Who’s buried by higher rates?

IN SERGIO LEONE’S MAGNIFICENT WESTERN, THE GOOD, THE BAD and the Ugly, Clint Eastwood and Eli Wallach are hunting for stolen gold. The treasure, they discover, is buried under a headstone in a huge cemetery. Trouble is, they don’t know which headstone. At this point Eastwood turns to Wallach and utters the immortal line: “In this world there’s two kinds of people, my friend. Those with loaded guns. And those who dig.”

In the U.S. today there are also two kinds of people: those who have hedged against interest-rate rises and those who will soon be digging to meet their monthly payments. The hedgers are mainly corporations, which understand how to use derivative instruments to reduce their exposure to unforeseen rises in the cost of borrowing. The diggers are mainly households, which have grown dangerously fond of variable-rate forms of borrowing, forgetting that what goes down can go up.

Consider first the likely path of interest rates. We know from his recent utterances that Federal Reserve chairman Alan Greenspan anticipates a tightening of monetary policy in the foreseeable future. He has detected the first signs of the economic overheating that may portend inflation.

The bond market has detected those same signs. In the past year the spread between regular ten-year Treasuries and index-linked (inflation-proof) ten-year bonds has widened by nearly a hundred basis points and now stands at close to 2.6%. A widening spread implies an expectation of rising inflation. If investors expected zero inflation there would be no spread at all.

The 20-year slide in long-term rates—from 15% in the early 1980s to 3% last year—is over. The only question is how high the rates will go. Doom-mongers like Paul Krugman are predicting “a ten-year bond rate of 7%, and a mortgage rate of 8.5%—with a substantial possibility that the numbers will be even higher.”

From the point of view of American corporations, an interest-rate rise, while scarcely a cause for celebration, is neither surprising nor a reason for panic. Since December 2000, according to the Bank for International Settlements, the gross market value of over-the-counter derivative contracts has grown from $3 trillion to nearly $8 trillion—and nearly all of the increase has been due to interest-rate derivatives. According to the International Swaps and Derivatives Association, more than 80% of the world’s top 500 companies use derivatives to protect themselves against interest-rate risks.

So we can assume that most big U.S. corporations are hedged. First, their chief economists will have been warning for a year that gathering economic recovery, plus the huge twin deficits on the U.S. current account and the federal budget, make rate rises all but inevitable. Second, their chief finance officers will have sought to risk adjust their positions accordingly. It’s what anyone with an MBA from a good business school would do.

However, this is not how households are behaving. On the contrary, they seem intent on increasing their exposure to interest-rate rises. Over the past ten years millions of ordinary Americans have maximized their consumption by borrowing like mad. According to research by Merrill Lynch, the average ratio of debt to income has risen from around 85% to 118%. Household liabilities have leaped from 16% to 22% of net worth. In particular, through new loans, refinancing, and equity withdrawal, Americans have taken advantage of low rates to crank up their mortgages. The total value of mortgage debt rose from just over $5 trillion at the start of 2000 to nearly $7 trillion in the fourth quarter of 2003.

What is especially remarkable is how many of those new mortgages have been based on adjustable rates rather than on the old fixed-rate system. A year ago little more than 10% of new loans secured on residential real estate were adjustable-rate mortgages (ARMs). The latest figures from the Mortgage Bankers Association put the share above 30%. The “ARMs” race has continued even as rates have gone up.

The implications are disquieting. Suppose ARMs account for 20% of the $2 trillion of new mortgage debt. If rates were to rise (as Krugman predicts) from 5.8% to 8.5%, the cost of servicing those mortgages would jump by more than $10 billion. For many households that would translate into an immediate credit crunch as rising mortgage payments ate into disposable income.

A family with a $500,000 ARM would need to find an extra $1,125 a month. Too bad Homer Simpson never took Economics 101, much less an MBA course in finance.

There are indeed two kinds of people in the U.S. economy: those who have anticipated the coming interest-rate rises and those who have not. Are you a gun-toting hedger—or a defenseless digger?

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