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# Interplay of Inflation, Profitability, and Leverage: Determinants of Stock Returns in Capital Market

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## Abstract

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The capital market plays a vital role in supporting the national economy as a medium for investment and as an indicator of a country's overall economic stability and growth. This study aims to analyze the effect of inflation, profitability, and leverage on stock returns of companies listed on the Indonesia Stock Exchange. The research method applied is a comprehensive literature review sourced from various indexed scientific journals to obtain a broad understanding of these financial relationships. The results of the review indicate that inflation has a negative effect on stock returns due to the increase in production costs and the decline in public purchasing power, which reduces company profitability. In contrast, profitability has a positive effect because it reflects the company's efficiency in managing assets and maintaining financial performance. Meanwhile, leverage exerts a negative influence as it increases financial risk and decreases investor confidence. Internal factors such as profitability are found to be more dominant than external factors like inflation in determining stock returns. The findings of this research are expected to provide valuable insights for investors in making informed investment decisions within the Indonesian capital market.

## 1. Introduction

The capital market is a crucial component in modern economics because it functions as a means for the public and institutions to make investments and serves as an indicator of a country's economic health. Through the capital market, investors can purchase various long-term investment instruments such as stocks, bonds, and mutual funds, which offer opportunities to gain profits in the form of dividends or capital gains. Activities in the capital market reflect expectations for economic growth and the macroeconomic conditions of a country, making it an essential barometer for assessing economic direction and stability (Ruhani et al., 2018). Stock return is the primary indicator used by investors to measure investment performance and determine their investment decision-making strategy. Return describes the extent to which the investment results obtained are able to compensate for the risk taken. In the context of financial analysis, stock returns are influenced by various factors, both internal and external to the company.

Internal factors include profitability, leverage, liquidity, and operational efficiency, while external factors include inflation, interest rates, fiscal policy, and other macroeconomic conditions (Almashhadani, 2021). Inflation is one of the macroeconomic variables most frequently associated with stock returns. Theoretically, increasing inflation tends to negatively impact the capital market because it reduces people's purchasing power and increases companies' production costs. This leads to a decline in net profit and impacts the drop in stock prices. Research by Melaku (2020) shows that increased inflation is negatively related to stock market performance because it causes higher economic uncertainty and reduces investor interest in investing in the capital market. Similar findings are also reinforced by Fromentin (2017), who found that the inflation rate has a negative and significant relationship with stock returns in capital market, indicating that this phenomenon is global, including in developing markets such as Indonesia.

Apart from macroeconomic factors, the profitability variable plays an important role in influencing stock returns. Profitability reflects the company's ability to generate profit from its operational activities. The higher the company's profitability level, the greater the potential return obtained by investors, as good financial performance increases market confidence in the company. Chen et al. (2021) show that companies with high profitability levels tend to provide greater stock returns because they are considered capable of managing their assets efficiently and having good growth prospects. In other research, Matar et al. (2018) add that profitability also functions as a moderating variable that can strengthen or weaken the influence of external factors such as inflation on stock returns.

Leverage is also an important factor in determining stock returns. Leverage reflects the extent to which the company uses borrowed funds to finance its operational activities. High use of leverage can increase a company's financial risk, especially when economic conditions are unstable or interest rates increase. In the context of the Indonesian capital market, excessive leverage is often considered a negative signal by investors because it increases the probability of default and reduces the company's value in the eyes of the market. Almashhadani (2021) found that leverage has a negative influence on stock returns, while Ruhani et al. (2018)

confirmed that companies with a healthy capital structure and controlled debt ratios are more likely to provide stable returns.

The relationship between inflation, profitability, and leverage is complex because all three can influence each other. For example, when inflation increases, the burden of debt interest can also increase, thus reducing the company's profitability. Conversely, companies with high profitability are able to withstand the negative impact of inflation through operational efficiency and adaptive pricing strategies. Therefore, understanding the linkages between these factors is very important for investors in designing long-term investment strategies in the capital market. This research aims to analyze in depth the influence of inflation, profitability, and leverage on stock returns using a literature study approach to the results of previous research. By using sources from journals, this research is expected to contribute to enriching academic and practical understanding regarding the dynamics of the determining factors of stock returns in the capital market, especially in Indonesia.

