence Islamic stock market development in Malaysia and Indonesia.

Based on the findings from previous studies, the hypothesis for this study is as follows:

H₄: FDI do not have a significant negative impact on the performance of Islamic stocks market in Malaysia.

H_a: FDI have a significant negative impact on the performance of the Islamic stock market in Malaysia.

METHODOLOGY

Data and Sample

This study uses quarterly data from 2009 to 2023 to examine the impact of macroeconomic variables, namely interest rates, inflation, GDP, and foreign direct investment (FDI) on the performance of Malaysia's Islamic stock market. The population consists of all Shariah-compliant companies listed on Bursa Malaysia, which operate in accordance with Islamic principles that prohibit activities involving *riba*, *gharar*, and *haram* elements (Naseh & Ghalia, 2024).

The sample is represented by the FTSE Bursa Malaysia Hijrah Shariah Index, which includes the top 30 Shariah-compliant companies selected based on strict screening by the Shariah Advisory Council of the Securities Commission Malaysia (Bursa Malaysia Berhad, 2024). This index serves as a reliable proxy for Islamic stock market performance due to its high liquidity, market capitalization, and strict adherence to Islamic ethical standards.

Macroeconomic data is collected from reputable sources such as the CEIC Database and the World Bank Data repository, ensuring consistency and reliability. The dependent variable is the FTSE Bursa Malaysia Hijrah Shariah Index, while the independent variables include interest rates, inflation, GDP, and FDI. The data is verified, cleaned, and aligned in terms of frequency and units for accurate analysis.

Variables Descriptions and Measurements

This section outlines the key variables used in the study and explains their measurement and sources. Variables are integral to research as they provide the foundation for examining

relationships and testing hypotheses. In this study, the variables are categorized into two groups, including dependent variable and independent variables. The dependent variable is the Islamic Stock Market Performance, measured by the FTSE Bursa Malaysia Hijrah Shariah Index, which reflects the performance of top Shariah-compliant companies listed on Bursa Malaysia. The independent variables include interest rates, inflation, gross domestic product (GDP), and foreign direct investment (FDI), all selected for their established relevance in financial literature (Aziz et al., 2020; Fianto et al., 2023; Mustafa et al., 2017). These macroeconomic indicators are used to assess their influence on the Islamic stock market and are sourced from reliable databases such as CEIC and the World Bank.

Table 1: Measurements of Variables

Variables		Acronym	Measurement Dependent
FTSE Bursa Malaysia Hijrah Shariah Index	FBMHS	The FBMHS is a tradable index comprising the 30 biggest firms listed on the FTSE Bursa Malaysia EMAS Index (Francis & Chia, 2024).	Independent Variables:
Interest rates term financing	IR	The bank rate that typically addresses the short- and medium-requirements of the private sector (World Bank Group, 2024b).	
Inflation	IF	The annual percentage change in the cost for the average consumer to get a basket of goods and services, which may be set or adjusted at specified intervals, such as annually (World Bank Group, 2024a).	
Gross domestic product country in one	GDP	Total market value of goods and services produced within a year, serving as a critical indicator of economic health (Orabi, 2023).	
Foreign Direct Investment	FDI	The investment activities of foreign investors in a country, involving the acquisition, establishment, or operation of businesses, either fully financed by foreign capital or in partnership with domestic investors (Halim, 2021).	

Estimation Models

The estimation model in this study is developed to explore the relationship between macroeconomic variables and Islamic stock market performance in Malaysia. The model integrates key macroeconomic variables, including interest rates, inflation, GDP, and FDI, as independent variables, while the FTSE Bursa Malaysia Hijrah Shariah Index represents the dependent variable, signifying Islamic stock market performance. Based on the hypothesis above in this study, the estimation of the baseline models is expressed as:

$$FBMHS_t = \beta_0 + \beta_1 IR_t + \beta_2 IF_t + \beta_3 GDP_t + \beta_4 FDI_t + \varepsilon_t$$

Whereby,

$FBMHS_t$	= Islamic stock market performance at time t
IR_t	= Interest rate at time t
IF_t	= Inflation rate at time t
GDP_t	= Gross Domestic Product at time t
FDI_t	= Foreign Direct Investment at time t
β_0	= Intercept term
$\beta_1, \beta_2, \beta_3, \beta_4$	= Coefficients of Independent Variables
ε_t	= Error Terms

To examine these relationships, the study adopts the Autoregressive Distributed Lag (ARDL) model. The ARDL approach is particularly suited for this research as it allows the inclusion of variables integrated at different orders (I(0) or I(1)), making it flexible for analyzing time series data.

