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Hedging Against a Rising Rate Environment

Eric Jordahl and Steve Sohn

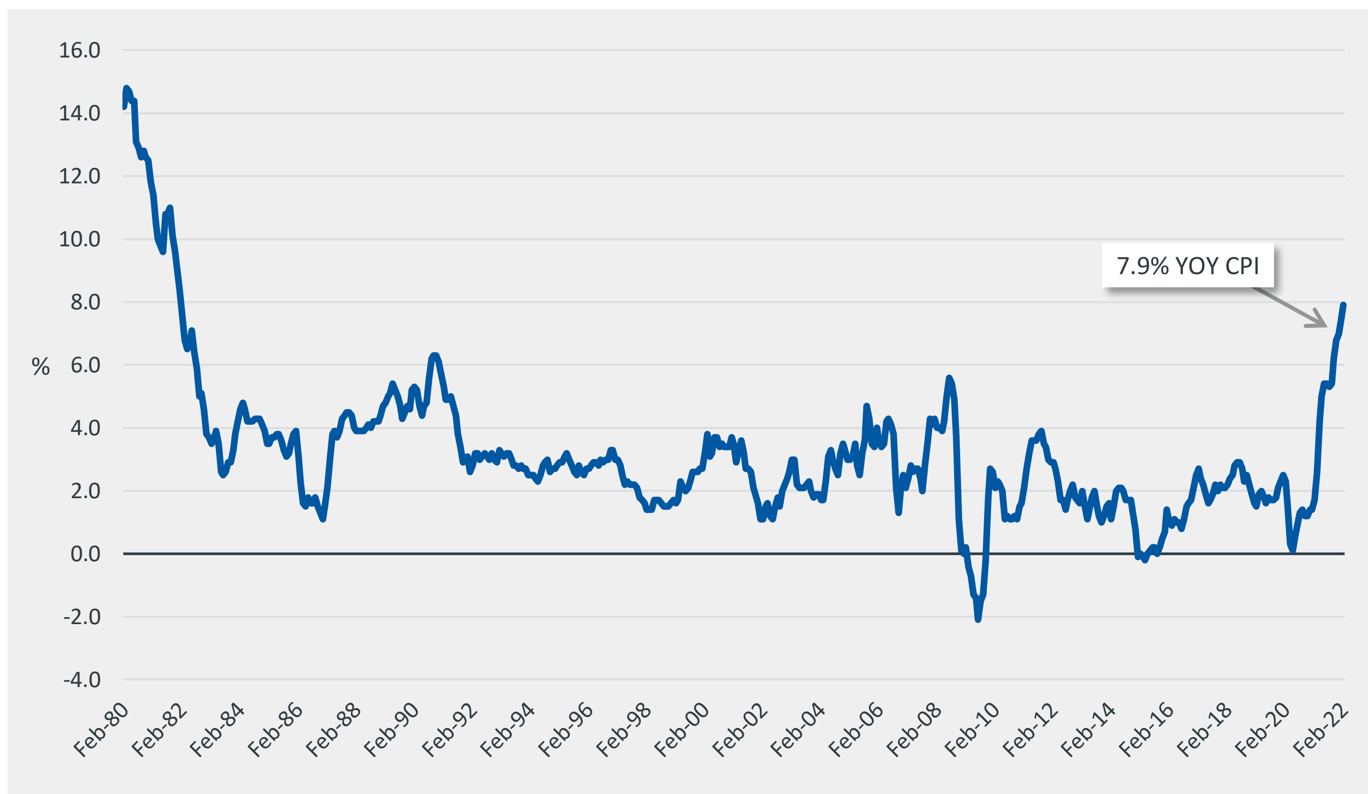
After a run of historically low interest rates, we face the prospect of a changing market. Organizations that are considering issuing debt must now factor in the risk of rising interest rates and decide whether to hedge against that risk.

