



# The Known and Unknown of Credit and Interest Rates

To capture the benefits of today's low rates, the strategy to hedge must be considered.

by Michael T. Newsome

Under normal circumstances, Treasury rates and other broadly employed interest rate indices (i.e. Libor) are real-time compendiums of collective market sentiments regarding current and future economic growth and the differences between the economic stability and prospects of the U.S. and other nation states. Interest rates and liquidity are linked, and it is the latter that has driven the former.

## WHAT WE KNOW

We are in the trough of a 40-year cycle with near zero rates of interest. Current rates are largely the product of the Federal Reserve's monetary intervention to maintain a nearly zero percent nominal rate of interest (known as "ZIRP") in an effort to stimulate

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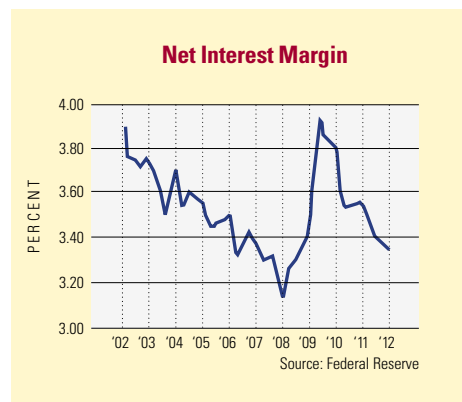
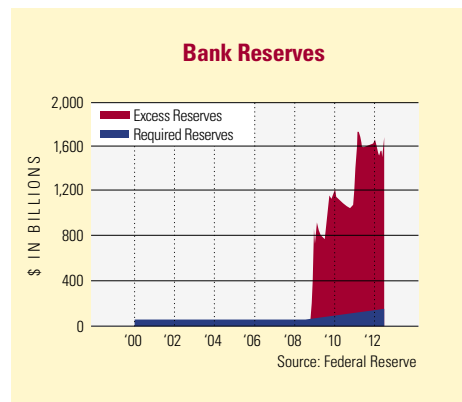
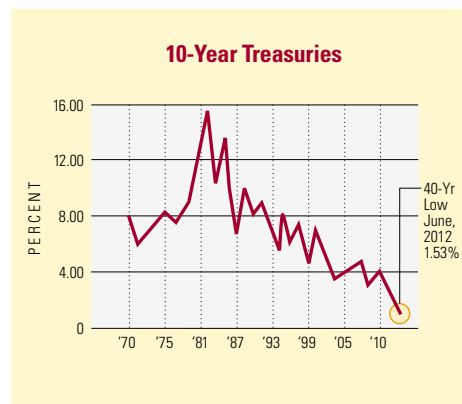
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economic activity, thereby clearing the market of lendable funds held by banks.

Yet, the Fed's impact on economic activity has been decidedly modest. Stagnant credit demand among businesses and individuals has piled up an unprecedented level of excess reserves within the banking system. Reserves are comprised of cash held, Fed Funds sold, deposits with, and funds due from other banks, outstanding repurchase (repo) contracts, and trading portfolios of highly liquid securities. These relatively idle assets on bank balance sheets represent the national store of unused lending capacity. In a sense, today's banking system is far too large for the requirements of the current economy.

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lending environment, particularly with regard to commercial and industrial lending. Credit pricing has steadily ratcheted down as lenders cut credit spreads to win new assets or just hold onto existing ones. This trend is readily apparent in the 50 basis-point erosion of aggregate

net-interest margins (the spread between interest income and interest expense).

With both credit spreads and Libor at historically low levels, the appetite for risk inevitably expands in the hunt for better yields. Burgeoning risk is manifested in longer maturities, higher leverage, and relaxation of debt service and collateral coverages. This is not to say that some bright line standard of prudent lending is being widely breached. The point is simply that the seeds of the next generation of credit problems are more liberally sown when bankers are hungry and credit demand is spare.

