

Getting the edge with managed funds

Getting interested in interest rates

What are interest rates?

Interest rates are the price of money or credit - or what you pay for borrowing money.

Interest rates rise and fall depending on a myriad of factors but critically on the supply and demand for credit. There are many interest rates, including: the price you pay a bank for a home loan; the (typically) higher price you pay for a personal loan; the price the Government pays the market for long-term loans; and the price companies pay for their short-term capital needs. Rates are typically much less volatile now than they were 20 - 30 years ago. Since the last peak in short-term interest rates in 1989 at over 18% pa, the cash rate has steadily declined, with just a couple of bumps, to a trough of 4.25% pa in 2002, and has since risen to 5.25% pa.

Interest rates are generally referred to as:

1. Short-term interest rates - which are influenced by the cash rate set by the Reserve Bank of Australia (RBA).
2. Long-term interest rates - which are influenced by the market in general.

Short-term interest rates

In setting short-term interest rates, the RBA considers:

- > the actual and potential strength of the Australian economy and the level of inflation
- > the maintenance of full employment
- > the stability of the Australian dollar

For example, the Governor of the RBA, Ian Macfarlane, announced a 0.25% increase in the cash target rate to 5.25% pa in December 2003. The reasons included:

- > economic conditions improving in the US and Asia
- > the Australian economy picking up strongly after the drought
- > inflation where the RBA wants it, and the risk that it might rise further if growth is not kept in hand.

Short-term interest rates feed through to financial products which have variable interest rates such as - investments (cash management trusts) and loans (variable rate mortgages and personal loans).

Generally, if the RBA increases interest rates, rates charged by banks and returns on cash investments increase by a similar amount. A 0.25% increase in the RBA's cash target rate usually results in standard variable mortgage rates also rising by 0.25%.

For most of us the biggest effect of increasing rates is the change in our mortgage repayments. The impact on mortgage repayments per \$100,000, repaid monthly over 25 years, is illustrated below:

Interest rate	Monthly repayment
6.75%	\$691
7.00%	\$707
7.25%	\$723
7.50%	\$739
8.00%	\$772

For larger mortgages, simply multiply the repayment figures. For example, double the figures in the table for a \$200,000 mortgage.

Long-term interest rates

Long-term interest rates are set by the market consensus - the investors who hold, buy and sell government bonds, including superannuation funds, investment managers, and overseas investors. The trading of government bonds by these investors determines their price - the interest rate or yield.

Apart from government bonds, long-term interest rates feed through to fixed deposits and fixed rate mortgages.

Again most of us notice the effect through our mortgage. With rising short-term rates many of us consider locking in part of our mortgage with a fixed rate. This can protect your exposure to rising interest rates, which can be particularly valuable for borrowers with very large mortgages. However, this decision requires careful consideration of the many factors involved.

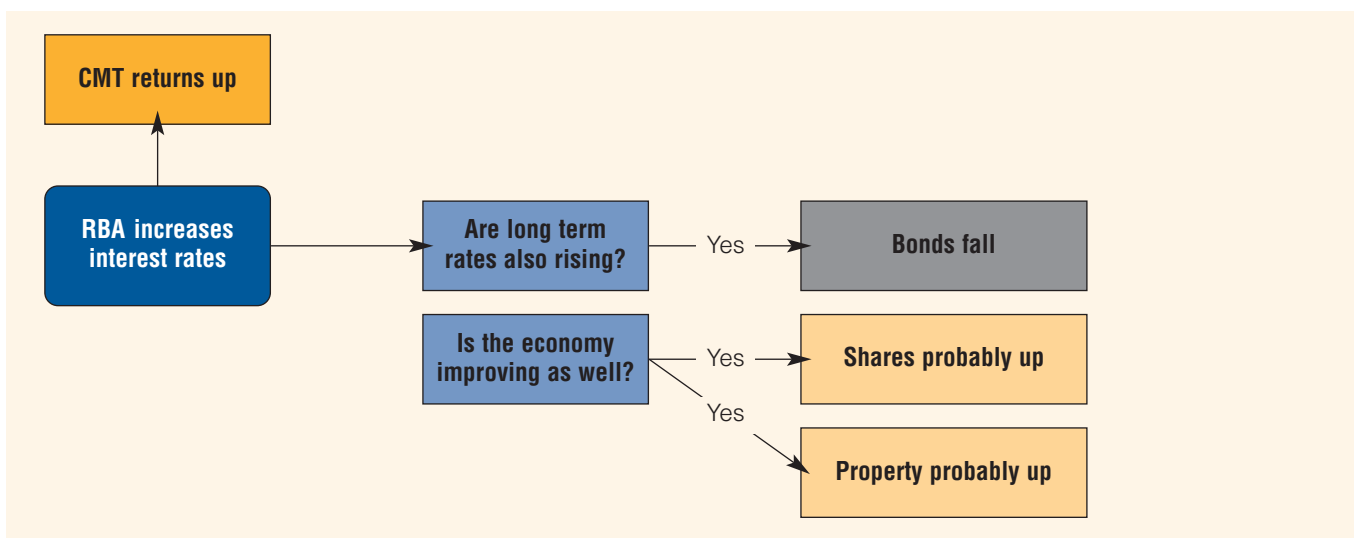
How do interest rate movements affect investments?

Interest rate movements have a complex effect on most investments; in fact there are only a couple of certainties:

- > when short-term interest rates change, cash management trust returns change in the same direction.
- > when long-term interest rates change, bond prices move in the opposite direction. Rising long-term rates mean that bond prices fall because a piece of paper promising 5% is worth less once pieces of paper promising 5.5% become available. Similarly falling long-term rates mean that bond prices rise.

For growth asset classes, what matters most are long-term not short-term rates, but the relationships are complex.

Probable effects of rate rises



As shown in the above diagram, if long-term interest rates are rising because the economy is improving, the market may come to the view that interest rates are rising for the “right” reasons. In that case, growth asset classes like shares and property might actually go up.

So investors have to assess the **net** effects of changes in long-term rates on their investments. They have to weigh up the positives and the negatives. During 2003 the positives outweighed the negatives, resulting in significant gains in shares and property.

To find out how interest rate rises could affect your financial position, including your ability to pay higher mortgage repayments, talk to a financial adviser. IFSA’s *Six Easy Steps* can help you find a financial adviser you feel comfortable with.