Data Analysis

The study adopts a quantitative research design using time-series analysis to evaluate the relationship between macroeconomic variables and Islamic stock market performance. The Autoregressive Distributed Lag (ARDL) model is employed due to its flexibility in handling variables with different orders of integration, I(0) or I(1), and its ability to distinguish between short-run and long-run effects (Kripfganz & Schneider, 2023). Descriptive statistics are first used to summarize key characteristics of the dataset, such as mean, standard deviation, and range (Mustafa et al., 2017). The main analysis is conducted using EViews software, which facilitates unit root tests, ARDL bounds testing, and other diagnostic procedures. This methodological approach ensures a robust evaluation of how macroeconomic conditions influence the performance of Malaysia's Islamic stock market over time.

Diagnostic Test

Diagnostic tests play a crucial role in validating the results obtained from econometric models. They help assess the reliability of the estimated model and ensure that the assumptions underlying the analysis are met. As highlighted by Aftab et al. (2021), diagnostic tests are essential for evaluating the stability and validity of the model. In this study, a series of diagnostic tests are conducted to evaluate the quality and robustness of the results from the ARDL model. These tests include the Unit Root test, ARDL Bounds test, Multicollinearity test, Heteroscedasticity test and Serial Correlation test. Each of these tests is designed to check specific issues that may affect the model's accuracy and the interpretation of the findings.

Unit Root Test

The Unit Root test is crucial in time-series analysis to determine the stationarity of variables, which influences the selection of appropriate econometric models (Aziz et al., 2020). This study applies the Augmented Dickey-Fuller (ADF) test to assess the stationarity of interest rates, inflation, GDP, FDI, and the FTSE Bursa Malaysia Hijrah Shariah Index. Identifying whether variables are integrated at level I(0) or first difference I(1) is essential to avoid spurious regression and ensure the validity of the ARDL model (Aftab et al., 2021; Fianto et al., 2023). In this study, the hypothesis for Augmented Dickey-Fuller (ADF) test can be expressed as:

H_0 : There has existed a unit root and non-stationary in an autoregressive model.

H_a : There is no unit root exists and stationary in an autoregressive model.

ARDL Bounds test

The ARDL Bounds Test is used to determine the existence of a long-run relationship between macroeconomic variables and Islamic stock market performance. It is preferred for its flexibility in handling variables integrated at different levels, $I(0)$ or $I(1)$, and its ability to include lagged variables to capture both short-term and long-term dynamics (Lone et al., 2024; Mustafa et al., 2017). In this study, the test evaluates whether interest rates, inflation, GDP, and FDI are cointegrated with the FTSE Bursa Malaysia Hijrah Shariah Index. The null hypothesis of no cointegration is tested against the alternative of a long-run relationship. If the F-statistic exceeds the upper bound, cointegration is confirmed (Aftab et al., 2021; Prakoso, 2022). The null hypothesis and alternative hypothesis can be defined:

$H_0: \phi_1 = \phi_2 = \phi_3 = \phi_4 = \phi_5 = 0$

$H_a: \phi_1 \neq \phi_2 \neq \phi_3 \neq \phi_4 \neq \phi_5 \neq 0$

Multicollinearity Test

To ensure the reliability of the regression estimates, a multicollinearity test was conducted. Multicollinearity occurs when two or more independent variables are highly correlated with each other, which may distort the true relationship between the dependent and independent variables (Kim, 2019). It is important to address multicollinearity in order to guarantee that the model generates coefficient estimates that are both dependable and consistent. The test was performed using the Variance Inflation Factor (VIF). According to Kim (2019), a VIF value greater than 5 to 10 may indicate the presence of multicollinearity. To prevent redundancy and distortion in the model, each variable that surpasses this threshold should be evaluated, either for removal or adjustment. The test of multicollinearity is based on the following hypotheses:

H_0 : Multicollinearity does not exist in the regression model.

H_a : Multicollinearity exists in the regression model.

Heteroscedasticity Test

The heteroscedasticity test evaluates whether the variance of residuals in a regression model is consistent across all levels of the independent variables. Heteroscedasticity occurs when there is an unequal variance of residuals for different observations, potentially leading to inefficient estimations and unreliable statistical inferences (Mahdi & Khaddafi, 2020). In this study, the Breusch-Pagan-Godfrey test will be employed to detect heteroscedasticity in the ARDL model. This test identifies whether the variance of the residuals depends on the independent variables.

