# Rates, and what they do to an index

> **DISCOUNT RATE**
>
> The rate at which future profits are converted into a value today. When it rises, the same expected profits are worth less, so index levels can fall with nothing having happened to any business. It is the single mechanism behind most days when an index moves on news that mentions no company.

An index can fall hard on a day when every constituent is trading normally and none has reported anything. This is the mechanism, and it is worth understanding properly because it explains a large share of index-wide moves.

## Future profit, present value

A share is a claim on profits that mostly have not happened yet. Converting those into a value today requires a rate, and the higher that rate, the less distant profits are worth now.

Raise the rate and every share priced on future profit gets less valuable at once, in the same direction, for the same reason. That is what an index-wide move on a rates headline actually is.

## Why it is not only about the central bank's decision

The decision is usually anticipated. What moves markets is the change in expectations - the language, the projections, the vote split - because the price already contained the expected decision.

So an index can fall on a rate cut, if the accompanying language suggests fewer cuts to come than were priced. "The market fell despite a cut" is not a paradox; it is a statement that expectations moved the other way.

## The duration effect

Companies whose profits are mostly far in the future - fast-growing ones, typically - are more sensitive to the discount rate than companies earning steadily now. The same rate move hits them harder.

An index weighted toward long-dated growth reacts more to rates.An index weighted toward banks can react in the opposite direction, since higher rates can widen their margins.So two indices can move opposite ways on one rate decision, and neither is wrong.

Which is lesson 4's subject: the composition decides the reaction.

## What this licenses

Expecting index-wide moves around rate events, and knowing which of your positions are exposed to the same driver at once - module 4 lesson 7's exposure count, met again.

It licenses nothing about direction. Whether rates rise, and whether the market has already priced it, are not things a chart tells you.

## Check your understanding

### 1. Why can an index fall on the day of a rate cut?

a. Cuts are always bearish for equities
b. The cut was expected, and the accompanying language implied fewer cuts to come
c. Rate cuts trigger index rebalancing

Answer: b. The price already contained the expected decision. What moves it is the change in expectations, which can go the other way from the decision itself.

### 2. Why do two indices sometimes move in opposite directions on one rate decision?

a. One is calculated with a delay
b. Their compositions differ - long-dated growth and banks react to rates differently
c. Currency effects always dominate

Answer: b. Distant profits are more rate-sensitive, and bank margins can widen with rates. The composition decides the reaction, which is the next lesson.