The impact of higher interest rates.

Interest rates will almost undoubtedly going up during the course of 2022, for the first time in three years. The Federal Reserve is expected to raise its benchmark interest rate by 0.25% next week to curb inflation, which is running at a 40-year high. Additional hikes (anywhere from five to seven) are likely later this year. Inflation hit 7% year over year, the national unemployment rate dipped below 4%, the Federal Reserve said it plans to terminate asset purchases in March and the Federal Open Market Committee on January 26 said, "It will soon be appropriate to raise the target range for the federal funds rate." The Fed started, to raise the discount rate in March (the rate the Fed charges banks for borrowing at the Fed's discount window) and the "federal funds rate" (the target rate it pays on reserve balances). These raises by the Fed mean banks and others will charge higher interest rates to consumers and businesses and may have a significant potential impact on investors. So, what impact can we expect?

American households will feel that policy impact in many ways, both positive and negative, according to financial advisors. The Fed raising rates touches pretty much every single corner of the economy.

Loans

Higher interest rates translate to costlier financing for borrowers. That's true for mortgages, student loans, auto loans, credit cards, margin loans on investment accounts and other types of debt. The higher rates go, it's harder and harder to be a borrower". Let's say a consumer wants to buy a $500,000 home; they get a $400,000 mortgage at a 30-year fixed rate. They would pay about $80,000 more over the loan's term and about $200 more each month with a 4% mortgage rate relative to 3%, for example.

Income qualifications and down payments increase with mortgage rates — meaning new home buyers may want to speed up their search so they don't get priced out of the market. Consumers shopping for a new car should also expedite that process to avoid pricier car loans. It may also be a good time for investors with margin loans on their brokerage accounts to focus on paying down that debt. Borrowers with variable interest rates on should also weigh refinancing to a fixed rate now or trying to pay off their debt more quickly. However, would-be homebuyers should still be in a good financial position to make a purchase. As a matter of fact, rushing to save money by buying could result in you ending up in financial hardship, which could be much more expensive in the long run. On the positive

side, higher mortgage rates may cool off a hot housing market and bring home prices back down to earth.

Jobs and wages

However, lower demand may impact jobs and wages in certain parts of the economy. High demand for workers and a limited supply of labor have led to record job openings and fast wage growth in recent months. People have gotten used to it being the first worker-friendly hiring climate in a while, but that dynamic may shift with higher interest rates.

Savings accounts

Consumers will likely see higher bank-account interest if the Federal Reserve acts. Online banks offering high-yield accounts tend to pay higher rates than traditional banks, according to advisors. Rates on other savings accounts like certificates of deposit would also rise. The gains likely won't be immediate, though. It generally takes several months to a year for banks to raise rates on savings accounts.

Investments and Corporations

Higher interest rates will likely pressure growth stocks, according to financial advisors. Such stock is issued by companies that have the potential to grow at an above-average rates relative to the broader market. These firms (the classic ones being the big technology companies) thrive when interest rates are low because they can invest in innovative projects more cheaply. It could be a rough road ahead for growth stocks. Investors may inadvertently be overweight in growth stocks due to big returns in that portion of their portfolio. They should allocate more money to value stocks — the easiest way being the purchase of a value-focused mutual fund or exchange-traded fund. In summary, value stocks are more likely to outperform growth stocks in a rising interest rate environment. With growth stocks also much more significantly overvalued than value stocks, at present, relative to measures of valuation over the past 30 years, there is even more optimism for the outperformance of value stocks, relative to that of growth stocks, over the next five to 10 years.

