An Exchange of Opinions: #1
Where Are Interest Rates Going?
by Klarise Yahya, Commercial Loan Broker

If you've missed some of the prior articles, basic guidelines on successful investing are in my book "Stairway to Wealth" available at LuLu.com.

Questions of general interest will be addressed in this column. Due to space limitations, not every question asked can be discussed in print although I'll try to respond at least once to every phone call (818) 500-9966 or email KlariseYahya@SBCGlobal.net. This month's question comes from a recent conversation with J.B. (Santa Barbara, CA):

Q: Do you think inflation is going to be as bad as I've read? How about interest rates? I've been thinking about refinacing but rates have gone up before I could act. Do you think they've peaked?

Mortgage interest rates, both fixed and variable, are the sum of (a) the index and (b) the margin. The index is the "risk-free" rate the lender could earn in an alternative investment. A common index is the 10 year Treasury note. The margin is the premium above the "risk-free" rate required by the lender as incentive to make the loan.

Margins vary over time, but recently they've been about 2.5%. So the interest rate on an apartment loan might be 2.5% plus whatever the 10 year Treasury is yielding at that moment in time. Well, over the past 47 years the 10 year T-note has, if I remember correctly, averaged about 7.04%. This suggests that the average interest rate over the past four decades or more – index plus margin – would be around 9.54%. While there's been a recent uptrend in rates we're still well below that level.

Several things can be gleaned from this data. First, if you haven't refinanced yet, you've missed the recent lows but it certainly does not look like interest rates have peaked so there is still time to get on the train. Secondly, if the interest rate on the adjustable portion of your current loan can go much above the long term average you might wish to refi now and lock in the longest term fixed rate your building can qualify for.

Of course, if you think inflation won't be bad, then you will have a different opinion.

Inflation, both actual and projected, affects interest rates by raising the index (both on existing and on new loans) as well as the margin (new loans only). It can be a double whammy. After all, who is going to lend long term money at 6% if inflation has pushed the "risk-less" alternative up to 8%? And if inflation is high then can't we expect the margin to increase at least enough to offset inflation, if nothing else?

Obviously, the higher the interest rate the lower the loan amount. As a baseline example, if inflation is near zero yet 10 year Notes are paying 3.75% then our expected rate for a new loan would be about 6.25% (index plus margin). At this rate a $100,000 of net

operating income would support a loan of just over $1,000,000. Your existing loan is $900,000 so you can refinance and maybe get a little cash out.

If inflation went up two points then our index would presumably rise to at least 5.75%. One could probably expect the lender to ask for a higher margin just to protect their investment. Say the margin went to 3%. That makes the initial interest during the fixed rate period 8.75%. That same $100,000 NOI would now only support a loan of a touch under $850,000. Clearly, as inflation becomes factored into interest rates the loan any given building will support gets smaller, maybe even to the point that the new loan won't even be has high as the current one. The building would be "underwater".

The question now becomes what might we expect of inflation? In 1980 Time Magazine reported that *"Inflation and interest rates, both topping 18%, are so far beyond anything that Americans have experienced in peacetime – and so far beyond anything that U.S. financial markets are set up to handle – as to inspire a contagion of fear"*.

That was during the Carter years and his deficit, adjusted for population growth and inflation, was $60 billion in current dollars. That shortfall was paid for by "risk-less" government borrowing, which competed with the commercial bond market.

We are now in President Obama's time, and his deficit was recently projected by NPR to be $2 trillion. *Trillion!* That's over 30 times the Carter deficit, even after adjusting for population and inflation. To put this into perspective, the Carter deficit forced the Prime rate up from 6.25% to 21.50% in four years. And we are now staring at 30 times the Carter deficit. Most folks who reflect on this come to the conclusion that interest rates may very well top the Carter years.

But what if a series of miracles happen and inflation stays benign? What if, instead of leaving all this money sloshing about the system, a way could be found to reduce excess money and, as a consequence, inflation never goes above the current near-zero level? What happens to interest rates, then?

It is theoretically possible that the excess liquidity could be evaporated from the economy in a manner that does not significantly affect inflation. In this example, inflation becomes a fractional banking issue.

The first "banks" may have been German goldsmiths, in that their shops had to be secure and they offset the costs of security by accepting deposits for safekeeping. Then they would lend the deposits out and collect interest, giving a little of it to their depositors and keeping the difference. It was a very nice little side business. Now, of course, that has become the main business of Bank of America, Wells Fargo, JPMorgan Chase, et al.

At first the goldsmiths may have lent only a small portion of their deposits, say, 25%. If they held $1,000 on deposit, they could lend out $250. Thus, they took the risk that not

all their depositors would demand their money back at the same time. There would be no "run on the bank", as it were.

Over time, however, they found that was far too conservative. Precious few depositors ever took their money out of the goldsmith's bank. So the proportion of deposits that were lent out began to climb. If only one of 10 depositors demanded their money back at any given time, the goldsmiths could lend out ten times their deposit base. A $1,000 deposit would support $10,000 in loans. Voila! The modern fractional banking system.

Let's see. We have to pay 5% interest on the $1,000 … that's $50 a year. But we make $10,000 of loans and charge 9% interest on those. That's $900 a year. Nine hundred dollars in, $50 out. Not a bad little business, huh?

Now, we're going to make a hypothetical situation here. Say banks are currently required to have deposits at least equal to 5% of their loan book. That means every $1 of deposits supports $20 of loans. They practice fractional banking in a 20-to-1 ratio.

How does this affect the problem of reducing economic liquidity without feeding inflation? Well, what if the authorities reduced the maximum fractional banking leverage to 10-to-1? Not immediately, of course, but gradually over a year or so. Right now $1 million in deposits results in $20 million in loans. A year from now (remember, this is hypothetical), that same $1 million in deposits would only generate $10 million in loans. Hasn't at least some excess liquidity been removed from the economy? Doesn't that reduced the threat of inflation?

Well, yes to both questions, but it may not be helpful to us. Let me explain.

Even though inflation may not have increased, *interest rates surely would*. All these people out there clamoring for loans, and the banks can only supply half their loan needs. Who gets the money? Well, maybe borrowers requesting small loans secured by big assets? In technnical language, that's a loan-to-value ratio. After all, the bank takes less risk with a 50% LTV loan (the borrower is self-insuring the first 50% of loss) than with a 75% LTV (the borrower self-insures only the first 25%).

What other loan qualifiers might change? Location (which affects both occupancy levels and rental increases), certainly. *"Oh, your building is way over there? Sorry, that's out of our footprint.* Or what about condition? *"There's peeling trim paint? Sorry, we don't do peeling paint.."* Or borrower reserves? *"Ok, we'll do this loan if the borrower leaves 20% of the loan amount on deposit as offsetting balances. Don't have the money? Sorry. Next!"*

Even more onerous, with only half as many loans being made isn't it reasonble to think that interest rates will shoot up? Supply and demand, and all that sort of thing?

Now, does this mean that apartment buildings will automatically become poor investments? Not at all. With extraordinarily high interest rates, how many new buildings do you think will be built? Your existing apartments, although their value at least in the short run will probably be less than today, will have very little new competition.

Whether or not it's a good investment depends partially on the sort of mortgage you got when mortgages were available.

Klarise Yahya is a Commercial Loan Broker, DRE 00957107. If you are thinking of refinancing or purchasing five units or more, Klarise Yahya can help. Find out how much you can borrow! For a complimentary mortgage analysis, please call her at (818) 500-9966 or email at KlariseYahya@SBCGlobal.net.