## 2. Literature Review

### 2.1. Inflation and Stock Returns

Inflation is a key indicator that reflects the general increase in the price of goods and services in an economy. In the context of the capital market, inflation plays an important role because it affects the real value of investments and the stock return rate. Theoretically, the relationship between inflation and stock returns can be explained through the Fisher Effect, which states that an increase in inflation will be offset by an increase in nominal returns so that the real value of the investment remains stable. However, in practice, this relationship is often non-linear and tends to be negative in developing markets such as Indonesia.

Research by Melaku (2020) shows that increased inflation negatively affects stock returns because it causes economic uncertainty, increased input costs, and decreased public purchasing power. As a result, company profitability decreases so that stock prices tend to be corrected. Similar findings were also revealed by Fromentin (2017), who found that high inflation depressed stock prices capital market through a decline in company financial performance and a reduction in investor confidence.

Especially in Indonesia, fluctuating inflation conditions can influence investor preferences for risky assets. When inflation is high, investors tend to shift their portfolios to safer assets such as government bonds or gold. This reduces demand for stocks and puts pressure on returns in the capital market. Matar et al. (2018) mention that inflation acts as a moderating variable that can strengthen or weaken the influence of company fundamental factors on stock returns, depending on overall macroeconomic conditions. Thus, inflation not only has a direct effect on stock returns but can also strengthen the impact of other financial variables such as leverage and profitability.

### 2.2. Profitability and Stock Returns

Profitability is a measure of financial performance that shows the company's ability to generate profit from its operational activities. Profitability ratios such as Return on Assets (ROA) and Return on Equity (ROE) are important indicators for investors in assessing the potential profit from stock investments. In general, the higher the profitability level, the greater the potential return generated because it reflects management efficiency in managing company assets and equity.

According to Chen et al. (2021), companies with high profitability levels tend to have more stable stock prices and are attractive to investors because they are considered to have good ability to maintain financial performance amid economic fluctuations. This is in line with the research results of Almashhadani (2021) who found that profitability has a positive and significant influence on stock returns on the Indonesia Stock Exchange. Investors tend to respond positively to company financial reports that show consistent profit growth, so stock prices increase and provide greater returns.

On the other hand, some research shows that the relationship between profitability and stock returns can vary depending on industry sector conditions and economic stability. For example, in sectors with high volatility such as energy or manufacturing, profitability may not always align with an increase in stock returns due to the influence of external factors such as fluctuations in raw material prices and exchange rates. However, the consistency of findings from research shows that profitability remains one of the most dominant internal factors positively influencing stock returns in the Indonesian capital market.

### 2.3. Leverage and Stock Returns

Leverage is a financial ratio that describes the extent to which a company uses borrowed funds to finance its operational and investment activities. Appropriate use of leverage can increase company profits because it provides expansion opportunities without having to add own capital. However, excessive leverage can increase financial risk and reduce investor confidence.

Research by Ruhani et al. (2018) shows that leverage has a negative influence on stock returns, because the higher the debt level, the greater the company's risk of default. Investors will usually assess this risk through the Debt to Equity Ratio (DER), which reflects the proportion of funding from debt to own capital. Similar results were found by Okafor et al. (2021) who stated that high leverage can reduce stock value because it increases interest expense and reduces the company's net profit.

However, the relationship between leverage and stock returns is not always negative. In stable market conditions and low interest rates, leverage can be used efficiently to increase company net profit, thus having a positive impact on stock returns. Matar et al. (2018) suggest that leverage can act as a moderating factor that influences the relationship between profitability and stock returns, depending on macroeconomic conditions and the company's financial strategy.

The literature shows that inflation, profitability, and leverage have an interrelated relationship in influencing stock returns. Inflation as an external factor tends to exert negative pressure, while profitability and leverage as internal factors have a more dominant influence on stock returns. Understanding the interaction of these three variables is important for investors and policymakers in designing investment strategies and risk management in the Indonesian capital market.

