CHAPTER 2

LITERATURE REVIEW

2.1. Theoretical Framework

2.1.1. Efficient Market Hypothesis

The Efficient Market Hypothesis is the grand theory of this study. The efficient market hypothesis is one of the foundational theories in financial economics, stating that asset prices fully reflect all available information. The hypothesis states that firm stock prices accurately represent a company's fundamentals, provided the market is efficient. (Fama, 1965). A market is efficient if three conditions are met. First, a market needs sufficient rational market practitioners seeking to maximize profits. Second, all market participants should have free access to information. Finally, pricing must adjust quickly when new information is released.

Based on the extent to which new information is reflected in stock prices, Fama (1965) suggests three market efficiency grades: weak-form, semi-strong-form, and strong-form efficiency. Weak efficiency levels refer to the current stock price that reflects all the information provided by the relevant stock historical prices. On a semi-strong efficiency level, stock prices reflect a time series of prior price changes as well as other publicly available data. The highest efficiency level implies that stock prices reflect all publicly available information as well as all internally created information, including the company's basic aspects (for example, financial ratios or economic indicators). Financial market participants have used fundamental data to measure the value provided by publicly traded enterprises. In a fully efficient capital market, an optimistic firm's financial performance would be represented by a rise in its share price (or positive stock returns). In contrast, bad financial performance should have resulted in a drop in the company's stock values.

2.1.2 Capital Asset Pricing Model

The Capital Asset Pricing Model is the middle theory of this study. William Sharpe, a renowned financial economist and Nobel Prize winner in economics, developed the Capital Asset Pricing Model (CAPM) in his 1970 book "Portfolio Theory and Capital Markets" (Kenton, 2019). The Capital Asset Pricing Model (CAPM) measures systemic risk. The Capital Asset Pricing Model (CAPM) evaluates systemic risks. Systematic risk is one of two types of hazards associated with an individual investment. Systematic risk stems from economic fluctuations, including macroeconomic data and natural disasters. Systemic risk affects both the market and the individual. Diversification cannot reduce systemic risk. Nonetheless, it is possible to anticipate and manage systemic risk. An individual investment carries both systematic and unsystematic risk. Unsystematic risk refers to the particular risk posed by individual organizations or businesses' financial and operational decisions. Diversification and portfolio development are excellent ways to reduce unsystematic risk.

2.1.3 Arbitrage Pricing Theory

Arbitrage Pricing Theory is the middle theory of this study. Arbitrage Pricing Theory (APT) is a financial theory that explains the relationship between an asset's expected return and various macroeconomic or systematic risk variables.

The APT assumes capital markets are competitive and frictionless. Investors have similar expectations for the k-factor model, which predicts securities' rates of return. The Arbitrage Pricing Model assumes that two investments with identical risks would yield the same returns and are priced accordingly (Damodaran, 1999).

The Arbitrage Pricing Model requires beta estimates for each factor's risk premium and the riskless rate. Typically, these are computed using historical stock data and factor analysis. A factor analysis explores historical data to uncover trends that affect a large number of equities. It calculates the beta of each investment compared to common factors and provides the risk premium for each component.

However, the factor analysis does not uncover the economic factors. Ross (1976) identified various factors that affect rates of return, including changes in inflation, industrial production, bond ratings, and yield curve slope. The APT

model considers macroeconomic conditions as variables that influence securities' predicted returns.

2.1.4 Financial Ratio Analysis

Ratio analysis is an important part of financial statement analysis. Accounting ratios are useful in understanding a company's financial status. Different users, including investors and management. Bankers and creditors use the ratio to examine a company's financial position before making decisions. The goal of ratio analysis is to help the reader of assets of account grasp the material by highlighting numerous significant links. (Mahesi and Suhas, 2008). Ratio analysis is one of the tools available to anyone looking to better understand a corporation. The account should be added to their array. (Ramsden, 1998).

Management can use ratio analysis to make key decisions. As we all know, ratio analysis is an extremely significant tool in financial analysis. The management can determine cost, revenue, and profit with the use of ratio analysis. (Goyal and Goyal, 2013).

According to Brigham and Houston (2012), financial ratios can be classified as:

1.Liquidity ratio

2.Asset management ratio

3.Profitability ratio

4.Debt management ratio

5.Market value ratio

Liquidity ratios are used to determine the company's capacity to repay short-term liabilities at maturity and its operational activities. (Anthony et al., 2011). Liquidity is just as crucial as profit in convincing investors to buy a firm's stock, and financial ratio research can assist investors in deciding which company to invest in.

The asset management ratio (also known as the asset utilization ratio) is a financial metric that determines how efficiently a company uses its assets to create revenue or sales. It assesses how well a corporation manages and deploys its assets to generate revenue. A greater ratio shows that the company is using its assets better, whilst a lower ratio suggests inefficiency. A study by Patin (2020) revealed that

Total Asset Turnover Ratios have a short-run positive impact on stock returns, indicating that improving operating efficiency can improve stock prices.

