CHAPTER I

INTRODUCTION

1.1 Background

Over the past five years, the Indonesian economy has experienced resilience amid global economic challenges, maintaining an average economic growth rate of 5.23% from 2019 to 2023. This steady growth has been driven by several factors, including the expansion of key industries, robust investment inflows, and substantial infrastructure improvements. These elements have played a critical role in stabilizing the economy and fostering an environment conducive to market growth and recovery.

Table 1
Indonesian Economic Growth

Year	Economic Growth Rate (%)	GDP (IDR trillion, current prices)	Inflation Rate (%)
2019	5.02	15833.9	2.72
2020	-2.07	15434.2	1.68
2021	3.69	16058.8	1.87
2022	5.31	19588.4	5.51
2023	5.05	20892.4	3.52

Source: www.bps.go.id

As of 2024, Indonesia's GDP growth has reached 5.4%, reflecting sustained economic momentum despite external pressures. A significant macroeconomic factor influencing this growth is inflation, which declined to 3.52% in 2023 from 5.51% in 2022. While this decline aligns with economic stability, inflation remains slightly above the government's 3% target, posing potential risks to financial markets. The interplay between economic growth and inflation has a notable impact on investor sentiment and market behavior, shaping the landscape of Indonesia's capital markets (Aristo et al., 2024). This dynamic creates both opportunities and challenges for investors navigating stock market fluctuations.

The Indonesian capital market has exhibited volatility, with certain stocks experiencing price declines while others, particularly in high-growth sectors like technology and e-commerce, have seen price increases. Additionally, foreign investment has declined, reaching $3.5 billion in 2023, while domestic investment has remained relatively high. To sustain economic stability, the government has implemented fiscal policies such as increased public spending and cost reductions, while Bank Indonesia has managed inflation through interest rate adjustments and liquidity controls.

Investor participation in Indonesia's stock market has risen significantly, with the number of investors reaching 13 million by mid-2024 (KSEI). This growth includes both retail and institutional investors, with domestic investors dominating market ownership and transactions. The increasing accessibility of stocks, coupled with improved regulatory frameworks, has strengthened investor confidence and market participation. Stocks have become a preferred investment vehicle, with investors relying on financial statement analysis to guide their investment decisions.

Financial performance analysis is a key tool for investors in selecting securities, as it provides insights into a company's growth potential. Stock returns, representing investor profits, are influenced by multiple factors, including a company's financial health and external macroeconomic conditions. Financial ratios are widely used to assess company performance, as they provide measurable indicators of profitability, liquidity, and leverage. These ratios help investors gauge a company's ability to manage assets, meet obligations, and generate shareholder returns. Positive financial ratios typically signal strong financial stability and growth potential, leading to higher stock returns. However, stock returns are not solely determined by internal financial performance; external economic factors, particularly inflation, play a critical role in moderating these effects.

Inflation significantly impacts stock returns by affecting purchasing power, interest rates, and corporate profitability. High inflation reduces consumer purchasing power, which can lower demand for goods and services, negatively impacting company revenues. Additionally, inflation often leads to interest rate hikes, which can increase borrowing costs for companies, thereby reducing profitability. On the other hand, in certain industries such as banking, higher interest rates may increase net interest income, benefiting financial performance. The effect of financial ratios on stock returns may vary depending on inflation levels—while strong financial performance can drive stock returns in stable inflation periods, the relationship may weaken or even reverse during high inflation (Rahmatika & Dadan, 2017). This variability underscores the need to analyze inflation as a moderating factor in the relationship between financial ratios and stock returns.

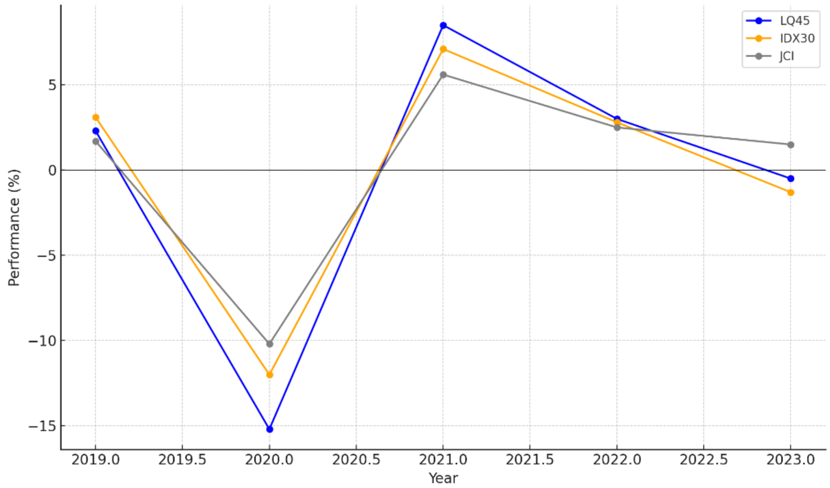

Figure 1 Historical Performance LQ-45 on Dec 30, 2014 - Jul 31, 2024

Source: Indonesia Stock Exchange, 2024

While other macroeconomic factors, such as exchange rates, interest rates, and GDP growth, also influence stock returns, this research focuses on inflation due to its direct and multifaceted impact on both corporate profitability and investor behavior. Exchange rates primarily affect companies engaged in international trade, making their influence sector-specific rather than broadly applicable across the LQ-45 index. Interest rates, while closely linked to inflation, are policy-driven and fluctuate based on central bank decisions, making their long-term effects less predictable. GDP growth, though a fundamental indicator of economic health, does not capture short-term market fluctuations as directly as inflation. Given these considerations, inflation serves as the most relevant moderating variable in analyzing the relationship between financial ratios and stock returns.

