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# The Interest Rate Dilemma

***By Rusty Tweed***

It's obvious that today's interest rates are dramatically low.   With one-year CDs paying 1.05%, 10-year US Treasuries paying 2.19% and 30-year mortgages at 4.07% (as of December 1, 2015, see www.bankrate.com) it's close to the lowest rates that we have seen in our lifetime.   This is great for borrowers, but a horror for savers and investors, especially the multitude of retirees who are living on their investments and savings and were counting on interest from their portfolio to give them extra income.  Truthfully, there are more problems being created by these unusually low rates than there are advantages.

As an investor, there are two issues that need to be closely looked at in this scenario.   First of all, how long are rates going to stay down? Second, what investment opportunities have been created by rates this low?

Let's take a look at the factors that have created these low rates in the first place.   We all know that we had a major crash in our economy in 2008 and that led the Federal Reserve to lower rates.   We all heard that the reason was to stimulate the economy.   The problem is that we've had these low rates for quite a while now and although the economy has been picking up, it's still got a ways to go. One would think that if low interest rates stimulate economies, our economy would be extremely stimulated by now, but that doesn't seem to be happening.

Let's look at the health of the US banking system.  In a "normal" economic environment less than 5% of US banks are on the Federal Reserve's watch list.   With the collapse of 2008 that spiked to 28% of US banks on the Fed's watch list and 60% that the Fed was concerned about.  That has improved markedly since then, but as of December 2014 there were still 15% of the banks on the watch list and 22% of concern.   (See Federal Reserve website www.frbsf.org CAMELS ratings)  So even though things have improved, the percentage of banks that are struggling is still way higher than normal.

Here's another amazing fact.   According to Zillow.com (you can log on and see their Negative Equity Report) as of 1st quarter 2015, the national negative equity rate, or the number of homes that have a mortgage greater than the value of the property, is still at 16.9% of all homeowners with a mortgage.  Even after four years of recovery, about 1 in 5 mortgage holders are underwater on their loan.

The point of this is that the banks are still struggling with a lot of issues and it's going to be some time before they have turned all this around.   In fact, I really think it's going to be at least 2-3 years before the banks are anywhere close to being normal.   This all points to interest rates staying low for some time.  Now with rates so low, investors and retirees are having a harder and harder time  generating income from their investments.   Where does one invest to get more than a 3.93% cash flow from fixed income or dividends?

Would you believe that the US Bond market at the end of 2014 according to www.sifma.org is $38.9 trillion dollars?  Everyday millions, if not billions of dollars of bonds are maturing that had much higher interest rates than what can be obtained today.  The owners of these bonds are now struggling to find a home for their cashed out funds that gives some sort of reasonable return.   This is causing a lot of money in America to "chase yields" (look for higher yielding investments).

A great example of this is the current apartment market.   Multi-family buildings have been bid up in price dramatically over the past several years.   Rental properties that would have sold for a 6 or 7% cap rate (Cap Rate is the Net Operating Income divided by the Fair Market Value of the property, this gives you the interest rate return from rents in relation to the value of the building) are now selling for 4 to 5% Cap Rates.  We've seen Cap Rates go as low as 3% in some markets.   So why would an investor be willing to buy a building with such a low return from rents when historically the income would have been much higher?   It's because alternatives such as CDs, bonds, etc. are so low that a 5% income from an apartment building seems great in comparison.  Plus, the apartment building potentially has a greater chance of appreciating than CDs, bonds, etc., but also a greater risk. So the apartment market is very strong right now, not only in LA, but over most of America.

This also is happening with publicly traded REITs (Real Estate Investment Trusts). REITs pay a dividend based on rents that are collected from the properties held in the REIT. According to NAREIT (National Association of REITs, www.nareit.com) the historical median yield from REITs has been 7.88%. , The average yield from REITs was only 4.00% as of Dec 2014. Similar to the apartment market, investors are willing to pay more for a REIT than normal to get the yield from the rents, since the alternatives are noticeably lower. In addition, the dividends being paid from REITs have some great tax advantages. Just as income from rental properties is sheltered from taxes due to depreciation of the building, a portion of the dividend from a REIT will also be sheltered due to the depreciation of the buildings held inside the REIT. This makes the dividend from the REIT even more attractive.

All these factors are making both good quality rental property and any investment based on rents - such as REITs - very attractive in today's low interest environment. All indications are that this could continue for the next several years as the Fed keeps interest rates fairly low.

As an investor, you need to be looking for assets that are paying a higher than normal income (without assuming too much additional risk) or investments that have a high likelihood of increasing the income, thus making the asset much more valuable in today's markets. Good quality rental properties may make the most sense to meet these requirements. There are many variations in rental properties, but the highest return strategy may be to find property that has lower than market rents and management determined to get the rents up to the average in the area, thus increasing the value of that property.

Naturally, there can be no guarantee that a rental property will achieve the return potential mentioned in this article, and real estate investments have a number of risk factors to consider including the potential for higher vacancy rates and maintenance issues. But in today's low interest rate environment, many investors find it worth investigating, on their own through a REIT, or with the assistance of a qualified investment adviser. If you would like more information regarding REITS, or a complimentary financial analysis, please give me a call at 800-526-1599.

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