FAQ: Interest Rate Movements & What They Mean for Investors

Interest rates impact our finances in many ways. For unit trust investors, changes in interest rates could affect the performance of selected unit trust funds as well as the overall pace of economic growth.

1. What are interest rates?

An interest rate is the price charged by a lender to a borrower for the use of funds. For borrowers, the interest rate is the cost of servicing their debt; while for savers, it is the rate of return on their deposits.

2. How are interest rates determined?

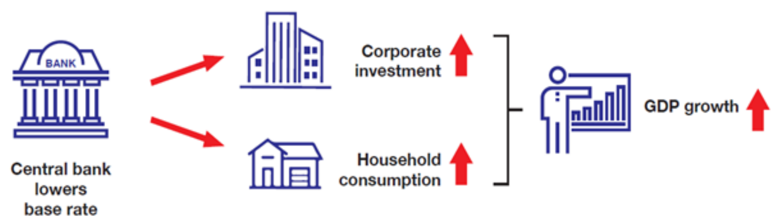
The base rate set by a country's central bank serves as a benchmark for interest rates offered by commercial banks. The central bank lowers the base rate when it seeks to stimulate the economy. Likewise, when the economy is showing signs of overheating amid rising inflation, the central bank may raise the base rate to slow down lending activities. To reflect higher base rates, banks will increase the cost of borrowing, which tends to reduce credit demand in the economy.

3. How do interest rates affect the economy?

When interest rates are high, it makes loans less affordable while higher rates on deposit accounts encourage savings rather than spending. Consequently, slower spending may affect the economy as moderating demand for goods, services and corporate investments will eventually impact businesses as well as employment levels.

In comparison, lower interest rates make borrowing cheaper while savings become less attractive with lower deposit rates. As a result, households and corporations are likely to increase their spending. With the growth in demand for products and services, the economy grows as businesses expand and boost employment levels.

Impact of Lower Interest Rates on the Economy



4. What do interest rate trends mean for investors?

Essentially, changes in interest rates potentially affect the outlook for the economy and financial markets. For example, when interest rates are reduced, listed companies with debt will benefit from lower borrowing costs. The valuations of stocks will generally be re-rated positively in an environment of lower interest rates as operating cash flows of listed corporates are valued more favourably when discounted at lower interest rates.

On the flip side, higher interest rates increase the cost of borrowing for companies, causing them to slow down their capital expenditure. The valuations of stocks will generally be reduced in an environment of rising interest rates as operating cash flows of corporates are valued less favourably when discounted at higher interest rates.

For bond investors, a decline in interest rates is positive for bond prices as bond yields and bond prices are inversely related. This is because the prevailing coupon payments become more attractive as interest rates decline. Likewise, when interest rates rise, bond prices tend to fall as coupon payments made by an existing bond will be deemed less attractive relative to the higher interest rates.

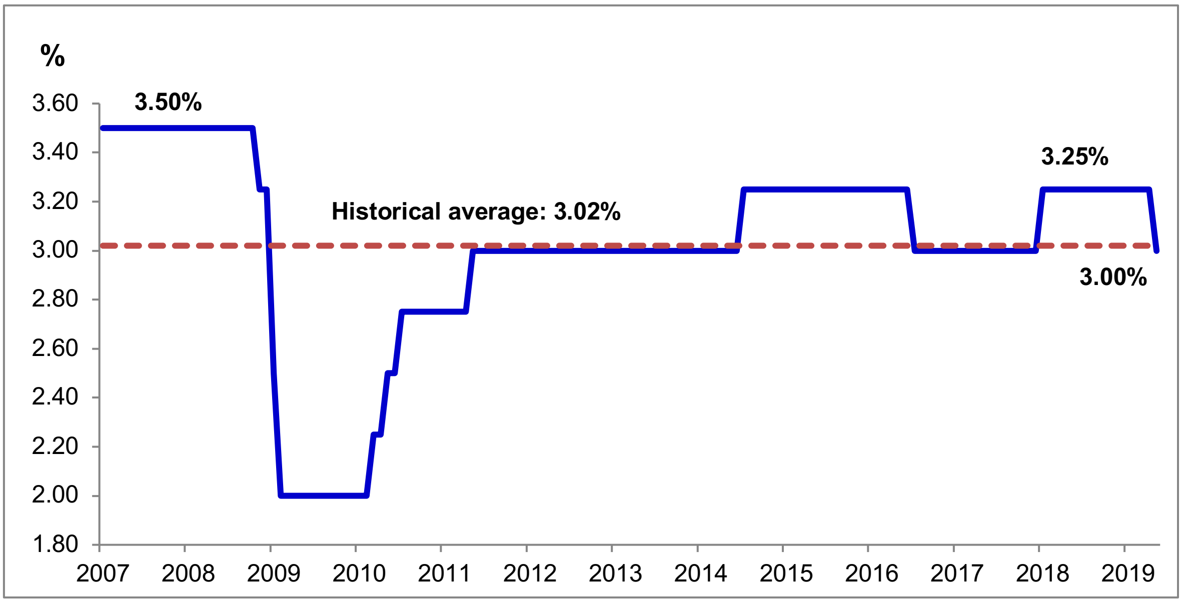
5. What affects the trend of Malaysia's Overnight Policy Rate?

The central bank of Malaysia, Bank Negara Malaysia (BNM), sets the Overnight Policy Rate (OPR) as one of the key monetary policy instruments to achieve price stability and sustainable economic growth. Given Malaysia's fairly open economy with close links to global trade and financial activities, global economic and financial conditions can often influence BNM's decisions on the OPR.

When the global economy entered a recession during the 2008-2009 Global Financial Crisis (GFC), the Malaysian economy slowed amid a contraction in exports. In line with global central banks' easing policies, BNM lowered the OPR by 150 basis points (bps) between November 2008 and February 2009 to help the economy recover from the GFC. More recently, in May 2019, the central bank cut the OPR by 25 bps to 3.00% to mitigate the impact of global trade uncertainties on the local economy.

On the other hand, positive developments in a robust economic environment may provide room for the central bank to raise the OPR to ensure consumer price levels remain stable.

Figure 1: Overnight Policy Rate Trend



Source: Bank Negara Malaysia

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