The companies listed in the LQ-45 Index play a significant role in driving Indonesia's economic growth. These firms, spanning various sectors such as banking, telecommunications, consumer goods, and infrastructure, are among the most liquid and well-capitalized in the country. Their financial performance is crucial to the stability of Indonesia's stock market and the broader economy. This study employs three key financial ratios to evaluate company performance: profitability (measured by return on equity), liquidity (measured by the current ratio), and leverage (measured by the debt-to-equity ratio). These ratios are widely recognized for their predictive power in assessing financial health and stock return potential (Kheradyar et al., 2011).

The profitability reflects a company's ability to generate profits from its equity. The research highlights ROE as a critical indicator of financial performance. A higher ROE signifies efficient management in utilizing equity to generate net income, which often leads to increased stock prices. Studies (Dewi et al., 2023; Suhadak et al., 2020) support that ROE has a positive, statistically significant impact on stock returns. This makes ROE an essential metric for investors assessing growth potential and return prospects.

Another important factor that effect stock return is the liquidity, which measures a company's ability to meet its short-term obligations. The current ratio (CR) indicates how well a company can cover its short-term liabilities with its current assets. Companies with high liquidity are considered financially stable, reducing the risk of default. This stability can boost investor confidence, leading to increased demand for the company's shares and higher stock returns (Dewi et al., 2023; Julianti et al., 2022). Liquidity is crucial, especially in uncertain economic conditions, as it signals resilience against financial shocks.

Furthermore, leverage assesses the extent to which a company uses debt to finance its operations. The debt-to-equity ratio (DER) evaluates a company's financial structure and risk level. A well-managed DER indicates that a company can effectively use borrowed funds to generate higher returns without excessive financial risk. Research (Anderson et al., 2021; Handoyo et al., 2023) shows a positive relationship between DER and stock prices when debt is managed efficiently, leading to enhanced investor confidence and potential stock return growth. However, the impact of these financial ratios on stock returns may not be consistent across different economic conditions, highlighting the need to examine inflation as a moderating factor.

The global outbreak of COVID-19, declared a pandemic by the World Health Organization on March 13, 2020, had a profound impact on global economies, including Indonesia. The pandemic led to significant disruptions in economic activities, affecting investor confidence and capital market stability. Indonesia experienced sharp declines in stock prices as market projections became uncertain due to lockdowns, reduced consumer spending, and global supply chain disruptions. The volatility in the stock market during this period highlighted the importance of understanding external shocks' influence on stock returns, emphasizing the need for robust financial performance and macroeconomic resilience in investment decision-making.

Given the mixed findings in existing research on the relationship between financial performance and stock returns, this study aims to fill the research gap by analyzing how inflation moderates the influence of ROE, CR, and DER on stock returns in the LQ-45 Index. By using data from the past five years, this study provides insights into the financial performance of companies that have consistently maintained their position in the index, offering valuable implications for investors and policymakers. Based on these considerations, this research is titled **"The Influence of Profitability, Liquidity, Leverage, and Covid-19 Effect on Stock Returns: The Moderating Role of Inflation on Indonesia Stock Exchange in 2019-2023 The Case of LQ-45 Index."**

1.2 Research Questions

1. Does profitability (return-on-equity) can influence stock returns of companies listed on LQ-45 Index?
2. Does liquidity (current ratio) can influence stock returns of companies listed on LQ-45 Index?
3. Does leverage (debt-to-equity ratio) can influence stock returns of companies listed on LQ-45 Index?
4. Does the covid-19 effect can influence stock returns of companies listed on LQ-45 Index?
5. Does the inflation rate can moderate the relationship between peofitability (return on equity) and stock returns of companies listed on LQ-45 Index?
6. Does the inflation rate can moderate the relationship between liquidity (current ratio) and stock returns of companies listed on LQ-45 Index?
7. Does the inflation rate can moderate the relationship between leverage (debt-to-equity ratio) and stock returns of companies listed on the LQ-45 Index?

