

Forces that Move Stock Prices

By James A. Andrews

Among the largest forces that affect stock prices are inflation, interest rates, bonds, commodities and currencies. At times the stock market suddenly reverses itself followed typically by published explanations phrased to suggest that the writer's keen observation allowed him to predict the market turn. Such circumstances leave investors somewhat awed and amazed at the infinite amount of continuing factual input and infallible interpretation needed to avoid going against the market. While there are continuing sources of input that one needs in order to invest successfully in the stock market, they are finite. If you contact me at my web site, I'll be glad to share some with you. What is more important though is to have a robust model for interpreting any new information that comes along. The model should take into account human nature, as well as, major market forces. The following is a personal working cyclical model that is neither perfect nor comprehensive. It is simply a lens through which sector rotation, industry behavior and changing market sentiment can be viewed.

As always, any understanding of markets begins with the familiar human traits of greed and fear along with perceptions of supply, demand, risk and value. The emphasis is on perceptions where group and individual perceptions usually differ. Investors can be depended upon to seek the largest return for the least amount of risk. Markets, representing group behavior, can be depended upon to over react to almost any new information. The subsequent price rebound or relaxation makes it appear that initial responses are much to do about nothing. But no, group perceptions simply oscillate between extremes and prices follow. It is clear that the general market, as reflected in the major averages, impacts more than half of a stock's price, while earnings account for most of the rest.

With this in mind, stock prices should rise with falling interest rates because it becomes cheaper for companies to finance projects and operations that are funded through borrowing. Lower borrowing costs allow higher earnings which increase the perceived value of a stock. In a low interest rate environment, companies can borrow by issuing corporate bonds, offering rates slightly above the average Treasury rate without incurring excessive borrowing costs. Existing bond holders hang on to their bonds in a falling interest rate environment because the rate of return they are receiving exceeds anything being offered in newly issued bonds. Stocks, commodities and existing bond prices tend to rise in a falling interest rate environment. Borrowing rates, including mortgages, are closely tied to the 10 year Treasury interest rate. When rates are low, borrowing increases, effectively putting more money into circulation with more dollars chasing after a relatively fixed quantity of stocks, bonds and commodities.

Bond traders continually compare interest rate yields for bonds with those for stocks. Stock yield is computed from the reciprocal P/E ratio of a stock. Earnings divided by price gives earning yield. The assumption here is that the price of a stock will move to reflect its earnings. If stock yields for the S&P 500 as a whole are the same as bond yields, investors prefer the safety of bonds. Bond prices then rise and stock prices decline as a result of money movement. As bond prices trade higher, due to their popularity, the effective yield for a given bond will

decrease because its face value at maturity is fixed. As effective bond yields decline further, bond prices top out and stocks begin to look more attractive, although at a higher risk. There is a natural oscillatory inverse relationship between stock prices and bond prices. In a rising stock market, equilibrium has been reached when stock yields appear higher than corporate bond yields which are higher than Treasury bond yields which are higher than savings account rates. Longer term interest rates are naturally higher than short term rates.

That is, until the introduction of higher prices and inflation. Having an increased supply of money in circulation in the economy, due to increased borrowing under low interest rate incentives, causes commodity prices to rise. Commodity price changes permeate throughout the economy to affect all hard goods. The Federal Reserve, seeing higher inflation, raises interest rates to remove excess money from circulation to hopefully reduce prices once again. Borrowing costs rise, making it more difficult for companies to raise capital. Stock investors, perceiving the effects of higher interest rates on company profits, begin to lower their expectations of earnings and stock prices fall.

Long term bond holders keep an eye on inflation because the real rate of return on a bond is equal to the bond yield minus the expected rate of inflation. Therefore, rising inflation makes previously issued bonds less attractive. The Treasury Department has to then increase the coupon or interest rate on newly issued bonds in order to make them attractive to new bond investors. With higher rates on newly issued bonds, the price of existing fixed coupon bonds falls, causing their effective interest rates to increase, as well. So both stock and bond prices fall in an inflationary environment, mostly because of the anticipated rise in interest rates. Domestic stock investors and existing bond holders find rising interest rates bearish. Fixed return investments are most attractive when interest rates are falling.

In addition to having too many dollars in circulation, inflation can also be increased by a drop in the value of the dollar in foreign exchange markets. The cause of the dollar's recent drop is perceptions of its decreased value due to continuing national deficits and trade imbalances. Foreign goods, as a result, can become more expensive. This would make US products more attractive abroad and improve the US trade balance. However, if before that happens, foreign investors are perceived as finding US dollar investments less attractive, putting less money into the US stock market, a liquidity problem can result in falling stock prices. Political turmoil and uncertainty can also cause the value of currencies to decrease and the value of hard commodities to increase. Commodity stocks do quite well in this environment.

The Federal Reserve is seen as a gate keeper who walks a fine line. It may raise interest rates, not only to prevent inflation, but also to make US investments remain attractive to foreign investors. This particularly applies to foreign central banks who buy huge quantities of Treasuries. Concern about rising rates makes both stock and bond holders uneasy for the above stated reasons and stock holders for yet another reason. If rising interest rates take too many dollars out of circulation, it can cause deflation. Companies are then unable to sell products at any price and prices fall dramatically. The resulting effect on stocks is negative in a deflationary environment due to a simple lack of liquidity.

In summary, in order for stock prices to move smoothly, perceptions of inflation and deflation must be in balance. A disturbance in that balance is usually seen as a change in interest rates and the foreign exchange rate. Stock and bond prices normally oscillate in opposite directions due to differences in risk and the changing balance between bond yields and apparent stock yields. When we find them moving in the same direction, it means a major change is taking place in the economy. A falling US dollar raises fears of higher interest rates which impacts stock and bond prices negatively. The relative sizes of market capitalization and daily trading help explain why bonds and currencies have such a large impact on stock prices. First, let's consider total capitalization. Three years ago the bond market was from 1.5 to 2 times larger than the stock market. With regard to trading volume, the daily trading ratio of currencies, Treasuries and stocks was then 30:7:1, respectively.

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