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In Anticipation of Higher Interest Rates

On Jan. 20, 2017, Donald Trump will be sworn in as the 45th President of the United States. Two months prior, Wall Street began betting that interest rates are about to rise, with bets on U.S. short-term rates at $2.1 trillion. Expectations for a Trump presidency include a Federal Reserve that will be under pressure to raise interest rates in a way that hasn't been seen for more than a decade.

What will rising interest rates mean for investors?

There are simple answers and more complex "it depends" answers to the impact of increasing interest rates. The "it depends" answers reflect the uncertainty that surrounds interest rates and the economy. (1) Interest rates have never been held artificially low for such an extended time. (2) Abnormally low interest rates for eight years have been interwoven into the fabric of our economy in ways that may not be understood until they increase. (3) The economy will play an important part in the impact. While increased interest rates would be expected to lower spending, if inflation or a growing economy generates spending, the real interest rate (the nominal rate minus expected inflation) could remain relatively steady.

On the lines of historical expectations, increasing interest rates are typically a negative for stock prices. That may not hold true this time. Stock markets have reacted favorably to a Trump presidency, anticipating increased economic growth and higher inflation. Higher interest rates also indicate a return to normalcy after eight years of Federal Reserve funds rates at 0 and near 0%, which may give greater confidence to consumers and businesses.

Bonds are different. When interest rates rise, investment grade bond prices fall. Bond funds will reflect this reality in lower prices. How much lower will depend upon how much interest rates change. Held to maturity, bonds will still have the same cash value, but investors suffer an opportunity loss when their funds are not earning market returns. New investments in bonds, however, should realize higher returns as a result of increased interest rates.

Individuals with money in a bank account should benefit from rising interest rates, provided banks actually pass the extra interest on to savers.

Pensions funds and other institutional investors will have higher return, low-risk options when investing incoming funds, which should improve their performance.

There's typically little in the way of good news for borrowers when interest rates increase. Credit card rates already have a huge gap between interest rates and the rates charged cardholders and may not see much impact. Variable rate loans could see a noticeable interest rate increase when they adjust, and the cost of new loans will increase. Longer term loans, such as 30-year mortgages, tend to be more influenced by economic expectations. If the economy improves, borrowing costs for homes and cars would be expected to increase.

The biggest negative impact of rising interest rates will hit the biggest borrowers, which are almost inevitably governments, from the federal government down to the state and local levels. The federal government has approximately $19 trillion in outstanding loan obligations on which it pays more than $432 billion a year in interest. The states have an additional $4 trillion plus in outstanding loans. Higher interest rates will take their toll when outstanding obligations are rolled into new debt offerings, or additional funds are raised through new borrowing. An improving economy with increasing tax collections could offset higher interest rates, however.

Perhaps the biggest advantage of interest rate increases will be a return to market-controlled interest rates along with normal business and market cycles. The Fed's nearly a decade-long experiment with artificially low interest rates has failed to produce expected benefits and resulted in a bloated Federal Reserve balance sheet with more than $4.4 trillion in debt-backed securities of questionable value, the consequences of which are still to come. Or to put it a bit more harshly in the words of financial analyst and author John Mauldin;

"By lowering rates to the zero bound, the Fed stacked the deck in favor of a relatively small number of people who own the vast majority of financial assets. In so doing, it created the conditions for moribund economic growth, persistent unemployment and underemployment of working-class citizens, and impoverishment of savers, and decimated fixed-rate income returns of pension funds and retirement plans for the middle class."

It's time for a return to normalcy.

[1] Wall Street Is Betting $2.1 Trillion That U.S. Rates Will Rise, by Min Zeng, Wall Street Journal, Nov. 22, 2016

Brian Carruthers

Brian R. Carruthers, CFP®, CMT

Brian R. Carruthers & Associates
Your Conservative Advisory Firm Since 1990
301 Forest Avenue
Laguna Beach, California 92651-2115 USA

Telephone: 1-949-464-1900
www.gobcafunds.com
brian@gobcafunds.com