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Two Sides of the Same Coin

Central National Bank
Money for Life

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Mesopotamia 3000 BC. There's no air conditioning, the common cause of death was dysentery and there was no Walmart. Fair to say, life was rough. Back in those days families had to fend for themselves if they had any chance of living to the ripe old age of 35, which meant keeping the family farm going was essential and that was not cheap.

Enter Villager #1. Living high on the camel, this guy had baskets full of shekels to spare. Villager #2 needed to purchase a brand-new carbon-free plough and some climate friendly oxen for the farm. But, alas, #2 was short on cash. So, being a good neighbor, Villager #1 gave Villager #2 the shekels to purchase the necessary farming equipment in exchange for the return of his principal plus interest. Ta-dah! The first loan was created.

Since that time people have used lending to build businesses, acquire property and/or create cash flow through this mutually beneficial process. And while the principal amount loaned out can be jaw dropping at times, an equally if not more important part of this financial transaction is the interest rate.

In the modern world we have many different types of loans: mortgage, commercial, student, and agricultural just to name a few. The Lender, typically a financial institution, provides the Borrower, individual or entity, with funds to buy goods such as a home, business, land, etc. The Borrower agrees to pay back the loan amount plus interest. And when interest rates are low – Borrowers get excited.

Can you say "free" money? It wasn't that long ago when you could walk onto a car lot and drive away with a new vehicle and auto loan at 0 percent down and 0 percent interest. And no, the salesman was not high on that incredible new-car smell – pre-COVID, car dealerships were practically giving new cars away. And over the past decade life has been very good for Borrowers. People had access to money with little to no interest and as the old saying goes, "Why spend mine when I can spend yours?". And spend it we did.

But there is another side to the proverbial coin. For every Borrower who was thrilled that interest rates were at historic lows you had a frustrated Investor. Individuals and entities wanting to purchase fixed income products like certificate of deposits (CDs) and bonds, or make deposits into money market or savings accounts were being offered rates less than 1 percent. Investors accustomed to rates over 6 percent in the early 2000s were not only disheartened but many were forced to abandon their "safe" investment strategies for riskier investment options to make ends meet.

Regardless of which side of the coin you find yourself, Borrower or Investor, there are risks to consider when looking at interest rates.

The borrower

Evaluating the interest rate landscape in the short-term is prudent, but don't spend too much time trying to predict which way rates are going to move. You can sit on the sidelines for a very long time waiting for that "perfect" rate.

For most people, a loan with a fixed rate is the sensible choice especially if the term of your loan is longer than a few years. I don't know where rates will be in 20 years, but I'm pretty sure they will go up at some point during that time period.

You and your budget do not want to be caught off guard with an increasing loan payment. Explore the option to refinance if rates drop low enough; otherwise, lock it in, budget for the loan you've got, and get on with life.

The investor

Unless you plan on exiting this planet like it's 3000 BC, you must play the long game. Even the relative security of fixed income products come with their own set of risks that should be considered.

Issuers of CDs and bonds do their best to forecast where they think interest rates will be in 1-year, 3-years, 5-years and 10-plus years down the road. They want to make sure if rates dip suddenly, they can adjust their fixed income positions with minimal fuss. One of the ways they do this is to issue a callable CD or bond. This allows the issuer to "call" the CD or bond prior to maturity. For example, you purchase a callable CD that is paying 5 percent for 3 years. In year 2 the going rate for a new CD drops to 2 percent. That issuer can redeem YOUR CD prior to maturity. You receive your principle in full but now your only reinvestment options into another CD will be at an interest rate of 2 percent.

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The goal for most investors looking at fixed income products is to receive the highest interest rate possible. But in anticipation of future rate changes, Investors should be structuring their portfolios to allow CDs and bonds to mature at different maturity dates. Staggering maturities or laddering is a great way to create flexibility and re-investment opportunities. For example, you have three-, five-, and seven-year CDs, and rates are dropping. When the three-year CD matures you can consider alternative investment options while still holding the five-, and seven-year CDs which are earning a higher rate rather than having your entire portfolio exposed to a low interest rate market.

Regardless of which side of the interest rate coin you find yourself on, borrower or investor, there are ways to earn more or save more.

1. Consider your long-term goals.
2. Research current rate environment and take action.
3. Understand the limitations and restrictions of your loan or investment so you can make the right changes when rates do move.

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