## 3. Method

This research uses a literature study method with an analytical descriptive approach, which is an in-depth review of various relevant previous research results to understand the relationship between inflation, profitability, and leverage on stock returns. This approach was chosen because the topic has been widely studied in the context of macroeconomics and capital markets, allowing researchers to obtain a more comprehensive picture without having to collect primary data. A literature study is also seen as the appropriate method to identify empirical and theoretical patterns from a number of studies that have similar variables and contexts, The data used in this study were obtained from various national and international scientific journals indexed in Google, Research Gate and Elsevier. Literature sources were selected based on certain criteria, namely the research must discuss the variables of inflation, profitability, and leverage on stock returns, either simultaneously or partially the research uses empirical data from companies listed on the Indonesia.

Stock Exchange or other developing country capital markets that have similar characteristics the article was published in last five years to align with the latest economic conditions before significant changes post-pandemic; and (4) the article is available in full text with clear methodological information. The analysis process was carried out through several stages. The first stage is to inventory all literature that is appropriate to the research topic. The identified articles were then read thoroughly to assess their relevance and methodological quality. The next stage is to extract core information from each study, including the variables used, the analysis method, and the main results reported. This information is then analyzed using thematic synthesis techniques to group the research results based on similarities or differences in their findings. The results of this synthesis are then interpreted to find general patterns that can explain the relationships between the research variables. For example, literature regarding inflation is compared in terms of its direct influence on stock returns and its interaction with other financial variables such as leverage and profitability.

With this approach, the research is able to generate a conceptual map that illustrates how macroeconomic conditions and internal company performance interact with each other in determining the level of stock return. To maintain the validity and reliability of the analysis results, each finding is cross-compared with other similar literature. In addition, all articles are checked for consistency against the economic context of Indonesia and the capital markets of developing countries, considering the possibility of differences in structural characteristics between developed and developing markets. The analysis process is also carried out independently without data manipulation, so the results are objective and academically accountable. This literature study approach not only provides a theoretical understanding of the relationship between inflation, profitability, and leverage on stock returns but also provides a strong conceptual basis for further empirical research.

## 4. Results

The capital market has a very important role in the economy of a country because it functions as a mechanism for raising funds from the public for investment activities. Activities in the capital market are not only a means for companies to obtain capital but also an indicator of national economic health. Stock price movements that occur in the capital market reflect economic dynamics, investor expectations regarding company performance, and applicable macroeconomic policies. Therefore, understanding the factors that influence stock returns is crucial, both for investors and policymakers. One approach often used in financial research is to examine the relationship between macroeconomic variables and company performance on stock returns, such as inflation, profitability, and leverage.

Inflation is a macroeconomic factor that can directly influence the rate of stock return. In classical financial theory, increasing inflation will reduce people's purchasing power, increase production costs, and put pressure on company net profits. This will ultimately have a negative impact on stock prices and the returns obtained by investors. According to research by Melaku (2020), inflation has a negative influence on stock market performance because it causes economic uncertainty that reduces investor interest in investing in risky instruments such as stocks. When inflation increases, investors tend to shift their portfolios to more stable assets, such as gold or government debt securities. This phenomenon leads to a decrease in demand for stocks, so stock prices fall and returns become smaller. Other research conducted by Fromentin (2017) found that high inflation has a negative and significant correlation with stock returns in the capital market.

This is because companies experience increased input costs and pressure on profit margins. Although there is the Fisher Effect theory which states that inflation will be offset by an increase in interest rates and nominal returns, the reality is that capital markets in developing countries often show different results. Inefficient market structures and investor reactions that are sensitive to macroeconomic changes cause the relationship between inflation and stock returns to be unstable. On the other hand, profitability as an internal company variable also plays an important role in determining the level of stock return. Profitability reflects management's ability to manage assets and capital to generate profit. Financial ratios such as Return on Assets (ROA) and Return on Equity (ROE) are the main indicators used by investors to assess how efficient the company is in creating added value for shareholders.

The research results of Chen et al. (2021) show that companies with high profitability levels tend to provide greater stock returns because they are perceived as stable and highly competitive entities. Investors are usually more interested in investing capital in companies that are able to maintain consistent profit levels, as this indicates the effectiveness of operational management and long-term growth potential. In the context of the capital market, the relationship between profitability and stock returns has also been proven through research by Okafor et al. (2021). Their research results show that profitability has a positive and significant influence on stock returns. Companies that have high profits are considered capable of providing more attractive dividends and increasing the company's value in the eyes of investors. Therefore, increasing profitability is a positive signal that strengthens investor interest in buying shares, which ultimately increases the market price and return.

