Yield Curve Buzz - What's it all about and what does it mean for real estate lending?

March 23, 2006 / By Michael T Sullivan

Recent discussions about yield curve, and the interpretation of the latest inversion, has lenders, analysts, and economists wondering what lies ahead. Through a brief discussion of the yield curve and the effects of increasing demand for long-term bond, it will be evident, that this inversion is different from the past. The level and shape of the yield curve is of particular interest to both real estate lenders and borrowers, as long-term loans typically use treasury yield as their interest rate benchmark.

The yield curve is a description of a line that connects the yields on various maturities, ranging from 3-month Treasury Bill to 30-year U.S. Treasury Bonds. Some people use it as a tool to help track and predict the overall movement of interest rates and the near future of the economy. Different bond maturity dates move independently of each other, and the yield curve helps us monitor the overall pattern. A normal, or positive, curve is created when long-term bonds produce higher yields than short-term bonds, because investors generally seek higher rewards to compensate for the risks involved with investing money for longer periods of time.

Does the current shape indicate economic slowdown?

In December 2005, the yield curve inverted, for the first time since 2000. This inversion brought an unsettling feeling to many economists and banking analysts. The shape of the yield curve has historically been a reasonably accurate and useful indicator of future economic activity. Typically, a flat curve, when long-term and short-term yields are the same, predicts economic slowdown.

Although the highly accurate predictive nature of the yield curve inversion brings fear, the full scope of considerations should be discussed. Yield curve is only one indication of economic activity. According to the Federal Reserve Bank of San Francisco, each of the six recessions since 1970 was preceded by a yield curve inversion[2]. That statistic, however, conveniently leaves out the two recessions that occurred in the 1950's and 1960's, which were not predicted by an inverted curve. Also to be considered is the inversion of 1998, when the collapse of Long Term Capital Management, a hedge fund founded by two Nobel Prize-winning economists, caused disorder in the financial markets, and inverted the yield curve. No recession followed within two years of this occurrence. These examples show that although generally correct, the shape of the yield curve is not always a precise indicator of the future of the economy.

Another factor contributing to the uncertainty of the economy is the recent change of leadership in the Federal Reserve and what new monetary policies will arise due to the technologically changing, global economy. In his last months, Federal Reserve Chairman Alan Greenspan considered the yield curve "conundrum," asserting that the yield curve is no longer a definite and accurate prediction tool, and that the current flattening is not leading to a recession. Greenspan is not alone in his perception.

Chairman Bernanke, since February this year, has had the weight of the conundrum on his shoulders. When interviewed by Doug Noland, from SafeHaven, he explained his interpretation on the current shape of the yield

Summary

The yield curve and latest inversion has lenders, analysts, and economists wondering what lies ahead. A brief analysis of the yield curve and the effects of increasing demand for long-term bond will help explain the December 2005 inversion.

Comments

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curve. Summarizing his view, he explained that, previously, the inverted yield curve occurred along with quite high long-term and short-term rates. This time, short-term interest rates are relatively average and long-term rates are historically, relatively low. It is due to this phenomenon, that this curve does not signify a drag on economic activity.[3]

Atlanta strategist, Dorsey Farr, Director of Asset Allocation at Wilmington Trust, explains why the flattening yield curve is a different problem from the past, "The problem, explained Farr, is not that short-term rates are too high but that long-term rates are unusually low, thanks to investor demand for relatively secure, safe U.S. Treasuries by foreign and domestic investors."[4] Many economists today believe that the inverted curve is more of a sign of the increasing demand for long-term debt, including the 30-year bond, which was introduced in February for the first time since 2001. "Demand for 30-year bonds was so strong -- there were twice as many bids as there were bonds for sale," says Charles Schwab's Jim White -- that it drove down interest rates (prices and yields move in opposite directions). Those who bought at the auction will earn 4.53 percent."[5] Only time will tell what the effects of the 30-year bond will have on the shape of the yield curve.

Effects on Real Estate Lenders

Ideally, banks would borrow on short-term and lend on long-term yields. When yield spread shrinks, not enough profit can be earned from the difference in rates, reducing the banks incentive to lend on long-term fixed rate loans, which could lead to a lower supply of capital available to their customers.

Commercial banks continue to be the primary debt source for real estate ventures, according to a 2006 Borrower Trends Survey, in National Real Estate Investor, regarding capital sources, "Over the past 12 months… 80% of respondents cite commercial banks and savings institutions…" The inverted yield curve affects long-term fixed rate loans, originating from banks, but there are other sources of capital. "As of the third quarter of 2005, commercial banks held the largest share of commercial/multifamily mortgages with $1.1 trillion, or 43% of the total. CMBS ranked second at $499 billion or 20%, while life insurance companies accounted for 10% of the total."[6] This shows the variety and amount of capital that is available to borrowers.

What will happen to interest rates for real estate loans over the balance of 2006 and into 2007? The growing demand for long-term treasuries will keep a cap on that yield, although most economists do predict short-term interest rates will rise a couple more times this year. For now, the various structural forces contributing to the flattening of the yield curve are probably going to remain influential. Locking in the lowest fixed rate loan still ranks high in today's borrower's list of reasons to finance their real estate holdings. Despite the high demand, supply of capital into the real estate sector will continue to meet and even exceed the demand, so long as real estate remains the preferred asset class. When combined with a low Treasury yield, interest rates should stay relatively low. Eventually, the curve will return to its "normal" shape, either through a decline in short-term yield, increase in long-term yield, or both.

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About Michael T Sullivan

Michael T. Sullivan is Managing Director of HVS Capital Corp., joining HVS in June 2001. Previously, he served as Managing Director of Sonnenblick-Goldman, which he joined in 1974. During his career, he has been responsible for the financing and sale of more than 650 hospitality properties (hotels, resorts, golf courses, and shared ownership) and for completing, on average, roughly $1.0 billion per year in debt and equity transactions in hotels/resorts nationwide. In his current position, he oversees a staff of hospitality banking professionals, all of whom are involved in the origination and placement of debt and equity realty assignments, with a primary focus on the Lodging and Leisure Industry. Mr. Sullivan attended the University of Arizona, where he received a degree in accounting and marketing. He is a Certified Instructor for the National Apartment Association and a frequent speaker for the Colorado Apartment Association, BOMA, and other trade real estate groups.