Take a Keen Interest When Rates Rise

Interest rates affect homeowners and credit card holders. But they also can have an indirect impact on the stock market.

Interest rates generally refer to the Federal Reserve's funds rate — the cost that banks are charged to borrow money from other U.S. banks. The Fed controls interest rates mostly as a way to ensure that inflation does not get too high (inflation has an eroding effect on your purchasing power). Too much inflation means rising prices and consumers having less buying power, which economists say can lead to business stagnation and higher unemployment.

When the Fed increases interest rates, it makes it more expensive to borrow money, which can have a moderating effect on prices. Interest rate hikes also have direct and indirect effects on most financial products, from credit cards and mortgages to stocks and bonds.

Because higher rates make it more expensive for consumers to borrow, consumer spending tends to slow. As a result, businesses may experience lower revenues and profits, and may decide to borrow less money to plow back into their companies.

Rising rates can indirectly harm the prices of certain stocks, which generally are valued based on future earnings. If enough businesses cut back on business spending due to decreased revenues, entire stock market indexes like the Dow Jones Industrial Average or S&P 500 can go down. In addition, since stocks are considered to be riskier than bonds, some investors will see rising interest rates as a signal to sell stocks and buy government securities such as Treasury bonds, which may offer a more stable rate of current return. That, too, can cause stock prices to go lower.

In fact, since 1913, U.S. stocks have gained an annual average of 9.3% when interest rates fell, but only 2.3% in periods when rates rose, according to a recent finance study cited in The Wall Street Journal. Bonds, by contrast, returned an average of 3.6% annually in periods when rates fell, but only 0.3% when rates rose.[1]

Keep in mind that all of these factors are interrelated, and that one can never say with certainty that an interest rate hike by the Fed always leads to lower stock prices. Keeping a portfolio that's well-diversified among stocks, bonds and cash could be an effective way to offset the market forces outside of your control, including interest-rate movements and stock-market declines.

1 Jason Zweig, "Sorry, You're Just Going to Have to Save More Money," The Wall Street Journal, July 13, 2016. Returns include the effects of inflation. Past performance does not predict future results; http://blogs.wsj.com/moneybeat/2016/07/13/sorry-youre-just-going-to-have-to-save-more-money%E2%80%8B/.

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