

# GAINING THE RIGHT EXPOSURE

**STEVEN MORTIMER OF BARCLAYS CAPITAL** EVALUATES THE CURRENT INTEREST RATE CYCLE AND ITS RELEVANCE TO CORPORATE INTEREST RATE RISK MANAGEMENT.

The recent performance of the UK economy does not meet the classical definition of a recession (two consecutive quarters of negative growth). Also, unlike all other post-war recessions, this was not caused by high interest rates puncturing an asset bubble. This recession was not attributed to any economic factors with GDP growth and stable inflation. This time excess capacity, loss in confidence of equity valuations, corporate indebtedness, geopolitical risk of war and corporate scandals have so far outweighed the expansive monetary and fiscal policies. Last year saw the worst performance of UK equities since 1974. Continued equity market weakness, low growth expectations and widening budget deficits and emergence of new lower-price producers such as China and India have all added to subduing the global economic outlook.

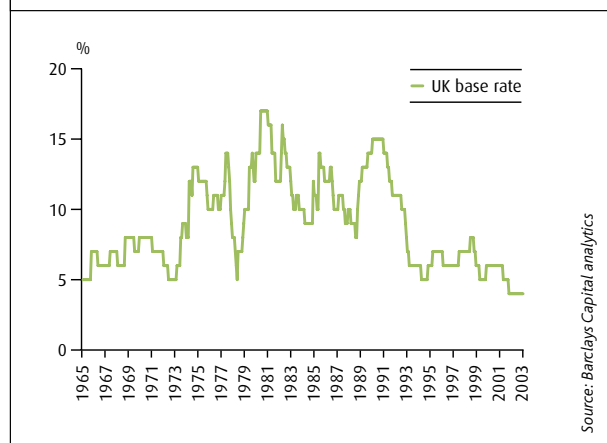
**ARE LOW INTEREST RATES HERE TO STAY?** In recent years, several factors have combined to produce a low interest rate and low inflation environment in the UK. Some of these have been cyclical and some structural. Some have been UK-specific and some have had an impact in many countries round the world.

The most significant structural impact on inflation is globalisation. This has resulted in many countries finding that they have been subjected to intense competition from developing countries where labour costs are far lower. This, combined with the increase in market transparency that has resulted from the development of the internet, has been one of the key factors why goods price inflation has been in negative territory for much of the past two years in the UK.

Another key structural reform is that independent central banks in the UK and Europe now use monetary policy to primarily target stable and low inflation.

All of this meant that retail price inflation fell from a peak of 10.9% in late 1990 to a trough of 0.7% in late 2001. Since the mid-1990s, of course, this drop in inflation has not been a reflection of weak growth. Indeed, the economy has grown in every quarter since the trough of the last recession in the second quarter of 1992. Put another way, the trade-off between inflation and growth has improved immensely.

**FIGURE 1**  
HISTORIC UK BASE RATE.

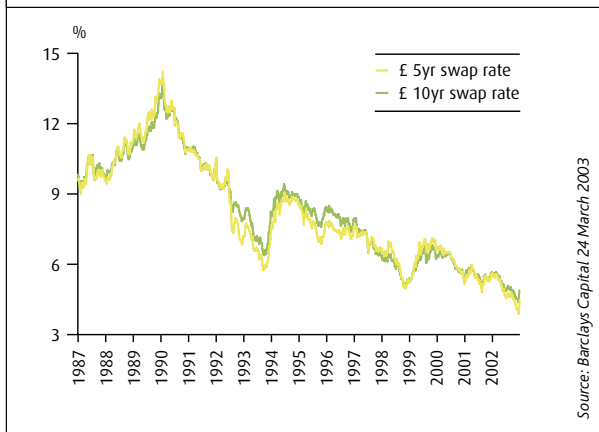


A sustained fall in inflation has allowed the UK economy and many others to benefit from lower nominal interest rates. Most recently, a combination of cyclical factors and one-off shocks has meant that interest rates have reached historical lows in many countries. In the UK, the official rate set by the Bank of England is at its lowest for 48 years (see *Figure 1*).

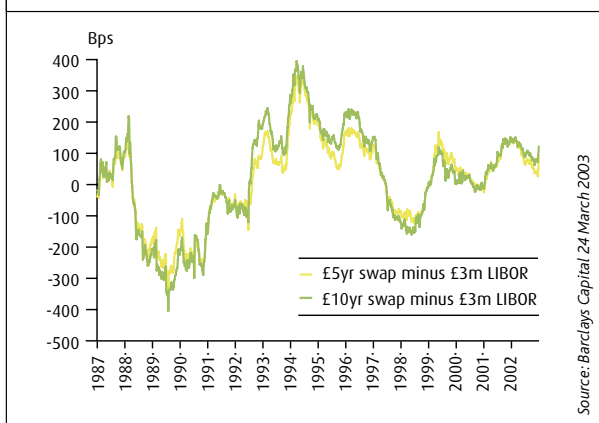
**WILL RATES GO LOWER AS IN JAPAN?** It is often asked whether the gradual drop in inflation in the developed western world is a signal that economies will soon start to encounter Japanese-style deflation, characterised by sluggish growth and an apparent ineffectiveness of conventional monetary policy.

