



Investment Insights

Kevin Kennedy

Rising Interest Rates: What It Means to You

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Interest rates are on the rise. After a four-year decline to 40-year lows, rates have begun a steady rise over the past 16 months, affecting everything from mortgages to the yield on your money market fund. Rising rates can help some people, while they are an economic drain on others. With the forecast of continuing rising rates for the foreseeable future, let's take a look at where this change in trend will impact you most.

Good news for savers

If you're a saver, rising interest rates can be great news. After suffering through interest rates below 1% on many certificates of deposit (CDs) and money market funds, yields have finally risen to a point where the interest you're earning is becoming meaningful again. According to Bankrate.com, the nationwide rate on 1-year CDs has more than doubled from 1.6% to 3.6%, over the past year and a half. And money market rates are up a similar amount. With the rise in overall rates in the economy, all types of corporate and government bonds have also seen a jump in yield. This is great news for those living on the interest earned on deposits, and hopefully signals an end to those "lean years" where the interest you earned barely covered the bills.

For savers and investors, now is a good time to evaluate your strategy in buying CDs and bonds. The sharp drop in rates most dramatically impacted those who prefer short-term investments like 3-month CDs. When rates dropped, the yields on those securities were immediately impacted, and as short-term CDs came due, investors were faced with renewing at much lower rates. Now is the time to consider strategies like "laddering" your portfolio by investing in securities of varying maturities. Spread out your investment dollars over a timeframe that's comfortable for you, and invest equally in all maturities. For example, you may decide to invest in CDs up to five years in maturity. In this case, invest 20% of your money into 1-year CDs, 20% in 2-year CDs, and so forth. This will insulate your portfolio from sharp changes in rates, and provide a more steady and predictable flow of income, as only 1/5th of your savings will mature each year and need to be reinvested at current rates.

Bad news for borrowers

Rising rates can be disastrous for borrowers if not managed carefully. The doubling in short-term rates, and corresponding rise in loan rates, can make monthly interest payments skyrocket. The prime rate, the rate by which many loans are set, has risen from

4.25% to 6.75% over the past year and a half, a 50% rise. This is most immediately felt on loans like home equity lines of credit and credit cards. Americans tapped over \$670 billion in home equity last year, and with the rise in interest rates, this results in nearly \$2 billion in additional interest on those loans. If you have variable rate loans like these that are adjusted based on prevailing interest rates, consider refinancing to a fixed rate to lock in a manageable payment, or pay those loans off entirely to avoid the shock of rapidly building charges.

An interesting situation exists in the interest rate world today that creates a great opportunity for borrowers: although short-term rates have risen dramatically, long-term rates are essentially unchanged over the past year. This means that loans like 15- or 30-year fixed rate mortgages are still near record lows. You may consider converting from a variable rate loan to such a fixed loan to take advantage of this circumstance. Market prognosticators believe long-term rates are due for a rise, and recently signs of inflation in the economy have caused these rates to bump up a bit, so the time is now to make this type of move.

Act now

The forecast is for further interest rate increases, possibly before year-end, and this will exacerbate the trend already in place. We all hear about Federal Reserve Chairman Greenspan, and the moves he makes on interest rates, but it's important to translate this into your own financial situation and respond accordingly. Your banker, investment advisor, and mortgage broker can all be great resources to help you with this process, so tap the experts to determine the best approach for your situation.

Kevin Kennedy is president of Kevin Kennedy, LLC, a registered investment advisor firm in Alameda. Reach him at 510-748-1898 or Kevin@KevinKennedyLLC.com. Stocks, bonds, and mutual funds involve risk, including loss of principal. Past performance is no guarantee of future results.