

# Macro market analysis technique to outline a portfolio construction plan essay ex...

[Business](#), [Marketing](#)



Good Performance of the economy influences the success of the stock markets. If the economy performs poorly, stock markets will decline leading to decline in prices of shares traded in the stock exchange markets.

Operation of stock markets is usually governed by various economic stock agents who use economic indicators in forecasting the future trends in the stock exchange. These economic agents are mainly stock investors and their activities in the stock markets are a major determiner of the direction the market takes. They influence these activities by use of all available information determining the performance of the economy. If political turmoil is expected in a country, the share price goes down indicating pessimistic future expectations of the investors about the performance of the economy. Other economic indicators of the performance of the economy include the unemployment figure, consumer price index, renting rates of property and the gross domestic product of a country (Blanchard, 2008).

In US stock prices index is usually shown in the S&P 500 which is maintained by the Standard and Poor's. Gross domestic product measures a country's economic performance. GDP is a measure of the total income earned by all producers of a country regardless of their nationality, thus it comprises both the domestic income and income earned by foreign entities in a country (Barro, 2007). GDP and stock prices have direct relationship. GDP serves as an indicator of how health is economy of a country. Therefore stock investors would use rise in level of a country GDP as a good indicator that firms of a country are performing better. If firms perform better, they will reinvest their excess profits and this will boost their future earnings implying share earnings will be higher and hence increase in their prices. Increase in GDP

over years will also lead to an increase of stock market. This is because the purchasing power of consumers increases leading to excess earnings which they use for investment in stock markets. Thus when closely analyzed, economy measured by GDP and stock prices represented by the S&P 500 shows that the two affect each other. S&P 500 tends to lead the GDP and its effects are usually observed after 10 quarters. GDP tends to lead the S&P 500 and its effects are realized after around 16 quarters thus there exists a vicious circle between the two which observed when the economy is performing well and when it is performing poorly.

### **Relationship between stock markets, Bond markets and interest rates:**

Bond markets and stock markets are correlated in a complicated way while the two have direct relationship with interest rates. Bond markets comprises of the general government bonds and corporate bonds. When bond market stocks rise, investors in stock markets tend to transfer their investments in stocks which are having higher returns (Blanchard, 2008). This results to low demand of stocks and consequently their prices crash. In fact the government uses government as a tool for combating inflation during periods of high inflation rates. The government offers attractive interest rates and investors shift their investments to government bills and bonds. When the interest rates in bonds crashes, investors will shift their investments to stock markets and this leads to increase in price of stocks. Thus the two are inversely correlated. Interest rates affect bonds and stock markets in the same manner but for different reasons. When interest rates fall, both bonds and stock markets prices tends to rise and they fall when

interest rates rise (Mishkin, 2005). Bonds have fixed interest rates and thus they are interest rate sensitive financial instruments. Increase in interest rates makes them unattractive to investors since they have fixed interest rates. When interest rates go down, investors divert their investments in stocks in order to earn more profits. Institutional investors also borrow at low interest rates and invest in stocks to earn the margin spread thus pushing prices higher.

### **Historic impact of inflation on interest rates:**

Inflation is the general increase in prices of goods and services over a period of time and it is measured by the consumer price index or the producer price index. Inflation just like interest rates is measured in percentage and the two are directly linked to each other. Historically, Inflation increase has been used as a tool for adjusting interest rates. For example, if the US the federal government decides that inflation is high, interest rates are adjusted upwards to reduce the borrowing power of the citizens. This is because inflation is usually caused by increased borrowing power due to previous low interest rates leading to increase in supply of money more than the availability of goods and services that are being produced. When the interest rates are increased, inflation rates adjust downwards since people's borrowing power is reduced. Thus there is a general vicious circle between inflation rates and interest rates.

## **Historic impact of inflation rates and interest rates on equity prices**

Historically, interest rates have been pushed up by increase in inflation. Government response to curb inflation damages the economic market forces of demand and supply. Inflation leads to increase in corporate's earnings in the short period thus pushing its share earnings. This makes share earnings price increase. However, in the long run, once the government intervenes, the corporate's earnings are impacted negatively and this pushes the share price downwards. Increase in inflation will also make investors risk averse and this will drive risk premium high leading to a general increase in share prices.

## **Internal activities of a company**

Security prices tend to move tandem with internal activities of companies. Announcement of mergers, acquisitions, supernormal earnings and discovery of new resources tends to push the price of securities upwards. Unfavorable events lead to crash of security prices.

## **Currency Exchange Rates**

Changes in interest rates tend to change costs of establishing business in foreign countries (Mishkin, 2005). Increase in exchange rates tends to increase costs of doing business in a foreign country and this exposes the company to risk of low earnings and decrease in profitability cause decline in security prices. Thus exchange rates have direct impact on securities. Short term exchange rates are normally influenced by factors such as future trading and events.

## **References**

Barro, R. J. (2007). Barro, Macroeconomics. . Cambridge.

Blanchard, O. I. (2008). Macroeconomics . I: Prentice Hall.

Mishkin, F. S. (2005). The Economics of Money, Banking, and Financial Markets. New York.