**Editor's Notebook**

# Interest Rates: Up, Up and Away, or Just Up?

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Fri Dec 17, 2010 06:29 AM CST

Talk about plans going awry. In the more than six weeks since the Federal Reserve Board unveiled its $600 billion plan to reduce longer-term interest rates, those rates have risen instead. On 10-year Treasury notes, the rate is up just slightly more than a percentage point to nearly 3.5 percent.


Jamie Stewart, president and chief executive officer of Federal Farm Credit Banks Funding Corp., speaking at the DTN/Progressive Farmer 2010 Ag Summit. (DTN/The Progressive Farmer photo by Jim Patrico)

This surprising development raises several questions of interest to big-borrowing agricultural producers.

--Has the Fed lost control? It has been known to happen. When bond investors sniff inflation, they can and do defy central banks. The chief executive of the Farm Credit Banks Funding Corporation, Jamie Stewart, thinks it's happening again, and it scares him. When the Fed announces a policy and the market moves the other way, Stewart told the DTN/Progressive Farmer Ag Summit in Chicago, "There's something seriously wrong with policy-making in this country."

As a former Federal Reserve official -- he was second in command of the New York Fed during 9/11 -- Stewart knows that central banks and government treasuries can't afford to be out of touch with the bond market; it has too much power. An aide to former President Clinton once said that if there's such a thing as reincarnation, he wanted to come back as the bond market so he could intimidate everyone. The Federal Reserve may now be relearning that lesson.

--If the bond market is in control, are we off to the races? Will interest rates soon surge to uncomfortable levels? Not necessarily. Over time interest rates will do that if Uncle Sam doesn't reign in his fast-growing debt. But there's a debate about whether that surge is already underway.

The yield on the 10-year Treasury is still relatively low and still below its 2010 high of 3.99 percent, set last April during the Greek debt crisis. The Wall Street Journal, which has criticized quantitative easing, thinks the bond-yield run-up reflects the recent run of better-than-expected economic data. "Count us among the optimists," the Journal wrote in a recent editorial. In this view, the rise in long rates is a return to normalcy that will enable the Fed to end quantitative easing sooner rather than later, not the beginning of hyperinflation.

Even pessimists admit it would be unusual for interest rates to soar when unemployment is high and inflation low. But we had high interest rates and high unemployment once before, in the late 1970s and early 1980s. And in the wake of Europe's sovereign-debt crises, Stewart said, the market may not be focused on current economic fundamentals. It may be anticipating a jump in the federal government's debt over the next five years from an uncomfortable 60 percent of gross domestic product to a perilous 90 percent, at which point Treasury paper would likely lose its triple-A rating. The rise is, Stewart said, "about the markets' view of the U.S. as a borrower."

--Whether rates rise a lot or a little, what can farmers do to protect themselves? Stewart offered some suggestions at the summit. Stay liquid, he said: "Liquidity is absolutely key in difficult times." And don't pay more for farmland than the land can produce in income. It's natural to fear that this is the last chance to buy farmland; don't succumb to that fear.

At a summit breakout session, Michigan farmer Barry Mumby and CME executive Jim Boudreault offered another suggestion: Hedge rates by selling Eurodollar futures. It's an interesting idea, at least in theory.

Eurodollars are U.S. dollars held by banks outside the U.S. The market for Eurodollar futures is highly liquid, even for contracts six and seven years out. The margin requirement is low. There's a reasonable correlation between the price of Eurodollar futures and changes in Libor, the London Interbank Offered Rate, to which some farm-operating loans in the U.S. are pegged.

Mumby, who grows corn, beans and specialty crops in Colon, Mich., is a believer. He still recalls paying 22.5 percent for money in the 1980s and is determined to protect the low rates now available. He trades Eurodollar futures to lock those rates in.

But he concedes Eurodollar futures aren't always a perfect hedge. Many farm loans are pegged to the U.S. Prime rate rather than Libor. Libor and Prime usually move in tandem, but in times of financial stress they may decouple. Mumby says he was forced to close out a Eurodollar futures position during the Greek debt crisis.

The CME lists Fed Funds futures contracts, which correlate more closely with Prime. But these contracts are less liquid and aren't available more than two years out, the CME's Boudreault said.

For more information, I recommend a paper Boudreault has written, "Hedging Borrowing Costs with Eurodollar Futures and Options," viewable at

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The more producers can educate themselves about the risks of rising interest rates and the options for dealing with them, the better their chances of making money-saving decisions.

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