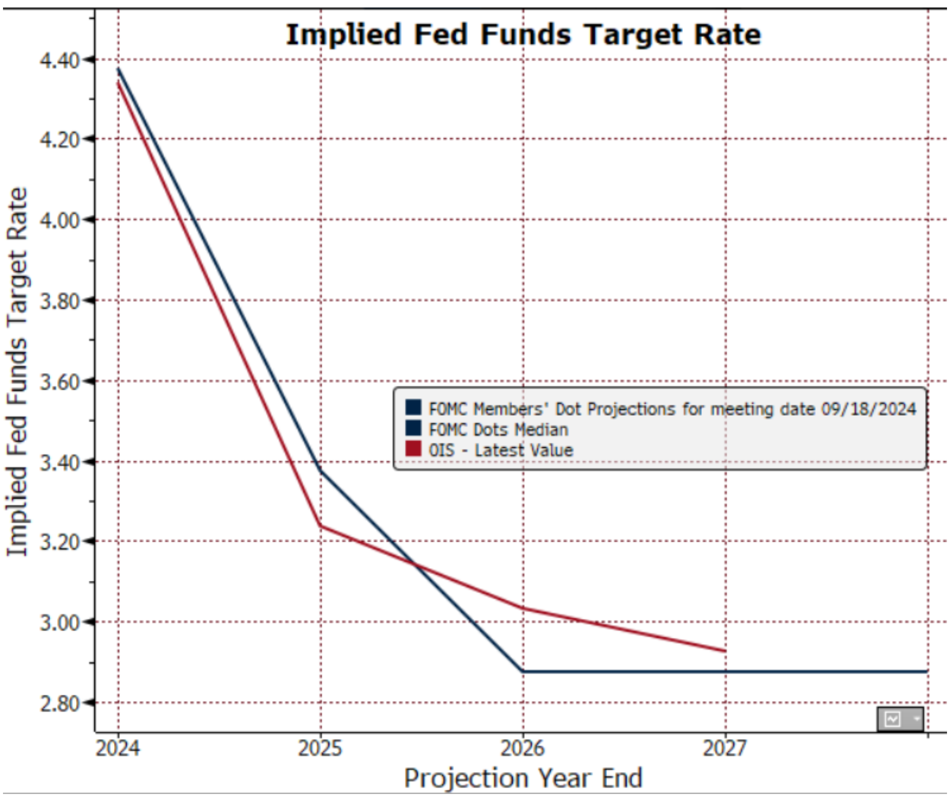
The Fed Cuts Rates and Borrowers' Reactions

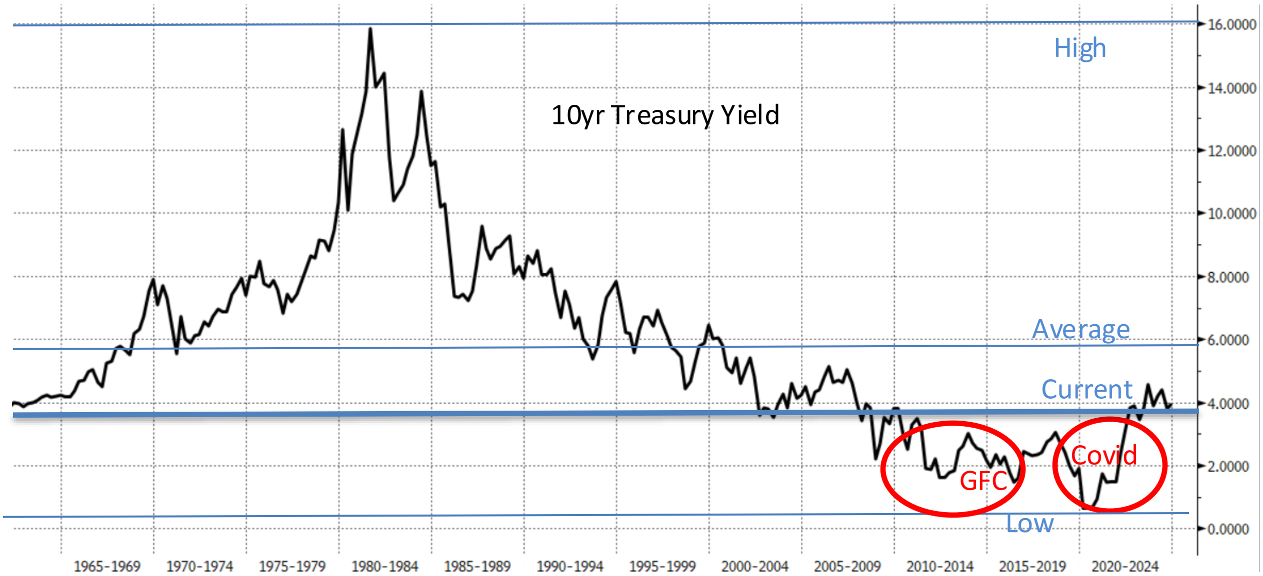
On September 18/24, the Fed lowered short term interest rates by 50 bps. However, the cut was hawkish in the messaging – the Fed highlighted the solid labor market and 9 of the 16 Fed officials forecasted no additional cuts in 2024. The Fed's latest implied target rate graph is shown below (Fed's view in blue and the market's view in red). Only the passage of time will prove where interest rates go.



