

Interest Rates & the Stock Market: Three risk that investors should consider

By Alex Garry,
Certified Investment Management Analyst®
Financial Advisor
Morgan Stanley

As a Financial Advisor, one of the most important aspects of my job is helping my clients understand the attributes of the investment strategies my team and I recommend based on each client's individual goals and circumstances. As a result, we are in constant communication with our clients so that they are aware of how their portfolio is positioned to deal with the current market environment including what risk they have exposure too.

One topic that has been top of mind for many of our clients recently has been interest rates. More specifically, clients want to know what impact higher interest rates can potentially have on their investments. Countless research papers and chapters in investment books have been devoted to this topic as it can be argued that interest rates are the single most important variable when it comes to investing in almost anything. However, for the purpose of this article, I want to address one particular question that I was recently put to me by a prospective client which is ***"Why are higher interest rates bad for the stock market?"***

Before I answer the question, I want to start off by saying that when it comes to the world of investing almost nothing is inherently *"bad"* or *"good"* for the stock market. Even when all the data available supports one conclusion, investors must keep in mind that markets can be irrational, and that they can easily move in the opposite direction to what investors are expecting. Therefore, the best we can do is make educated decisions around the risk of the investments we are considering.

I also want to be clear that following points are my general thoughts only and are by no means a recommendation to invest (or not invest). I am simply writing this to give some high-level insights on how we frame the answer to the question – and how my team and I think about interest rate risk as it pertains to the overall stock market (and not specific investment strategies).

Now that we have those points out of the way, for me the question has a three-part answer (note how I have slightly refined the original question) – ***"Why are higher interest rates potentially bad for the stock market?"***

1. Higher interest rates can negatively impact corporate profit margins.

Most companies have debt on their balance sheets. Therefore, when interest rates remain high, at some point there comes a time when companies must refinance their debt at the higher prevailing rate. When this occurs, it can negatively impact their profit margins because they must now pay more money to service their debt – thus leading to lower profitability and ultimately, when companies make less profits, the stock market reacts accordingly.

2. Higher interest rates can affect consumer demand.

When interest rates remain high, consumers (everyday people like you and I) tend to spend less money. This is very important because similarly to point number one, when people spend less money, companies make fewer profits. It can also be argued the U.S. consumer is the single greatest driver of economic growth and corporate profits in the entire world. In fact, roughly 70% of U.S. GDP (the primary measure of the size of the U.S. economy) comes from consumer spending¹.

3. Higher interest rates can affect investor demand in the stock market.

This last point is slightly more analytical than the previous two but, none-the-less, it is still very important. There is an opportunity cost to investing in any asset class. For example, if you choose to invest in the stock market, by default you are choosing not to invest in something else (such as the bond market). If, for argument's sake, you only compare stocks and bonds – when interest rates are low, your expected return on bonds are also low. However, when interest rates start to go higher, your expected return on bonds also starts to go higher. Thus, if you could earn 5% by investing in a U.S. government bond, you might start to reconsider placing your hard-earned dollars in a riskier investment like the stock market.

All of this is important right now because the stock market can be considered by some investors as being expensive. Depending on the metric you look at, stock market valuations are currently above their historical averages. This is partially to do with the strong stock market returns we have seen over the past 5 years during a period of low interest rates. As a result, the potential impact that current interest rates can have on the stock market are something that my team and I are watching very closely as it pertains to our client's investments.

If you would like to discuss any of the points mentioned in this article, or you would like to learn more about the process my team and I have for managing risk in our client's portfolios, please don't hesitate to reach out.

Alex Garry
Financial Advisor
Certified Investment Management Analyst®
Tel: 609-844-7975
Cell: 609-633-5561
Fax: 609-580-2197
alex.garry@morganstanley.com
NMLS #2534491

ABOUT THE AUTHOR

Alex Garry is a Financial Advisor and partner on The Blue Cornerstone Group at Morgan Stanley Wealth Management. He has over a decade of experience working in Financial Services including holding various positions at some of the top investment management firms in the world. The cornerstone of Alex's practice involves working with client's and their families to create a detailed financial plan that helps them prioritize what is most important to them financially. Using that plan as a foundation, he then creates his clients a highly customized investment portfolio designed to help meet their immediate and long-term goals in the most tax efficient manner possible.

¹Source: J.P. Morgan Asset Management (March 31st, 2024). *Guide to the Markets* (pg. 17).
<https://am.jpmorgan.com/content/dam/jpm-am-aem/global/en/insights/market-insights/guide-to-the-markets/mi-guide-to-the-markets-us.pdf>

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