

Special Research Paper

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Why Would Anyone Take on Adjustable Rate Debt Now? ...yet, that is what the US Treasury is (in effect) doing.

Smart money

Most people are intimidated away from questioning what people in influential positions do. Those higher-ups must be smart; they must be expert; above all, they must know thousands of things that we don't. In order to dispute that presumption, we only need to look five years into stock market history. At that time, on these pages, we decried the fact that six months after creation of a dot-com company in someone's garage, an Internet Idea could sell stock to the public that was valued at more than the combined market cap of 3 or 4 household names in American business.

In 1999, "they" said we were wrong to make such comparisons.... We were myopically mired in 20th Century shackles, focused on out-of-vogue, earnings-based methods for estimating the value of a company. We were simply failing to recognize that future growth companies would be hatched from Cyber-eggs, leaving "legacy companies" writhing in the dust. Indeed, whenever value-style investing was mentioned among people in the know, a smirk was the standard reaction.

When stocks became commodities

There was a sort of double-helix relationship constructed between the ever-crafty distribution/supply side of the securities industry and the demand-monster they created to absorb their supply. They successfully turned fundamentals-valued equity shares into supply-and-demand-valued commodities, in chain-letter fashion. One would suppose that a rational free market would never be drawn into a transparently Greater-Fool buying panic. But, it was. Cable television became the new medium to convey endless squawk about emerging-company rumors and whispers that went on literally day and night. Venture capitalists, who had always had an investing time horizon of 8 years or so, ratcheted

that span down to a period of months. Special brokerage facilities sprang up to absorb the hordes which had left decent paying jobs to become day traders. New Economy enthusiasts made cartoon characters out of those who dared to continue wearing business suits. We could go on. Instead, we will simply re-remind you that all of this was barely more than five years ago.

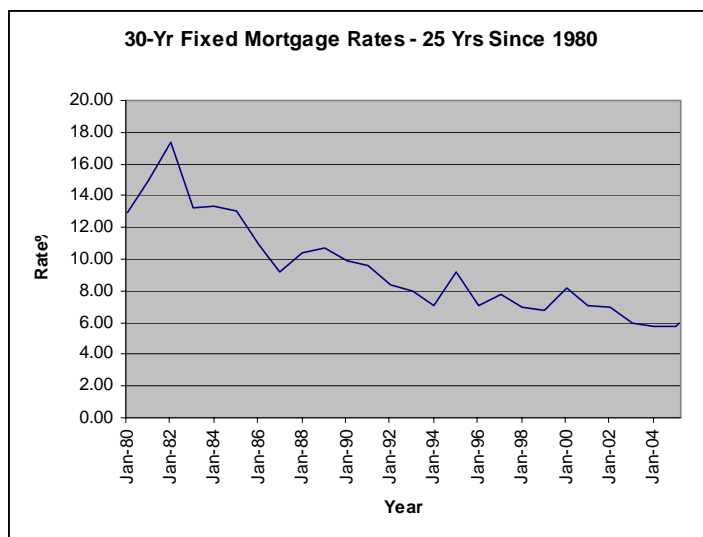
The Fed scraped bottom

Beginning immediately after New Years Day of 2000, the Federal Reserve began what became a 4-year process of exorcising the economic depression demon, via an incessant pattern of interest rate cuts. The process eventually had us holding our breath, for fear the Fed would go the way of the 1990's Bank of Japan...which had proven that an economy bloated with enough excess gas could continue to deflate, even in the face of a zero borrowing-rate stimulus. If US rates were lowered to zero without causing a recovery, we wondered, what would/could the Fed then do to regain its influence? And what would happen to the US Dollar along the way?

As the Fed reached a 46-year interest rate low of 1 percent in 2004, its rate cutting had finally worked, although not quite as expected. Instead of juicing up corporate borrowing, capital spending and jobs growth as intended, it was consumers who responded to the Fed's largesse. They single-handedly bailed the leaking US economy, via leveraging up their homesteads. Attracted by ultra-low mortgage interest rates and a barrage of lender advertising, consumers drew down and spent many billions of their home equity dollars and reduced monthly debt payments to buy not only larger roofs over their heads, but also very pricey and inefficient vehicles, home entertainment centers with \$3,000 TV screens and waterfront properties. Our nomination for poster-child of this spending era: the Hummer.

Home equity debt recipe: borrow long, spend short

This vast expansion of household debt is one thing, but **how** they borrowed it is, we think, more significant. Despite the fact that consumers had the opportunity to buy, or re-finance home mortgage money at the lowest 15- and 30-year fixed rates they had seen in their lifetimes, the majority of them, heavily coached by lenders, opted instead for the super-low current rates available from home equity lines and ARMs. So, it now seems apparent that the jaws of the bear-trap are set, **if** the US's future involves re-birth of the economic monster composed of: (a) rising government deficits, as a percentage of GDP, (b) rising price inflation rates and (c) rising interest rates.... Predictably, if this trilogy of bugaboos does in fact emerge, it will likely drown the large portion of variable-rate mortgage borrowers whose households operate on a limited amount of free cash flow and liquid assets. Those very borrowers are the ones who bypassed record-low fixed rate mortgages in order to grab even lower monthly payments, via variable rates; it is they who are likely to have cash flow margins that are too thin to manage rising debt service payments. Riskiest situations: those that signed up for the ultimate low-payment version of a variable rate mortgage...the interest-only loan.



