



## July 2023 – Interest Rates and the Stock Market

**Interest rates are to asset prices like gravity is to the apple. And when there are higher interest rates, the gravitational pull on asset prices is stronger.**

**- Warren Buffett (paraphrased)**

### Interest Rates and the Stock Market

Interest rates are one of the most important factors that affect the stock market. In general, rising interest rates tend to be bad for stocks, while falling interest rates tend to be good for stocks.

There are a few reasons for this. First, higher interest rates make it more expensive for businesses to borrow money. This can lead to lower corporate profits, which can in turn lead to lower stock prices. Second, higher interest rates make it more attractive for investors to put their money in bonds instead of stocks. This is because bonds typically pay a fixed interest rate, which is not affected by changes in the stock market.

However, the impact of interest rates on the stock market is not always straightforward. For example, if interest rates are rising because the economy is doing well, this could actually be good for stocks. This is because a strong economy means that businesses are more likely to be profitable, which can lead to higher stock prices.

Ultimately, the impact of interest rates on the stock market depends on a number of factors, including the overall state of the economy, the level of inflation, and the expectations of investors.

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The last four paragraphs may seem to you to be of some interest, but they do not exactly grab you and make you want to read on. We agree, but we did not write that, rather Google Bard (the Google version of Chat GPT) did. We thought it might be of interest to have a letter written by Artificial Intelligence. (The entire letter that Bard wrote is attached as an appendix to this letter.) We promise to not make it a habit in future letters.

What we want to discuss in this letter is the relationship between stock values and interest rates, and we wanted to join every other company in the world to show that Artificial Intelligence is going to affect our future. It remains to be seen how creative or “original” Artificial Intelligence will be, but over time we believe it will get better, more interesting, and more prevalent in our lives. Now back to our point on interest rates with our words, not Bard’s.

As interest rates increase, fixed income investments become more attractive. In addition, with high quality bonds, FDIC insured Certificates of Deposit and U. S. Government securities you will not only recover your investment back but also you get a decent return.



Fixed income securities do have risks. But certain risks, like credit risk can be mitigated by only investing in high-quality debt instruments. Interest rate risks and inflation risks can also be reduced by investing in the short and medium term.

Callahan Advisors has always believed that stocks provide the best return over the long term, but as we all grow older the long term becomes shorter and market losses may not always be recovered. Nevertheless, we believe that a sound investment philosophy involves taking your risks with stocks and minimizing your risks with investments in fixed income securities. Accordingly, we are delighted that with rising interest rates investors can have decent returns on fixed income investments as opposed to what we have been living with in the last fifteen years of exceptionally low interest rates. Those years were great for stocks but terrible for the risk averse.

We are all grateful for the returns that stocks like Apple, Alphabet (Google), Amazon, Microsoft, Facebook (Meta), Stryker, United Healthcare, NextEra Energy, Exxon, et al. have given to us, but we are happy that we can now own investments that do not fluctuate as much.

In summary, we believe that your risk tolerance trumps all. The shorter your investment horizon, the more likely you are likely to seek safe, fixed income investments. The longer your investment horizon is the more likely you are to tolerate valuation fluctuations as an option.

We have said before that the pain of a loss supersedes the joy of a gain, but the risk of loss is the price we should be willing to pay for the ability to achieve our financial goals.

As always, we are grateful for your support, and we welcome any of your comments and questions.



## Appendix A: Google Bard

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How do interest rates affect the stock market?

There are a few ways that interest rates can affect the stock market:

- **Cost of capital:** Interest rates are the cost of capital for businesses. When interest rates rise, it becomes more expensive for businesses to borrow money, which can reduce their profits and make their stock less attractive to investors.
- **Valuation:** Interest rates also affect the valuation of stocks. When interest rates rise, the present value of future earnings falls, which can lead to lower stock prices.
- **Economic growth:** Interest rates can also affect economic growth. When interest rates rise, it can slow economic growth by making it more expensive for businesses to invest and consumers to borrow money. This can lead to lower corporate profits and lower stock prices.

How do rising interest rates affect the stock market?

