Expansion

2014 US Interest Rate Forecast *from* Cardea Partners

Are We Finally in the Clear?

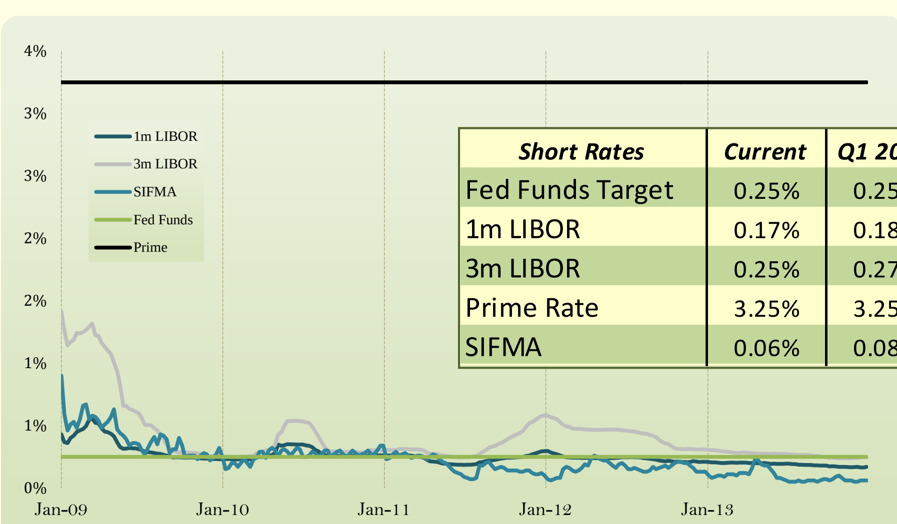
"Nothing happens until something moves."

-Albert Einstein

While the sheer greatness of market movements in 2013 was generally under-expected, including by ourselves in last year's forecast, our directional accuracy on long term rates, the steepening curve, and a generally dovish Federal Reserve leaves us feeling like another shot at predicting the future is warranted, if not deserved, for 2014. The move upward in yields this summer at the first mention of 'Taper'—the Fed's attempt to slow (and eventually stop) asset purchases for a portfolio now valued at more than $3 trillion—definitely added 50 bps to the back end of the curve that we failed to anticipate. Short term rates have settled to levels even closer to zero. As the unemployment rate fell to 7% over the course of the year, global equities *trailed* US markets while still returning 20% YoY! Gold slumped nearly 30%, but the Fed still saw enough downside risk and 'inflationlessness' to abstain from hiking the fed funds target rate, which they say won't move until mid-2015. Future moves by the Fed will be tied to economic data and spearheaded by new Chair Janet Yellen, who brings a perceived continuity to the organization. Ben Bernanke will leave with a generally positive legacy by current estimates as the recovery expands and a double dip recession appears to have been averted without traumatic inflation or currency devaluation as yet. Yellen gets the keys February 1st.

The government managed to do just enough to keep market participants thinking about opportunity instead of risk in 2013, coming to terms on a debt ceiling rise and a budget that will forestall another protracted fight until February at least. Obamacare legislation started off weakly with a botched website rollout and some losing existing coverage, but the response to this initial failure, including postponing mandatory small business adoption and the emergence of state exchanges, may prove beneficial to the economy in 2014. As the certainty wave washes over more and more citizens with improving home values (+13% YoY) and more disposable funds available (unemployment down 1% and personal income up 3%), the first third of the year at least should be bountiful to those looking for risk-adjusted returns. And <u>short term</u> borrowing costs won't rise much, if at all.

Historical Short Term Rates and 2014 Forecasted Levels



Short Rates	***Current***	***Q1 2014***	***Q2 2014***	***Q3 2014***	***Q4 2014***
Fed Funds Target	0.25%	0.25%	0.25%	0.25%	0.25%
1m LIBOR	0.17%	0.18%	0.22%	0.24%	0.25%
3m LIBOR	0.25%	0.27%	0.32%	0.35%	0.36%
Prime Rate	3.25%	3.25%	3.25%	3.25%	3.25%
SIFMA	0.06%	0.08%	0.12%	0.15%	0.20%

The LIBOR rigging scandal has subsided mostly, and 1- and 3-month borrowing rates touched all-time lows below the Fed Funds ceiling of 0.25% during 2013. But they may drift slightly higher in anticipation of Fed action at year end or in 2015.