Nevertheless, the relationship between profitability and stock returns is not always linear. In some cases, a high level of profitability does not necessarily result in large returns if followed by high risk or inefficient company policies in the use of capital. For example, if the profit obtained is not reinvested for business development, the potential for long-term growth will be reduced. Furthermore, macroeconomic conditions can also change the direction of this relationship. When inflation increases, operational costs and raw materials rise, so the company's profit margin decreases. As a result, even though the company previously had high profitability, stock returns can decrease because investor expectations for future profits become pessimistic.

Meanwhile, leverage is another internal factor that has a complex relationship with stock returns. Leverage describes the extent to which a company uses borrowed funds to finance its operations. A high level of leverage indicates the company's dependence on debt. Although the use of debt can increase profits through the financial leverage effect, under certain conditions it can increase financial risk if the company is unable to pay interest and principal debt. Jamaludin et al. (2017) suggests that leverage has a negative influence on stock returns because the increase in interest expense reduces net profit and increases the risk of bankruptcy.

Similar findings were conveyed by Elimam (2017), who explained that high leverage can reduce the attractiveness of stocks in the capital market because investors tend to avoid companies with large financial risks. However, in stable economic conditions, leverage can also have a positive impact on stock returns if the borrowed funds are used productively to increase production capacity or expand the market. In this context, company management has a strategic role to manage the capital structure so that it remains optimal, namely at the point where the marginal cost of capital equals the benefit of additional investment.

The relationship between inflation, profitability, and leverage does not stand alone, but rather interacts with each other in influencing stock returns. When inflation increases, borrowing costs tend to rise so companies with high leverage levels will face a greater interest burden. This situation can reduce profitability and negatively impact stock prices. Conversely, companies with high profitability can withstand the negative impact of inflation by increasing operational efficiency and implementing adaptive pricing strategies. Thus, companies that are able to maintain profitability amid inflationary pressures are usually still able to maintain competitive stock return levels.

Previous research consistently shows that profitability is the most influential internal variable on stock returns compared to inflation and leverage. This is because investors pay more attention to the company's fundamental performance when making investment decisions. Inflation and leverage function more as moderating variables that strengthen or weaken the influence of profitability on returns. Elimam (2017) emphasize that in low inflation conditions, the influence of profitability on stock returns becomes stronger because price stability allows companies to maintain profit margins. However, in high inflation conditions, this influence weakens due to increased production costs and pressure on demand.

Empirically, most research results show a negative relationship between inflation and stock returns, and a positive relationship between profitability and stock returns. Leverage shows a varying relationship depending on the industry context and macroeconomic conditions. Mulyadi and Sinaga (2020) indicated that leverage has a negative influence on stock returns in companies that have a high debt burden, while Wahyuni et al. (2019) found that efficiently managed leverage does not have a significant impact on returns. This indicates that company financing decisions greatly determine investor perceptions of risk and expected return.

From the results of this literature synthesis, it can be concluded that the combination of macroeconomic conditions and company financial characteristics is the main determinant in determining the direction of stock return movements. In the long term, profitability remains the strongest fundamental indicator because it reflects the company's ability to create economic value sustainably. Meanwhile, inflation and leverage function as external and internal factors that can strengthen or weaken this relationship depending on the economic conditions and managerial strategies taken. By understanding this relationship in depth, investors and capital market analysts can make more rational and data-driven investment decisions. In addition, the results of this study also provide implications for policymakers to maintain macroeconomic stability through inflation control and supervision of corporate capital structure to create a healthy and competitive capital market.