Rising interest rates can have a negative impact on the stock market. This is because higher interest rates make it more expensive for businesses to borrow money, which can lead to lower corporate profits. Lower corporate profits can then lead to lower stock prices.

In addition, higher interest rates can make it more attractive for investors to put their money in bonds instead of stocks. This is because bonds typically pay a fixed interest rate, which is not affected by



changes in the stock market. As a result, investors may be less willing to buy stocks when interest rates are rising.

How do falling interest rates affect the stock market?

Falling interest rates can have a positive impact on the stock market. This is because lower interest rates make it less expensive for businesses to borrow money, which can lead to higher corporate profits. Higher corporate profits can then lead to higher stock prices.

In addition, lower interest rates can make it less attractive for investors to put their money in bonds instead of stocks. This is because the yield on bonds will fall when interest rates fall. As a result, investors may be more willing to buy stocks when interest rates are falling.

### Conclusion

The impact of interest rates on the stock market is complex and depends on a number of factors. However, in general, rising interest rates tend to be bad for stocks, while falling interest rates tend to be good for stocks.

There are a few reasons why interest rate hikes can have a negative impact on the stock market. First, higher interest rates make it more expensive for businesses to borrow money, which can slow down economic growth. Second, higher interest rates can make stocks less attractive to investors, as they can offer lower yields than bonds.

However, it's important to note that the relationship between interest rates and the stock market is not always straightforward. In some cases, a rate hike can actually boost the stock market, if it's seen as a sign that the Fed is taking inflation seriously.

Ultimately, the impact of interest rate hikes on the stock market will depend on a number of factors, including the overall health of the economy and the pace of inflation.

### Here are some of the key takeaways from the recent interest rate hike:

- The Fed is committed to fighting inflation, even if it means raising rates more aggressively than expected.
- Higher interest rates will likely slow down economic growth, but they could also help to cool inflation.
- The stock market is likely to remain volatile in the near term, as investors adjust to the higher interest rate environment.

**Investors who are concerned about the impact of rising interest rates on their portfolios should consider the following strategies:**

- Rebalance their portfolios to include more defensive assets, such as bonds.



- Consider investing in dividend-paying stocks, which can provide a steady stream of income even when interest rates are rising.
- Be patient and stay focused on the long-term. The stock market has always recovered from periods of volatility, and it's likely to do so again in the future.

**For more information on how to manage your portfolio in a rising interest rate environment, please consult with a financial advisor.**

**Here are some additional factors that could impact the stock market in the coming months:**

- The pace of economic growth. If economic growth slows significantly, it could lead to a recession, which would be a negative for the stock market.
- The direction of inflation. If inflation continues to rise, the Fed may be forced to raise interest rates even more aggressively, which could further dampen economic growth and the stock market.
- The outcome of the upcoming midterm elections. If the Democrats lose control of Congress, it could make it more difficult for the Fed to raise interest rates, which could lead to higher inflation.
- The geopolitical situation. The ongoing war in Ukraine and the recent COVID-19 lockdowns in China could both have a negative impact on the global economy, which could also hurt the stock market.

Overall, the outlook for the stock market in the coming months is uncertain. However, investors who are prepared for the possibility of higher interest rates, slower economic growth, and geopolitical instability should be well-positioned to weather the storm.

**In addition to the above, here are some other things to keep in mind:**

- The stock market is cyclical, and it's normal for there to be periods of volatility.
- The long-term trend of the stock market is up, so investors who stay invested over the long term are likely to see positive returns.
- It's important to have a diversified portfolio, which can help to reduce risk.
- Investors should monitor the economic environment and the stock market closely in order to make informed investment decisions.

**Here are some additional thoughts on the impact of interest rate hikes on the stock market:**

- The impact of interest rate hikes on the stock market will vary depending on the individual stock. Some stocks, such as those in the financial sector, may be more sensitive to interest rate changes than others.
- The impact of interest rate hikes on the stock market will also depend on the overall health of the economy. If the economy is strong, then the stock market may be able to withstand higher interest rates. However, if the economy is weak, then the stock market may be more vulnerable to interest rate hikes.
- Investors should monitor the economic environment and the stock market closely in order to make informed investment decisions.