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Interest rates: Are they ever going to go up?

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The pesky question we keep asking ourselves is when interest rates will rise. I, you, we all have said for several years that interest rate rise is inevitable, just around the corner. We have all been wrong. By now, we know this is not a normal market based process. The Federal Reserve Bank has and continues to manipulate what happens.

A quick refresher: After the Great Recession, the Fed started quantitative easing, that is, purchasing treasury bonds and mortgage-backed securities. They ramped up spending to $85 billion per month, in hopes of pushing bond prices up through demand, and therefore interest rates down for the long-term. While this effort certainly helped bring us out of the worst part of the recession, its impact lessened later on. It also has some potential negative ramifications including creating bubbles in bonds and some types of corporate debt.

Now that the economy is looking stronger, the Fed is "tapering" and has reduced its monthly purchases from the $85 billion to approximately $50 billion. This has driven long-term rates up slightly, but not dramatically and therefore not yet dampening economic growth. In short, tapering seems to be working without the negative impact of increasing long-term rates.

So, once again we "rate predicators" are puzzled. If tapering did not cause a significant rise in rates, then what happened? This is where it is important to distinguish between the long-term rates and short-term rates which include the Federal discount rates and Federal funds rates. The Fed has control over the Discount Rate, which it can raise or lower and which it uses to charge commercial banks to borrow directly from the Federal Reserve. It has a direct impact on bank lending, and particularly mortgage rates related to real estate. The Federal Funds Rate is similar to the discount rate, but it relates more to banks willingness to lend to each other. Thus, when the Feds says it will keep rates near zero, it is talking about short-term interest rates, and it does have relatively autonomous control.

The disconnect between the short-term rates, which the Fed controls, and the long-term rates which it has influenced through bond buying, is part of the reason why we real estate people have been wrong about interest rate creep. As a result, we have become slightly more sanguine about longer term real estate investments. But we should be more aware about what rates actually are important.

Since August, the short-term Federal Funds Rates have remained at zero, while the long-term bond yield has increased to 2.7%. This suggests that banks are awash with funds they can loan for the short-term, but real estate investors should still be nervous about future long-term rates. In other words, it is still a crapshoot.

The latest rate strategy the Fed has taken is to continue tapering bond buying, while also making strong statements about keeping short-term interest rates at or near zero. The Fed believes that clarity and predictability will do as much to stimulate the economy as had the recent purchase of bonds. The more they repeat their stance, the more convinced we are. Thus, I believe real estate investors can continue to count on low borrowing rates in the 5-year term category. As we get near the 10-year borrowing period, coterminous with the 10-year Treasury note, we have reason to be more nervous. Longer term rates will climb, and the difference between short-term and long-term will increase, thus steepening the so call yield curve. The conclusion: Same as before. The Feds can control rates for the near future. Only significant employment gains, continued improvement in the economy, or potential signs of inflation would cause them to change direction. This should be comforting to real estate participants ...... at least for the time being.

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