It is now widely accepted that the situation in Japan has been caused by problems at a structural level, particularly significant labour and product market rigidities. This is mainly why 'normal' monetary and fiscal policy measures have not been able to solve the problem.

**FIGURE 2**  
HISTORIC STERLING FIVE- AND 10-YEAR SWAPS.



**FIGURE 3**  
HISTORIC COST OF CARRY.



Structural distinctions between many developed economies and that of Japan offer perhaps the most persuasive reason why the UK and US economies in particular do not seem to be threatened by deflation. These economies are structurally sound, have well-functioning labour markets, product markets and banking systems. In turn, monetary policy is effective in these countries, meaning that cyclical difficulties and one-off shocks can ultimately be dealt with effectively.

**WILL THERE BE DEFLATION IN THE UK?** For the UK in particular, it is often asked whether the deflation that we have recently seen in the goods sector will be transmitted to the service sector, giving overall price deflation. There are several reasons for thinking that this will not be the case. The most persuasive being that, while goods price inflation has been falling steadily for several years, the opposite has been true of service sector inflation. The service sector is growing and is sufficiently detached from the goods sector (not least because such a high proportion of its costs are for labour, rather than materials) that there is no reason why goods price deflation must automatically lead to service sector deflation.

'AT THIS PARTICULAR POINT IN TIME, OF COURSE, CONCERNS ABOUT DEFLATION SEEM PARTICULARLY MISPLACED. RPIX INFLATION (THE MEASURE THAT EXCLUDES MORTGAGE INTEREST PAYMENTS AND IS TARGETED BY THE BANK OF ENGLAND) HAS DOUBLED SINCE LAST JUNE, TO 3%'

**RATE OUTLOOK.** At this particular point in time, of course, concerns about deflation seem particularly misplaced. RPIX inflation (the measure that excludes mortgage interest payments and is targeted by the Bank of England) has doubled since last June, to 3%. This is primarily a reflection of the strength of house price inflation (which is used as a proxy for the 'housing depreciation' component of the RPI) and petrol price inflation. Both of these factors are likely to unwind fairly rapidly, but Barclays Capital still expects RPIX inflation to be at 2.8% at the end of this year and then 2.9% in December 2004. After that, growth in the economy should be sufficiently robust to mean that the repo rate has to rise gradually to 5.25% by the third quarter of 2004, to ensure that underlying inflation falls back to the target rate of 2.5% or below.

**WHAT DOES THIS LOW RATE ENVIRONMENT MEAN FOR CORPORATE RISK MANAGEMENT?**

**CAUTION IN LOOKING AT RELATIVE RATE VALUE.** It should be noted that viewing rates in isolation can be dangerous, given that we are in an extreme rate cycle. For example, if you viewed absolute rate levels only, you would consider fixing rates a compelling argument. However the *relative* expense of fixing should also be considered by the steepness of the curve (see *Figures 2 and 3*).

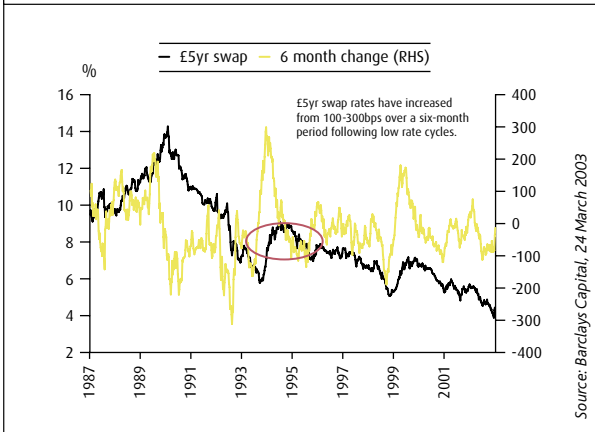
**TRADE STRATEGIES. SWAPPING FIXED INTO FLOATING.** From a strategic point of view, swapping from fixed into floating can look attractive because of low floating rates and the consequential cost of carry gains. However, due consideration needs to be given to any embedded negative market to market on existing fixed positions. These will be crystallised by swapping into Libor + premium and could prove expensive if the swap curve steepens again.

**RATE LOCKING.** There are compelling reasons to fix rates and to pre-hedge any forthcoming bond issuance at attractive gilt/swap levels. To enhance the argument for pre-hedging is the *Figures 4 and 5* showing that rates tend to be most volatile after low rate periods. Other opportunistic fixing needs to be considered with associated market to market and IAS implications.

