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# Forces That Move Stock Prices

By DAVID R. HARPER Updated February 16, 2024

Reviewed by JEFREDA R. BROWN

Fact checked by KIRSTEN ROHRS SCHMITT

Stock prices are determined in the marketplace, where seller supply meets buyer demand. But have you ever wondered about what drives the stock market—that is, what factors affect a stock's price? Unfortunately, there is no clean equation that tells us exactly how the price of a stock will behave. That said, we do know a few things about the forces that move a stock up or down. These forces fall into three categories: [fundamental](#) factors, [technical](#) factors, and [market sentiment](#).

- Fundamental factors drive stock prices based on a company's earnings and profitability from producing and selling goods and services.
- Technical factors relate to a stock's price history in the market pertaining to chart patterns, momentum, and behavioral factors of traders and investors.



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## Fundamental Factors

In an efficient market, stock prices would be determined primarily by fundamentals, which, at the basic level, refer to a combination of two things:

1. An earnings base, such as [earnings per share \(EPS\)](#).
2. A valuation multiple, such as a [P/E ratio](#)

Part of these earnings may be distributed as [dividends](#), while the remainder will be retained by the company (on your behalf) for [reinvestment](#). We can think of the future earnings stream as a function of both the current level of earnings and the expected growth in this earnings base.

As shown in the diagram, the valuation multiple (P/E), or the stock price as some multiple of EPS, is a way of representing the discounted [present value](#) of the anticipated future earnings stream.

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## The Earnings Base

Although we are using EPS, an accounting measure, to illustrate the concept of earnings base, there are other measures of [earnings power](#). Many argue that cash-flow-based measures are superior. <sup>[1]</sup> For example, [free cash flow per share](#) is used as an alternative measure of earnings power.

The way earnings power is measured may also depend on the type of company being analyzed. Many industries have their own tailored metrics. [Real estate investment trusts \(REITs\)](#), for example, use a special measure of earnings power called [funds from operations \(FFO\)](#). Relatively mature companies are often measured by dividends per share, which represents what the shareholder actually receives.

## The Valuation Multiple

The valuation multiple expresses expectations about the future. As we already explained, it is fundamentally based on the discounted present value of the future earnings stream. Therefore, the two key factors here are:

1. The expected growth in the earnings base

What determines the discount rate? First, it is a function of perceived risk. A riskier stock earns a higher discount rate, which, in turn, earns a lower multiple. Second, it is a function of [inflation](#) (or [interest rates](#), arguably). Higher inflation earns a higher discount rate, which earns a lower multiple (meaning the future earnings are going to be worth less in inflationary environments).

In summary, the key fundamental factors are as follows:

- The level of the earnings base (represented by measures such as EPS, [cash flow per share](#), dividends per share)
- The expected growth in the earnings base
- The discount rate, which is itself a function of inflation
- The perceived risk of the stock

## Technical Factors

Things would be easier if only fundamental factors set stock prices. Technical factors are the mix of external conditions that alter the supply of and demand for a company's stock. Some of these indirectly affect fundamentals. For example, [economic growth](#) indirectly contributes to earnings growth.

Technical factors include the following.

## Inflation

We mentioned it earlier as an input into the valuation multiple, but inflation is a huge driver from a technical perspective as well. Historically, low inflation has had a strong [inverse correlation](#) with valuations (low inflation drives high multiples and high inflation drives low multiples). <sup>[2]</sup> [Deflation](#), on the other hand, is generally bad for stocks because it signifies a loss in [pricing power](#) for companies.

suggested that economic/market factors account for 90% of it.) For example, a suddenly negative outlook for one retail stock often hurts other retail stocks as "guilt by association" drags down demand for the whole sector.

## Substitutes

Companies compete for investment dollars with other [asset classes](#) on a global stage. These include [corporate bonds](#), government bonds, [commodities](#), real estate, and foreign equities. The relationship between demand for U.S. equities and their substitutes is hard to figure, but it plays an important role.

