

The Functions, Pricing Determinants, and Macroeconomic Influence of Stocks

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Abstract. Against the backdrop of expanding retail participation, rising passive ownership, and evolving market microstructure, understanding the links between trading, pricing, and the real economy has renewed importance. This review examines how equity markets function, what determines stock prices, and how those prices shape macroeconomic outcomes. The study's theme is integrative: it synthesizes theory and evidence on four core market functions (price discovery, risk sharing, capital formation and governance, and liquidity provision), organizes pricing determinants across present-value logic, risk-based factor models, and demand- or constraint-driven mechanisms, and traces macroeconomic transmission through household wealth, firm investment, credit conditions, and monetary policy. This study connects canonical models with recent empirical findings and institutional observations, highlighting points of agreement and contention. The significance of this study lies in providing an integrated framework for researchers and policymakers: it clarifies when prices primarily reflect cash-flow news versus pressures driven by discount rates or order flows; it highlights how ownership composition and intermediation capacity shape price impacts; and it identifies practical implications for estimating the cost of capital, designing markets, and monitoring financial stability.

Keywords: Stocks, Stock Pricing, Risk Sharing, Stock Market

1. Introduction

Equity markets are multi-purpose institutions that aggregate information, allocate risk, finance real investment, and provide continuous liquidity. The efficient markets tradition views security prices as sufficient statistics for discounted cash flows under rational expectations and competitive trading [1]. Market microstructure research shows how that aggregation happens—through order flow from informed and uninformed traders, inventory management by liquidity providers, and the design of trading venues—that in turn shapes the speed and accuracy of price discovery [2]. At the same time, evidence of excess volatility and return predictability challenges the strongest efficiency claims and points to time-varying discount rates, heterogeneous beliefs, and frictions [3,4].

This study will explore three aspects: first, this paper will analyze the core functions of the stock market (price discovery, risk sharing, capital formation and governance, and liquidity). Secondly, examine the determinants of stock pricing. Finally, it analyzes the macroeconomic channels that relate stock prices to consumption, investment, credit conditions and monetary policy.

2. Functions of stock in the financial market

2.1. Price discovery and information aggregation

The stock market is an information aggregation machine. In the efficient markets view, competition among traders ensures that prices promptly reflect available information [1]. Microstructure clarifies the mechanics: in Kyle's framework, an informed trader optimally dribbles orders to conceal information, market makers update prices to balance inventory and adverse-selection risk, and noise trading provides camouflage [2]. This trading technology implies that price discovery depends on depth and resiliency. When depth is high and adverse selection low, new information is absorbed with small price impact; when liquidity is thin or information asymmetries are acute, transitory mispricings can be larger and resolution slower. These dynamics matter for how quickly stock prices incorporate firm-specific news (earnings, guidance) and macro news (policy surprises, growth signals).

2.2. Risk sharing and intertemporal allocation

Stocks facilitate intertemporal risk sharing by allowing households and institutions to hold diversified claims on future cash flows. In representative-agent models, the equity premium compensates for aggregate consumption risk; in practice, participation is incomplete and heterogeneous, and institutions with liabilities, mandates, and constraints often set marginal prices. A central implication is that the menu of priced risks—captured by factor models and investment-based frameworks—helps investors align portfolios with desired exposures and provides a language for sharing risk across balance sheets [5,6]. By mobilizing long-horizon savings into risky productive assets, equity complements bank credit and bond markets in financing growth [4].

2.3. Capital formation and corporate governance

Primary equity issuance (IPOs, SEOs) finances expansion and innovation, while secondary markets deliver valuation signals that discipline managerial decisions via pay, proxy contests, and takeover threats [4]. When prices are informative, managers can rely on them to screen projects, time financings, or restructure. When prices are noisy—due to arbitrage constraints, inelastic demand, or temporary liquidity shocks—feedback effects can become inefficient: undervalued equity may induce overinvestment or speculative acquisitions, whereas depressed valuations can delay value-creating investments or steer firms toward debt financing and risk-sensitive covenants.

