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What now with Rates? Still expected to rise?

In December, for the first time in seven years, the Federal Reserve increased the Federal Funds rate -what bank's charge each other for overnight loans- and by extension, the Prime lending rate.

The former was raised from zero to .25%, pushing Prime from 3.25% to 3.50%.

Then the global economy showed signs of wheezing in the 4th quarter, particularly China, the main growth engine of late. And the stock market reacted with a correction in January that continues today.

Taken together, there are many who feel that raising interest rates any further is premature. But then, few outside of the Fed ever feel as if the time is right for increasing rates. It's the Fed's job to take the proverbial punch bowl away before anyone has had too much (they have had mixed results in performing that mandate, see housing/mortgage crisis 2008-12).

If you allow for any inflation at all, then a healthy credit market will pay interest rates north of the near zero rate it has been paying on short term funds since the Great Recession.

This first increase to the Fed Funds rate and the commitment to more increases signals the economy and the banking system have finally strengthened enough that free money is no longer needed.

There are a couple of interest rate indices that businesses should monitor to evaluate the cost of borrowed funds: The Prime lending rate, currently at 3.5%, and the 10 year Treasury rate, currently at a remarkably low 1.71%.

The Prime rate is what the strongest of businesses are charged for short-term loans.

The 10-year Treasury bond is the rate that lenders will often use to base a longer-term fixed rate loan to businesses.

If you add 2-4% to the 10-year treasury, you get an idea of the range of rates most private businesses pay to borrow for terms from 5-10 years (3.75%-5.75% today).

The financial impact of the 25 basis points increase to short term rates is negligible, and has in fact been offset by the impact of the 10 year Treasury falling by more than 50 basis points over the last two months.

You have to go back to the mid 1950s to find the Prime rate as low as it is today and has been since the Great Recession. A more normal range for the Prime rate over the past 50 years is above 5%. So money is still a relative bargain when compared to conditions over the past 50 years.

Bear in mind that the Federal Reserve can more easily impact short-term rates by raising the Federal Funds Rate. The Fed's ability to influence long-term rates is limited, but takes place through their purchasing of large quantities of government debt.

So how high and how fast will rates rise?

After surveying the opinions of market experts and market media, from Bloomberg Business to the Wall Street Journal, the majority of market observers believe that the Fed Funds rate will be raised another two times in 2016, by 25 basis points each time. This same pace is expected to take place in 2017, such that short term rates will rise by 1.25% over 24 months from the initial increase. Expect the Federal Funds rate in 2017 to be 1.25%, and the Prime Rate to reach 4.0%-4.5%.

None of these rate increases will have a direct bearing on long-term rates.

Most important to the direction of long term rates will be the degree of safety global investors seek in US dollar investments, the level of inflation, and the expectations of inflation going

forward. Most pundits cite the lack of any inflation momentum and the continued flight to the safety of dollar denominated investments as reasons why long term rates will not rise as quickly as short-term rates. Many feel that short-term rates may rise by 1.25-1.75% over the next 2 years, while long term rates may add 75 basis points.

The upshot to all of this?

If you have debt on your business, and expect to take many years to repay, it would be a good idea to fix the rate today on as much of this debt as possible. While that may increase the rate slightly on the debt initially, it will save money in the years ahead when rates may be appreciably higher.

Thanks for reading. Please let us know if you would like our help on improving your borrowing rate and terms.

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