## Incidental Transactions

Incidental transactions are purchases or sales of a stock that are motivated by something other than belief in the [intrinsic value](#) of the stock. These transactions include executive [insider](#) transactions, which are often pre-scheduled or driven by portfolio objectives. Another example is an institution buying or shorting a stock to [hedge](#) some other investment. Although these transactions may not represent official "votes cast" for or against the stock, they do impact [supply and demand](#) and, therefore, can move the price.

## Demographics

Some important research has been done about the [demographics](#) of investors. Much of it concerns these two dynamics:

1. Middle-aged investors, peak earners who tend to invest in the stock market
2. Older investors, who tend to pull out of the market in order to meet the demands of retirement

The hypothesis is that the greater the proportion of middle-aged investors among the investing population, the greater the demand for equities and the

and popularity buoys the stock higher. On the other hand, a stock sometimes behaves the opposite way in a trend and does what is called [reverting to the mean](#).

Unfortunately, because trends cut both ways and are more obvious in hindsight, knowing that stocks are "trendy" does not help us predict the future.

## Liquidity

[Liquidity](#) is an important and sometimes under-appreciated factor. It refers to how much interest from investors a specific stock attracts. Walmart's stock, for example, is highly liquid and thus highly responsive to [material news](#); the average [small-cap](#) company is less so. <sup>[3]</sup> Trading volume is not only a [proxy](#) for liquidity, but it is also a function of corporate communications (that is, the degree to which the company is getting attention from the investor community).

Large-cap stocks have high liquidity—they are well followed and heavily transacted. Many small-cap stocks suffer from an almost permanent "liquidity discount" because they simply are not on investors' radar screens.

## News

While it is hard to quantify the impact of news or unexpected developments inside a company, industry, or the global economy, you can't argue that it does influence investor sentiment. The political situation, negotiations between countries or companies, product breakthroughs, mergers and acquisitions, and other unforeseen events can impact stocks and the stock market. Since securities trading happens across the world and markets and economies are interconnected, news in one country can impact investors in another almost instantly.

vice versa). But some companies that are not making that much money still have a rocketing stock price. This rising price reflects investor [expectations that the company will be profitable](#) in the future. However, regardless of the stock price, there are no guarantees that a company will fulfill investors' current expectations of becoming a high-earning company in the future.

## Market Sentiment

Market sentiment refers to the psychology of market participants, individually and collectively. This is perhaps the most vexing category. Market sentiment is often subjective, biased, and obstinate. For example, you can make a solid judgment about a stock's future growth prospects, and the future may even confirm your projections, but in the meantime, the market may myopically dwell on a single piece of news that keeps the stock artificially high or low. And you can sometimes wait a long time in the hope that other investors will notice the fundamentals.

Market sentiment is being explored by the relatively new field of [behavioral finance](#). It starts with the assumption that markets are apparently not efficient much of the time, and this inefficiency can be explained by psychology and other [social science](#) disciplines. The idea of applying social science to finance was fully legitimized when [Daniel Kahneman](#), Ph.D., a psychologist, won the 2002 Nobel Memorial Prize in Economic Sciences (the first psychologist to do so). <sup>[4]</sup> <sup>[5]</sup> Many of the ideas in behavioral finance confirm observable suspicions: that investors tend to overemphasize data that come easily to mind; that many investors react with greater pain to losses than with pleasure to equivalent gains; and that investors tend to persist in a mistake.


Some investors claim to be able to [capitalize](#) on the theory of behavioral finance. For the majority, however, the field is new enough to serve as the "catch-all" category, where everything we cannot explain is deposited.



themselves to technical forces with the following popular argument: technical factors and market sentiment often overwhelm the [short run](#), but fundamentals will set the stock price in the long-run. In the meantime, we can expect more exciting developments in the area of behavioral finance, especially since traditional financial theories cannot seem to explain everything that happens in the market.

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