2.4. Liquidity provision and the cost of capital

Continuous trading and professional intermediation supply immediacy to buyers and sellers. Bid-ask spreads, market depth, and resiliency summarize the cost of immediacy and influence required returns: illiquidity premia compensate investors for expected trading costs and execution risk. Venue design (limit-order books, maker-taker fees, off-exchange trading), transparency, and competition among liquidity providers affect these premia [2,4]. At the aggregate level, more liquid markets attract broader participation and lower the cost of equity, potentially raising investment and productivity over time.

2.5. Market completeness and financial innovation

Equity markets also foster financial innovation—such as the creation of new share classes, exchange-traded funds (ETFs), and factor and thematic funds—that customizes risk exposures and improves market completeness. While innovation can improve risk sharing and pricing efficiency, it can also concentrate flows through mandates or narratives, reinforcing inelasticity and amplifying price impact during rebalancing [7,8]. The institutional architecture of equity—indexation rules, stewardship practices, disclosure standards—thus has first-order implications for both micro efficiency and macro resilience.

3. Determinants of stock pricing

3.1. Present-value logic and the volatility puzzle

In frictionless benchmarks, the price of a stock equals the expected present value of future cash flows discounted at a (possibly time-varying) rate. Shiller’s volatility bounds showed that observed price fluctuations exceed those justified by ex post dividend variation if discount rates are constant, motivating models with stochastic discount factors and time-varying premia [3]. Campbell, Lo, and MacKinlay formalized return decomposition tools that separate news about discount rates from news about cash flows, providing empirical diagnostics for predictability and event responses [4]. In practice, both components matter: around earnings, cash-flow news dominates; around macro or policy surprises, discount-rate news can be central.

3.2. Risk-based factor models

Risk-based models trade off parsimony and explanatory power. The five-factor model expands the Capital Asset Pricing Model (CAPM) by incorporating size, value, profitability, and investment factors, thereby capturing cross-sectional premiums associated with firm-specific attributes [5]. Investment-based (q-factor) models derive similar factors from firms’ optimal investment conditions under adjustment frictions, linking expected returns to profitability, investment, and expected growth [6]. These models are workhorses for cost-of-capital estimation, performance attribution, and strategic asset allocation. They further suggest that shocks altering the price of systematic risk—such as shifts in risk aversion or intermediation capacity—will induce comovement across broad-based portfolios.

3.3. Demand inelasticity and flows

A newer literature emphasizes that investor demand for risky assets is inelastic in the short to medium run: when a dollar flows into a sector or index, prices rise more than under a highly elastic demand curve [7]. Mechanisms include mandate-related constraints (e.g., passive replication, benchmark hugging), funding constraints (e.g., margin requirements and risk limits), and investor clientele segmentation (e.g., retail versus pension funds). In this view, prices reflect not only expected cash flows and discount factors but also who holds the marginal share and with what constraints. The inelastic markets hypothesis parsimoniously explains large price impacts of flows and issuance, comovement induced by index inclusions, and the persistence of certain premia when supply shifts are slow.

3.4. Sustainability tilts and ownership composition

Sustainable/ESG investing has reallocated capital across firms, potentially lowering the cost of capital for favored issuers and raising it for disfavored ones. In equilibrium models, mandated or preference-driven tilts move prices and expected returns even if cash flows are unchanged, with long-run real effects as investment responds to altered financing costs [8]. The magnitude of these effects depends on demand elasticities [7]: with more inelastic demand, smaller flow imbalances produce larger price changes. The interaction of ESG preferences with indexing (passive implementation of ESG screens) can further concentrate flows, amplifying impact at rebalancing horizons.