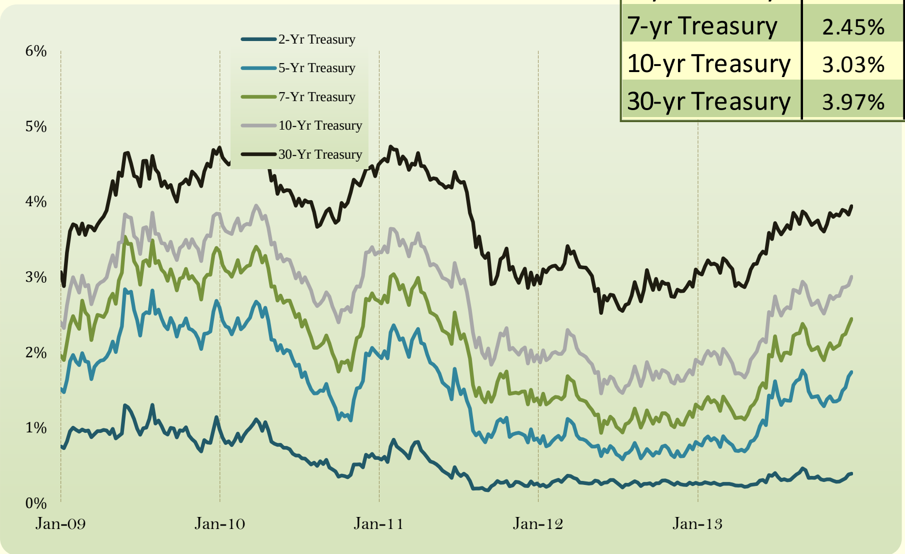
On the Run

Has the 30-year Treasury bull finally been put out to pasture, leaving yields to aggressively do the running? Starting with a move in May, everything between five and ten years in maturity essentially doubled in yield during the second half of 2013. The spread between 2s to 10s rose 1% YoY, a 60% steepening, and even the 30-year long bond yield climbed to within 3 bps of 4% to close the year at its two-year high—so is it over for falling rates? Our thought is yes, but not completely in 2014. Even as the Federal Reserve buys much of the duration instead of panicked global investors nowadays, demand for Treasuries is still well above its long term average, and the least publicized story of the year may have been the better than expected decline in the US deficit (-40% YoY, although obviously from an absurd level). The Federal Reserve is clearly sensitive to the level of the 10-year Treasury and its effect on the mortgage market, even if they don't spell that out explicitly, and the $10 billion taper to commence this month isn't really that hawkish, even if it expands and they completely phase out QE3 due to continued economic improvement. At these yields, hold-to-maturity types like retirees or pension funds might actually be pleasantly content with near-2% real returns for a while longer.

So we do think that our government bonds are currently oversold, which could continue into the second quarter, but those looking to catch the lowest borrowing costs of the year might wait until the weather turns, in our opinion. 2013 lacked a global-scare catalyst for the Treasury markets, and we think this year will bring some calamity in Europe and/or Asia to spook confidence for a time. We can never discount the chance of the US government adding to the turmoil, either, particularly in an election year for 33 Senators and the entire House of Representatives, although a gambling man wouldn't bet on control of either house changing. We do think that important, bipartisan reforms for both the tax code and immigration will be tabled until after the new Congress forms in November. The introduction of floaters based on the 13-week T-bill may add a wrinkle to the short end also.

Historical US Treasury Yields and 2014 Forecasted Levels

Treasury Yields	*Current*	*Q1 2014*	*Q2 2014*	*Q3 2014*	*Q4 2014*
2-yr Treasury	0.38%	0.37%	0.34%	0.40%	0.45%
5-yr Treasury	1.74%	1.65%	1.45%	1.65%	1.80%
7-yr Treasury	2.45%	2.40%	2.20%	2.40%	2.50%
10-yr Treasury	3.03%	3.00%	2.75%	3.10%	3.35%
30-yr Treasury	3.97%	4.05%	3.85%	4.00%	4.15%



Rising rates and a steepening yield curve should persist overall in 2014, but we don't see as much selling in Treasuries as some have forecasted, with the Federal Reserve too sensitive to asset values to allow a downturn in either the residential or commercial mortgage markets that are so intimately linked to consumer and business confidence.

