Interest Rates - Careful What You Wish For

Many real estate market participants have been hoping for relief in the form of lower interest rates. The hope is that lower interest rates could prop up prices, by making low cap rates seem more attractive and by making debt cheaper, thereby making higher valuations achievable with higher debt ratios.

Investors are getting part of their wish: lower interest rates are here, and short-term rates are headed lower, but that may not provide much relief to real estate prices. Risk spreads have widened, diminishing the benefit of lower rates, and the reason for lower rates — a weakening economy — does not bode well for continued rent growth.

Recent Trends

Both short-term and long-term rates have declined substantially during the last six months. The 3-Month T-Bill yield has fallen from 5% in July 2007, to 2.9% currently, a drop of 210 basis points. Long-term rates have fallen as well, though less precipitously. The 10-Year T-Bond yield has fallen from a recent high of 5.26% in June 2007, to 3.63% currently, a decline of 163 basis points.

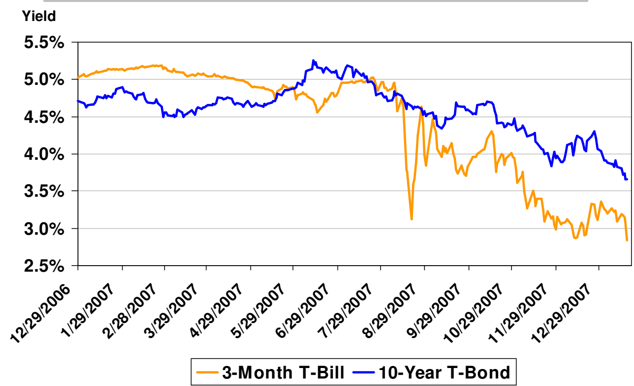
Rates really started to come down in August 2007, as the impact of subprime mortgage defaults spread to create a broad credit crunch. After the 50 basis point Fed rate cut on September 18, short-term and long-term yields rose briefly. But by the second half of October, investor sentiment became much more pessimistic, and rates began to fall again.

One area of improvement has been the spread between LIBOR and short-term Treasury rates. With the emergence of the credit crunch and a sharp reduction in liquidity, LIBOR rates had remained stubbornly high, despite Fed rate cuts and falling short-term Treasury yields. LIBOR rates actually rose in August and September, while Treasury yields were falling. As a result, the spread between 3-Month LIBOR and the 3-Month T-Bill reached as high as 238 basis points, compared to a spread of about 40 basis points before the onset of the credit crunch. The spread has contracted significantly during January 2008, and stands at about 100 basis points currently.

The Fed

The Fed is concerned about inflation, but in the short-term it is more concerned with the bursting of the home price bubble and the ensuing credit crunch. The Fed has cut the Federal Funds rate by 100 basis points since it began easing on September 18, when it cut the Federal Funds rate by 50 basis points. It has lowered the rate in its subsequent two meetings, each time by 25 basis points.

Treasury Yields
During 2007-2008



Recent Interest Rates and Inflation

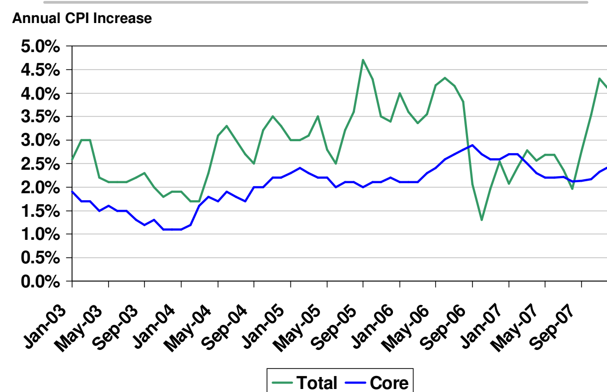
	Interest Rates			Inflation	
	3-Mo	10-Yr T-Bond			Long-
	T-Bill	Nominal	Real	1-Year	term**
2003	1.0%	4.0%	2.1%	2.3%	2.0%
2004	1.4%	4.3%	1.9%	2.7%	2.4%
2005	3.2%	4.3%	1.8%	3.4%	2.5%
2006	4.9%	4.8%	2.3%	3.2%	2.5%
2007	4.5%	4.6%	2.3%	2.7%	2.3%
2008*	3.2%	3.8%	1.5%	---	2.3%
Jan-18	2.9%	3.6%	1.4%	4.1%	2.2%

* Year-to-date average.

