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The Debt Edge

By admin

The use of debt in your financial affairs is akin to a double-edged sword. On the one hand, it is very useful to assist you in buying and owning assets using "other people's money (OPM)" such as a home or other financial asset. On the other hand, it can be a problematic tool to use in the event of a job loss, cash flow interruption, recession or rising interest rates amongst various possible scenarios.

While we have been in a credit/debt-based economy since at least the end of WW II, there are two things now that may mark an inflection point in the advisability of using debt as a financial planning, asset-building tool.

The first point is trying to be a contrarian as a way of standing apart from the crowd and doing what most other people are not doing – reducing debt while the rest of the world seems to be slipping further into debt with each passing day. Everywhere you look, debt levels are at record highs for governments, Canadian consumers and even corporations. The challenge is to plan for the day when debt is no longer so favourably looked upon as a mainstream planning tool.

The second point is to recognize that falling interest rates, since the peak in 1981, has made it easier and less expensive to carry the same or greater debt for the same cash flow cost. This trend has likely ended following a decade of near zero real interest rates. The Canadian and US Central banks have been slowly increasing the prime interest rate for the past year or so. This is being reflected in slightly higher mortgage rates, and personal line of credit rates, amongst other interest sensitive consumer products.

From a planning perspective, it may be prudent to consider that interest rates will likely continue to climb, albeit in a zig zag pattern over the next 5 years or decade or more. You can conservatively plan for this in your cash flow and budgeting to assist you in adapting to this possibly new long-term reality.

As you may have noticed, it is relatively easy to get into debt, but it seems to be much harder to repay that debt. Here is a look at why that may be the case:

Let's look at Mary and Bill as an example. They are able to pay $10,000 per year in debt and carrying costs for their mortgage. With an interest rate of 10% they could afford a mortgage of $100,000. But as interest rates fell to say 2% they were able to carry debt of $500,000 for the same annual payment.

Now the challenge comes as interest rates slowly turn the corner and start to increase. At 4% mortgage rates, the annual cash flow becomes $20,000 or double what it has generally been.

It may take time for any interest rate increase to affect you personally as you may be insulated because your mortgage or other debt does not come up from renewal for some time. But make no mistake, wise investors are thinking ahead now for how they will manage this new reality.

The key is to pay off credit card debt, car loans, credit lines and other consumer debt today and as soon as possible. In doing so, you will be given more flexibility to meet any increased mortgage costs over the next several years. This is very important in cities and areas such as Vancouver and Toronto and others that have experienced strong real estate markets and much higher mortgage debt levels on average than other parts of the country.

Call us today for a meeting [1] to review your cash flow and debt situations.

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