

Financial Commentary

The Crescent Group at RBC

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Wealth
Management

Yielding to Risk

Depending on how much you follow the financial news, you may know that interest rates have moved up quite a bit over the past several months.

An important point to keep in mind is that interest rates act like gravity on the value of financial assets. Lower interest rates boost the value of financial assets, and higher interest rates pull down the value of financial assets. Speculation about where interest rates are heading causes investment markets to move up and down, which we have also seen happen over the past several months.⁽¹⁾⁽²⁾

You might be wondering how interest rates started moving up over the summer, months before the Federal Reserve officially increased its target interest rate on September 16th. Doesn't the Fed control interest rates? Well, the Fed does have a target interest rate, called the Federal Funds Rate, which it seeks to control through monetary policy. This is the interest rate that the Fed increased on 9/16. The fed funds rate then spills over to interest rates more broadly. So yes, the Fed does influence interest rates. But market forces can also cause shifts in interest rates without Fed action, and that's what we saw happen for a few months prior to the Fed's interest rate increase on 9/16.⁽³⁾

The main market forces that pushed interest rates higher include the burgeoning U.S. government debt load, the enormous expected debt issuance needed to pay for computational infrastructure construction, the looming Social Security funding shortfall, and higher inflation driven by higher fuel prices and tariffs. Some economists have said the higher interest rates are a product of a strong economy. I often wonder why no one discusses the record government deficits supporting our economy. What does the economy look like if you take away those deficits? What happens to our economy if our government can't overspend this way in the future? Can we call an economy strong if it relies on record deficits?⁽⁴⁾

Back to interest rates. Given that interest rates have moved higher due to both market forces and the Fed, it makes sense to think about the economic impact of higher interest rates. Well, higher interest rates obviously increase the cost of borrowing for everyone: businesses, governments, and people. Looking at recent headlines, it appears there are three major concerns regarding the recently increased borrowing costs. These include (1) increased costs to fund the computational infrastructure "AI boom" (2) increased costs to service the burgeoning U.S. government debt (3) increased costs for consumer borrowing, especially with mortgages in an already stagnant housing market.⁽¹⁾⁽³⁾

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Should these increases in borrowing costs concern you? It's true that the higher borrowing costs add risk to the economy. It's also true that the higher borrowing costs appear to reflect increased risks in different parts of the economy. Yet other economists say the higher interest rates reflect a return to a more "normal" interest rate structure that existed prior to the Financial Crisis. While I think it's important to recognize the potential risks of higher interest rates, and ensure your portfolios are positioned to manage those risks, I'm inclined to agree with economists who think we're experiencing a return to a more "normal" interest rate environment.⁽⁵⁾

As you may recall, the Fed cut interest rates to zero during the Financial Crisis. Although the "Great Recession" ended in June 2009, the Fed didn't start to raise interest rates until the end of 2015, after holding rates near zero for seven years. Up to that point, the Fed was basically paralyzed with fear, thinking that raising rates would hurt the economy. And because inflation was low, the Fed could keep rates low.⁽⁶⁾

As you know, over the past five years, our economy has faced elevated inflation. And the Fed has raised interest rates to reduce inflation. And it has not led to any sort of disaster or obvious problem for our economy. In fact,

what higher interest rates do achieve is they give us room to lower interest rates when our economy does face a problem in the future.⁽⁷⁾

So in the end, I view the increased interest rates as a positive. Yes, they do lead to more financial market volatility. Yes, they do increase the cost of borrowing. But they also mean the U.S. economy has moved past a period of economic difficulty that may have required artificially low interest rates. And it means the Fed has more room to lower interest rates to stimulate the economy when we do face economic challenges.

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Sources: (1) The Wall Street Journal 9/10/26. (2) Business Insider 1/22/22. (3) The Wall Street Journal 9/2/26. (4) CNBC 8/19/26. (5) CNBC 9/2/26. (6) The Guardian 12/16/15. (7) The Wall Street Journal 9/16/26.

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