In the near term, it is a dogfight among the banks and an exceptional time to borrow money that can be put to a productive purpose.

## WHAT WE DON'T KNOW

The timing of the rise in interest rates remains elusive. But, ZIRP is not a permanent phenomenon. Borrowers, hedge-fund managers, and investors in general seek clues to when rates will begin to step up. The Fed expresses confidence it can skillfully reverse course and gradually allow rates to rise toward the long-term mean of 6.7%. The Fed has also said that it will begin raising short-term rates (the Fed Funds rate) once the unemployment rate falls below 7%, (perhaps in 2015?) The timeline is more ambiguous for curtailing the effort to depress long-term rates. There is some discussion percolating within the Fed suggesting the volume of QE3 and QE4 asset purchases be scaled back this summer, followed by suspension of the program prior to the end of the year. Once Fed asset purchases end, its \$3 trillion plus securities portfolio must be dealt with. Much of conventional wisdom in financial markets hews to the belief that all of this can be accomplished without notable economic disruption. However, countervailing forces, which include commodity inflation, currency devaluation and rebounding demand, are already at work exerting upward pressure on long rates. Ten-year Libor has already crept up 46 bps off its June 2012 low.

## AS ALWAYS, CHANGE WILL COME

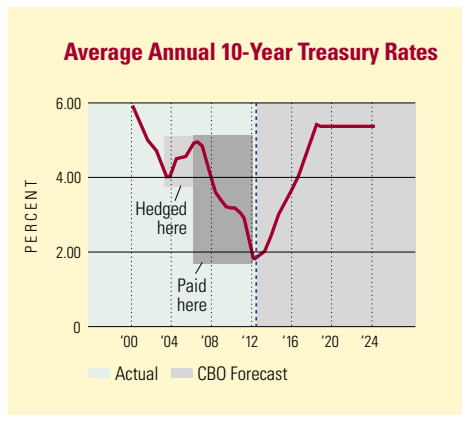
Debate continues over how and when the Fed unwinds its monetary intervention and the longer-term implications of these actions.

This is not well-charted territory. No one can predict with certainty what the economic consequences will be except that liquidity must be drained from the banking system and rising interest rates will follow. The Congressional Budget Office's (CBO) crystal ball forecasts a three-fold increase in the 10-year Treasury rate from an average of 1.8% in 2012 to 5.2% by 2018, as shown in the adjacent chart. Concurrently, the CBO projects short rates (3 month Treasuries) moving from 0.1% to 4.0%. Time will tell.

**WHAT TO DO IN THIS ENVIRONMENT?**

Numerous businesses anticipated rising interest rates prior to the onset of the financial bust beginning in 2008 and, at the urging of lenders, put three to ten year swap contracts in place. By 2010, virtually all of those contracts were underwater, adding an inescapable premium over the unhedged cost of credit. For many, that bitter pill left borrowers more reluctant to enter into hedges in the future.

Once free from the shackles of a swap con-



tract, staying at the short end of the yield curve (one month Libor) has been a rewarding strategy. Accordingly, interest-rate risk management has been a less important endeavor that has shifted focus to the credit spread and away from the long-term, all-in cost.

We think that failing to hedge will prove to be a mistake with a real cost. While we do

not put forth ourselves as experts on hedging strategies, we offer a few recommendations:

- If your business is sensitive to a material hike in interest rates, hedge!
- Don't be complacent because a prior hedging effort was not perfectly timed. Unfortunately, the precise timing is likely to elude all but a few.
- Caveat Emptor; do not exclusively rely on your bank for advice on hedging structure or pricing. As documented in every swap contract, the bank is not a fiduciary beholden to the interest of the borrower. Consult an independent interest rate risk advisor to provide insight on pricing and alternatives that banks are reticent to offer.

When interest rates move up, it will likely happen rather abruptly. To capture the benefits of today's low rates, action to hedge must be taken ahead of the markets' anticipation of the change. ♦



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