The hypotheses for the heteroscedasticity test are:

H_0 : The variance of error terms is homoscedastic.

H_a : The variance of error terms is heteroscedastic.

Serial Correlation Test

The serial correlation test is a fundamental procedure for diagnosis in time series analysis that detects autocorrelation in regression model residuals. The assumption of independence among error terms is violated when the residuals exhibit serial correlation, often referred to as autocorrelation, across time. This can lead to inefficient or biased estimations,

undermining the reliability of the regression results (Fan et al., 2024). In this study, to determine if serial correlation exists in the ARDL model's residuals, the Breusch-Godfrey Serial Correlation LM test will be used. The test is particularly useful in time-series data as it accounts for higher-order autocorrelation and is robust to the inclusion of lagged dependent variables in the regression model.

The hypotheses for the serial correlation test are as follows:

H_0 : The error terms are not serially correlated.

H_a : The error terms are serially correlated.

EMPIRICAL FINDINGS AND DISCUSSION

Descriptive Analysis

Table 2: Descriptive Statistics

Variables	N	Mean	Minimum	Maximum	Std. Deviation
FBHMS	60	12510.4297	6814.6055	14948.6263	1897.1168
IR	60	4.6097	3.3048	5.4733	0.5261
IF	60	1.9541	-2.5556	4.5133	1.5540
GDP	60	316470.155	173159.2667	476725.621	81948.5030
FDI	60	9811.5292	-3540.5400	31496.9660	6469.6876

Table 2 presents the descriptive analysis of all variables used in this study, comprising the dependent variable, which is the FTSE Bursa Malaysia Hijrah Shariah Index (FBMHS), and the independent variables, namely Interest Rate (IR), Inflation Rate (IF), Gross Domestic Product (GDP), and Foreign Direct Investment (FDI). FBMHS representing the Islamic stock market performance, has a mean value of approximately 12,510.43. The index shows significant variation, with values ranging from 6,814.61 to 14,948.63 and a standard deviation of 1,897.12. The IR has a mean of 4.61, a standard deviation of 0.53, and values that range from a minimum of 3.30 to a maximum of 5.47. IF presents more fluctuation, with a mean of 1.95 and a wide range from -2.56 (deflation) to 4.51, resulting in a standard deviation of 1.55. GDP has a substantial mean of 316,470.16, with values spanning from 173,159.27 to 476,725.62, as well as a standard deviation of 81,948.50. FDI averaged 9,811.53, with a minimum value of -3,540.54 (indicating a net outflow) and a maximum of 31,496.97, and a standard deviation of 6,469.69.

Correlation Analysis

Table 3: Pearson's Correlation Matrix

	FBMHS	IR	IF	GDP
FBMHS	1.000000			
IR	-0.393330 0.0019***	1.000000		
IF	-0.002602 0.9843	0.077982 0.5537	1.000000	
GDP	0.573926 0.0000***	-0.381244 0.0027***	0.082165 0.5326	1.000000
FDI	0.332816 0.0094***	-0.318781 0.0130**	0.403325 0.0014***	0.397655 0.0017***

Significance level: ***1%, **5%, *10%

The linear relationships between the independent macroeconomic variables (IR, IF, GDP, and FDI) and the dependent variable (FBMHS) were investigated using a correlation analysis. The Pearson correlation coefficients and their corresponding p-values are presented in Table 3. The results show several significant relationships. The findings reveal that the Islamic stock market performance (FBMHS) is positively correlated with GDP (0.573926) at the 1% significance level. This implies that the Islamic stock market's performance is generally improved by an increase in economic output.

Similarly, at the 1% significance level, there is a significant positive correlation (coefficient of 0.332816) between FDI and the performance of the Islamic stock market, suggesting that stronger market performance is associated with higher levels of foreign investment inflows. Additionally, FDI has a significant positive correlation with inflation at the same level with a coefficient of 0.403325, which means that greater inflation may lead to more foreign investments. GDP and FDI are strongly connected (0.397655), and this association is also significant at the 1% level.

Conversely, the Islamic stock market exhibits a substantial negative correlation with the interest rate at the 1% significance level (-0.393330). This suggests that stock market weakness is typically associated with raised interest rates. The interest rate is negatively correlated with both GDP (-0.381244) and FDI (-0.318781). At the 1% level, the negative relationship with GDP is significant, while at the 5% level, the negative correlation with FDI is significant.