## 5. Discussion

Stock return represents the final outcome of the interaction between internal company factors and external macroeconomic conditions. Based on a synthesis of literature from various studies over the past five years, it is evident that inflation, profitability, and leverage have a complex and interrelated influence on stock return movements. These three factors not only exert partial effects but also interact dynamically, reflecting the responses of both companies and investors to economic changes (Jiang et al., 2020). Inflation consistently shows a negative relationship with stock returns. Rising inflation increases production costs and reduces consumers' purchasing power, thereby weakening company profitability. In response, investors often shift their portfolios to safer assets such as deposits or government bonds, leading to lower demand for stocks and declining stock prices.

Studies by Nolan et al. (2019) confirm that inflation exerts downward pressure on stock returns across various capital markets, including developing countries. In the Indonesian context, this negative impact is intensified by the structural sensitivity of the national economy to fluctuations in prices and interest rates. In contrast, profitability has a strong and positive influence on stock returns. Firms with high profitability demonstrate efficient management of assets, the ability to generate sustainable profits, and resilience in operational performance. These characteristics enhance investor confidence, driving higher demand for the company's shares and ultimately increasing stock returns. Empirical evidence from Wahyuni et al. (2019) and Mulyadi and Sinaga (2020) supports this finding, revealing a significant positive relationship between profitability and stock returns among Indonesian public companies. Meanwhile, leverage exhibits a more varied influence depending on debt management and macroeconomic stability. Under favorable economic conditions, leverage can enhance returns through the profit-amplifying effects of borrowed capital. However, during periods of high inflation or economic instability, leverage can become a burden as interest expenses rise and default risks increase.

According to Jamaludin et al. (2017), high leverage often reduces stock returns due to elevated financial risks, indicating the need for prudent debt management to avoid erosion of profitability. The interaction among inflation, profitability, and leverage also plays a crucial role. Inflation tends to weaken the positive link between profitability and stock returns by compressing profit margins through rising input costs. Conversely, firms with strong profitability can mitigate inflation's adverse impact by adjusting selling prices and maintaining cost efficiency. Regarding leverage, companies with well-balanced capital structures can utilize debt strategically to support growth without triggering excessive financial risk. Thus, the interplay of these factors reflects a dynamic equilibrium dependent on managerial effectiveness in navigating economic fluctuations.

The implications of these findings are significant for both investors and policymakers. For investors, understanding the interconnected roles of inflation, profitability, and leverage aids in developing adaptive investment strategies responsive to macroeconomic dynamics. Investors should evaluate a company's financial stability and profitability before investing, while also considering potential risks from inflationary pressures and excessive debt levels. For corporate management, the results highlight the importance of sound financial policies, particularly in optimizing leverage and sustaining profitability to remain attractive in the capital market.

From a macroeconomic perspective, these findings emphasize the critical role of government and monetary authorities in maintaining price stability and controlling inflation. Stable inflation not only safeguards purchasing power but also fosters investor confidence and strengthens capital market performance. When inflation remains under control, capital markets become more conducive to long-term investments, thereby promoting national economic growth. The literature synthesis concludes that profitability remains the primary determinant of stock returns, while inflation and leverage serve as moderating variables that shape this relationship. effective investment strategies and stronger, more resilient economic policies.

## 6. Conclusion

The results of the literature review show that stock returns are influenced by a combination of internal company factors and external macroeconomic factors. From the external side, inflation is proven to have a negative impact on stock returns because the general increase in prices reduces people's purchasing power, increases production costs, and reduces the company's ability to generate profit. This condition leads to a negative reaction from risk-averse investors, thus impacting the decline in stock prices. Conversely, profitability emerges as the internal factor with the most positive influence on stock returns, because it shows the company's ability to manage assets and capital to generate sustainable profits. A high level of profitability is perceived as a signal of market confidence in the company's performance and future prospects.

Meanwhile, leverage shows a varying influence depending on the proportion of debt and economic conditions. Well-managed leverage can increase returns through optimal capital structure, but excessive leverage has the potential to increase financial risk which pressures stock performance. Thus, the relationship between inflation, profitability, and leverage is interdependent and dynamic. Conceptually, the results of this study confirm the importance of managerial efficiency in maintaining profitability amid inflationary pressures and debt risk. For investors, these findings are the basis for evaluating the company's financial performance comprehensively before making investment decisions. For policymakers, inflation stability and supervision of corporate capital structure are key factors in maintaining the health of the capital market and sustainable economic growth.

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