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TFA Monthly Newsletter

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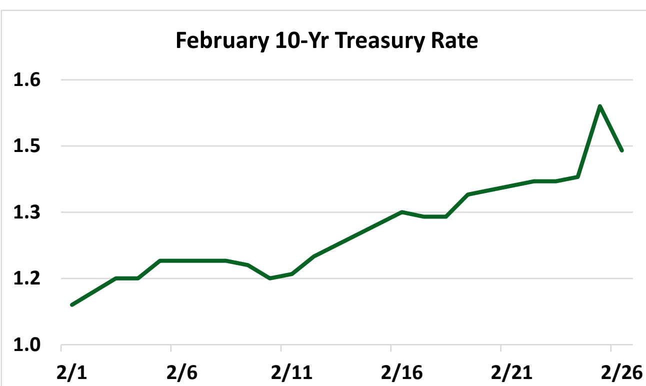
Interest Rates are Rising… Should You be Concerned?

By Kristi Jackson

In the month of February, the yield on the benchmark US 10-year Treasury Note has increased from 1.0% to 1.5% – a 50% increase. While the absolute rate level remains at historic lows, this represents a dramatically sharp jump in the rate itself.

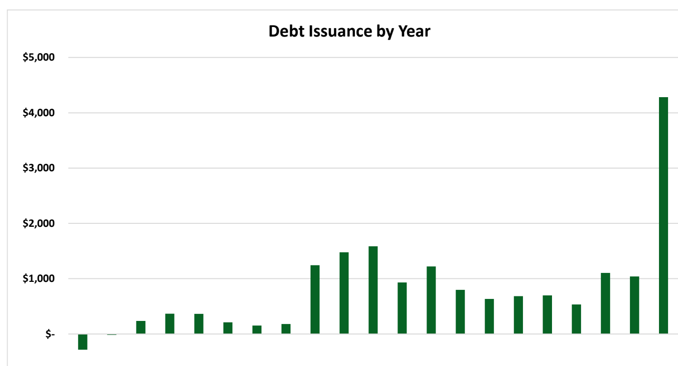


Source: [U.S. Department of the Treasury]

What is driving this recent increase – and importantly, should you be concerned? It depends on your perspective – but here are some of the considerations.

Massive Government Debt Issuance

In order to support the COVID-related relief packages, since March of 2020, Treasury has issued roughly $4 trillion in new bonds to finance the programs. According to SIFMA and the Department of the US Treasury statistics, for the annual periods from 2000 through 2019, the average annual US debt issuance has been approximately $650 billion per annum. In 2020, debt issuance was over 6 times that average, or $4.3 trillion, as the chart below shows:



Source: [Securities Industry and Financial Markets Association]

This staggering level of issuance was needed to support the economy and the millions of people affected by the forced shutdown. The ramifications of this skyrocketing US debt level however will be felt for generations. The saving grace is that the absolute level of interest expense related to the debt balance is low. According to the Central Budget Office, while the US national debt relative to GDP has grown 65% over the past 10 years, the total annual interest cost has grown only 25% relative to the size of the economy. While we are spend-

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ing much more on interest given the massive increase in debt, Treasury keeps issuing, extending maturities and refinancing at historically low rates.

The massive amount of new government debt supply is a cause of higher rates – however, we believe there is another more important factor driving the increase in yield.

Strong Economic Recovery

The main reason for the sharp rise is the prospect of reopening economies and the return of booming consumer demand. As of last week, nearly 14% of the US population had received the COVID-19 vaccine. With drug manufacturers joining forces to supercharge the production over the coming weeks and months, many believe that all Americans that want the vaccine will have it by this summer. A report issued by Johns Hopkins medical center last week proposed that the US could see herd immunity by April given the immunity offered to those who have already had COVID.

A vaccinated population will emerge and spend – many having saved up during the prolonged closure. This rebound in consumer spending may put pressure on prices as supplies of goods and services fall short of demand. Yields tend to rise with inflation expectations.

What does this mean for borrowers and investors? We think there are three factors to consider:

Higher interest rates – while still low in absolute terms, we do see the economic recovery putting upward pressure on rates, a form of "crowding out". Some of this may be mitigated with hedging, but we suggest incorporating higher borrowing costs into your forecasts.

Wage and price inflation – higher interest rates will weave their way through the economy eventually in the context of causing an increase in the price to the consumer. While the Fed will attempt to target a long-term 2% inflation rate, we can expect to see periods where the increases are higher in the near term as we move through the recovery.

Higher discount rates mean lower valuation of future cash flows – when valuing the cash flows of any income stream, whether that be earnings of publicly traded companies or those of a wholly-owned operating company, consider the impact that using a higher discount rate will have on the net present value. Many use the 10-year Treasury rate in calculating a discount rate – a dramatic rise like the one we've recently seen will increase the denominator and cause valuations to be lower.

Tribes as borrowers and investors are impacted by this recent trend. We think the pain may be well worth it - the underlying cause of the recent upward spike in the treasury rate is extremely positive – returning to a healthy economy.

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2/15/21 – WorldCasinoDirectory.com

Hamptons Casino Construction to Begin This Summer, Shinnecock Nation Says

2/17/21 – ABC7NY.com

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TFA

201 Continental Boulevard
Suite 110
El Segundo, CA 90245
tfacp.com

KRISTI JACKSON
CHAIRMAN
310.341.2335
kjackson@tfacp.com

DAVID HOWARD
CEO
310.341.2795
dhoward@tfacp.com

WILLIAM NEWBY
PRESIDENT
310.341.2796
wnewby@tfacp.com

WILLIAM CRADER, CFA
MANAGING DIRECTOR
310.341.2336
wcrader@tfacp.com

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