How Do Interest Rates Affect the Stock Market?

By Mary Hall | Updated August 3, 2018 — 9:47 AM EDT

The investment community and the financial media tend to obsess over interest rates—the cost someone pays for the use of someone else's money— and with good reason. When the Federal Open Market Committee (FOMC) sets the target for the federal funds rate at which banks borrow from and lend to each other, it has a ripple effect across the entire U.S. economy, not to mention the U.S. stock market. And, while it usually takes at least 12 months for any increase or decrease in interest rates to be felt in a widespread economic way, the market's response to a change (or news of a potential change) is often more immediate.

Understanding the relationship between interest rates and the stock market can help investors understand how changes might affect their investments and how to make better financial decisions.

The Interest Rate That Impacts Stocks

The interest rate that moves markets is the federal funds rate. Also known as the overnight rate, this is the rate depository institutions are charged for borrowing money from Federal Reserve banks.

The federal funds rate is used by the Federal Reserve (the Fed) to attempt to control inflation. Basically, by increasing the federal funds rate, the Fed attempts to shrink the supply of money available for purchasing or doing things, by making money more expensive to obtain. Conversely, when it decreases the federal funds rate, the Fed is increasing the money supply and, by making it cheaper to borrow, encouraging spending. Other countries' central banks do the same thing for the same reason.

Why is this number, what one bank pays another, so significant? Because the prime interest rate—the interest rate commercial banks charge their most credit-worthy customers—is largely based on the federal funds rate. It also forms the basis for mortgage loan rates, credit card annual percentage rates (APRs) and a host of other consumer and business loan rates.

What Happens When Interest Rates Rise?

When the Fed increases the federal funds rate, it does not directly affect the stock market. The only truly direct effect is that borrowing money from the Fed is more expensive for banks. But, as noted above, increases in the federal funds rate have a ripple effect.

Because it costs them more to borrow money, financial institutions often increase the rates they charge their customers to borrow money. Individuals are affected through increases to credit card and mortgage interest rates, especially if these loans carry a variable interest rate. 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 disposable income. This means people will spend less discretionary money, which will affect businesses' revenues and profits.

But businesses are affected in a more direct way as well because they also 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 higher rates of interest on their loans. Less business spending can slow the growth of a company; it might curtail expansion plans or new ventures, or even induce cutbacks. There might be a decrease in earnings as well, which, for a public company, usually means the stock price takes a hit.

Interest Rates and the Stock Market

So now we see how those ripples can rock the stock market. If a company is seen as cutting back on its growth or is less profitable—either through higher debt expenses or less revenue—the estimated amount of future cash flows will drop. All else being equal, this will lower the price of the company's stock. (For related reading, see: *Taking Stock of Discounted Cash Flow*.)

If enough companies experience declines in their stock prices, the whole market, or the key indexes (e.g., Dow Jones Industrial Average, S&P 500) many people equate with the market, will go down. 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 equities can be viewed as too risky compared to other investments.

However, some sectors do benefit from interest rate hikes. One sector that tends to benefit most is the financial industry. Banks, brokerages, mortgage companies and insurance companies' earnings often increase as interest rates move higher, because they can charge more for lending.

Interest Rates and the Bond Market

Interest rates also affect bond prices and the return on CDs, T-bonds and T-bills. There is an inverse relationship between bond prices and interest rates, meaning as interest rates rise, bond prices fall, and vice versa. The longer the maturity of the bond, the more it will fluctuate in relation to interest rates. (For related reading, see: *How Bond Market Pricing Works*.)

When the Fed raises the federal funds 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. 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 dips lower, investors might feel stocks have become too risky and will put their money elsewhere.

One way governments and businesses raise money is through the sale of bonds. As interest rates move up, the cost of borrowing becomes more expensive. This means demand for lower-yield bonds will drop, causing their price to drop. As interest rates fall, it becomes easier to borrow money, causing many companies to issue new bonds to finance new ventures. This will cause the demand for higher-yielding bonds to increase, forcing bond prices higher. Issuers of callable bonds may choose to refinance by calling their existing bonds so they can lock in a lower interest rate.

For income-oriented investors, reducing the federal funds rate means a decreased opportunity to make money from interest. Newly issued treasuries and annuities won't pay as much. A decrease in interest rates will prompt investors to move money from the bond market to the equity market, which then starts to rise with the influx of new capital.

What Happens When Interest Rates Fall?

When the economy is slowing, the Federal Reserve cuts the federal funds rate to stimulate financial activity. A decrease in interest rates by the Fed has the opposite effect of a rate hike. Investors and economists alike view lower interest rates as catalysts for growth—a benefit to personal and corporate borrowing, which in turn leads to greater profits and a robust economy. Consumers will spend more, with the lower interest rates making them feel they can finally afford to buy that new house or send the kids to a private school. Businesses will enjoy the ability to finance operations, acquisitions and expansions at a cheaper rate, thereby increasing their future earnings potential, which, in turn, leads to higher stock prices.

Particular winners of lower federal funds rates are dividend-paying sectors such as utilities and real estate investment trusts (REITs). Additionally, large companies with stable cash flows and strong balance sheets benefit from cheaper debt financing. (For related reading, see: *Do Interest Rate Changes Affect Dividend Payers?*)

Impact of Interest Rates on Stocks

Nothing has to actually happen to consumers or companies for the stock market to react to interest-rate changes. Rising or falling interest rates also affect investors' psychology, and the markets are nothing if not psychological. When the Fed announces a hike, both businesses and consumers will cut back on spending, which will cause earnings to fall and stock prices to drop, everyone thinks, and the market tumbles in anticipation. On the other hand, when the Fed announces a cut, the assumption is consumers and businesses will increase spending and investment, causing stock prices to rise.

However, if expectations differ significantly from the Fed's actions, these generalized, conventional reactions may not apply. For example, let's say the word on the street is the Fed is going to cut interest rates by 50 basis points at its next meeting, but the Fed announces a drop of only 25 basis points. The news may actually cause stocks to decline because assumptions of a 50-basis-points cut had already been priced into the market.

The business cycle, and where the economy is in it, can also affect the market's reaction. At the onset of a weakening economy, the modest boost provided by lower rates is not enough to offset the loss of economic activity, and stocks continue to decline. Conversely, towards the end of a boom cycle, when the Fed is moving in to raise rates—a nod to improved corporate profits—certain sectors often continue to do well, such as technology stocks, growth stocks and entertainment/recreational company stocks.