

Up, Up and Away



May 2003

Financial positioning in a rising interest rate environment

With current interest rates still trending near 40 year lows, an obvious question begs: *when*, not if, will interest rates eventually rise. Because our subheading implies taking action, we approach this dialogue sooner, rather than later. In this month's *Fiscal Fitness*, we will discuss our thesis for rising interest rates and appropriate financial strategies. Not to worry: a boring, long-winded, economic dissertation will not ensue; rather, we offer a boring *short* one.

Considering the interest rate bellwether, the Federal Funds Rate, currently stands at 1.25%, any further significant rate cuts seem unlikely. The Fed doesn't have many (economic) bullets left so any further rate reductions will be used sparingly. Also, upward pressure on rates will occur from the need to finance expected federal deficits forthcoming. Estimates range anywhere from \$400 billion to well over \$1 trillion over the next 5-8 years, due to lower tax receipts generated from a weak economy. Additionally, events such as the Iraqi War/rebuilding and fiscal stimulus packages may prove to be costly government tabs paid by Treasury bonds. Lastly, the U.S. trade deficit continues to rise, meaning we are importing more than we are exporting. More dollars leave the country; hence the value of the dollar falls against other currencies. Theory suggests raising rates to make the currency more attractive.

That said, rates continue to stay low due to Fed fear that any increase in rates will have an adverse effect on an already fragile economy. As long as the economy remains soft with little inflation, rates will likely stay unchanged.

If you are a net saver (you have more money saved than owed), then you know the pittance that currently passes for money market rates. So rising rates wouldn't be so bad for you. Here are a few other suggestions in a rising interest rate environment:

- ✓ If you are one of the few who haven't refinanced your home within the last 3 years, consider doing so immediately. Fixed rate term loans at these levels are more prudent than adjustable rates. Variables such as the expected length of ownership and household budgets are an important consideration in what type of mortgage you obtain.
- ✓ Focus on paying off any adjustable rate revolving debt such as credit cards and lines of credit.
- ✓ If a large ticket item (i.e.: auto, appliances, golf clubs) is anticipated, consider buying it sooner rather than later to take advantage of low or no interest. But again, use debt sparingly and cautiously.
- ✓ Resist the temptation to reallocate your portfolio and investments entirely to bonds. While the financial scars from the current bear market may still be painful, don't compound the problem by chasing the current "hot" asset class. Depending on your investment goals, some exposure to bonds/fixed income can be wise. At these rates, we are currently suggesting bonds/bond funds with maturities/duration no longer than 6 years. Rising interest rates will negatively affect bond prices with terms longer than this.
- ✓ If current income is a main concern, consider some allocation to high yield, corporate bonds. We liken them to equities in drag. They have equity characteristics with a fixed income "kicker" in the form of high coupon payments. High yield bonds are not for everyone but if you feel the economy is recovering, you may be paid handsomely for taking the extra risk.
- ✓ One of our favorite current investment ideas is buying Treasury Inflation Protection Securities (TIPS). They pay income monthly and are revalued upwardly as interest rates (CPI) rise. Interesting, this investment class has also done well in a falling interest rate environment - as evidenced by its 8% annual return the last 5 years. A conservative yet prudent hedge.

While we would like to see short and long term interest rates low for a long time, that would suggest a continued sluggish economy. Instead, we vote for a robust economy and will accept the interest rate adjustment that would likely follow. Expect this eventuality and position yourself now to minimize any adverse effects later.

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