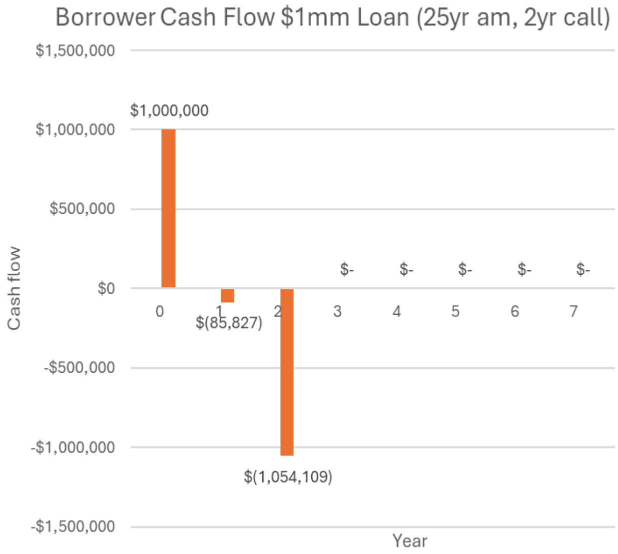
Some borrowers have concluded that the correct financing choice is to borrower on short-term facilities until interest rates reach lower levels. We believe that this strategy is a mistake for borrowers that have long-term assets and long-term financing needs for the following reasons:

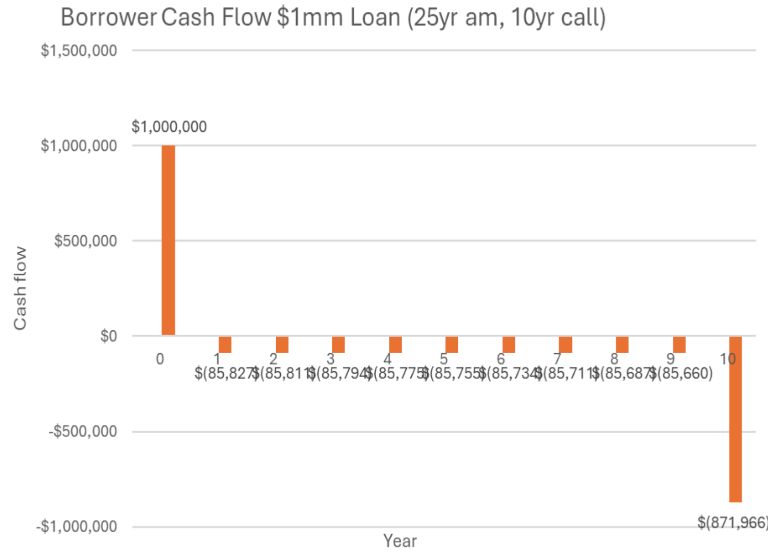
1. Short-term rates are not necessarily correlated with long-term rates, and what the Fed does with the overnight rate has little bearing on a borrower's cost of financing term debt.

2. There is no free lunch for market participants. Waiting to lock longer-term rates means that borrowers are paying more during that wait – the yield curve is still inverted, and short-term credit is more expensive than longer-term credit. By waiting to lock in permanent financing, borrowers are expected to pay the same debt carrying cost over time (borrowers pay the exact more in the short-term than they save by locking in the future, and assuming borrowers do not know more than the market).
3. The cost of borrowing is not high by historical standards as shown by the 10yr Treasury yield since 1960 in the graph below.



4. Borrowers do not often appreciate the liquidity risk with short-term facilities. Below are two graphs representing a borrower's $1mm loan cash flows for a 2yr loan and a 10yr loan. On a 2yr loan the borrower has two years to find takeout financing, and future credit markets and pricing are unknown. Further, the borrower's final year payment is larger than $1mm because of interest costs. On a 10yr loan the borrower has 10 years to find takeout financing and the final payment is substantially lower than $1mm because of debt paydown over time. This liquidity risk is double edged – it concerns the lender as much as the borrower.





Consideration for Bankers

1) Discuss why a borrower may want to choose long-term financing for long-term assets.
2) Explain why most borrowers are unable to outwit the market?
3) Highlight the liquidity risk to a borrower and bank for short-term facilities.
4) Outline the future flexibility to the borrower in having a loan that is both assumable and permits collateral substitution – a risk mitigation tool that many borrowers do not fully appreciate.

Action Item

Contact the ARC Team to obtain a presentation for your specific borrower.

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