Role of interest rates in your investment decision making

Synopsis

Interest rates and stock prices are closely related. Changes in interest rates may have a significant impact on the economy and financial markets, including the stock market. Interest rates can affect company earnings, the cost of borrowing money, and the demand for stocks

Ever wondered why there is always a hype around RBI's Monetary policy meetings? Has it ever occurred to you that this is the reason for media attention on the US Federal Reserve's FOMC meetings. The answer to it is two heavy words – 'Interest Rates'. If the economy is believed to be a machine then money supply would be its Oil and Interest rate is the lever through which the supply of money is controlled. Much like a gearbox. RBI through its periodic meetings decides upon the liquidity to be allowed into the system through controlling the bank prime lending rates in other words interest rates. The interest rate plays an integral part in the lives of everybody. It has its significance in almost every facet of the economy. When it comes to investing, especially in the stock market it is one of the crucial indicators.

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The direction of interest rates has an impact on stock valuation, stock pricing, and risk premium. For investors to invest in something riskier than the safe Treasury bills, or risk-free rate, they require a higher return or risk premium. The direction of interest rates impacts a company's theoretical value and that of its shares, and therefore the risk premium.

According to financial theory, a stock's value proposition starts there: stocks are risky assets, even riskier than bonds because bondholders are paid their capital before stockholders in the event of bankruptcy. Therefore, investors require a higher return for taking on extra risk by investing in stocks instead of Treasury bills, which are guaranteed to pay a certain return.

The extra return that investors can theoretically expect from stocks is referred to as the "risk premium." Historically, the risk premium runs at around five percent. This means that if the risk-free rate (the Treasury bill rate) is 6%, then investors would demand a return of 11% from the stock. Therefore, the total return on a stock is the sum of two parts: the risk-free rate and the risk premium. As the risk free rates increase, expectations of returns from equity increases and the prices fall and vice-versa.

Hence the understanding of how interest rate change becomes very much important. Change in interest rates happen because of the following parameters:

- Inflation
- Liquidity in the system

- Exchange rate movement
- Trade surplus / deficit
- Fiscal surplus / deficit
- Domestic and global economic outlook

Understanding inflation: One of the major reasons for change in interest rates is inflation. Inflation has plunged countries into long periods of instability. Politicians have won elections with promises to combat inflation and lost after failing to do so. Indeed, many countries have grappled with high inflation—and in some cases hyperinflation, 1,000 percent or more a year. In 2008, Zimbabwe experienced one of the worst cases of hyperinflation ever, with estimated annual inflation at one point of 500 billion percent. Such high levels of inflation have been disastrous, and countries have had to take difficult and painful policy measures to bring inflation back to reasonable levels, sometimes by giving up their national currency, as Zimbabwe has. Higher inflation may be due to improper governance by the state, lax monetary policy, trade deficit or inefficiencies on the production and supply side like hoarding of goods, low productivity etc.

Although high inflation hurts an economy, deflation, or falling prices, is not desirable either. When prices are falling, consumers delay making purchases, anticipating lower prices in the future. For the economy this means less economic activity, less income generated by producers, and lower economic growth. Japan is one country with a long period of nearly no economic growth, largely because of deflation. Preventing deflation during the global financial crisis that began in 2007 was one of the reasons the US Federal Reserve and other central banks around the world kept interest rates low for a prolonged period and have instituted other monetary policies to ensure financial systems have plenty of liquidity.

Hence neither low nor high inflation is good for the economy. A range bound or predictable inflation is good for the economy. If inflation is low and predictable, it is easier to capture it in price-adjustment contracts and interest rates, reducing its distortionary impact. Moreover, knowing that prices will be slightly higher in the future gives consumers an incentive to make purchases sooner, which boosts economic activity. As a result, many central bankers have made their primary policy objective to maintain low and stable inflation, a policy known as inflation targeting. RBI has maintained a stance to keep the inflation target at 4% with tolerance between 2-6% by changing the repo rate, open market operations etc.

In India, change in repo rate has following impact both on the economy & stock markets as follows:

1. **Impact on borrowings**: The borrowing cost of corporates go up in rising interest rate scenario. For corporates, it impacts the bottom line. As a result, the stock prices tend to fall due to rising interest rates and vice-versa.
2. **Impact on disposable income**: The borrowing cost of individuals goes up in rising interest rate scenarios. For individuals, it impacts their disposable income and hence the demand for goods from consumers decreases and businesses' revenues and profits decrease. As a result, the stock prices tend to fall due to rising interest rates and vice-versa.
3. **Impact on discounted cash flows**: Changes in interest rates impact the theoretical value of companies and their shares — basically, a share's fair value is its projected future cash flows discounted to the present using the investor's required rate of return. If interest rates fall and everything else is held constant, share value should rise. That's why the market generally cheers when the RBI announces a rate cut. Conversely, if RBI raises rates (holding everything else constant), then share values are likely to fall.
4. **Impact on Economy**: Interest rates can impact economic growth. When interest rates rise, it can slow down economic growth, which can lead to a decrease in company earnings. As a result, stock prices can decline.

5. **Dividend yield**: When interest rates rise, fixed income investments become more attractive to investors. This can lead to a decrease in demand for stocks, which can lower stock prices. Companies may also be less likely to pay high dividends when interest rates are high.

What happens when Interest Rates rise?
When RBI increases the repo rate, it immediately elevates short-term borrowing costs for financial institutions. This has a ripple effect on virtually all other borrowing costs for companies and consumers in an economy.

Because it costs financial institutions more to borrow money, these same financial institutions often increase the rates they charge their customers to borrow money. So, individual consumers are impacted through increases to their credit card and mortgage interest rates, especially if these loans carry a variable interest rate. When the interest rate for credit cards and mortgages increases, the amount of money that consumers can spend decreases.

Consumers still have to pay their bills. When those bills become more expensive, households are left with less disposable income. When consumers have less discretionary spending money, businesses' revenues and profits decrease.

So, as rates rise, businesses are not only impacted by higher borrowing costs, but they are also exposed to the adverse effects of flagging consumer demand. Both of these factors can weigh on earnings and stock prices.

What happens when Interest Rates fall?
When the economy is slowing, RBI cuts the repo rate to stimulate financial activity. A decrease in interest rates by the RBI 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. This, in turn, leads to greater profits and a robust economy.

Consumers will spend more, with the lower interest rates making them feel that, perhaps, they can finally afford to buy that new house or send their 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. This, in turn, leads to higher stock prices.

Thus, there is a strong negative correlation between interest rates and stock prices. As a result, a dynamic band for equity allocation is necessary to accommodate the change in interest rate scenarios. A higher PE at lower interest rates may be similar to a lower PE at higher interest rates. Due to the dynamic nature of the band, the same equity allocation can be done when interest rates were low and PE was high and vice-versa.

Although the relationship between interest rates and the stock market is fairly indirect, the two tend to move in opposite directions. As a general rule of thumb, when the RBI cuts interest rates, it causes the stock market to go up; when the RBI raises interest rates, it causes the stock market to go down. But there is no guarantee as to how the market will react to any given interest rate change.

Therefore, keeping an eye on interest rates is important when investing in the stock market. It can help investors assess the broader economic environment and make informed investment decisions that are in line with their investment goals and risk tolerance. Overall, the impact of interest rate changes on stock prices can be complex and multifaceted. It's important for investors to consider the broader economic environment and company-specific factors when assessing the potential impact of interest rate changes on stock prices.

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