



# Starboard Advisors

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## MARKET COMMENTARY: WHY INTEREST RATES MATTER TO STOCK MARKET INVESTORS

### Market Update

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With all the focus on the Federal Reserve and its interest rate policies, it is a good time to review how interest rate levels and changes influence stock market investing. Essentially, interest rates impact the stock market in four separate, but equally important, ways. We review these four factors below:

- 1.) **The Impact on General Economic Activity.** The level of interest rates can impact the economy through its encouragement, or lack thereof, in housing, corporate investment, and overall capital spending. Lower rates also stimulate additional consumer borrowing and spending which are positive factors for overall economic growth. This growth will enhance corporate profits which drive stock market performance. Higher rates inhibit spending and growth, thereby reducing corporate profit potential and stock market attraction.
- 2.) **The Impact on Corporate Profits.** Since corporations are net borrowers, interest costs go up and down with rate changes and influence corporate profits accordingly. For example, the latest data from the Federal Reserve put total corporate debt at more than \$11 trillion, half of which is in the form of loans whose costs move up and down with the direction of interest rates. Higher rates translate into higher costs and lower profits which will directly impact stock prices.

- 3.) **The Impact on Margin Trading.** As of the end of March 2019, total margin debt outstanding was \$574 billion (Source: **Barron's** April 26, 2019). An increase in rates, for example, will encourage margin account selling to cut down on the cost of the trading strategy. Similarly, a decrease in rates will encourage additional margin account trading with a positive impact on the equity markets.
- 4.) **The Impact on Competing Investment Alternatives.** With low or declining interest rates, investors will look to sell fixed income securities whose returns are less attractive than equities which offer current dividends and potential capital gains. As rates increase, however, stock investments become relatively less attractive as funds leave equities to take advantage of more attractive fixed income opportunities.

Investors should keep these four influential factors in mind as they watch Federal Reserve policy actions and statements. No one factor will always be the most influential, but together they should be reviewed and analyzed for their potential impact on the equity markets.

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