

The study has investigated the risk return relationship of microeconomic variables and stock returns of 50 listed firms on Karachi stock exchange for the period of July 1998 to December 2008. The study comprises of five namely macroeconomic indicators: inflation rate, exchange rate, interest growth of industrial production, money supply M2 and term structure and the stock exchange returns have been represented by the general price index of the Karachi Stock returns ,as sample is time series in nature, they are being checked as stationary by applying first order augmented Dick fuller test, the return for each stock is calculated by taking the difference of natural log of current closing price (pt) previous day closing price (pt-1). This study employ GARCH model to demonstrate the behavior of variance of microeconomic variables in relation with stock returns. The results find significant relationship between the macroeconomic indicators and stock returns, and show that macroeconomic as risk factors influencing the movement of returns. The results show that sensitivity coefficient of industrial production is negative indication that real sector risk unfavorably effects stock returns. The money supply risk positively effects stock returns and the inflationary shock and exchange rate shock negatively effects stock returns, similarly the sensitivity coefficient of term structure is negative implying that stock term structure adversely affects stock returns.