3.5. Market microstructure: information frictions and trading costs

Prices form through trade. Asymmetric information raises adverse-selection costs, widening spreads and lowering depth. Market makers manage inventory risk and adjust quotes to order-flow imbalances; these dynamics generate short-horizon return patterns and affect how quickly information is incorporated [2]. Microstructure therefore shapes measured expected returns (via transaction costs and illiquidity premia) and realized returns (via slippage around large trades). Design choices—tick sizes, dark trading, auctions versus continuous matching—create trade-offs between price discovery, liquidity, and execution quality [2,4].

3.6. Crisis dynamics and the role of news

Crisis episodes stress-test pricing mechanisms. During the period 2020-2022, equity markets exhibited unprecedented responsiveness to public health and policy-related developments; bid-ask spreads expanded intermittently, and liquidity provision gravitated toward electronic market makers. Institutional reports document how liquidity backstops, policy communications, and intermediation capacity affected price resilience during stress [9,10]. These dynamics are consistent with discount-rate shocks (risk-aversion and policy rates), cash-flow revisions (growth expectations), and flow-driven price pressure under inelastic demand [7]. For identification, event-study windows around scheduled policy announcements and high-frequency order-book data help separate these channels [4,9,10].

4. Influence of stock price on the economy

4.1. Household wealth and consumption

Equity prices affect consumption through wealth effects. When valuations rise, households feel wealthier and may increase expenditures; when valuations fall, they retrench. The size of the marginal propensity to consume out of equity wealth varies across households (age, income, participation) and over time (credit availability, sentiment). In aggregate data, consumption and wealth comove at low frequencies, but identification is hard because both respond to shared fundamentals. A pragmatic synthesis uses mixed evidence: (i) structural models where time-varying discount rates link expected returns to intertemporal substitution and precautionary savings; (ii) micro evidence that realizations of capital gains trigger spending responses among stockholders; and (iii) institutional monitoring showing that post-pandemic wealth swings coincided with volatile consumption paths across countries [4,11,12]. For policy, the key is state dependence: wealth effects

are likely stronger when balance sheets are lightly levered and credit is plentiful; weaker when constraints bind or uncertainty is elevated.

4.2. Investment, Tobin's q , and the external-finance premium

On the firm side, equity valuations guide investment via Tobin's q —the ratio of market value to replacement cost—and via the costs of external finance. In q -theory, firms invest until marginal q equals 1; with adjustment costs and financing frictions, investment co-moves with average q and internal funds [9]. High valuations lower the cost of equity issuance, enabling firms to finance expansion and innovation, while low valuations raise the external-finance premium and slow capital expenditures. Empirically, investment regressions that include q and cash-flow terms capture both valuation effects and financing constraints; issuance waves often coincide with elevated q . The “real effects of mispricing” argument adds that when managers condition on perceived market signals—because compensation or financing depends on the stock price—over- or under-valuation can distort project selection, M&A, and R&D intensity. From a welfare standpoint, market mechanisms that enhance informational efficiency—such as improved disclosure quality, analyst coverage, and liquid trading—can thereby improve capital allocation by refining the q signal [4-6].

4.3. Credit conditions, balance-sheet effects, and amplification

Equity and credit are intertwined. Rising stock prices strengthen borrower balance sheets, improve collateral values, and relax covenants, lowering the cost of debt and broadening credit supply. Falling equity values do the reverse, tightening constraints and raising spreads. Through these balance-sheet channels, shocks to equity valuations amplify business-cycle fluctuations: higher valuations reduce external-finance premia and stimulate activity; lower valuations raise premia and propagate downturns. Institutional surveillance since 2020 highlights how sectors with thin equity buffers or high refinancing needs were more sensitive to valuation swings, while deep equity markets tended to cushion shocks by facilitating recapitalizations [9,11,12]. In bank-centric systems, equity market depth also influences banks' market-to-book ratios and funding costs, indirectly affecting credit supply.