** Long-term inflation as implied by the spread between nominal and real 10-Yr T-Bond rates.

Sources: Federal Reserve, Bureau of Labor Statistics, Bloomberg, Foresight Analytics

Inflation Since 2003
Total vs. Core CPI



In his most recent comments (January 10 and 17) about the economy, Fed Chairman Ben Bernanke spoke at length about the credit crunch and the risks to the economy, closing with remarks that additional easing may be necessary and that the Fed was prepared to act in a “decisive and timely” manner. Nevertheless, the Fed remains concerned about inflation. In addition to Chairman Bernanke, Fed Governor Mishkin and Cleveland Fed President Pianalto have both recently emphasized the importance of keeping inflation expectations in check. Thus, while actual inflation may be elevated (4.1% in December), the Fed is keeping an eye on the bond market, to make sure that long-term expectations for inflation are not rising.

In addition to monetary easing, the Fed has sought creative solutions to the liquidity crisis. In August, it cut the Discount Rate to a 50 basis point spread over the Fed Funds rate, to encourage borrowing through its discount window. And in December, the Fed partnered with other central banks to create a “term auction facility” (TAF), with the goal of overcoming drawbacks to discount window borrowing. The TAF has seemingly been a success, with the Fed auctioning $40 billion through it in December, and planning on another $60 billion in January.

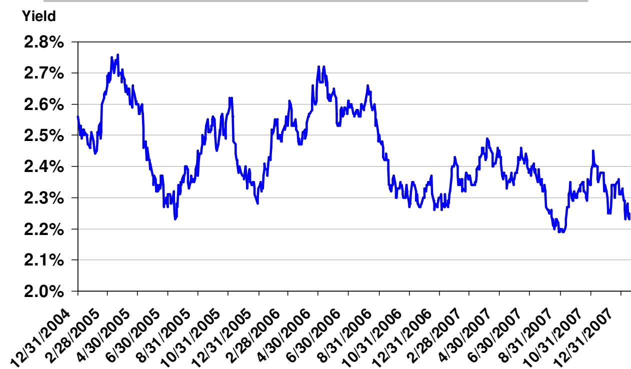
The Bond Market

The bond market has shrugged off inflation, and is instead worried about a recession. With the 10-Year T-Bond yield close to 3.6% and the inflation-adjusted 10-Year yield at 1.4%, long-term interest rates are the lowest they have been since 2003-2004. The decidedly pessimistic outlook has brought long-term inflation expectations down to about 2.2%, down from a recent high of 2.45% in November.

The economic picture has indeed soured considerably, with lackluster job growth during the second half of 2007. Job growth fell below the 2004-2006 trend in June 2007, and the dismal December 2007 job figures have widened the gap between trend and actual to over 700,000 jobs.

However, we believe a certain degree of panic is driving pricing in the bond market, and that the long-term inflation expectations are somewhat low. While the Fed takes some cheer from oil futures prices indicating somewhat lower prices in coming years, long-term demand for oil from Asia is bound to increase, and will put a floor on how low prices can go. Thus, even a recession in the United States is likely to have much less of an impact on oil prices than in previous cycles. Furthermore, it seems that firms in all industries have intensified their efforts to pass through higher costs by raising prices.

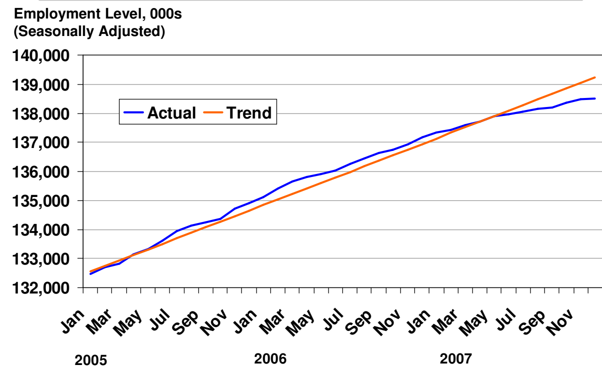
Long-Term Inflation Expectations*
Since 12/31/2004



* Spread between nominal and real 10-year T-Bond rates.