Is home ownership in fact the ultimate safe investment? Can one presume that his/her home equity will continue to grow, year by year, without any risk of decline? If we believe that is so, then we are married to the notion that home mortgage debt will *always* create positive leverage. Moreover, lenders promoting home equity loans up to 100 percent of market value

appear to be making these same rosy, perpetual assumptions. Achilles heel: Though mortgage lenders do hold title to valuable real estate collateral, any set of conditions that would cause a large number of foreclosures on the castles owned by Everyman American will neither be market-practical, nor politically acceptable. And, if such a scenario becomes reality, it will likely eat the default cushions in mortgage-backed securities for breakfast. This crisis scenario was apparently what Alan Greenspan was clearly concerned about when he testified before Congress in mid-April, when he made the case for reigning-in Fanny Mae's and Freddie Mac's capacity for buying up an unlimited amount of mortgages.

More smart money? The US Treasury becomes a home equity-style borrower

Perhaps this paragraph should begin with where the Treasury's head was five years ago. We can perhaps set that scene by referring to an article titled *Fiscal Policy in an Era of Surpluses*, written by the Treasury's Under Secretary for Domestic Finance and released exactly 5 years ago. We recently found it...still on the New York Fed's web site. It is fascinating to read the author's views of how the Treasury would manage the diminishing issuance of debt securities in the early part of this decade, as Uncle Sam's borrowing needs were to be winding down. Guess we fixed that dilemma.

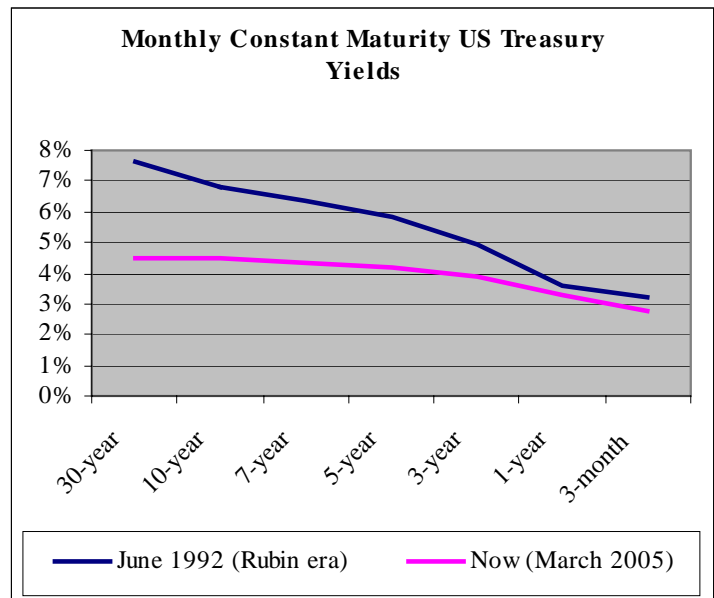
Returning to the beginning of this piece (about the Smart Money).... Four years ago, a difficult-to-fathom wave rolled onto the US Government's financing beach. The Treasury simply ceased issuing the popular benchmark 30-year bond, which had been its longest maturity. Instead of replenishing the supply of those long bonds, the Treasury's new issues were sprinkled into much shorter maturities. Maybe we are missing something here. Why would a government (or anyone) with super-long term unfunded liabilities (Social Security, for example) fail to take advantage of the least expensive long term borrowing rates available in modern history and, instead, issue paper that will simulate variable rate debt? At record-low current and recent rates, why wouldn't the US government issue at least some amount of truly long term debt.... say, 50-years, or even longer? In fact, that is just what some corporate treasurers and several foreign governments have done.

We did see the Treasury dramatically shorten its maturity structure once before, during the first

Clinton Administration, under the direction of crafty Secretary Robert Rubin who had been recruited from the top of Goldman Sachs. It was a big bet at the time, but not a wild one, because the yield curve was steep (long maturity bonds were much higher interest cost than shorter term notes). Then too, productivity gains were strong and getting stronger, which had calmed both the rate of inflation and the threat of it; this, in turn made the likelihood of rising interest rates remote. So, Rubin's maturity-shortening bet worked extremely well, saving the taxpayers a Texas ton of interest payments. But, odds are slim that a similar strategy makes much sense now for Secretary Snow. Today, the US yield curve is more like a pancake, meaning that the Treasury's borrowings, at whatever maturity, will cost about the same *rate of interest to their respective maturity dates*. (See graph at right.)

When would you (logically) issue a long-maturity bond?

But cost-to-maturity is not the point. Maturity matters. Let's say the Treasury floats a 5-year note today with a 4.2% yield, when at the same time it could have sold a 30-year bond paying 4.5%. It is fairly easy to argue that the long bond would likely be materially less expensive for taxpayers over the next 30 years, because the 5-year note will have to be re-financed five times in whatever interest rate environment exists at each of those future rollover points. Market history and today's conditions form a good set of odds that those future 5-year rollovers will mostly be at higher rates than today's available 30-year rate.



Note re March 2005 yield curve: The 30-year rate shown is the current yield on the last-issued long bond (now 27 years to maturity).