Clarity Wealth Advisors
Financial Planning Newsletter
August 2013 | Volume 3, Issue 8
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Interest Rates

Hello!

Over the past several weeks, equity and fixed income markets have experienced periods of volatility. A contributing factor had been Ben Bernanke's announcement in June that the Federal Reserve (Fed) may start slowing its economic stimulus program sooner than expected which resulted in an increase in interest rates and a decline in the U.S. equity and fixed income markets. I thought it was timely for interest rates to be the focus of this month's newsletter and to share how they affect consumers, businesses, the overall economy, and the securities markets.

Interest rates are an economic metric tool used to control the amount of money in the economy. In periods of high interest rates, it becomes difficult for consumers and businesses to borrow funds and therefore, creates an environment of saving over spending. For businesses, this could result in them holding off on hiring or expansion plans. When interest rates are low, as we have been experiencing the past few years, it encourages borrowing by individuals and companies which in turn puts more money to work in the economy.

Effect on Consumers

Consumers are less likely to make major purchases during periods of rising interest rates. For those who carry credit card balances with variable rates or have adjustable rate loans such as mortgages and home equity lines of credit, they will be subject to higher payments which will result in having less to spend on discretionary items. There is a higher probability of default of both secured and unsecured debt.

When interest rates are falling, consumers are more likely to increase their discretionary spending on goods and services, and also make major purchases in homes and cars. Those with variable loans will see their minimum monthly payments will go down.

Effect on Businesses

Even though changes in interest rates can have various potential effects on businesses, its borrowing power tends to be most impacted. Since some companies often need to take out short-term loans to make up for shortfalls in payroll or other expenses, higher interest rates make these loans more expensive.

Businesses looking to finance larger amounts in order to purchase equipment, hire more employees, or engage in expansionary projects may choose not to do so in periods of rising rates as they do not want to commit the funds to such projects. Less spending by businesses can reduce its growth rate, resulting in a decline in revenues and profit.

Effect on the Equity Markets

With the direction of interest rates having an impact on consumer and business spending, this directly affects the equity markets. In a rising interest rate environment, consumers and businesses will reduce their spending levels which will cause a decline in a company's earnings and thereby making its share price fall. Investors can earn more by investing in money market funds, CDs, and fixed-income securities. This can lead to a selloff in stocks and putting additional pressure on share prices.

On the other hand, when interest rates are low, spending by consumers and businesses increases which leads to growth in company earnings and higher share prices.

Effect on Fixed Income Markets

Bonds are issued by governments and corporations to raise money. As interest rates increase, the cost of borrowing becomes more expensive. Those bonds with lower yields will experience declines in prices. As interest rates fall, companies may choose to issue new bonds to finance expansion resulting in an increase in demand for higher-yielding bonds, and therefore, forcing bond prices higher. The longer the maturity of the bond, the greater it will fluctuate as interest rates move.

Fixed income investors should regularly review the yields on their current holdings compared to what they could get elsewhere in the market.

Effect on the Economy

During periods of higher interest rates, it is usually associated with a slowing down of the economy and conversely, when interest rates are declining, it stimulates the economy and leads to growth and expansion.

The direction of interest rates can have a positive or negative effect on our economy and is overseen by the Fed through its federal funds rate, which is the cost financial institutions are charged for borrowing money from Federal Reserve Banks. By making adjustments to the federal funds rate, this is how the Fed manages to control inflation or recessions. During inflationary periods, there is higher demand versus supply for goods and services which results in prices going up. By influencing the amount of money available for purchasing goods and services, the Fed can control inflation.

Conclusion

The movement of interest rates affects the economy in terms of spending by consumers and businesses, causing volatility in stock and bond prices, and potentially moving an economy towards a period of inflation or into a recession. Historically, there is generally a 12-month lag for the effects of any increase or decrease in interest rates to be felt in an economy.