

# **How Interest Rates Affect The Stock Market**

September 1, 2006 | By Jim Mueller

<u>Interest rates</u>. Most people pay attention to them, and they can have impacts upon the stock market. But why? In this article, we'll explain some of the indirect links between interest rates and the stock market and show you how they might affect your life.

# The Interest Rate

Essentially, <u>interest</u> is nothing more than the cost someone pays for the use of someone else's money. Homeowners know this scenario quite intimately. They to use a bank's money (through a mortgage) to purchase a home, and they have to pay the bank for the privilege. Credit card users also know this scenario quite well - they borrow money for the short term in order to buy something right away. But when it comes to the stock market and the impact of interest rates, the term usually refers to something other than the above examples - though we will see that they are affected as well. (To read more, see *Who determines interest rates?*)

The interest rate that applies to investors is the <u>U.S. Federal Reserve</u> discount rate. This is the cost that banks are charged for borrowing money from Federal Reserve banks. Why is this number so important? It is the way the Federal Reserve (the "Fed") attempts to control inflation. <u>Inflation</u> is caused by too much money chasing too few goods (or too much demand for too little supply), which causes prices to increase. By influencing the amount of money available for purchasing goods, the Fed can control inflation. Other countries' central banks do the same thing for the same reason.

Basically, by increasing the <u>discount rate</u>, the Fed attempts to lower the supply of money by making it more expensive to obtain. (To see more on the Federal Reserve, read <u>Get To Know The Major Central Banks</u>, <u>The Fed Model And Stock</u> <u>Valuation: What It Does And Does Not Tell Us</u> and <u>Formulating Monetary Policy</u>.)

### Effects of an Increase

When the Fed increases the discount rate, it does not have an immediate impact on the stock market. Instead, the increased discount rate has a single direct effect – it becomes more expensive for banks to borrow money from the Fed. However, increases in the discount rate also causes a ripple effect, and factors that influence both individuals and businesses are affected.

The first indirect effect of an increased discount rate is that banks increase the rates that they charge their customers to borrow money. Individuals are affected through increases to credit card and mortgage interest rates, especially if they carry a <u>variable interest rate</u>. This has the effect of decreasing the amount of money consumers can spend. After all, people still have to pay the bills, and when those bills become more expensive, households are left with less money disposable income. This means that people will spend less <u>discretionary money</u>, which will affect businesses' top and bottom lines (that is, revenues and profits).

Therefore, businesses are also indirectly affected by an increase in the discount rate as a result of the actions of individual consumers. But businesses are affected in a more direct way as well. They, too, borrow money from banks to run and expand their operations. When the banks make borrowing more expensive, companies might not borrow as much and will pay a higher rate of interest on their loans. Less business spending can slow down the growth of a company, resulting in decreases in profit. (For extra reading on company lending, read <a href="When Companies Borrow Money">When Companies Borrow Money</a>.)

# **Stock Price Effects**

Clearly, changes in the discount rate affect the behavior of consumers and business, but the stock market is also affected. Remember that one method of valuing a company is to take the sum of all the expected future <a href="cash flows">cash flows</a> from that company discounted back to the present. To arrive at a stock's price, take the sum of the future discounted cash flow and divided it by the number of shares available. This price fluctuates as a result of the different expectations that people have about the company at different times. Because of those differences, they are willing to buy or sell shares at different prices.

If a company is seen as cutting back on its growth spending or is making less profit - either through higher debt expenses or less revenue from consumers - then the estimated amount of future cash flows will drop. All else being equal, this will lower the price of the company's stock. If enough companies experience a decline in their stock prices, the whole market,

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or the indexes (like the <u>Dow Jones Industrial Average</u> or the <u>S&P 500</u>) that many people equate with the market, will go down. (To learn more, check out <u>Why Do Markets Move?</u>, <u>Forces That Move Stock Prices</u> and <u>What causes a significant move in the stock market?</u>)

### **Investment Effects**

For many investors, a declining market or stock price is not a desirable outcome. Investors wish to see their invested money increase in value. Such gains come from stock price appreciation, the payment of <u>dividends</u> - or both. With a lowered expectation in the growth and future cash flows of the company, investors will not get as much growth from stock price appreciation, making stock ownership less desirable.

Furthermore, investing in stocks can be viewed as too risky compared to other investments. When the Fed raises the discount rate, newly offered government securities, such Treasury bills and bonds, are often viewed as the safest investments and will usually experience a corresponding increase in interest rates. In other words, the "risk-free" rate of return goes up, making these investments more desirable. When people invest in stocks, they need to be compensated for taking on the additional risk involved in such an investment, or a premium above the risk-free rate. The desired return for investing in stocks is the sum of the risk-free rate and the risk premium. Of course, different people have different risk premiums, depending on their own tolerance for risk and the company they are buying. However, in general, as the risk-free rate goes up, the total return required for investing in stocks also increases. Therefore, if the required risk premium decreases while the potential return remains the same or becomes lower, investors might feel that stocks have become too risky, and will put their money elsewhere.

# Interest Rates Affect but Don't Determine the Stock Market

The interest rate, commonly bandied about by the media, has a wide and varied impact upon the economy. When it is raised, the general effect is to lessen the amount of money in circulation, which works to keep inflation low. It also makes borrowing money more expensive, which affects how consumers and businesses spend their money; increases expenses for companies, lowering earnings somewhat for those with debt to pay; and, finally, it tends to make the stock market a slightly less attractive place to investment.

Keep in mind, however, that each of these factors and results are all interrelated. What we described above are very broad interactions which can play out in innumerable ways. Interest rates are not the only determinant of stock prices and there are many considerations that go into stock prices and the general trend of the market - an increased interest rate is only one of them. Therefore, one can never say with confidence that an interest rate hike by the Fed will have an overall negative effect on stock prices.

To read further on interest rates, see <u>Trying To Predict Interest Rates</u>, <u>Forces Behind Interest Rates</u> and <u>Dividends</u>, <u>Interest Rates And Their Effect on Stock Options</u>.

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