Results and Discussion

Short-term relationship between Macroeconomic variables and Islamic stock market performance

Table 4: Short-term relationship (ARDL Error Correction Model)

Variables	Coefficient	Probability
D(IR)	N/A	N/A

D(IF)	-0.087908	0.1837
D(GDP)	0.154749	0.2292
D(GDP(-1))	-0.365167	0.0002***
D(GDP(-2))	-0.303365	0.0071***
D(GDP(-3))	-0.343266	0.0030***
D(GDP(-4))	-0.451033	0.0008***
D(FDI(-1))	-0.005362	0.5400
CointEq(-1)	-0.104246	0.0000
R-squared	0.5398	

*Note: *** denotes rejection of the null hypothesis at the 1% significance level.*

Prior to estimating the regression model, several diagnostic tests were conducted to ensure the validity and reliability of the results. The findings revealed no evidence of multicollinearity, as all Variance Inflation Factor (VIF) values were below the critical threshold. Similarly, the Breusch-Pagan-Godfrey test confirmed the absence of heteroscedasticity, while the Breusch-Godfrey Serial Correlation LM test indicated no serial correlation in the residuals. With these diagnostic checks satisfied, the results of the regression analysis can be interpreted with confidence.

Table 4 presents the results of the ARDL Error Correction Model (ECM), analyzing the short-run impact of macroeconomic variables on Islamic stock market performance in Malaysia, represented by the FTSE Bursa Malaysia Hijrah Shariah Index (FBMHS). The model confirms a valid short-run adjustment mechanism, as indicated by a negative and highly significant error correction term (CointEq(-1) = -0.1042, $p = 0.0000$), suggesting that 10.42% of the disequilibrium is corrected each quarter. The model's R-squared value of 0.5398 indicates that approximately 54% of the variation in Islamic stock performance is explained by the macroeconomic variables.

Among the independent variables, only GDP lagged by one to four quarters shows a statistically significant negative effect on Islamic stock performance. For instance, GDP(-1) has a coefficient of -0.3652 ($p = 0.0002$), indicating a 1% increase in GDP is associated with a 0.37% decline in current Islamic stock returns. This pattern continues with other lags, suggesting a consistent delayed negative relationship between GDP growth and Islamic stock performance. These findings support earlier studies such as Ismail et al. (2016) and Yurista and Ayuningtyas (2019) that found GDP lag terms significantly lowered stock market returns.

On the other hand, interest rate, inflation, and foreign direct investment (FDI) do not exhibit significant short-term effects on the Islamic stock market. The non-significant result for interest rate aligns with prior research such as Hanif and Bhatti (2018) and Nawindra and Wijayanto (2020) emphasizing the limited impact of interest-based instruments on Islamic indices. Similarly, inflation shows no significant influence, consistent with findings from Aziz et al. (2020) and Pardiansyah et al. (2024). FDI also lacks a significant short-run relationship, echoing results from Muharam et al. (2019) and Sia et al. (2023), suggesting external investment flows may not immediately affect Islamic stock returns.

Long-term relationship between Macroeconomic variables and Islamic stock market performance

Table 5: Long-term relationship

Variables	Coefficient	Probability
IR(-1)	-0.023221	0.5921
IF	0.092386	0.1421
GDP(-1)	-0.060098	0.0198**
FDI(-1)	-0.025018	0.1960

*Note: **denotes rejection of the null hypothesis at the 5% significance level.*

Table 5 presents the ARDL long-run estimation results, revealing that only GDP lagged by one period shows a statistically significant long-term relationship with Islamic stock market performance. Specifically, GDP(-1) has a negative coefficient of -0.0601 ($p = 0.0198$), indicating that a 1% increase in GDP is associated with a 0.06% decline in the FTSE Bursa Malaysia Hijrah Shariah Index. This inverse relationship suggests that economic growth does not always translate into improved performance for Shariah-compliant stocks, aligning with previous findings by Masrizal et al. (2020), Muharam et al. (2019) and Saleem et al. (2021). It may also reflect the defensive nature of Islamic stocks, which tend to attract investors during uncertain economic periods (Jabeen & Kausar, 2022).