Numerous factors are driving this change:

- Inflation—the product of supply chain disruptions, infusions of stimulus money, and pent-up demand for goods and services—has risen to levels not seen since the 1980s (Figure 1).
- The Federal Reserve is tightening what has been an extremely accommodative monetary policy, in place since the Great Recession of 2008-09, to address inflationary pressures and to begin to unwind a balance sheet that has approximately doubled to $9 trillion since the pandemic began in 2020. The Fed raised the federal funds rate by 25 basis points at the Federal Open Market Committee (FOMC) meeting in mid-March and signaled a total of up to seven rate increases over 2022, with additional increases possible in 2023.
- Russia's invasion of Ukraine has significantly heightened geopolitical risk and has introduced pronounced volatility into the markets, at least for the short term.

These factors generally support an upward rate bias, but there is a good deal of uncertainty around the impact and duration of each, which contributes to uncertainty over whether and by how much long-term interest rates might rise.

Figure 1. *U.S. Consumer Price Index Year Over Year*



Source: Bloomberg, Bureau of Labor Statistics – U.S. Consumer Price Index Urban Consumer Year Over Year

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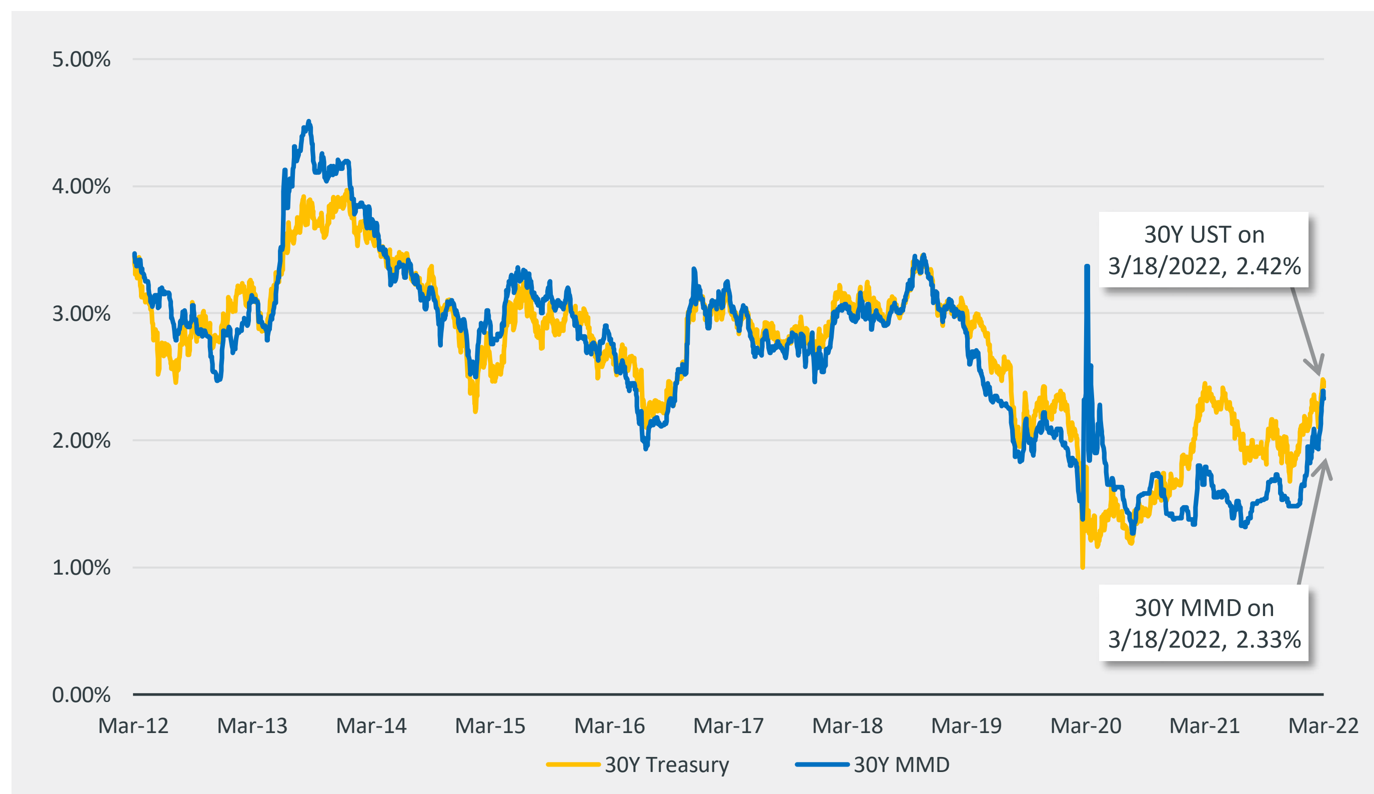
Figure 2. *Interest Rate Trends (30Y MMD and 30Y Treasury), March 2012–2022*