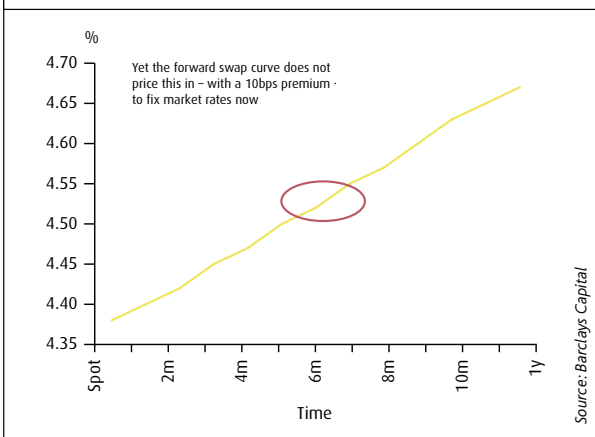
**CANCELLABLE SWAPS (SELLING OPTION VOLATILITY).** High underlying market volatility in the last 18 months has resulted in much higher implied option volatility (*Figure 6*). This provides opportunities for corporates in risk management. If your treasury duration policy has flexibility for swapping into more floating debt and the timing of these swaps, then selling option volatility can significantly reduce current fixed coupon costs.

**IMPORTANCE OF VOLATILITY.** Volatility of interest rate payments can affect credit rating and covenant interest coverage ratios,

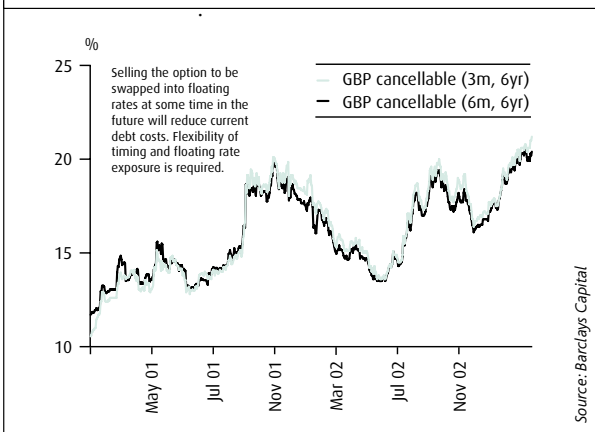
**FIGURE 4**  
RATES ARE MOST VOLATILE AFTER LOW RATE CYCLES.



**FIGURE 5**  
IMPLIED £ 5YR SWAP FORWARD CURVE.



**FIGURE 6**  
IMPLIED £ OPTION.



therefore creating an inherent threshold for volatility. If this volatility risk can be measured accurately then a company can minimise interest rates costs within an acceptable risk frame (This 'volatility versus cost' trade-off forms the platform for our pragmatic approach to optimal duration analysis).

**HOW TO MEASURE VOLATILITY OF INTEREST RATE PAYMENTS?**

Measuring the volatility of interest rate payments is separated by two approaches, as follows:

- **Volatility of underlying Libor rates.** Given the volatility thresholds above, it is important to analyse the potential increases in Libor rates and therefore debt costs in the future. In a low rate environment, applying historic percentage moves of Libor to today's spot rate, tends to underestimate risk. This is because it takes a relatively small nominal rate change to create a large percentage move. It is therefore more prudent to evaluate risks from nominal rate moves or average rate levels. Barclays Capital uses all three methods when evaluating curve risk for clients and this gives a fuller picture of relative Libor levels.
- **Ebitda correlation to Libor.** Company specific real volatility of interest payments will be effected by correlation of Libor and Ebitda. If earning has a very high correlation to six-month Libor, for example, then overall volatility of interest payments will be smaller with increased exposure to six-month Libor, regardless of its stand-alone volatility.

**OUTLOOK FOR THE UK**

The fundamentals for economic growth are there with structurally sound employment (growing in public sector), high productivity and sustained fiscal and monetary stimulus. This, coupled with the recent inflation increases, make the outlook for UK rates upward.

The relative value of low-term swap rates needs to be valued on both a relative (steepness) and absolute basis (historic nominal rates). This means swapping into low Libor rates from term-fixed rates needs to be evaluated against relative curve steepness.

There are compelling arguments to pre-hedge rates, given the increased risk of rates rising after low rate cycles and the fact that the forward curve is not fully building in this risk.

Current high implied option volatility also makes selling options very attractive, given flexibility of timing is consistent with your treasury policy.

Low interest environments also require a more pragmatic approach to measuring future rate moves and associated costs. In particular, putting less emphasis on historic percentage measures and more on nominal rate changes and average rates.

Understanding your volatility thresholds is key, given the consequences to interest coverage ratios and related ratings and covenant triggers. By better modelling the volatility of your interest payments, you can create a risk framework that enables you to confidently have the right exposure to floating rates and potentially gain from lower debt costs.

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