1.3 Research Objectives

Based on research problem above, the objectives of this study are:

1. To determine the effect of profitability (return-on-equity) on stock return of companies listed on LQ-45 Index.
2. To determine the effect of liquidity (current ratio) to stock return of companies listed on LQ-45 Index.
3. To determine the effect of leverage (debt-to-equity ratio) to stock return of companies listed on LQ-45 Index.
4. To determine the effect of covid-19 effect to stock return of companies listed on LQ-45 Index.
5. To determine the role of inflation rate in moderating the relationship between profitability (return-on-equity) and stock return of companies listed on LQ-45 Index.
6. To determine the role of inflation rate in moderating the relationship between liquidity (current ratio) and stock return of companies listed on LQ-45 Index.
7. To determine the role of inflation rate in moderating the relationship between leverage (debt-to-equity ratio) and stock return of companies listed on LQ-45 Index.

1.4 Contributions of the Research

1. Theoretical Contributions

This research advances the understanding of how financial ratios affect stock returns by incorporating the inflation rate as a moderating variable, offering new insights into market efficiency theory. By reviewing and evaluating existing studies, it identifies research gaps and serves as a valueable reference for academics and researchers, enriching the literature on the relationship between financial ratios, inflation, and stock returns.

2. Practical contributions

The findings of this study provide insights for corporate managers in the LQ-45 Index sector, to develop effective financial strategies by focusing on key financial ratios that influence stock returns. Additionally, the results can be used as investment decisions as well as constructing the relevant market policies, leading to capital gain for investors in the Indonesia stock market.

1.5 Scope of Research

The scope of the research is designed to keep the focus on the subject matter, ensuring that the writting stays aligned with the research objectives. To prevent an overly broad discussion, the author narrows the focus of the study to the financial ratios being analyzed: return on equity for profitability, debt equity ratio for leverage, and current ratio for liquidity. These financial ratios serve as the independent variables, while stock return is the dependent variable.

1.6 Research Outline

The systematics of writing in this study consists of five chapters which have their respective functions and purposes of writing. The systematics of writing are as follows:

CHAPTER I: INTRODUCTION

This chapter is an introductory chapter which contains the background, problem statement, objectives of the research, contributions of the research, scope of the research and writing system.

CHAPTER II: LITERATURE REVIEW

This chapter contains the theoretical basis consisting of a literature review, framework of thought, previous research and hypothesis.

CHAPTER III: RESEARCH METHODS

This chapter describes the data and data Sources, data collection methods, population and research samples, research variables, and data analysis techniques that will be carried out by the author.

CHAPTER IV: RESULTS AND DISCUSSION

This chapter contains an explanation of the research results which will be described by the author based on the results obtained from data that has been processed using the system and hypotheses that have been made.

CHAPTER V: CONCLUSION

This chapter is a closing which contains the conclusions from the results of the analysis and puts forward Some suggestions as improvements for further research.

CHAPTER II

LITERATURE REVIEW

2.1 Theory and Concept

2.1.1 Signaling Theory

Signaling theory, or signal theory, is a concept which focuses on how companies provide information to interested parties, such as investors, through various actions and financial reports (Gumanti, 2009). Signal theory or signaling theory is the impact of information asymmetry. Companies adopt these signals to reveal hidden attributes to stakeholders. This information may be in the form of financial ratios, financial reports, or promotional materials that illustrate the company's financial performance (Noor, 2015). According to signaling theory, a company's long term sustainability is a key indicator of its health, which helps attract investor confidence. Companies demonstrate this by disclosing audited financial statements to the public, as noted by Julianti et al., (2022), in a corporate setting, signaling theory highlight the importance of conveying pertinent and reliable information to investors and creditors. This may encompass positive financial outcomes, promotions and other beneficial announcements.

This theory emphasizes the need for comprehensive, relevant, accurate, and timely information to make sound investment decisions. As suggested by Brigham in Agustin et al., (2023), signaling theory acts as a roadmap for investors, helping them to understand how management actions aimed at capitalizing on industry opportunities relate to the variable of the study. Financial ratios serve as critical indicators that reduce the information gap between firms and investors, facilitating more informed decision making. The addition of inflation as a moderating variable add a layer of complexity to the interpretation of these signals and shed light on how economic conditions influence investor reactions to company performance. This methodology highlights the critical role that accurate and timely financial information plays in optimizing stock returns, particularly in the context of the LQ-45 Index on Indonesia stock exchange, where inflation is considered a critical moderating factor.

2.1.2 Stocks

Stock and shares represent a form of investment whereby an individual posesses a fraction of a company's shares. This grants them the entitlement to share in the company's profits as well as ownership rights. Stock is type of invesments that related to company has listed on exchange (Nurjanah et al., 2023). Stocks represent an individual or business entity's ownership in a company's financial market instruments. Each stock represents a claim to some part of the equity of the company and automatically translates into voting rights in corporate decisions and a sharing in the risks and profits accruable to the company. Rights to dividends, which are distributions from the company's earnings paid out per the extent of the ownership, are among the privileges accorded to shareholders. Stock values can also change due to the supply and demand in market share; hence, shareholders can earn capital gains when the selling price of their stock is higher than the purchase price and experience capital losses when the selling price is lower than the purchase price.