4.4. Monetary policy transmission and information effects

Monetary policy affects equity prices through discount-rate and cash-flow channels. A surprise policy easing (relative to expectations) generally raises equity valuations by lowering discount rates and, when interpreted as supporting growth, by boosting cash-flow expectations. Conversely, surprises that signal weaker growth can lower stock prices even when policy is easier—an “information effect” arising because central bank actions reveal assessments of the outlook. High-frequency event studies demonstrate that within minutes of announcements, order flows, volatility, and factor returns adjust as markets process policy rate trajectories, balance sheet guidance, and economic projections [4,9,10]. The strength of transmission depends on intermediation capacity and liquidity at announcement times: when depth is thin, price impact per trade increases, and discount-rate shocks can leave larger footprints on valuations, with potential spillovers into risk-taking and financing conditions.

4.5. Global development, ownership trends, and policy relevance

At the country level, deeper, more liquid equity markets are associated with higher market capitalization-to-GDP ratios, broader participation, and more robust firm financing. International organizations track these metrics and their cyclical behavior. Recent reports discuss post-pandemic wealth dynamics, the role of equity in risk sharing, and vulnerabilities stemming from non-bank intermediation [11,12]. Cross-country data show wide dispersion in market capitalization and listing activity, reflecting differences in legal frameworks, disclosure, investor protection, and the composition of institutional investors [13]. Ownership trends matter for policy: the rise of passive funds concentrates voting power and flow dynamics, while sustainability mandates reallocate capital. Inelastic demand implies that modest regulatory or benchmark changes can shift prices and financing costs more than under elastic-demand benchmarks [7,8]. Policymakers therefore face design choices—index governance, stewardship codes, liquidity backstops—that can shape both pricing efficiency and real outcomes.

4.6. Identification challenges and research frontiers

Causal identification is difficult. Prices, cash flows, and macro conditions are jointly determined; flows can be endogenous to expected returns; and microstructure can obscure fundamental signals. Progress comes from (i) high-frequency identification around scheduled events to isolate discount-rate versus information effects [4,9]; (ii) quasi-experimental variation—index inclusions, rule changes, benchmark rebalances—to trace flow-induced price pressure and corporate responses [7,8]; and (iii) administrative and granular data linking household portfolios, firm financing, and spending or investment. A unified framework that embeds demand inelasticity and intermediation constraints into present-value logic can help reconcile factor premia, flow impacts, and macro transmission.

5. Conclusion

This review has outlined how equity markets perform four essential tasks—information aggregation, risk sharing, capital formation and governance, and liquidity provision—while explaining stock prices through a synthesis of present-value logic, risk-based factors, and demand- or constraint-driven forces. A central takeaway is that price movements reflect shifting mixes of cash-flow news, discount-rate variation, and flow-induced pressure; the mix depends on market depth, intermediation capacity, and the composition of investors. From a macroeconomic perspective, equity valuations exert influence on the real economy through household wealth effects, firms' cost of capital and investment decisions—including the channel of Tobin's q —as well as via credit conditions and balance sheet effects, and through the information and discount rate channels of monetary policy. These mechanisms are state-dependent: they amplify when liquidity is scarce, leverage is high, or uncertainty is elevated, and they attenuate when balance sheets are resilient and market depth is ample. Practically, the framework helps researchers structure identification strategies, guides practitioners on cost-of-capital and liquidity considerations, and informs policymakers weighing transparency, stewardship, and resilience in market design.

As a narrative synthesis, the review cannot settle debates on magnitudes or causal ordering across settings; publication bias, overlapping samples, and model itself also limit comparability. Two avenues appear especially promising. First, integrating demand inelasticity and intermediation constraints into unified present-value frameworks may reconcile factor premia with large price impacts of flows. Second, exploiting quasi-experimental variation—such as benchmark rebalancing,

index governance changes, and disclosure reforms—combined with micro-level portfolio and order-book data can strengthen causal inference regarding the effects of prices on investment, innovation, and credit. Continued attention to ownership trends, index rules, and liquidity backstops should improve both pricing efficiency and macro-financial resilience.

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