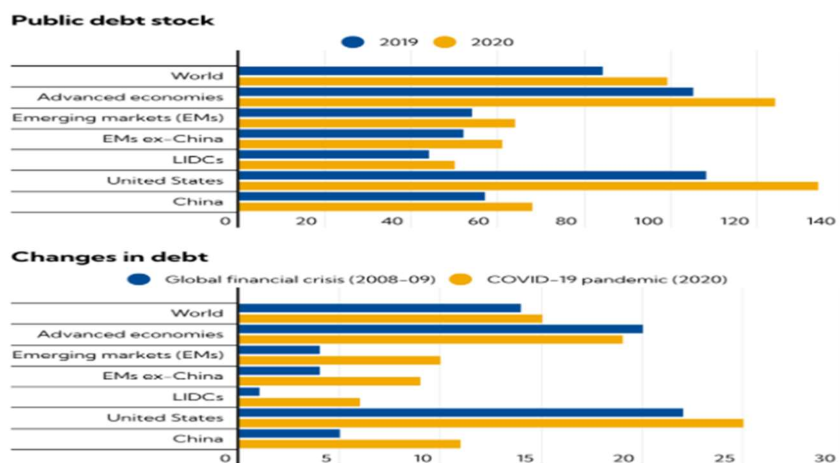
Bonds will also likely lose money in the short term. That's because bond prices move opposite to interest rates. The dynamic is more pronounced for bond funds with a long duration (those with bonds maturing in 10 years vs. 1 year, for example). If you have to pay for college or buy a house in a year, you shouldn't be thinking, I can't lose money in bonds. However, in the long term, higher interest rates ultimately mean higher returns for bond investors; new bonds are issued at higher yields that correspond to prevailing interest rates.

The cost of credit for corporations for all types of borrowing will increase. The prime rate (the lowest rate banks charge on short-term loans to large and financially stable corporations) were at a quite low 3.25% but have been increased in March and expected to further take the elevator in the months to come. Depending on loan amount and term, many variable loan rates are tied to the prime rate plus 2.25% to 4.75%. Corporations that issue bonds are likely to see costs increase in the future if the Fed aggressively increases short-term interest rates. By historical standards, corporate borrowing costs remain low, and in past years, many corporations took advantage of low interest rates to issue longer-term bonds. For most corporations, only a modest negative profit impact is expected in 2022. Any rate rise would have a larger impact in the following years as lower yielding bonds mature and are replaced. Bottom line: profit margins might very well be impacted.

National debt

Around 60% of debt to GNP (Gross National Product, a slightly larger measurement than the GDP since it also includes profits from capital held abroad) is regarded as the healthy way to generate enough economic growth for years to come. As in the case of countries with a much higher ration, the future inflation might generate the vicious effect of being able to only re-imburse past interests. Interest rate hikes from the U.S. Federal Reserve and other central banks are therefore likely to worsen a global debt crisis, particularly for developing countries, according to a new report from U.K. non-profit the Jubilee Debt Campaign. The Federal Open Market Committee meets this week to decide the path for its tightening of monetary policy as it looks to contain soaring inflation. Some analysts are expecting the central bank to hike rates four times from their pandemic-era lows in 2022.

In a report published Sunday, the Jubilee Debt Campaign highlighted that developing countries' debt payments rose 120% between 2010 and 2021, and are currently at their highest since 2001. The average portion of government revenues channeled toward external debt payments increased from 6.8% in 2010 to 14.3% in 2021, with payments shooting up in 2020. The sharp increase in debt payments is hindering countries' economic recovery from the pandemic, the report suggested, and rising U.S. and global interest rates in 2022 could exacerbate the problem for many lower income countries. The International Monetary Fund said last week that Fed rate hikes could "throw cold water" on already weak recoveries in certain countries. Higher U.S. interest rates, and thus a rise in the dollar, could make it more expensive for countries to meet their dollar-denominated debt obligations. The debt crisis continues to engulf lower income countries, with no end in sight unless there is urgent action on debt relief. The debt crisis has already stripped countries of the resources needed to tackle the climate emergency and the continued disruption from Covid, while rising interest rates threaten to sink countries in even more debt.



…and ultimately, inflation itself

The reason the U.S. central bank raises interest rates is to cool the economy to tame inflation. If the policy has its desired effect, consumers should see recent rapid price increases for food, clothing, and other goods and services begin to moderate. This knock-on effect stems from higher borrowing costs. Costlier financing translates to less investment from consumers and businesses, which cools demand in the economy and tamed prices.

Marcello Tedeschi, April 11, 2022