PEARL CREEK
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THE BATTLE RAGES ON BETWEEN THE MARKET AND THE FED

Introduction

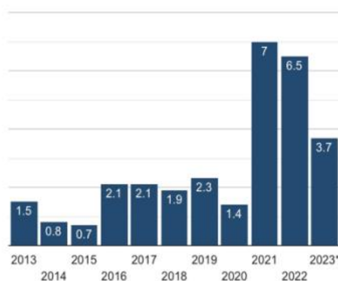
In our last market update at the beginning of 2023, we indicated that the battle lines have been drawn with the ***financial markets signaling that the Federal Reserve will not raise interest rates much further in 2023 while the Fed was signaling that it was committed to raising interest rates to keep inflation under control***. In other words, the Fed believed that the financial markets were underestimating long term inflation. Please see the [January 2023 PCA Market Update] for more background. Well, the Fed was right and the market bet wrong..... The Fed has raised interest rates four times this year, raising the Fed Funds rate from 4.5% to 5.5%. And there is speculation that the Fed may raise rates even further.

It's All About Inflation

In early 2021, market participants became worried about higher inflation due to two primary factors: a shortage of goods created by COVID induced supply chain disruptions and unmet demand caused by too much COVID relief funds being pumped into the economy by the Federal Government. And the market had a right to be worried, urging the Fed to raise rates. And the Fed now admits that it reacted too late - and has been playing catchup ever since.

In late 2021 consumer prices rose 5.7% from a year earlier, rose to 7% in December and accelerated to a 7.5% annual rate in January, the highest level in four decades. And it did not slow down, reaching 8.5% in March of 2022, and remained stubbornly high for most of 2022 to end at a year-to-year inflation rate of 6.5%, well above the Fed's target of 2-3%.

Throughout 2023 we have seen inflation come down to an annual inflation rate for the end of September of 3.7%.



So, why would the Fed continue to raise interest rates despite a trend line showing that inflation is easing?

The Labor Market

The labor market continues to befuddle the experts. Near historical low unemployment (3.7%) and higher than expected job growth has the Fed convinced that the economy is not slowing down to an acceptable level. This has caused a rise in interest rates over the past several weeks because the market now believes there is less likelihood of a recession and Fed rate cuts.

Experts expected an economic slowdown over the summer due to high interest rates, elevated inflation (things and services cost more), the resumption of student-loan repayments, and rising oil prices. Instead, the economy picked up steam over the summer, fueled mostly by consumer spending, with employers adding 336,000 jobs, the most since the beginning of 2023.

And the hiring was well-rounded. Overall private-sector jobs are up 3.5% from pre-pandemic levels. Interestingly, one of the few sectors where employment is below pre-pandemic levels includes nursing and assisted-living facilities. And high profile labor strikes underscore how workers continue to leverage the still-tight labor market for higher wages and other concessions.

And the Fed knows its history. The U.S. economy struggled between 1966 and 1982 because it was caught in a wage-price inflationary spiral until interest rates topped out at 20% in 1982. So, that is why the Fed is very concerned about wage growth and its impact on inflation. And this helps explain why the Fed may continue to raise interest rates. And the truth be told - the Fed is probably willing to risk a mild recession to avoid that upward spiral in inflation and interest rates.

Rates Revisted

Interest Rate Comparisons

	Jan-22	Jan-23	Oct-23
Fed Funds Rate	0.25%	4.50%	5.50%
SOFR (LIBOR)	0.15%	4.30%	5.30%
10-Year Treasury	1.75%	3.50%	4.60%
30-Year Treasury	2.10%	3.65%	4.75%
30-Year MMD	1.65%	3.30%	4.25%
30-Year BBB Rated Healthcare	2.40%	5.00%	6.50%
30-Year Non-rated Healthcare	3.40%	5.90%	7.25%
79% of SOFR Swap (30YR)	1.40%	2.35%	3.10%

It may be useful to revisit how much interest rates have changed in less than two years. And there is a sticker shock component to this that is very real. In January of 2022, the Fed Funds rate was at 0.25% and the 10-year treasury was at 1.75%. More importantly, bank rates were near 0% before adding credit spread. Long-term interest rates for tax-exempt borrowers were at all-time lows, even for non-investment grade 501© borrowers (3.5% for 35 years). So, even though rates rose drastically during 2022 with the 30-year MMD rising from 1.65% to 3.30% and rates for lower rated 501c3s rising by 250 basis points, deals got done. With rates continuing to rise in 2023, fewer financings occurred in the non-profit healthcare space, and almost none in senior living, especially for non-investment grade credits.

