

INTEREST RATES ARE GOING UP, BUT IT'S NOT ALL BAD NEWS

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The Federal Reserve has been raising rates. After years at zero, the Fed Rate is climbing. That change can have a significant impact on borrowing costs, but it is not all bad, as Fed Rate increases might have little effect.

According to Kenneth Kuttner¹ of the Federal Reserve Bank of New York, “Conventional wisdom is that an increase in the target Fed funds rate leads to an immediate increase in market interest rates and a fall in bond prices; yet evidence for this view is elusive.” While some studies in the 1970s showed proof of a connection, the reality is that when the market expects rates to increase, the impact of those rate hikes is actually minimal.

While interest rates will keep rising, for companies in the right position, there are some notable positives.

BORROWING COSTS

It is true that interest rates in the economy are highly correlated to the Fed Rate.² As the Federal Reserve raises rates, interest rates are going to go up across the board. Rates on mortgages and auto loans will go up along with the cost of credit. For companies considering a significant purchase, it makes sense to take out those loans before the rate gets too high. The impending increase in borrowing costs could be a catalyst.

REAL ESTATE

Real estate values are also impacted by rising interest rates.³ The value of an investment is the total of future cash flows, discounted to present value. As interest rates go up, the cash flow investors can realize from their real estate investments goes down, and that drives down the price of real estate. At the same time, as interest rates increase, investors may require a higher return on investment. Ultimately, this means that the value of real estate will go down as the Fed raises interest rates — making it the perfect time for companies to invest in buying property.

LIQUIDITY

Rising interest rates also require additional planning on the liquidity front.⁴ It is not unusual for consumers to spend less as interest rates go up. That means companies will enjoy less revenue — but forewarned is prepared. As interest rates go up, it can be a smart time to lock in a lower interest rate on a line of credit. Your company will be better prepared to weather any impending downturns and for less than you would spend if you tried to obtain a line of credit later on.

INVESTMENT

Low interest rates⁵ are generally tied to a slowdown in economic growth, which can, in turn, encourage savings and depress investment. The effect can take on a downward spiral, perpetuating itself — but when the cycle is broken, and interest rates go up, investment tends to increase. People stop saving as much money and start taking on risk, which includes private investment in small to medium-sized companies.



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CURRENCY VALUE

Companies that transact with suppliers overseas may experience another positive when interest rates increase — currency values go up. As interest rates grow, the value of the dollar typically goes up with it because people are more likely to save in U.S. banks and purchase U.S. bonds. The stronger the dollar, the more buying power domestic companies have.

Interest rates impact many areas of the economy, and they affect companies in a myriad of different ways. Borrowing costs will go up, real estate prices may go down, liquidity decreases, investment increases and currency values go up. For companies in a financial position to take advantage of these circumstances, interest rate increases can be a good thing — as long as they have the right bank in their corners.

To discuss these topics in more detail, please contact your PNC Relationship Manager.

- 1 https://www.newyorkfed.org/research/economists/medialibrary/media/research/staff_reports/sr99.pdf
- 2 <https://www.investopedia.com/articles/investing/010616/impact-fed-interest-rate-hike.asp>
- 3 <https://fundrise.com/education/blog-posts/the-effects-of-rising-interest-rates-on-real-estate>
- 4 <https://www.economicshelp.org/macroeconomics/monetary-policy/effect-raising-interest-rates/>
- 5 <http://wisburg.com/wp-content/uploads/2017/08/The-Low-Level-of-Global-Real-Interest-Rates.pdf>

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