OPINION

Prepare for five to 10 years of financial disruption from persistent high interest rates

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A vital detail is often missed when we talk about the coming decline of interest rates.

For sure, rates will come down. The aspect that needs more discussion is how far they fall. Some of the smartest people in money management recently weighed in on this subject with the ominous thought that we have reached the end of cheap money. In this case, cheap money refers to the low interest rates we had until last year.

Your investing preferences, costs and results will be affected if this outlook is correct, as will homebuying decisions and spending habits. Prepare for an impact on the taxes you pay, or on the level of government spending on services. The end of cheap money is good for savers and safety-first investors, but over all it means harder times in most other areas of personal finance.

Economists have raised the idea that persistent inflation will keep rates higher than we're used to, and now financial professionals are doing likewise. The end of cheap money was recently highlighted as a key trend over the next five to 10 years in a report from the CFA Institute called Future State of the Investment Industry. The report was based on views expressed in a global survey of more than 3,000 holders of the chartered financial analyst designation, which is high-level in the world of finance.

Interest rates were low before the pandemic and then fell further as central banks around the world worked to stabilize the global financial system. The CFA report says low rates gave people incentive to take risks with their finances.

The investing boom of 2021 was an example of risk-taking, and so was the concurrent housing boom. The risk in homebuying was exposed when mortgage rates jumped. Monthly mortgage costs have already risen by hundreds of dollars in some cases, and people renewing a mortgage any time soon will experience the same.

Cheap money built the housing market by keeping costs in the realm of affordability while prices increased. The end of cheap money raises questions about the capacity for the housing market to live up to past performance. Keep this in mind if you expect endless price gains to justify buying an expensive property.

Low rates also drove a lot of money into stocks in search of better returns, and that helped drive big gains for global stock indexes. The CFA report links these gains to intense interest in index investing, which in turn brought low fees to more investors. Index-tracking ETFs are much cheaper to run than funds where a portfolio manager actively makes buy and sell decisions.

The CFA report sees investors adjusting to the new normal for rates by continuing to favour money market funds more than in the low-rate era. We'll include investment savings accounts and high-interest savings account exchange-traded funds in this category. All offer returns in the 4.5-per-cent to 5.3-per-cent range these days, with minimal risk at most.

The report sees more opportunity for active fund management – the argument is that managers should be able to find value in today's high-priced markets. Hardcore indexers would counter that by noting the fact that buying into benchmark stock indexes has consistently delivered better long-term results. Regardless, active management costs more. Mind your fees if you put more active management into your portfolio.

An end to cheap money also affects governments, which until recently were able to borrow at low rates and almost painlessly finance deficits. The CFA report suggests a future where governments cut spending and raise taxes to improve their finances, which in turn dampens both economic growth and investing returns over the next five to 10 years.

Deficit reduction inhibits efforts to address economic inequality, the report notes. "As fiscal stimulus subsides, the potential for anti-capitalism backlash grows," it says. "Climate change and inflation disproportionately affect less affluent households, accentuating class divides."

The era of cheap money began about 30 years ago, after the previous outbreak of inflation was contained. A lot of the financial high points since then – strong investment returns, a roaring housing market – were fed by these low interest rates. So, too, was the bad habit of piling on debt at the household level.

An end to cheap money could bring more subdued returns, but also a more careful attitude toward debt. We may end up in a better place with that trade-off.

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