Return on Equity (ROE) and Return on Assets (ROA) are the most commonly utilized profitability statistics for forecasting stock prices or returns. According to Ristyawan (2019), the company's potential to make profits for shareholders may be assessed by examining its ROE. The higher the ROE, the more efficient a company is at using its shareholders' capital to generate profit. ROA is also a helpful profitability metric that evaluates a company's ability to use assets to generate profits (Kowoon et al., 2022; Malau, 2020).

2.1.5 Stock Return

Stock return refers to the net profit or loss produced by investors from holding a particular individual stock or equity. Fundamental analysis, which studies the primary elements influencing stock return, allows investors to examine the critical financial components while analyzing market investment prospects (Muhammad and Ali, 2018). In other words, fundamental analysis enables investors to examine a company's financial situation and future financial prospects, as well as predict stock return movements. greater financial success is correlated with greater stock prices in the stock market. (Brealey et al., 2007; Tandelilin, 2010).

2.1.6 Market Return

The market return is the total return of the stock market or a market index (such as the JKSE, Dow Jones Industrial Average, or Nasdaq). It is a broad measure of how all stocks or a specific basket of equities perform within a specified period.

2.2 Hypothesis Development

2.2.2 Fundamental Financial Determinants of Consumer cyclical Industry Stock Return

The Effect of Usage Asset Efficiency on Stock Return

The asset efficiency, which is represented by the total asset turnover ratio, is calculated by dividing the total value of a company's sales revenue by the value of its total assets including physical assets, inventory, and receivables.

Patin (2020) studies that stock prices are significantly influenced by the operating performance of a company in efficiently utilizing its assets. For that matter, operating efficiency (as measured by the total asset turnover ratio) plays a role in portfolio investment decisions. to boost stock prices for rewarding shareholders, firms should improve internal managerial efficiency, among others. To increase total asset turnover ratios, they should effectively utilize physical infrastructure to generate additional income, adopt a just-in-time approach to managing inventory, lessen the use of assets to generate a certain level of profitable sales, expedite collection of accounts receivables, and ensure capital discipline. A company should exercise discipline and prudence in how much money it borrows, raises, and spends, in order to deliver the best sustainable return to its shareholders. At the same time, shareholders ought to press for tighter capital discipline emphasizing value rather than volume and leasing physical assets since they are not recorded as assets in a company's balance sheet. To add further, a company can perform better on this metric by decreasing the amount of assets to achieve a certain level of sales. Studies by Widiyanti et al. (2019) showed that asset efficiency (Total Asset Turnover) has no significant effect on stock return. Studies by Kurniawan (2021) revealed that Total Asset Turnover partially had a positive and significant impact on stock returns in property and real estate companies in IDX.

H1a: Asset efficiency positively affects the stock return of the consumer cyclical industry in Indonesia

The Effect of Liquidity on Stock Return

The correlation between liquidity and stock returns is a significant focus in financial economics, especially in the consumer cyclical sector. Liquidity is a key factor in understanding cross-sectional volatility in stock returns. The liquidity premium compensates investors for retaining less liquid assets, therefore stocks with better liquidity tend to have lower returns (Datar, 1998). Research by Chang

(2010) also revealed that liquidity had a significant negative effect to stock return in Japan. Studies by Narayan et al. (2011) found that liquidity had a negative effect on stock return in the Shenzhen Stock Exchange (SZSE) and a study of Thamrin and Sembel (2020) found that liquidity does not significantly affect stock return.

H1b: Liquidity negatively affects the stock return of consumer cyclical companies in Indonesia

The Effect of Profitability on Stock Return

A study by Berggrun et al. (2020) shows that despite their higher valuation ratios, larger size, and higher investment needs, profitable firms outperform, in both raw and risk-adjusted returns compared with unprofitable firms in Latin America.

Based on the study of Nadyayani et al. (2021), it is found that ROA, ROE, and NPM simultaneously have a significant positive effect on stock returns. ROA partially has a significant positive effect on stock returns. This shows that the higher the ROA, the higher the company's profit, which causes stock returns to increase and investors are interested in investing in manufacturing companies.

A study by Silver et al. (2022) finds that profitability significantly positively affects stock returns, while liquidity and capital structure have no significant effect on stock returns in plantation companies listed on the IDX. This study implies that investors must pay close attention to the profitability ratio, as a high profitability ratio correlates to a higher rate of return. Profitability is a ratio to measure how effective management is in getting profits (Brigham and Daves, 2014). The profitability indicator used is ROA. Return on Assets, also known as ROA, is a profitability ratio measuring tool that measures a company's ability to generate profits or profits using the assets owned by the company in a certain period (Butar et al., 2021)

H1c:Profitability positively affects the stock return of consumer cyclical companies in Indonesia

2.2.2 Macroeconomics Model

There are also some studies showing the effect of macroeconomics on the stock return performance.

