Steepening of the yield curve prompts a need to adjust hedging strategies - by Kristen Gaudreau & Brian Pratt

March 09, 2018 - Financial Digest

Kristen Gaudreau,
Harbor Derivatives

Brian Pratt
Capital Markets Specialist

Commercial real estate borrowers have an opportunity to properly adjust their interest rate hedging strategy as we approach a new phase in the rates market. From 2010 to 2015 the difference between short term and long term borrowing costs had been historically wide, prompting borrowers to stay short with their hedging plans and for some, not even hedge their interest rate exposure.

This strategy has worked well in the past few years as the cost of borrowing based on short-term LIBOR being considerably less than paying long-term fixed. This funding benefit is likely to change before long. Spanning from January 2014 to January 2018, the curve has flattened with 2s10s swap spreads narrowing from 261 bps to 50 bps now. Going back 20 years we have seen cyclical swings in the steepness of the curve. We have experienced a relatively steep curve twice, from 2003-2004 and 2011-2014. The market experienced flat curves at 3 points in time with the difference the curve steepness being zero as seen in the years 2000 and 2006. Borrowers should consider now to be a prime opportunity to move out the curve and lock in longer term rates before the curve steepening begins as expected.

With this information in mind, it is predicted that this number will begin reverting to the mean of approximately 180 basis points as the new year picks up. A relatively strong 2.6% GDP number accompanied by an increased hourly average wage growth of 2.9%, and the most recently released CPI YOY of up 2.1% will likely boost inflation causing long-term rates to rise. The Federal Reserve, with Jerome Powell as the new chair, will presumably continue to unwind their $4.5 trillion balance sheet, and as the Treasury aims to find alternative investors of their debt, the growing deficit and new tax implications will require them to have to issue even more supply, while some foreign governments have curtailed investments in US debt. While Fed is expected to increase its Fed Funds Target causing LIBOR to rise with it, the market feels that long term rates will move higher in a more dramatic fashion. This will ultimately have an impact on the entire rate curve, moving it higher.

A combination of all of these factors will surely put significant pressure on long-term rates. Already, the ten year swap has risen 45 bps YTD, and 185 basis points since last September. With this sell-off comes the return of volatility. Higher volatility implies that interest rates will experience greater movements in both directions over a short period of time, and with the steepening of 2s10s curves, a larger swing both ways is expected.

To obtain protection from these highlighted scenarios, it is strongly recommended that borrowers satisfying hedging needs by purchasing a cap for construction loans and for hedging financings with investment horizons 3 years and under. With a cap, you will receive a hedge that provides risk reduction and security within an environment that has rising short-term interest rates. With a swap or collar, you will receive a hedge that provides security when there are volatile interest rate movements in both directions. Both of these options are guaranteed to give you cash flow security and a sense of peace of mind.

Kristen Gaudreau is marketing coordinator at Harbor Derivatives in Scituate, Mass. and Brian Pratt, capital markets specialist at a wholesale funding provider, Boston, Mass.