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Higher Interest Rates are Coming

What Should You Do?

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This past spring I attended an annual meeting of a commercial bank. During the Q&A session, I asked the CEO what he most worried about. I expected him to say increased regulation, new internet-based sources of competition, staying current on technology, cybersecurity threats, or global geo-political uncertainly. But instead he was most concerned about how the Fed would unwind from the unprecedented seven year experience with ultra low interest rates. Since we have no history to help predict what will happen when rates increase, this bank CEO was concerned about how it will be done, and what unforeseen impacts will ensue.

For over 18 months, the financial news media has been overflowing with speculation about when interest rates will rise, and to a lesser extent, with the impact on the U.S. and global economy.

What Rates Will Rise and When?

Exactly what rates are we talking about? The discussion of rising rates almost always includes reference to the Federal Reserve. But the Fed does not control all interest rates. In fact it directly controls only two – the discount rate and the federal funds rate. The discount rate is what the Fed charges banks to borrow from it to fund shortages of cash. The discount rate is not a market rate (it is an "administered rate"), and borrowing from the Fed's "discount window" is rare. Thus the discount rate does not have a significant impact on other market rates.

The other interest rate controlled by the Fed is federal funds, and unlike the discount rate, the fed funds rate has enormous significance. Banks and other financial institutions actively trade with each other the balances that they hold at the Fed. This trading is usually overnight, and is done on an uncollateralized basis. The Fed controls the borrowing rate on these fed

funds by buying and selling Treasury securities, which either drains or adds to the stock of balances that are available to banks to trade with each another. When the Fed buys securities, it pays for those securities with cash (actually by crediting the seller's account) and thus adds to the stock of fed funds, which via the interaction of supply and demand will reduce the "price", or rate, banks charge each other for those funds. Conversely, when the Fed sells securities, it will reduce the stock of fed funds, and thus the rate for those funds will increase. Since December 2008, the Fed's target for the fed funds rate has been 0 – 0.25%.

The second major observation is that even though market observers talk about a rise in interest rates as if it is a virtual certainty, no one knows when it will happen. Speculation about rising rates has been going on for well over a year. There was talk of interest rates rising throughout 2014. Earlier this year, there was much discussion of rates increasing in June. While other market rates have fluctuated during the last couple of years, the Fed's target for fed funds has not budged. There is no guarantee when the Fed will push up the fed funds rate, even though the chair of the Federal Reserve, Janet Yellen, recently testified to Congress that she expects the Fed will do so later this year. Ms. Yellen qualified her comment by saying higher rates would be contingent on economic conditions (qualifying any forecast has become an art form for all Fed officials).

Impact of the Fed Funds Rate

When the Fed does increase its target for the rate on fed funds, what will happen to other interest rates? Which interest rates will rise along with the fed feds rate?

The most obvious rate that will increase, and it will be immediate, is the prime rate, currently 3.25 percent at virtually all banks in the U.S. For decades, the prime rate has moved in lockstep with the Fed's target fed funds rate. The formula is simple: the prime rate equals the target fed funds rate plus 3.00%. The "official" prime rate is understood to be what is published in the Wall Street Journal on a daily basis, which is based on a survey of the prime rate at a number of large U.S. banks.

Another important rate that will increase is Libor, which stands for London Interbank Offered Rate. This is the rate at which international financial institutions trade so-called Eurodollars, which have nothing to do with the Euro currency that is used by most members of the European Union, including Greece (for now). Rather Eurodollars are deposit balances denominated in U.S. dollars, but held at institutions outside the U.S. Eurodollars are traded at various maturities, generally one month to three months, although longer maturities do exist. The rate on Eurodollars, unlike prime, does not move in lock step with the fed funds rate, but the two are correlated. Libor has attracted much unfavorable news lately, amid allegations that certain traders have at times rigged this rate - many fines and lawsuits have ensued, and more will come. However, trillions of financial transactions world-wide are tied to Libor, so it has an outsized impact on the world economy.

Treasuries of short maturities (one year or less) will also tend to move up with the fed funds target, although the two are not correlated one-to-one.

The interest rate on loans (including credit card balances) tied to any of the above - prime, Libor, or U.S. treasuries - will increase. The rate on new borrowings will increase immediately. However, rates on

existing loans will increase only when they next reset – which could be immediately, months, or even years depending on the terms of the underlying loan agreement between the lender and the borrower.

Other Rates

What other interest rates may rise when the Fed increases its target for fed funds?

Deposit rates at banks and credit unions, such as checking accounts, money market accounts, and certificate of deposits, will increase. Historically, these have not risen in lock-step with other short term rates. Banks tend to lag increases in market rates. There are reasons to think this lagging behavior will be muted this time, as customers are armed with online information, and can move money from one place to another with ease. Thus, if banks want to retain their deposits, they might have to match their most aggressive competitors.

Any long-term rates (greater than 1 year maturity) on any type of dollar denominated securities will likely increase. There is some correlation between short term rates and long-term rates, but it is not one-to-one. There have been periods when short-term rates increase and long-term rates decline, and vice versa. Nevertheless, expect long-term rates to increase for all newly issued dollar based securities – corporate, municipal, federal agency and treasury bonds.