The Impact of Exchange Rate on Stock Return

Mahapatra (2019) studies that the exchange rate risk factor is becoming a prominent determinant of stock returns, indicating that Indian investors are increasingly expecting a risk premium on their investment for their added exposure to exchange rate risk. This is also further corroborated by the study by highlighting the fact that the higher the foreign exchange exposure of industry, measured by trade balance (net inflows), the higher their sensitivity to exchange rate risk (βS).

Khan (2019) indicates that the exchange rate has a negative and significant impact on the stock returns of Shenzhen stock exchange. Gbadebo (2023) studies that the exchange rate volatility has a negative impact on stock market development - returns, capitalization, and volume.

H2a: Exchange rate negatively impact the stock return of the consumer cyclical industry in Indonesia.

The Impact of Interest Rate on Stock Return

Kasman et al. (2011) study results suggest that interest rate and exchange rate changes have a negative and significant impact on the conditional bank stock return.

Mensah et al. (2020) found a positive shock to interest rate and exchange rate led to a persistent increase in the price levels over the 60-month horizon on stock market returns in Ghana, Nigeria, and South Africa. The study results of Fahnayu et al. (2024) found that interest rates have a significant negative effect on stock returns.

H2b: Interest rate negatively impact the stock return of the consumer cyclical industry in Indonesia.

2.2.3 The Impact of Market Return to Stock Return

A study by Thamrin and Sembel (2020) shows that Market return significantly positively influences the stock return, and this study also shows that the company's fundamentals, market return, and macro economy collectively influence the stock return. Research by Ihsan, F., Sembel, R., and Malau, M. (2023) shows that market return and Return on Equity have a positive significant effect on the stock return. A study by Chiang, Sembel, and Malau (2024) shows that market return affects stock return positively and significantly.

H3: Market Return positively affects the stock return of consumer cyclical companies in Indonesia

2.2.4 Covid-19 Moderates Macro Economy

Covid-19 Moderates the Impact of Foreign Exchange Rate on Stock Return

Research by Rahmayani (2021) shows that the exchange rate has a negative effect on stock return, and the pandemic COVID-19 does not have a significant impact in the short term but negative effects in the long term. A Study by He (2022) showed that statistically and economically the exchange rate of USD/RMB and the return of the U.S. stock market were strongly correlated. This was consistent with traditional economic theory. In terms of the equation of variance, the appreciation of the U.S. dollar would reduce the volatility of the U.S. stock market. The new cases of COVID-19 had a minor impact on the volatility of the U.S. stock market. To be specific, the new cases of COVID-19 had caused fluctuations in the U.S. stock market in the short term, but in the long term, this relationship did not exist. Study by Ikhsan (2022) shows that the exchange rate had an impact on stock prices in the manufacturing sector during the pandemic COVID-19.

H4a: Covid-19 Moderates the Impact of Foreign Exchange Rate on Stock Return.

Covid-19 Moderates the Impact of Interest Rate on Stock Return

A study by Widjanarko et al. (2020) showed that the interest rate also had a significant negative impact on stock performance during the COVID-19 period. Research by Rahmayani (2021) shows that interest rates positively affect stock markets, and the pandemic COVID-19 does not have a significant impact in the short term but negative effects in the long term. A study by Ikhsan (2022) shows that interest rates had no effect on stock prices in the manufacturing sector during the COVID-19 pandemic.

H4b: COVID-19 Moderates the Impact of Interest Rate on Stock Return

Covid-19 Moderates the Impact of Market Return on Stock Return

A study by Jessica et al. (2023) showed that COVID-19 has a negative significant impact on stock market returns and a study of Xu (2020) showed that COVID-19 has a negative significant impact on stock market returns in Canada, with asymmetric responses in the US due to uncertainty.

H4c: COVID-19 Moderates the Impact of Market Return on Stock Return

2.2.5 The Impact of COVID-19 on Consumer Cyclical Industry Stock Return

In 2020, the coronavirus pandemic struck Indonesia, which affected almost all industrial sectors with financial distress and had a huge impact on the capital market.

A study by He et al. (2020) shows that COVID-19 has a negative but short-term impact on stock markets of affected countries and that (ii) the impact of COVID-19 on stock markets has bidirectional spill-over effects between Asian countries and European and American countries. However, there is no evidence that COVID-19 negatively affects these countries' stock markets more than the global average.

