Larry Tomaszewski *AXA Advisors LLC*

How the Fed and Interest Rates May Affect Your Investments

There is usually no shortage of news reports when the Federal Reserve Board (Fed) meets—especially if they decide to adjust interest rates. If you're wondering why the financial world watches the actions of the Fed and its chairman so closely, it's because their decisions may have an impact on the economy, the markets and even your investments.

The Federal Reserve System, the national banking system, was established by Congress in 1913 to keep the U.S. economy steadily chugging along. The chairman of the Fed's board of governors, currently Alan Greenspan, has been appointed chairman by three different presidents.

Driving the Economic Machine

The Fed is charged with monitoring the supply of money in the economy. It sets economic policy by setting the interest rates that banks charge one another for loans. Any rate changes the Fed makes can result in our overall economy speeding up or slowing down and, by extension, interest rate changes may also affect the stock and bond markets.

If the Fed lowers banks' rates, the effect may be lower interest rates on credit cards, auto loans and mortgages. Generally, that will mean that consumers and businesses may spend and borrow more, helping to give the economy a boost. This can also be healthy for the stock market, since lower interest rates make it cheaper for businesses to borrow the money they need to grow and for consumers to finance mortgages and other purchases.

Interest Rates and Inflation: What Goes Up . . .

On the other hand, when the Fed raises interest rates, businesses and consumers may borrow and spend less, slowing economic growth. However, a positive aspect of higher interest rates is that you may earn more interest on your investments. Why raise rates and slow growth? Generally because the Fed is concerned that too much spending and growth could lead to higher inflation. Conversely, too little spending and growth could lead to a recession. As watchdog of the nation's economy, the Fed meets every six weeks to review interest rates.

So the next time you hear reports about Alan Greenspan and the Fed, listen carefully. When the Fed changes interest rates, it's not just news on Capitol Hill—it could have an effect from Wall Street to Main Street.

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