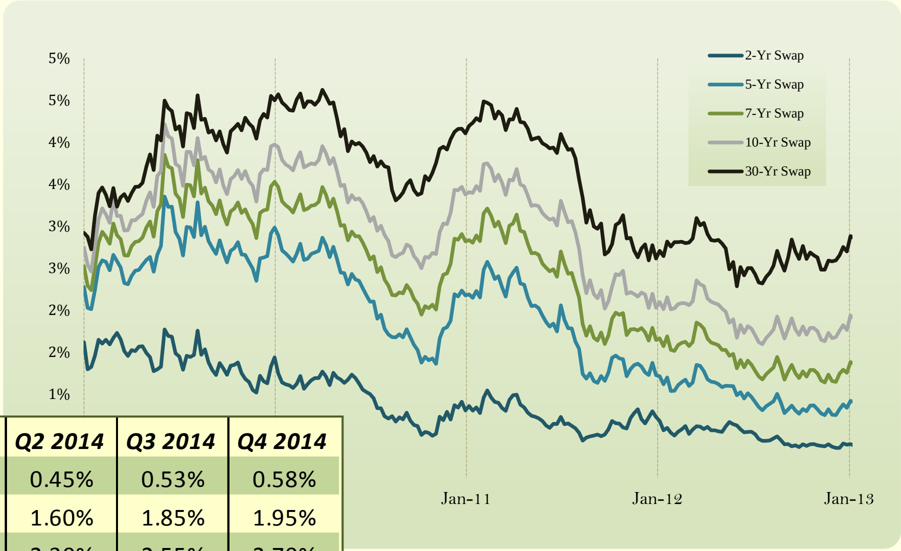
Widening Spreads for Swaps

In the interest rate world, swaps are the single-rate representation of LIBOR expectations for any given period of time. While the defined term Swap in the Dodd-Frank Act includes many other types of derivatives under its umbrella, the plain vanilla swap has two parties, one paying LIBOR or another floating rate index, and the other paying a fixed rate. This fixed rate is driven mostly by then-current Treasury yields these days, as so-called swap spreads* are now down to between 10 and -3 basis points across the curve horizon (the 30-year swap spread has been negative for almost all of the last five years). Swap spreads are historically low right now, which could mean (1) AA-rated bank risk is not that different from US government risk in Treasuries, (2) demand for swaps is low compared to historical norms, or (3) Treasury yields may be relatively inflated. We think this ‘low spread’ trend will fade over the course of 2014, meaning that available fixed rates relative to Treasury yields will rise. While this reversion won’t likely get spreads anywhere near their mean over the last few decades, it may make swaps seem even less desirable compared to the cost of floating at the LIBOR index with softer hedges. Please give us a call if you are managing this risk for your organization.

Our expectation is that swap rates will drop through mid year, even as spreads widen, thanks to a rest for base Treasury yields, then rise even faster into year end as spreads widen to at least 10-15 bps curve-wide. The 30-year swap spread should move into the positive and remain there if the economy keeps its footing and heads towards consistent 3% annualized GDP growth. If the Fed does signal true hawkish motivations in 2014, LIBOR and swap rates are going to rise. How strong that signal will be should be a function of unemployment levels, signs of inflation, and mortgage rates. Signals we monitor now point to a modest continuation of the new rising rate trend that introduced itself in 2013.

Historical 3m LIBOR Swap Rates and 2014 Forecasted Levels

*For a 10-year non-amortizing structure, the current 3.094% 3-month LIBOR swap rate minus the 3.028% yield on the 10-year Treasury give us the swap spread of 0.066%, or 6.6 basis points, well below the year’s high of 26 bps, the all-time high of 125 bps, and the historical average of 49 bps for the 10-year tenor. Swap spreads for all tenors are historically low at the 2013 year-end levels.



Swap Rates	*Current*	*Q1 2014*	*Q2 2014*	*Q3 2014*	*Q4 2014*
2-yr LIBOR Swap	0.49%	0.50%	0.45%	0.53%	0.58%
5-yr LIBOR Swap	1.79%	1.80%	1.60%	1.85%	1.95%
7-yr LIBOR Swap	2.48%	2.50%	2.30%	2.55%	2.70%
10-yr LIBOR Swap	3.09%	3.10%	2.85%	3.20%	3.45%
30-yr LIBOR Swap	3.93%	4.05%	3.90%	4.10%	4.30%

Hedging from Theory to Action

Expertise and Data Can Drive Your 2014 Decision Making

When you are in the term sheet phase of new financings, how do you evaluate the interest rate options that are presented to you? You may be presented with fixed rate offerings, or maybe the option of a floating rate loan with a hedge, which may be mandatory. Do you make your decisions based on ease of execution, the rate (price), covenants, recourse, or all of the above? Price always matters to us, and in our experience, many intangible points can be negotiated after best price has been discovered. But you need to weigh the objectives for the debt proceeds, your organization's sensitivity to the economy and interest rates, and the prospects for future refinancing. Your deliberations should (1) assess your tolerance for future liabilities that hedging products can present, (2) establish a baseline rate-neutral position for your portfolio, and (3) identify the capabilities of the debt and hedge providers available to you. You have a lot to consider! This phase of negotiation is when borrowers have the most leverage over their lenders, and we want to be part of your team to help you quantify all of the costs associated with your hedge and debt at this stage and beyond. We work with your brokers, we help you negotiate with your bank, we bring answers to the many questions that come with complex financial instruments. We provide another sounding board and the triple-check.

For five years now, post-Crash, the market has had certainty in the dearth of short term rate movements, thanks to the Federal Reserve's unprecedented policy. And your organization has survived the turmoil. It's closer to 'business as usual' and the economy is in expansion mode. The low-rate era may be finally coming to an end, sure. Knowing if and when LIBOR will move from quarter to quarter is pivotal, certainly, but knowing the potential cost of your exposures in present value terms and over the life of your deals adds an invaluable perspective to the decision making process. Let us equip you with the data and market tools to make smart decisions in the next five years and beyond. Please call us to discuss your portfolio or your current deal any time, and have a brilliant New Year in 2014.

Don't hedge without us!

Other Movers	*Current*	*Q1 2014*	*Q2 2014*	*Q3 2014*	*Q4 2014*
Dow	16576	17500	16800	17500	18000
S&P 500 Index	1848	1950	1875	1950	2050
GDP QoQ (ann)	4.1%	3.1%	2.4%	3.3%	3.5%
EURUSD	1.375	1.39	1.41	1.42	1.43
VIX	14%	15%	18%	16%	15%
Gold ($/oz)	1200	1250	1300	1325	1300

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