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How Do Falling Or Rising Interest Rates Impact The Stock Market?

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Changes in interest rates not only impact the economy, but they also often impact the market prices of stocks and other assets. Learn how falling and rising interest rates tend to affect the stock market.



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Interest Rates – The Basics

Interest is exchanged between a borrower and a lender as compensation for borrowed funds. Consumers pay their bank interest on standard loans, lines of credit, and mortgages. Companies pay debtholders interest on debt issued to help finance their business development.

Interest rates differ depending on term, creditworthiness, currency, and other considerations. Rates are linked to the *Time Value Of Money* – a dollar today is worth more than a dollar tomorrow, so people need to be compensated for lending the money they have today.

Often, a longer-term loan carries a higher interest rate than a shorter-term loan, as it **usually** (but not always) costs more to have lenders part with their money for a longer period of time. A creditworthiness premium is easy to understand; a lower rate loan makes sense when lending to a borrower who is highly likely to be able (and willing) to repay the loan. Borrowers with poor credit ratings will have to agree to a higher interest rate.

What Is The Federal Funds Rate?

The Federal Funds rate is an interest rate set by the Federal Open Market Committee, or FOMC, policymaking committee of the Federal Reserve System. Commercial banks use the FOMC's target rate for borrowing or lending cash overnight to meet the Fed's reserve requirements. So this is the base rate for very short-term loans.

The [New York Fed maintains a daily history](#) of the Federal Funds Rate.

How Does The Federal Reserve Raise Interest Rates?

The Federal Reserve raises interest rates by increasing its Federal Funds Rate, which is the target reserve rate that banks use for overnight loans. The Fed also raises rates by selling short-term bonds in the open market. Both of these actions reduce the money supply for the purpose of slowing the economy, which may reduce inflation.

How Does The Federal Reserve Lower Interest Rates?

The Federal Reserve lowers interest rates by decreasing its Federal Funds Rate, which is the reserve interest rate that banks use for overnight loans. The Fed may also lower interest rates by purchasing short-term bonds in the open market. Both of these actions increase the money supply for the purpose of stimulating economic growth.

Important: When the U.S. Federal Reserve increases the Federal Funds Rate, they're increasing the base cost on **short-term borrowings**. Long-term interest rates may or may not change when Federal Reserve adjusts the Fed Funds Rate.

Interest Rates & Inflation

Interest rates usually follow inflation rates. If the economy is overheating and inflation pressures are on the rise, the U.S. Federal Reserve may increase interest rates to cool down the economy. On the other hand, if the economy is sluggish and inflation is low, interest rates might be lowered to help lower borrowing costs, thus stimulating the economy.

Higher interest rates usually serve to cool inflation pressures, so inflation may fall after interest rates have risen. Equally, inflation might pick up after interest rates have been lowered to boost the economy.

How Rising Interest Rates Impact Bond Prices

There is an inverse relationship between interest rates and bond prices. When interest rates are rising, existing fixed-rate bonds that are paying the old rate suddenly become less attractive. The opposite is true when interest rates are declining – lower rates make existing bonds with higher interest more attractive.

Thus, when interest rates rise, existing bond securities tend to fall. When interest rates decrease, existing bond securities tend to rise in price.

Note: The longer the duration on a bond, the more sensitive it is to interest rates. For example, when interest rates are rising, the prices for long-term bonds, or those with durations over 10 years, tend to fall more than those with shorter durations.

How Rising Interest Rates Impact Stock Prices

When interest rates rise, it's more costly to fund a business project, and existing projects funded by debt are suddenly less profitable. Furthermore, risk assets such as stocks become comparatively less attractive when risk-free interest rates are rising. Thus, higher interest rates tend to (but not always) impact stocks negatively.

Higher borrowing rates tend to shrink profit margins for corporations. Since their customers are also faced with higher borrowing costs, the demand for goods and services is often reduced, which can further erode business profitability.

Interest Rates & Premiums Paid For Risky Assets

Investors who buy and hold stocks expect to receive higher returns in exchange for taking on greater risk, as compared to holding a risk-free asset, such as a U.S. Treasury bill, or T-bill. This excess return above the risk-free rate is called the risk premium. The required risk premium often increases as interest rates are rising.

When interest rates fall, investment markets often experience the opposite; existing risk assets appear more attractive as the required risk premium shrinks.

Note: The risk premium is the return an asset is expected to produce in excess of the risk-free rate of return, which is the return expected from an investment with low chance of financial loss. A traditional proxy for a risk-free asset are U.S. Treasury bills, or T-bills, because it's backed by the U.S. government.

Bottom Line

Interest rates impact the stock market and the broader economy. Changes in interest rates may affect bond and stock prices immediately, whereas the effect on the economy may take several months. Falling rates stimulate the economy by decreasing the cost of borrowing, whereas rising rates aim to slow the economy and control inflation by increasing the cost of borrowing.

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