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What will interest rates be? Not your father's loan package - by Daniel Calano

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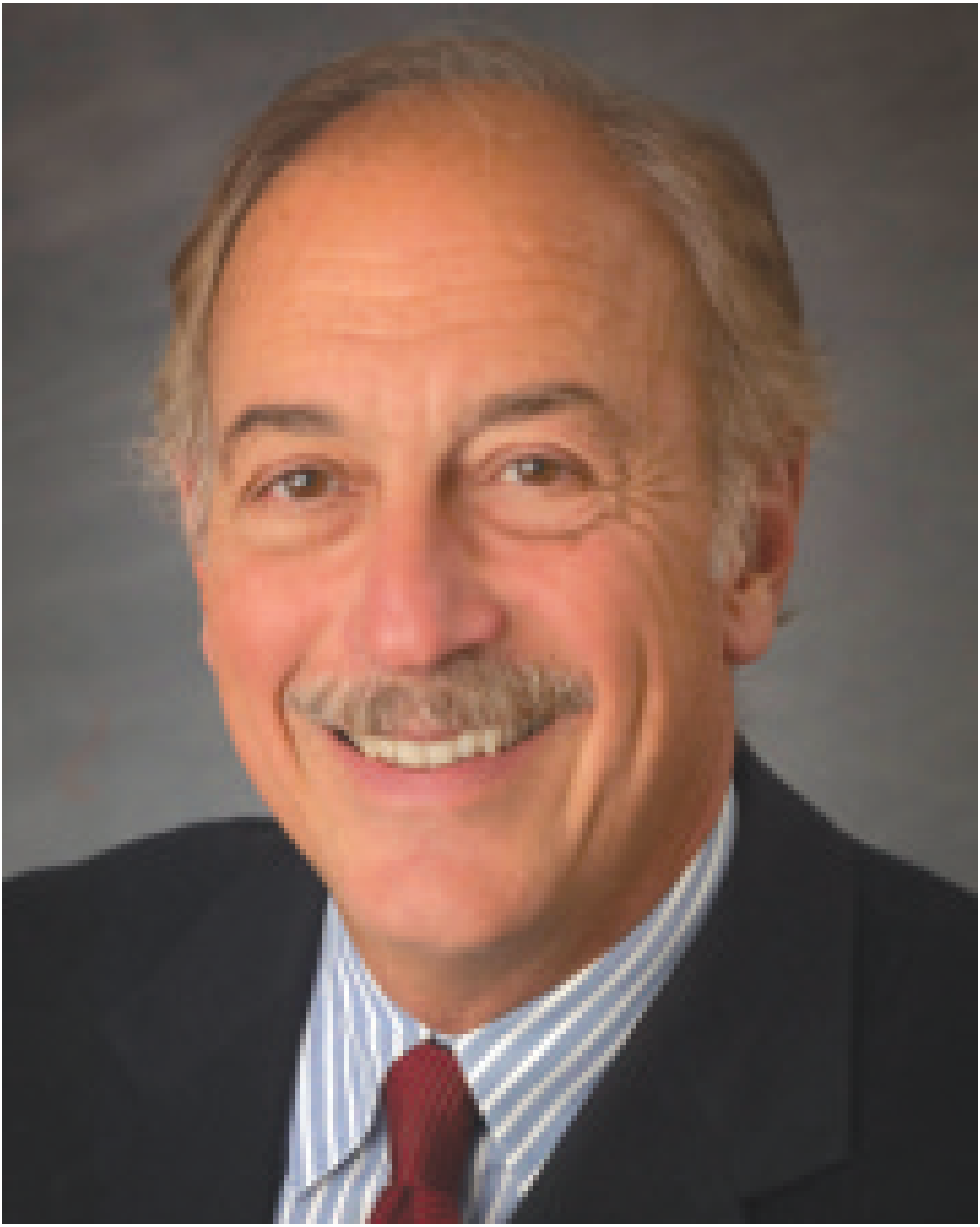

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Back in the good old days, and I do mean old, real estate planning was relatively simple: The key metric was location, location, location, later improved by timing, timing, timing. Yes, there was a nod to supply/demand analysis, and thus competition, but the data was not as available as you needed. The good news was you knew what the cost of money would be for the next 10 years, clearly 2.5% to 3.5%...right! It all seemed to fit conveniently on an Excel spread sheet.

Fast forward to today, and it is clearly a different game. Namely, you can still pick your location, but you have no idea what the interest rate will be in 10 years, let alone the current year. In fact, the interest rate in the next month could be higher or lower than today. It is simply that volatile. Most believe that we have a path, albeit twisty, on which to move forward. Not a superhighway, but a path. It is called the Federal Reserve Bank, and the cop in charge can determine whether he and his gang push the rate up or down.

We are all obsessed with the “Fed watch,” but wait, this obsession is only about the “overnight bank rate,” that is, the rate set for intra bank borrowing, hardly a rate you want to use in your spreadsheet. We need a long-term rate to rely on, right, the one we can fix for the 10-year period. While the long-term rate can move similarly to the short term, there is no guarantee. The real influencer is not the Fed chair, but is an amalgam of factors, mostly impacted by the bond market. You economists out there, please note that you know more, but the simple answer is as follows: the United States has considerable debt, some $30 trillion, with a typical increase of $1 trillion per year. The typical way to chip away at debt is to create and sell bonds, backed by the United States, at an attractive rate that will stimulate buyers at auction.

Here comes the tricky part. The major buyer is Japan, followed by a few other countries and institutions, followed by individuals wanting steady annual cash flow in the way of bond interest payments. In recent auctions, Japan has shown less interest in purchasing U.S. bonds than it has in the past. With less buying demand, the U.S. treasury will raise the interest rate to make it more enticing. In the process, the face value of the bond is lowered in the process. While the details are well below the scope of this article, suffice it to say that the credit of the United States goes a little lower.

So how does it relate to our real estate spreadsheet. The bond market is far more important than the ifs, ands, or buts of the Fed rate. Further, the loss of faith in the U.S. credit is causing rates to increase to stimulate purchase. In short, the long-term rates are likely to stay high, or even potentially increase. That said, the current strength of our economy is a very good offset to improve our credit around the world. Improved credit will increase bond demand and thus potentially lower the need for higher rates to be paid.

Clearly, nobody really knows in this volatile world. We haven’t even touched on the issues of wars around the world, financial interactions with other key economies, commodities fluctuation such as oil production/costs. The bottom line is: Don’t underestimate the cost of money in your spreadsheet. Overestimating is a better path now, so if rates are actually lower, your profits will be better than expected. It’s always better to over-estimate your costs and under-estimate your profit, pleasantly surprising your investors in the end.

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