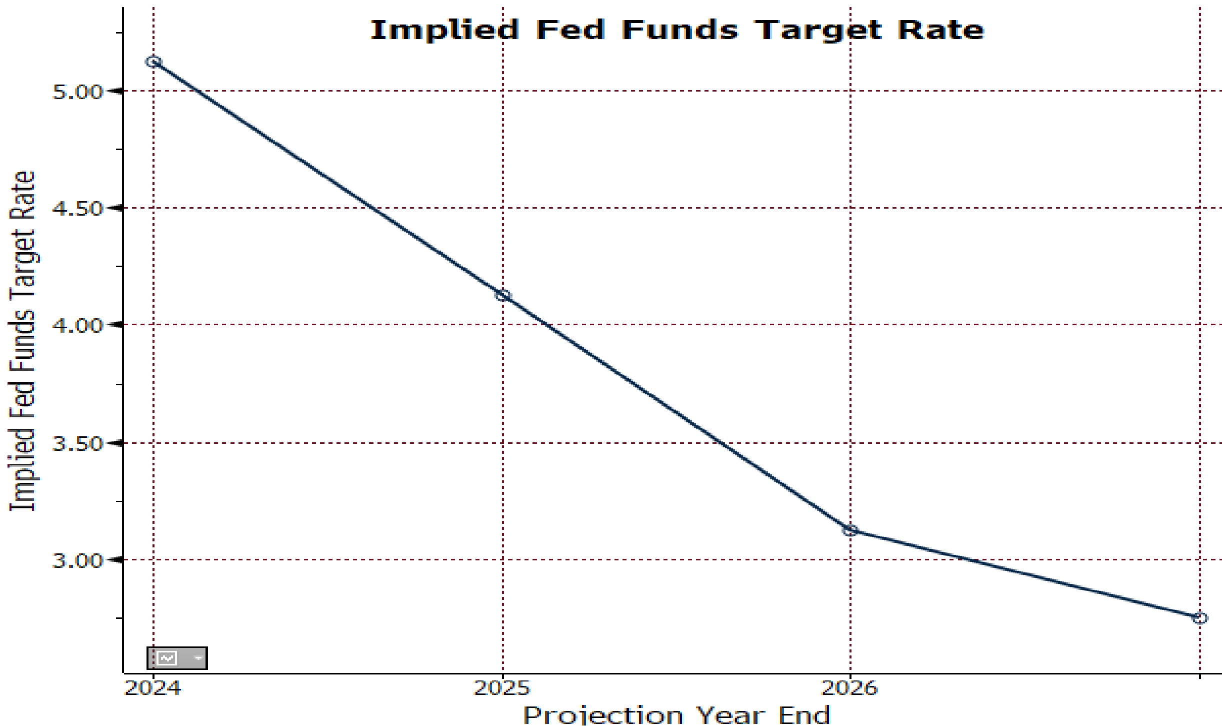
The Fed Ready to Cut Rates and The Opportunity For Borrowers

With high probability, the market now expects the Fed to cut interest rates by 25bps at its September meeting. The Fed's latest implied target rate graph is shown below. But much can, and will, change in the course of time.



One important question facing borrowers is determining the right entry point to fix long-term financing needs. No one can predict the future, but a few basic and intuitive rules can frame the correct approach. Every specific borrower situation is different, but the following basic concepts should apply to most customers wanting to make a prudent decision:

1) Timing the market for the lowest cost is an impossible task. However, for obligors with multiple facilities, a laddered approach may be best. This means staggering credit facilities rather than having all facilities with similar start and termination dates.

2) Short-term assets should be financed with short-term credit facilities. Each asset should be assessed for its useful life and expected hold period. Long-term assets should be financed with stable, longer-term credit facilities.

3) Short-term rates are not necessarily correlated with long-term rates. Therefore, what the Fed does with the overnight rate (the index which it directly controls) has little bearing on a borrower's cost of financing term debt.

4) Borrowers should appreciate their cost of financing in the correct context. Context is created by comparing current rates to historical rates given similar set of circumstances. Therefore, borrowers should not compare the cost of borrowing today versus the cost of borrowing during the pandemic, the greater financial crises, or during the very high inflation periods of the 1970s and 1980s. The graph below shows the cost of financing 3-year debt without credit charge (the underlying index with no credit spread). The graph shows the three-year treasury yield over the last 50 years. The average three-year Treasury yield over the period is 5.26%, at the time of this article the yield is 3.71% (1.55% below the historical average). Excluding the high inflation periods of the 70's and 80's and excluding the periods of the great financial crises and the pandemic, the three-year Treasury yield averaged 5.63% (1.92% below historical average in the correct context). Similar conclusions can be reached analyzing 5, 7, or 10-year Treasury yields.

Consideration for Bankers

The current inverted yield curve allows lenders to use the ARC program to achieve the following results:

1) Lower a borrower's interest rate (by up to 2.00%) and lower periodic payment, creating stronger free cash flow.
2) Increased yield to the bank.
3) Generate substantial hedge fee income for the bank.
4) Provide more future flexibility to the borrower by allowing the loan and rate to be secured with substitute collateral in the future (via a sale or 1031 exchange).
5) Lock in important relationship to minimize poaching by competition.

Action Item

Contact the ARC Team to obtain a presentation for your specific borrower showing the benefits of a hedged loan using various structures and terms.

ARC@SouthStateBank.com