WSJ

What Fed Rate Increases Mean for Your Financial Plans

How to time your financial decisions as interest rates rise

By *Julia Carpenter*
June 15, 2022 5:30 am ET
Wall Street Journal

The Federal Reserve is expected to raise interest rates Wednesday, stepping up its efforts to rein in inflation. The move will ripple through the financial world and the wallets of millions of Americans, changing the math on a range of money decisions big and small.

With inflation hitting 8.6% in May, the cost of everything from lawn care to air conditioning is on the rise. The Fed rate increases are intended to cool the economy and slow the runaway growth in prices. The market has been falling for several weeks as the Fed started to raise rates and on Monday, stocks entered into a bear market.

As rates rise, it makes sense to accelerate some financial plans and put off others, financial advisers say. Credit-card debt and other loans with variable rates are likely to get more expensive and should be dealt with first. When considering borrowing for major purchases such as a car or a home, it might make sense to delay.

“It’s important to really start thinking about what should be the optimal decisions, given that the interest rate environment is going to change so much going forward,” said Yiming Ma, assistant professor of finance at Columbia University.

Here’s how to rethink the order of operations for your money in both the short and long term.

Focus on paying down debt before it gets even more expensive

An increase in interest rates usually means credit cards will raise annual percentage rates, or APR. The average annual percentage rate for those with good credit was roughly 19%, according to WalletHub's June report on more than 1,500 credit-card offers. That number could go up, given the expected rate increase.

Higher rates mean the cost of borrowing goes up and nowhere is this more true than with credit-card debt. Fear of inflation and the threat of a recession could make people reluctant to dip into savings or other funds to pay down debt. But doing so now will still save you considerable future money spent on interest, said Peter Gallagher, founder and managing director of Unified Retirement Planning Group in Briarcliff Manor, N.Y.

"We've met people who have $200,000 in the bank account and $20,000 in debt. It doesn't make sense," he said.

Confused about which card to pay down first? Mr. Gallagher recommends starting with the higher-interest debt, then ordering your payments accordingly.

Maximize the return on your savings

Once you've paid down debt, look at your savings. One upside of a rate increase: Many banks and other institutions will likely offer at least slightly better rates on high-yield savings accounts and other savings vehicles.

Interest rates offered on many certificates of deposit and savings accounts will usually move with the federal-funds rate. During the pandemic, many Americans were able to save, leading to the highest personal savings rate in decades.

As of June 2022, the average annual percentage yield on a one-year CD is 0.21%, according to the Federal Deposit Insurance Corp., meaning any dollars saved there are losing value due to inflation. Online banks like Ally are also offering 0.9% for their high-yield savings products, and Goldman Sachs Group Inc.'s Marcus account is now offering 0.85%.

"If one has spare funds that you don't need to buy groceries, this is a good time to really think about where one can put that amount of money," Ms. Ma said.

Also consider the one true safe space from inflation and volatile markets: Inflation adjudged government savings bonds, or I Bonds, which currently return a guaranteed rate of 9.6% interest.

Consider whether to postpone certain financial moves

Just as you should give priority to paying down existing debt, think carefully before taking on any new debt, such as a mortgage or an auto loan.

The average rate on a five-year new-car loan was 4.53% the week of June 14, according to Bankrate.com, already up from 4% in March. Keep in mind individual lenders and dealerships can charge you different amounts. Be sure to do your own math before purchasing a vehicle.

Mortgage rates, however, are based largely on the yield of the 10-year U.S. Treasury bond. This rate is used as a benchmark for many types of loans, including mortgages. When the Fed raises rates, the increase pushes the yield on the Treasury note higher, which in turn pushes mortgage rates higher.

House hunters have already seen this at work—the average rate on a 30-year fixed-rate mortgage was 5.23% as of the week of June 10, according to Freddie Mac. Just a year ago, the same rate was 2.93%.

Applications for adjustable-rate mortgages are on the rise, but Mr. Gallagher cautions these loans come with particular risks as rates are rising. The interest rate on these mortgages is reset periodically and could grow considerably more expensive over time.

"It's sometimes hard to know what your cash flow will be in two to three years."

Ms. Ma advises house hunters to consider their own timelines more carefully. Waiting may feel frustrating in this hot housing market, but if fears of a recession ultimately come to fruition, then interest rates and house prices will likely move lower, she said.

If you feel a lot of pressure to buy a house as soon as possible—maybe you're in between places now or are putting your own home on the market—locking in a mortgage rate now might save you money down the line, before rates go up even more. But if you have some flexibility in your timeline, then waiting could benefit you as rates could drop in the future.

As for when rates will level off, Fed Chairman Jerome Powell said in an interview last month that economic data would be the guide. "What we need to see is clear and convincing evidence that inflation pressures are abating and inflation is coming down. And if we don't see that, then we'll have to consider moving more aggressively," he said.