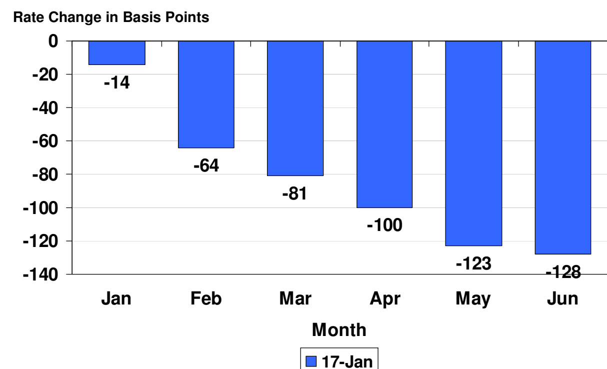
Source: Federal Reserve, Foresight Analytics

U.S. Job Growth
Actual vs. 2004-2006 Trend



Source: Bureau of Labor Statistics, Foresight Analytics

Market Expectations for Rate Cuts
Implied by Futures Prices



Sources: TradingCharts.com, Foresight Analytics

Expectations for future interest rate cuts by the Federal Reserve have intensified with the deteriorating economic outlook. The prospect of a 50 basis point rate cut at the Fed's January 29/30 meeting has been widely discussed, and futures market prices currently indicate approximately a 50% likelihood of a 25 basis point or greater cut in the federal funds rate at the Fed's next meeting. Futures prices indicate even sharper cuts thereafter, with an implied federal funds rate of 3.0% in May and June, a 125 basis point decrease from the current rate.

Outlook

The Fed will cut the federal funds rate by 100 to 150 basis points over the next several months, as the economy continues to soften and bank sector liquidity remains a problem. A 50 basis point cut at the end of January is virtually certain, but with inflation remaining as a concern, the Fed will try to make more gradual cuts in 25 basis point increments thereafter. Moreover, with the recent success of its term auction facility, the Fed may be emboldened to take more of a "wait and see" attitude. Lastly, the Fed will be inclined to cut rates more gradually because lower rates will put more pressure on the already weak US dollar (down 11% versus major currencies in the last year), and bring about more inflation through higher import prices.

We expect short-term interest rates to bottom out in the 2.5% to 2.75% range, and consider it highly unlikely that rates will get as low as the 1% rates during 2003. In contrast to 2003, deflation is not a concern, whereas inflation is. The Fed will also be unwilling to fuel another asset price bubble, as occurred in the housing market.

Long-term rates are close to their near-term lows. The 10-Year T-Bond yield could fall another 20 to 30 basis points, to the 3.3% to 3.4% range, but is unlikely to remain there for long. Our 6 to 12 month outlook is actually for long-term rates to climb somewhat, with the 10-Year yield in the 3.8% to 4.0% range, and inflation-indexed yields in the 1.5% to 1.7% range. We believe that current long-term inflation expectations are somewhat low, and as it becomes more apparent that higher energy costs will be around indefinitely, expectations for inflation will return to the 2.3% to 2.4% range.

Interest Rate Outlook
Next 6 to 12 Months

Scenario	3-Mo T-Bill	10-Yr T-Bond	Likelihood
Base	2.75%	3.8 to 4.0%	55%
Alt. 1	1.50%	3.3 to 3.5%	35%
Alt. 2	3.50%	4.2 to 4.5%	10%

Source: Foresight Analytics

Alternate scenarios include:

- Alternate 1: the economy weakens further substantially (deep recession) and the Fed cuts the fed funds rate to about 1.5% (-275 basis points from the current rate). Inflation pressures ease (to about 2.0% long-term) and 10-Year T-Bond yields fall to 3.3% to 3.5%. We estimate a 35% chance of this occurring.
- Alternate 2: the economy strengthens by late 2008. The Fed stops cutting rates or even tightens slightly. On the stronger outlook, long-term inflation expectations and real interest rates both pick up slightly, resulting in 10-Year T-Bond yields of 4.2% to 4.5%. We estimate a 10% likelihood for this scenario.

Implications

Low interest rates will likely not benefit the real estate market like they did in the 2001 to 2006 period. Risk spreads have widened substantially with the onset of the credit crunch, diminishing the value of lower benchmark interest rates to borrowers. Spreads for highly-rated borrowers have widened by 100 basis points, while risky spreads — for high yield corporates and riskier real estate — have widened by 300 to 400 basis points. Given the recent anxiety about real estate risk, we believe that borrowers can hope for a modest reduction in risk spreads at best.

A weakening economy — the reason for lower interest rates — will also sap strength from rent growth in 2008 and 2009, further diminishing investors' hopes for higher prices.

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