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Recent Bond Activity

So, the number of deals completed in 2023 in certain sectors have been few and far between. A few of the senior living deals that have been completed include: a BBB- rated **$60 million** deal in Ohio completed in ***late July*** with an 18-year rate of 5.50%; an A- rated **$118 million** deal in Washington completed ***in August*** with a 25-year rate of just above 5%; a BBB+ rated **$160 million** deal in Pennsylvania completed ***in September*** with a 21-year rate of 5.45%; and a BBB- rated **$48 million** deal in Ohio completed ***in September*** with a 30-year rate of 5.77%.

Two healthcare transactions priced last month offer additional data points. Anmed (rated AA-) came to market with a $126 million bond transaction with the 25-year maturity priced to yield 4.72%. North Canyon Medical Center (non-rated) came to market with a $46 million transaction with the 26-year maturity priced to yield 7%, a difference of 228 basis points compared to the AA- rated transaction.

Normally borrowers would flock to bank financing when bond rates have increased so dramatically. However, due to the many headwinds facing the healthcare and senior living sectors (workforce issues to name one), banks are weary of these sectors. In addition, the Silicon Valley Bank collapse have made previously bullish lending institutions more cautious in deploying any new capital. And with short-term rates so high, tax-exempt variable rate bank debt is currently approaching 6%.

What Can We Expect Ahead?

As we explained in our last Market Update, the Fed will be aiming for what economists call a "soft landing" - getting the economy to a more healthy inflation rate of 2% to 3% while maintaining positive GDP growth, thus avoiding a recession.

As the Fed threads the needle in trying to bring down the rate of inflation without dumping the U.S. economy into a recession, it must decide when to stop raising interest rates. With the Fed Funds Rate currently at 5.5%, many economists predict that the Fed will raise rates another 25 basis points and then stop. But hope that the Fed will begin cutting rates any time soon is dwindling.

With the U.S. labor market still tight, we believe the Fed will continue to exert downward pressure on the U.S. economy by leaving rates elevated. The higher-for-longer approach, we believe, will eventually result in a mild U.S. recession.

So, no soft landing. However, it is anyone's guess as to when that will happen. So, we believe rates for non-profit borrowers, especially lower rated and non-rated credits, assuming no major events like additional wars, government shutdowns, etc. occurs, rates will remain between where they were at the start of 2023 and where they stand currently.

Borrowers have the option to invest bond proceeds (including debt service reserve funds "DSRFs") in Collateralized Repurchase Agreements ("Repos") or Guaranteed Investment Contracts ("GICs"). The difference is that Repos are usually collateralized by government securities - so are secured - while GICs are not. During low interest rate cycles, most borrowers felt like it was not worth locking their DSRFs into low yields. With higher interest rates, Repos, but especially GICs, are again fashionable.

As quick data points, 5 year and 10 year Repos are currently yielding 3.38% and 3.60% respectively. And if your Trust Agreements allow GICs the yields climb to 5.03% and 5.05% respectively. So, there may be an opportunity to lock in higher yields in DSRFs.

A few caveats - Yields on bond proceeds, including DSRFs cannot exceed the arbitrage rate on the bonds. The bad news is that most bond transactions completed in the last few years, especially in 2020 and 2021when interest rates were exceptionally low, had huge premiums. Without getting technical, this means that the arbitrage rate (allowable yield on proceeds) is well below the actual cost of capital or true interest cost of the bonds. The good news is that if the proceeds of the bond issue in question were used for construction, the borrower most likely has negative arbitrage that can be offset by the positive arbitrage earned in a DSRF. And there is no time limit to recapture that negative arbitrage. A final comment. GIC brokers usually bid out these contracts to providers. The fee that the GIC broker charges is allowed to be incorporated into the yield calculation on the Repo or GIC as long as it is "fair and reasonable." So make sure you know what that fee is and make sure that bond counsel has determined that the fee is fair and reasonable. There is actually a "safe harbor" fee that can be used without such an opinion. Because of these nuances, it is recommended that you use a trusted advisor to help guide the process.

And as pointed out in almost every Pearl Creek market update, in addition to Treasury rates, cash inflows and outflows from tax-exempt mutual funds also impact long-term tax-exempt rates. And that dynamic will cause rates to fluctuate in that "early 2023 and current rate range." Fortunately, 2023 was not a repeat of 2022, where record cash outflows occurred, doubling the next worse year. However, for the first time in 2023, tax-exempt mutual funds during the last two weeks experienced consecutive outflows totaling over $1 billion, putting upward pressure on tax-exempt rates, which is one reason we have seen a recent upward surge in tax-exempt interest rates. Hopefully, this trend will not continue.

There is some good news. Because of the current high interest rate environment, borrowers who do have long-term bond debt on their balance sheet with debt service reserve funds are able to possibly lock in higher yields on those moneys. Please see insert.