Interest rates and shares

Interest rate changes affect more than just fixed interest investments. They affect all investments to varying degrees.

Take shares, for example. In a low interest rate scenario, term deposits become *less* attractive relative to growth assets like shares. This is because the rate of interest paid on a term deposit is fixed at a low rate, while shares have the flexibility to provide a higher rate of return (in the right circumstances).

Low interest rates also make it more attractive for investors to borrow specifically to buy growth assets, such as shares or property.

It becomes a self-perpetuating cycle; because individuals and companies are paying less interest servicing their mortgages or overdrafts, there is more cash flowing through the economy. This means greater economic activity and more demand for goods and services, which in turn means higher corporate profits and higher share prices. In addition, for companies, a ready supply of cheap capital means they can more easily fund their operations to expand and increase profits.

In the high interest rate scenario, the opposite applies. That is, there is less money flowing through the economy, meaning less demand, less corporate activity and generally lower profits. Of course, high rates also make interest-bearing deposits more attractive relative to growth assets, thus reducing the demand for and price of those assets.

Liquidity is the term used to describe how much money is flowing through the economy. So when economists talk of the Reserve Bank ‘injecting liquidity’ into the economy, they simply mean cutting interest rates. Liquidity is one of the major factors that drives investment markets, because the more people and institutions have to invest, the more money will find its way into the sharemarket and the economy.

ENDS

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