A study by Chatjuthamard et al. (2021) found that COVID-19 growth increases volatility and jumps in the global stock market while reducing return, outweighing economic, financial, and political risks. The study of Dospatliev (2022) showed that the growth rate of COVID-19 deaths per day in Bulgaria had a negative effect on the stock returns and had the strongest influence on them in the fourth pandemic wave. In addition, our results showed that stock returns in healthcare, IT, utilities, and real estate sectors were negatively affected before the COVID-19 pandemic, while the first COVID-19 pandemic wave had a positive effect on healthcare and consumer staples sectors. During the second COVID-19 wave, the stock returns of the IT sector had a positive effect, while the Utilities sector had a negative effect. The third COVID-19 wave had a positive effect on the industrial and consumer staples sectors, while healthcare, real estate, and IT sectors showed a negative effect. During the fourth COVID-19 wave, the stock returns of the IT sector had a positive effect and the consumer staples sector had a negative effect. A study by Yousfi (2021) showed that the pandemic COVID-19 has impacted the US stock market negatively. Tan (2022) found that the pandemic COVID-19 negatively impacts stock returns in G7 countries.

H5a: There is a difference in variances of consumer cyclical stock return before and after COVID-19 in the consumer cyclical industry in Indonesia.

H5b: There is a difference in consumer cyclical stock return before and after COVID-19 in the consumer cyclical industry in Indonesia.

2.3 Research Framework

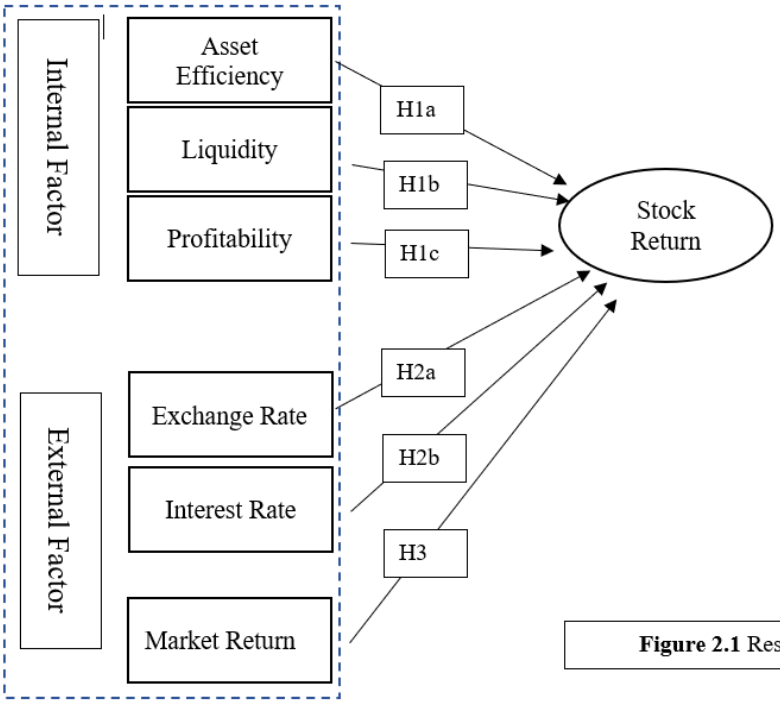

Figure 2.1 Research Framework 1

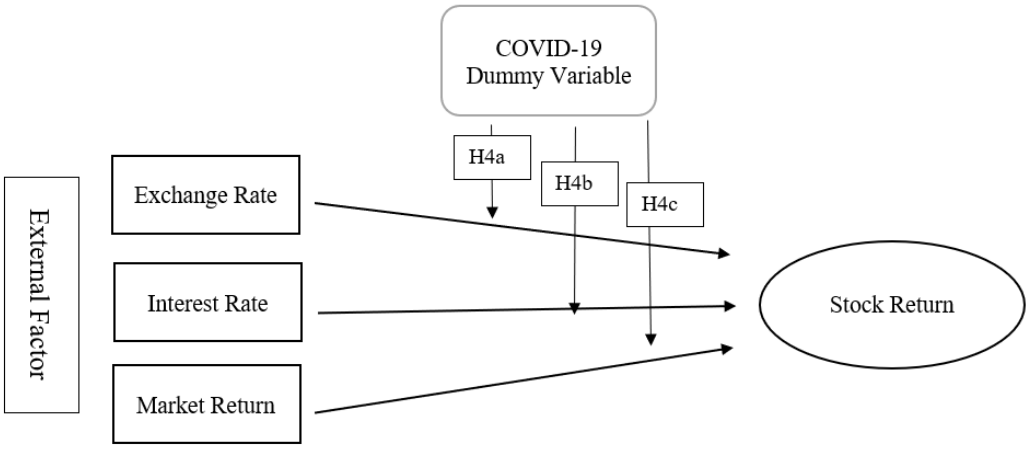

Figure 2.2 Research Framework 2