New fixed rate loans offered by banks, credit unions, mortgage companies, marketplace lenders, finance companies, pawn shops, etc. will rise (maybe not for pawn shops). Again, these rates tend to be correlated with fed funds and Libor, but the relationship is far from exact or predictable. Rates on new loans reflect factors such as the institutions' appetite for loans, cost of funding these loans, and rates and terms offered by competitors.

How Much and How Fast?

How much will the fed funds rate increase, and how fast will it go up?

Most observers expect the Fed to increase rates slowly and in increments of 0.25 – 0.50%, at least at first. Later increments may be higher.

The Fed will wait and watch after each increase, to evaluate the impact on the U.S. and global economy. This careful examination would indicate increases no more frequently than every 2-3 months.

Economic Impacts

Stronger Dollar:

- Higher rates will tend to strengthen the dollar against other currencies, as international money managers move funds from assets denominated in other currencies to take advantage of the higher interest to be earned on dollar-based assets.

- A stronger dollar has a downside. All other things being equal (which is never the case in the world of economics and finance), the price of exports will increase, which will reduce demand for those exports, which will not be good for US businesses that export significant amounts of goods and services. However, a stronger dollar will result in lower prices for imported goods, which is beneficial to U.S. consumers and businesses, leaving them with more money to spend on other goods. Which effect will have the stronger impact on the US economy? Hard to say. The impact on exports will likely be more immediate, whereas the value of lower import prices will take time to flow through the economy.

- The stronger dollar will make it less expensive to travel overseas, as long as you travel to a country whose currency declines against the dollar, as the Euro, Japanese yen, and most other currencies have done in the past 12 months.

- Conversely, the stronger dollar will make it more expensive for foreigners to travel to the U.S. (again, as long as their home currency declines against the dollar). Companies that benefit from foreign travelers should take note.

- Market rates and currency values tend to reflect expectations as well as current conditions. As a result, it may be that the dollar will not strengthen much, if at all, when rates increase. After all, dollar interest rates have not increased in the last year, but the dollar has strengthened significantly against most currencies.

Impact on Banks and Other Financial Institutions

- Banks will likely lose low cost deposit balances, which are the cheapest source of funds for their business. When market rates are miniscule, as has been the case since 2008, even financially sophisticated individuals and businesses leave money lying around in non-earning deposit accounts, because the opportunity cost of doing so is minimal. It's a lot of trouble to move money around to gain 0.02%. However, the incentive to move money increases as interest rates rise.

- Even with this impact on deposit balances, however, increases in rates are expected to benefit banks, as they have suffered margin compression for the past seven years. The yield on bank assets has declined by more than rates paid on deposits, as it is problematic to lower deposit rates below zero.

Impact on Savers and Investors

- The past seven years have not been kind to risk adverse investors. Rates on low risk assets, such as non-junk bonds, have been so low that they have led Warren Buffet to remark that such assets offer "return free risk". Investors have been motivated to pursue higher yields, and there is only one way to do that – by taking on more risk. It is not accidental that US stock markets have enjoyed record highs, as investors have piled into equities in the hope of achieving greater yields. This move into higher risk assets is the direct result of the market conditions created by seven years of minimal interest rates.

- Many observers, notably the Wall Street Journal, have argued that by keeping the fed funds rate so low for so long, the Fed has distorted capital flows, which has not only punished savers, but has had a dampening impact on economic growth. They are also concerned about asset bubbles in equity markets, which inevitably burst and wreak havoc on the economy. These observers welcome a return to more "normal" capital markets, where interest rates reflect market participants' views as to their true required return, adjusted for the credit worthiness of the borrower and inflationary expectations. In such markets, capital will be directed to uses based on what investors view as optimal, not what the Fed wants. If this happens, many observers see a downward correction in stock prices. However, they also foresee a pickup in economic growth from the improved allocation of capital to beneficial uses.

Conclusions

Even though no one knows when or exactly how, higher interest rates are coming. What can you do now to prepare?

- If you have been putting off overseas travel, consider taking that trip soon. The dollar may appreciate further, but it may be that the impact of higher rates has already been baked into the value of the dollar today.

- If you have been planning to buy a new house or condo, or refinance an existing mortgage, consider doing so now.

- If you expect to finance a major new purchase such as a piece of capital equipment or car, consider doing so now.

- If you, or your business, have borrowing arrangements that are floating rate and the need for those funds will continue for 3-5 years, consider replacing that debt with a fixed rate.

- If exports (or travel by foreigners to the U.S.) are a significant portion of your business, consider hedging your exposure to a stronger dollar. Currency hedging can be tricky, especially for individuals and small businesses, but there are strategies, such as using Exchange Traded Funds (ETFs), to mitigate the impact of currency fluctuations.

- If you buy a lot of imported goods and services, consider yourself lucky and enjoy the ride.

- If you manage a bank, credit union or savings and loan, revisit your deposit and loan pricing mechanisms. Carefully consider who your true competitors are, and whether you can afford to lag increases in market rates. In addition, do you have any opportunities to motivate borrowers to replace fixed rate loans with floating rate instruments?

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