Source: Bloomberg and Thomson Reuters, as of 3/18/2022

The response of fixed income investors to all the unsettling economic, monetary, and geopolitical developments during the past several months has been curve flattening, driven by the shorter end moving up faster than the long end. Longer-term rates are moving up, however, as shown in Figure 2, with 30-year MMDs up 84 basis points and 30-year Treasuries up 52 basis points since Dec. 31, 2021 (as of March 18, 2022).

Deciding Whether to Hedge

Against this backdrop, it may be prudent for an organization that plans to issue debt to consider hedging strategies to protect against rising interest rates. Hedging is a relatively straightforward process; lock in a rate today with a forward premium and wait for the settlement date (coinciding with the bond sale). If rates are higher than the "locked" rate, the organization selling the bonds receives a payment, but sells the bonds at the higher prevailing rate. If rates are lower, the organization must make a payment, but sells the bonds in a lower rate environment. The question of whether to hedge is, however, more complicated and involves several tactical considerations.

Confidence that issuance will occur. A decision to hedge commits the organization to a financial obligation independent from any bond issuance decision. The organization should be highly confident that it will issue bonds in the foreseeable future before it commits to a hedge.

Assessment of rate environment. A decision to hedge should also include an assessment of the rate environment, including the probability that rates will increase and the potential magnitude of that increase. The more probable and significant a rate increase is, the more seriously an organization should consider a hedging strategy.

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Rate lock product considerations. For taxable debt, the Treasury rate lock should be the basis for the hedge, but only if the issuance is within approximately 12 to 18 months for good execution; after that, a SOFR-based product is the next best option. The timeframe is shorter for tax-exempt debt; pricing for the forward premium on an MMD rate lock will jump about six to nine months out. SIFMA and SOFR-based rate locks do not have similar forward period concerns but introduce basis risk.

Amount to hedge. Hedging does not require an "all or nothing" decision. An organization might, for example, break up the hedge into multiple pieces and observe the market for opportunistic entry points.

Hedge cost tolerance. There are transaction and premium costs associated with a hedge; a rate increase must be significant enough to cover these costs to achieve a breakeven or positive outcome. The organization must also be able to tolerate the possibility of making a settlement payment if rates fall; although the organization will still be able to sell the bond at a lower rate, which reduces the impact of the payment, the decision to hedge may result in "buyer's remorse."

Alternatives to hedging. There are other strategies that can help mitigate rising interest rate risk. For example, an organization might elect to issue shorter term fixed rate bonds ("put bonds") or variable rate obligations.

If finance leadership decides to pursue hedging strategies, communication and transparency with the Board is essential. Discuss the organization's plan with the Board early on and get its approval in place so the organization can move quickly to take advantage of opportunistic market conditions.

Many organizations may already be receiving multiple queries from financial institutions seeking conversations about hedging possibilities. A considered process that evaluates the pros and cons of a hedging strategy and its applicability to the specific needs of your organization will help you determine the best path forward in a rising rate environment.

For more information on hedging strategy considerations, please contact
Eric Jordahl (ejordahl@kaufmanhall.com) or Steve Sohn (ssohn@kaufmanhall.com)

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