

Current Rate Inversion Historic Perspective 10-Year Swap Rates vs. 3-Month LIBOR



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What is a yield curve, and which yield is being used? What is meant by a flat or inverted yield curve? To answer the first question, think about mortgage rates and financing your house. Typically, as borrower, we would expect an increase in the mortgage rate if we select a longer term mortgage. If you plotted all of the mortgage rates on a graph in relation to their maturity you would have a mortgage yield curve. Yet, in today's interest rate

Figure 1

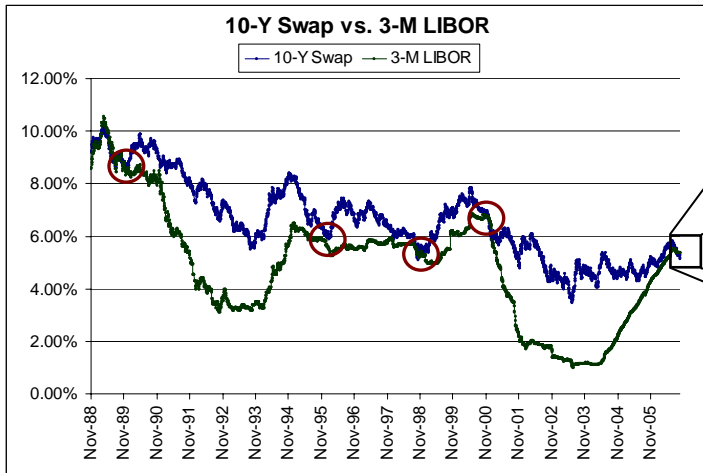
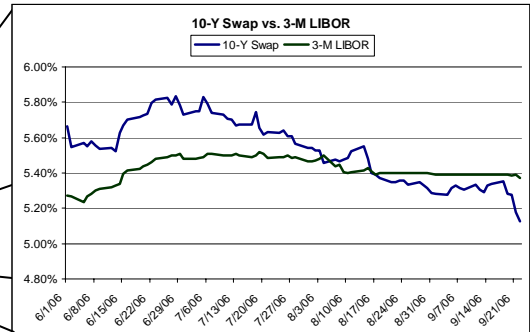


Figure 2



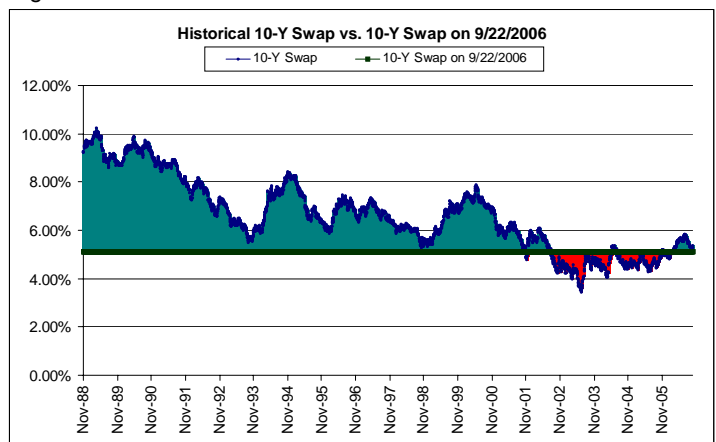
environment the picture would look more like a “Yield Line” rather than a “Yield Curve”. This is because the mortgage rate does not increase very much if you select a mortgage with a longer maturity. This same reality exists in other interest rate markets in the United States such as the Treasury, Agency and Interest Rate Swap markets. In fact, if you look at the interest rate swap market, the rate on a 10-year LIBOR swap is actually *lower* than the 3-month LIBOR rate. When a long term rate, like a 10-year yield, is less than a 3-month rate, the yield curve is said to be “inverted”. While this has occurred before in history, it is rare that it happens during a period of time when long term rates are historically low.

Since 1988, the 10-year swap rates have only been lower than today's rates 19.86% of the time. Over the same time period, the 10-year swap and 3-month LIBOR rates have only been inverted 3.54% of the time. Yet, there have only been **two days** in the last 18-years when 10-year rates were lower than today's levels and inverted. Although the yield curve has been inverted before, as shown by the circled regions of Figure 1, it is typically in a higher yield environment.

The current interest rate environment creates opportunities for borrowers including the following hedging instruments: long dated swaps, constant maturity swaps (CMS), collars, and swaps with an option to extend or cancel the swap.

In fact, a borrower with a construction loan could lock-in a borrowing rate below their current floating rate and significantly reduce the interest reserve. This could help increase the proceeds available to the borrower and reduce the inherent risk associated with the project.

Figure 3



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