



### Why the Fed should expedite lower long-term rates now

What we know and what the markets are now learning is that rich world economies are ensnared in a balance sheet recession that by the few historical examples we can use to compare, will take a decade or more to run its course. The finish-line to this super-cycle will be nothing less than consumer balance sheets with enough free capacity to spend from wealth, not credit. By several measures, this is a long way off.

Understanding this framework is crucial to understanding how the Fed can help mitigate its severity. While media headlines are largely focused on the minute to minute excitement of bank solvency, the real root problem lies with the consumers/borrowers; 70% of U.S. G.D.P. With the tremendous load of debt on households, spending can come only after debt service payments are paid.

The size of these payments is of course related to US Treasury rates (think mortgage, prime, Libor, etc.). In an environment such as this, consumer spending is directly related to the debt service burden they have. Lower long-term interest rates directly help this group. (We have been advocating these ideas for some time, see 11/14/2008 Financial Times op-ed, next page)

Many are quick to point out that lower long-term mortgage rates do not translate into a household's ability to refinance a mortgage because of tighter bank credit standards and underwater mortgages. We agree, however; that is not the point.

The point is that lower rates foster an environment that helps over time. They are the pre-requisite to any other programs (debt-forgiveness, underwater re-financing, etc) that

can achieve more re-financings. Interest rates are a slow working mechanism that exert their influence by how long they are available, but also by how long the public thinks they will be available.

The Fed knows this and that is why they gave the pledge to keep short-term rates at 0% for years at their August 2011 meeting. The logical next step is to influence long-term rates in the same way. A 3% 30yr mortgage rate serves no purpose without it being available for a lengthy period.

It is also important to point out that every basis point of lower rates is worth more as a percentage to nominal debt service payments now than it would be in a higher rate environment. For instance, the interest payment for a 3% mortgage is 25% less than a 4% one, versus a 10% mortgage rate going to 9% is just 10% cheaper.

Lower long-term rates also have the effect to incentivize banks to lend, where the steepness of the yield curve has allowed them to get too comfortable not lending and collecting the spread between long and short rates.

Tomorrow, most are expecting (including us) the Fed to announce they will move some of their balance sheet of Treasuries out to longer maturities. This is an important step towards helping consumers in a contentious political environment not necessarily focused on them.

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## Markets & Investing

# Let's start at the basement to kickstart US housing sector



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INSIGHT

No later than the summer of 2007, the consequences of unaffordable mortgage interest costs for US homeowners were becoming evident.

As the credit crisis emerged, two approaches to rescue could have been taken. One was to bail out homeowners, reducing foreclosures. The other approach was to bail out lenders. These approaches were not then, and are not now, mutually exclusive.

By opting to keep lending institutions intact, officials may have assumed that lenders would be more helpful to borrowers. The stimulus package, intended to forestall recession rather than prevent systemic collapse, amounted to a drop in the bucket of US consumer spending, which drives more than 70 per cent of the nation's economy. "Rebate" cheques of several hundred dollars were meaningless to property owners losing tens of thousands, or hundreds of thousands of dollars of value in equity as foreclosures undermined prices of surrounding houses. On the whole, US mortgage rates remain resistant to Fed rate cuts and to the reversal of inflationary forces.

Falling housing prices remain at the heart of the ongoing credit crisis. Qualified US borrowers continue to experience difficulties in refinancing and obtaining new mortgages at affordable and predictable interest rates. But it is inaccurate, to state that reductions in the Fed funds target rate have been meaningless. The Fed funds target rate has been cut to 1 per cent. A variety of borrowers, including those whose mortgages are pegged to the prime rate, have benefited.

The troublesome benchmark is the sticky yield on the inflation-sensitive 10-year US Treasury. The chorus of Fed speakers citing inflation dangers has been

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tantamount to jawboning up the 10-year yield. A reduction in that yield could lower the cost of carry for homeowners and reduce other borrowing costs for consumers. Since few US mortgages have prepayment penalties, if fixed rates come down, the creditworthy majority of borrowers with equity remaining could refinance. New buyers would find houses more affordable. The resulting savings

can fuel consumer spending.

There are three ways to accomplish this. The first is communication. Central bankers need to tell markets that the health of the global financial system does not currently hinge on controlling current and future inflation. While others may argue real rates of return, the relationship of targeted interest rates to GDP and inflation, and historical yields, we focus on the reality of rapid asset deflation in real estate, fuel prices, and other commodities.

Second, the US Treasury can reduce its issuance of longer-dated debt. Auctions of the 30-year US Treasury were halted and resumed. Issuance of the 10-year can certainly be cut back. Most current debt issuance is taking place at the short end of the yield curve anyhow. A third approach is for the Fed to buy 10-year notes. This may be the type of easing from which homeowners can gain relief, not more machinations at the short end of the yield curve.

To help borrowers, rates used in long-term financing need to move down dramatically before further asset deflation takes hold. To those who argue that low rates caused the current crises, we reply that easy credit did much more damage than cheap credit, and lending standards have tightened dramatically.

Given the recent massive

capital infusions to the banking industry, some combination of US Treasury officials and federal regulators should be quite capable of dictating to the banking and mortgage industries some rational limits on spread relationships

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employed in homeowner financing. For example, they might set maximum spreads between interest rate benchmarks (such as the 10-year US Treasury maturity) and 15-year and 30-year mortgages. Risk premium, we suggest, should be the domain of premium "points" charged at origination by lenders, not a special burden of perennial extra expense on those borrowers least able to meet their mortgage obligations.

In the same vein, some wholesale alterations to the framework of mortgage lending could help to liquefy the housing market. Making the majority of mortgages assumable with the transfer of property to new buyers under acceptable conditions could reduce foreclosures.

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