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Weekly Farm EconomicsManagement Implications of Non-Decreasing Interest Rates

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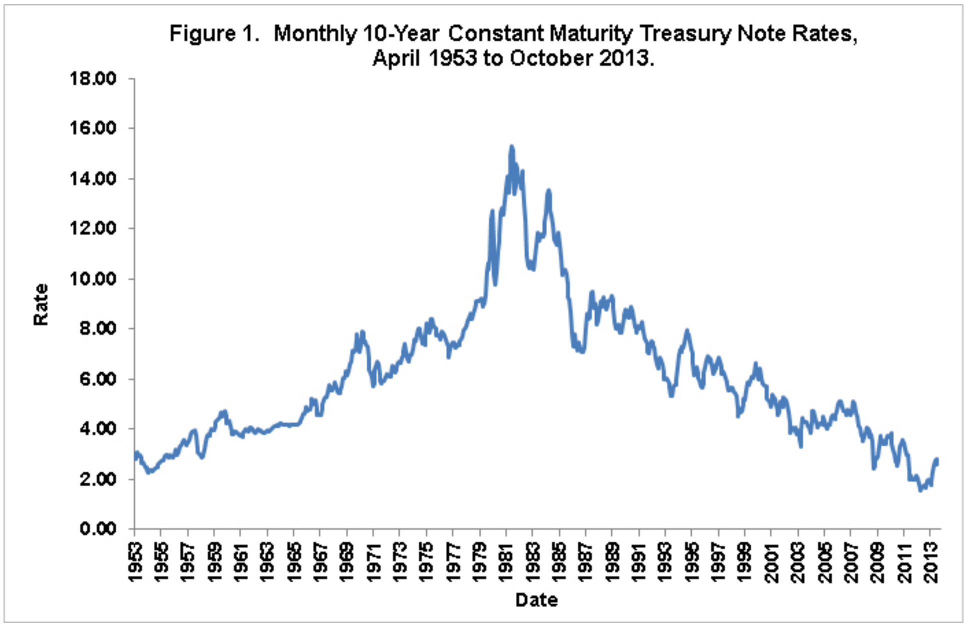
Since the mid-1980s, interest rates generally have been decreasing. This downward trend is not likely to continue as it is difficult to see how interest rates can decrease from their already low levels. Since interest rates are not likely to decrease further, the possibility of having lower interest payments in the future is not likely. As a result, additional caution may be warranted when making debt-financed investments.

Historical Interest Rates

Generally, interest rates follow the same general pattern as rates on the 10-Year Treasury. In Figure 1, 10-year constant maturity rates are shown from April 1953 through October 2013. As can be seen, there were two major periods during this time frame: a period of rising rates up until the early 1980s, followed by a period of falling rates from the early 1980s through the middle of 2013. There was variability within these two periods. For example, 10-year rates decreased for short time periods prior to the early 1980s, and rates increased for short time periods after the early 1980s. Overall though, there were two periods: a rising rate period up to the early 1980s and a decreasing rate period after the early 1980s.



Almost by necessity the period of decreasing rates has come to an end. From current low levels, it is difficult to see how interest rates could fall further. In fact, 10-year rates have increased slightly in recent months. Between May 2012 and May 2013, 10-year rates were below 2%. In June, rates climbed above 2% and increased each month until October: 2.30% in June, 2.58% in July, 2.74% in August, and 2.81% in September. In October, the 10-year rate decreased to 2.62%. Much of this recent increase can be attributed to Federal Reserve Board discussions of slowing Quantitative Easing, a program involving the purchase of longer-maturity bonds by the Federal Reserve designed to lower long-term rates.

The decreasing rate period coming to an end does not signal a period of rising interest rates. If certain Federal Reserve Board policy makers have their way, a protracted period of low interest rates could ensue. In her confirmation hearings for Federal Reserve Board chair, Janet Yellen indicated that she prefers to continue the period of accommodative monetary policy. If successful, this policy would lead to a protracted period of low rates, with rate variability similar to that experienced in the last six months. This protracted low rate period likely will occur, unless the economy unexpectedly grows leading to higher real interest rates or inflationary pressures grow leading to higher nominal rates.

Implications of Non-Decreasing Rates

Since the mid-1980s, marginal investment decisions have been aided by decreasing interest rates. For example, there may have been little margin in cash flows from a debt financed investment at the time the investment was original undertaken. Decreasing rates often led to lower interest payments after the investment, thereby causing cash flows to become more favorable.

From 1985 through 2013, 10-year rates decreased an average .26 percentage points each year, leading to a reduction of 1 percentage point every four years. It is unreasonable to expect similar reductions in the future.

Given the end of decreasing rate period, farmers may wish to build more safety margin in their investment decisions. It will be unlikely that decreases in rates will reduce debt servicing requirements in the future. Moreover, there is a risk of increasing rates, leading to larger fund requirements to service debt.

Summary

Some may have gotten conditioned by falling interest rates during the past three decades of decreases. Almost by necessity, the era of decreasing interest rates is ending. Therefore, debt servicing requirement made on investments today likely will not be decreased by falling rates. This suggests additional reflection when undertaking debt-financed investments.