Investments: Interest Rates Rise

What To Do If Interest Rates Rise?

By: Joe the Investor

Interest rates have been very low for many years now. There has been talk about interest rates rising, which is evidenced by the bond market. What do you do with your money if interest rates rise?

There are several aspects of your money to look at when asking this question. The first area is debt. When interest rates rise, the cost of paying any kind of debt will go up on average. The exception might be credit cards, but the rate on this type of debt is very high to begin with. If you have debt, prioritize it into debt that has a fixed interest rate or a variable interest rate. The fixed interest rate debt is typically mortgages or loans with a certain time limit as per the debt contract. Variable rate debt would be lines of credit, or a mortgage that has a variable interest rate. The variable rates should generally be paid down first in the event of rising interest rates, since these will be affected the soonest. The fixed rates may be left until they are renegotiated, but thought should be given as to how you can pay the new interest rate when it comes into effect. If these fixed rate loans are years into the future, this consideration can be left until 1 to 2 years before the current rate expires. The next step is to choose the highest variable rate loans and pay them first. I would include credit cards in this list, as these tend to have the highest interest rates for most people. If you currently have variable rate loans, you can consider locking in a fixed interest rate for a longer time period. If you absolutely need a static payment each month and cannot afford a higher interest rate, this option would be a good idea for you.

The next area is your cash investments. Rising interest rates are generally good for savings accounts and GICs, as these would pay more interest. If you have money sitting in a bank account, and you have no other uses for the money, it should probably be left in the bank account or put into a high interest savings account which would pay more money as interest rates rise. Some bank accounts don't pay much interest, and this would likely stay the same even if interest rates start rising. If you have GICs that are fixed in length, you would usually have to wait until they expire before reinvesting the money. You would likely get a higher interest rate at that time, if rates have moved up as of the expiry date. If you have GIC's that are not locked in, or they can be redeemed at any time, you may want to redeem these when you see the posted rates higher than the rate you are currently getting. Make sure that when you renew this type of GIC that the new investment is still cashable and the holding period is short before cashing out. In periods of rising interest rates, you may find that you would have to keep renewing this type of GIC as interest rates rise to take advantage of higher rates. This process usually doesn't cost any fees and contains no additional risk, so renewing as interest rates go up is generally a good idea in this situation.

The following area is the fixed income portion of the investment portfolio. There are certain investments that will get affected more than others in the investment arena. The first thing to notice is “which interest rate is moving higher?” There are interest rates for 1 day deposits, 1 month, 6 months, 1 year and so on all the way out to 30 years in length. The Bank of Canada or U.S. Federal Reserve will announce the overnight lending rate, but the other interest rates are determined by the markets in which they trade. Sometimes the overnight rates may not change, but the longer term rates may change based on what the bond market perceives as the interest rate direction. This has happened recently as the United States 10 year bond rate has risen but the overnight rates have not changed. If you have fixed income investments, which include bonds, mortgages, or any type of debt where you are receiving the interest instead of paying it, you would be affected by a change in interest rates. This is because the interest rate is the “price” of your investment, and if the interest rate rises, the price of the debt security would fall. This translates into “it is cheaper to achieve the same interest received that it was when interest rates were lower”. If you are holding this investment until it matures, the prices will change, but you will not be affected because you are holding the individual bond. If you are holding a pool of bonds or mortgages, like a mutual fund, the securities would keep changing and so you cannot assume that you will get a certain amount of money at a maturity date. Depending on which interest rate is rising, you may or may not be affected. If you are holding the 10 year United States Treasury bond and the 10 year United States bond interest rate rises, you would be affected directly. If you are holding the 30 day United States Treasury Bill at the same time, this security would not be affected unless the 30 day rate has also risen.

Looking at the equities portion of the investment portfolio, interest rates will generally have an effect on stocks but the effect varies depending on what type of company it is. It should be noted that higher interest rates in general take more money out of people’s pockets, thereby reducing economic growth all else being equal. This is like saying that a lower tide lowers all ships – but not equally. The equity markets in general tend to go down when there are interest rate increases, but not all equities get affected the same way. The more the company is affected by debt and interest rates, the bigger the reaction of the stock price to an interest rate move. For example, a bank that makes money on mortgages and issues interest on GICs would make less profit with higher interest rates. An industry that is highly leveraged like a hedge fund, would find borrowing more expensive which would limit the ability to amplify profits on borrowing. Home builders and auto makers generally decline when interest rates rise, because homes and cars get more expensive for the consumer, and sales will decline. If you already have a home or a car, it will also get more expensive to keep these items. The same trend tends to happen with industries that rely on homes and cars: furniture, appliances, large electronics producers, renovations, and so forth. If the industry does not get affected by interest rates, like perhaps food, utilities, water or companies working for fixed costs that are paid in advance, these stocks would have much effect. There also some exceptions that rise when interest rates rise – these would be companies like alcohol, tobacco, basic food producers, utilities or gambling companies. When the economy gets worse, which usually happens when interest rates rise, companies that flourish that counteract the economic slowdown.

What about real estate? As was noted above, higher interest rates will tend to make real estate more expensive because borrowing is often associated with buying and keeping real estate. The correlation is not always direct or instantaneous, meaning that sometimes interest rates may rise for months before real estate prices show any effect. Unlike the equity or bond markets, people take more time to deal in real estate because it is less liquid, and because a real estate transaction is usually given much more thought because it is quite expensive for most people. Exceptions might be rental units, apartment buildings, foreign real estate in areas where the interest rates are not in effect, senior homes, medical facilities, or government owned real estate.

What if I own hard assets like art, precious metals, collectibles etc.? These types of goods will be driven the perceptions within their markets. If a lot of wealthy people own art, and they have paid cash for their art, and they have plenty of disposable income and no debt, interest rates will likely have no effect. The same idea may apply to precious metals and collectibles. If the reason why interest rates are rising is due to inflation, these goods may rise in price in conjunction with the inflation. Since these are physical goods, they actually counteract inflation. If interest rates are rising due to economic rebalancing, there may not be any effect for these kinds of goods.

In the case of annuities, pension payouts, CPP or OAS payments, these can be viewed the same way as bonds. The wrinkle here is that if you are receiving the annuity, and the company paying you the money has guaranteed a fixed amount each year, an interest rate rise would affect the issuers' ability to pay you. Only if there is a drastic change in the company's condition as a result of an interest rate rise will this have any effect on the payments received. If you are not receiving payments but a total value of these payments instead, which is similar to the price of a bond, then you may lose money because higher rates would make the value of that payment go down.

As you can see, what to do with your money will depend on what it is invested in, and how interest rates would affect it. As with most things, there are no absolutes and no guarantees – there are generalities with some exceptions that can exist. This article provides a starting point to dig deeper into what you may have to get more prepared for possible outcomes.

Contact me, Joe Barbieri by email at joetheinvestor.today@gmail.com, or by telephone at 647-286-8020 for an independent consultation on what these options are. **Note: This site is intended for people who want to learn about the world of investments and how to research for themselves. If you would like to buy or sell investment products, or specific advice on investment products, tax or legal issues, please consult your investment advisor, accountant or legal counsel.**