Other macroeconomic variables, including interest rate, inflation, and FDI do not exhibit significant long-run effects. This is consistent with prior studies, such as Almaida et al. (2024) and Karyatun et al. (2021), who emphasized that Islamic finance's detachment from interest-based mechanisms makes the interest rate less relevant. Inflation's insignificance also echoes the results of Sriwanti et al. (2023) and Vejzagic and Zarafat (2013), who argued that inflation lacks long-term predictive power. Similarly, the non-significance of FDI aligns with findings by Halim (2021) and Pratama (2024), which noted that foreign capital flows, especially those directed toward non-compliant sectors, have limited influence on Islamic stock indices.

CONCLUSION AND RECOMMENDATIONS

This study explored the impact of selected macroeconomic variables, including interest rates, inflation, gross domestic product (GDP), and foreign direct investment (FDI) on the performance of Malaysia's Islamic stock market, represented by the FTSE Bursa Malaysia Hijrah Shariah Index. Using quarterly data from 2009 to 2023 and the ARDL model, the findings revealed that only GDP exhibited a statistically significant negative relationship with Islamic stock returns in both the short and long run. Specifically, lagged GDP values indicated that previous periods of economic growth tended to correspond with a decline in Islamic stock performance, suggesting a delayed negative effect. This contrasts with the statistically insignificant results for interest rates, inflation, and FDI, indicating that these conventional economic indicators may not directly influence Shariah-compliant equities. The findings align with existing literature suggesting that Islamic stocks behave differently due to ethical constraints, sector exposure, and the real-economy basis of Islamic finance.

The study contributes significantly to the understanding of macroeconomic influences on Islamic equity markets, especially by focusing on the FTSE Bursa Malaysia Hijrah Shariah Index, which is rarely examined in depth. The use of the ARDL model provides robust insights into both short and long-term relationships, reinforcing the distinct behavior of Shariah-compliant assets. The key contribution lies in identifying GDP as a negative determinant of Islamic stock performance, challenging the conventional assumption that economic growth always supports equity market gains. Instead, this suggests that investors in ethically governed markets may respond more cautiously during periods of rapid economic activity, possibly viewing Islamic stocks as stable or defensive options. Conversely, the lack of significance for interest rates, inflation, and FDI emphasizes that Islamic equities may exhibit independence from traditional macroeconomic forces, possibly due to their unique screening criteria and financial structures.

These findings have important implications for policymakers, regulators, and market participants. Policymakers should ensure that economic growth strategies are inclusive of sectors represented in Islamic indices, such as halal industries and ethical finance. The limited effect of interest rates and inflation suggests that traditional monetary policy tools may be less

effective for influencing Islamic capital markets, and efforts may be better directed toward strengthening Shariah-compliant instruments and governance frameworks. Additionally, since FDI inflows may not always target Shariah-compliant sectors, foreign investment strategies should incorporate Islamic finance principles, encouraging ESG-aligned and halal-compliant investments. For investors and fund managers, the results urge a re-evaluation of traditional assumptions. Reliance on general macroeconomic forecasts may be less effective for Islamic portfolios, and strategies should focus on firm-level fundamentals, long-term value, and ethical consistency. Fund managers should not rely heavily on interest rate or inflation changes when adjusting Islamic equity holdings, as these variables showed no significant influence. Corporate decision-makers in Shariah-compliant firms should also align their strategies with ethical standards and economic resilience to attract long-term investment.

Despite its contributions, the study has limitations. It focuses only on four macroeconomic variables and excludes others such as exchange rates, commodity prices, money supply, and global shocks, which are particularly relevant for an open economy like Malaysia's. The reliance on the FTSE Bursa Malaysia Hijrah Shariah Index provides a broad view but overlooks variations across different sectors within Islamic stocks. The quarterly data used, while appropriate for long-term analysis, may miss short-term market shocks or responses to unexpected events. Lastly, the findings are limited to the Malaysian context, which may not be generalizable to other Islamic financial markets such as Indonesia, Saudi Arabia, or the broader Middle East, each with distinct economic and regulatory environments.

To address these gaps, future research should expand the range of macroeconomic variables to include exchange rates, fiscal policy indicators, and commodity price trends. Researchers are encouraged to adopt a sectoral approach, analyzing how different industries within the Islamic stock market respond to economic changes. High-frequency data such as monthly or weekly observations can offer better insights into volatility and market sentiment. Additionally, cross-country studies would be valuable to determine whether similar patterns exist in other Islamic financial hubs, thereby enhancing the global relevance and applicability of the findings.

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