AST DEFEASANCE RATE MARKET UPDATE

Flash Update: US Rate Markets – Tuesday 2/27/2024

- **Rates pause ahead of the release of key economic data this week and Chairman Powell's Congressional testimony next week**
- **Key data this week includes GDP (2/28) and PCE inflation data (2/29)**
- **There are a host of Fed-officials scheduled to speak this week and next week**
- **There is the potential for elevated rate volatility as we move through the rest of the week**

Good Morning –

US Treasury and SOFR swap rates opened mixed this morning – the short-end of the swap curve opened *slightly* lower this morning but medium and long term swap rates moved a touch higher. Overall, the swap curve is virtually unchanged from last night's close. This morning, Durable Goods data showed that orders placed with US factories for business equipment barely rose in January after falling the prior month, suggesting companies may be restraining their investment amid an uncertain outlook. Housing prices increased more than expected and consumer confidence figures dropped, but the market largely shook off those numbers. The overall market reaction to the data this morning was muted as traders await the release of GDP and PCE, a deluge of "Fed-speak" (See Chart 2) and Chairman Powell's upcoming Congressional testimony.

GDP revisions are due tomorrow at 8:30 AM. Expectations are calling for a 3.3% headline figure and Price Index of 1.5%. The GDP data is not expected to provide any major surprises. GDP is an important number but the highlight this week will be the PCE inflation data released on Thursday at 8:30 AM. Headline PCE is anticipated to print at 2.4% and Core PCE at 2.8%. If PCE exceeds expectations, it means the last three inflation reports (CPI, PPI, PCE) have all shown hotter-than-expected inflation and rates are likely to move a bit higher. A lower than expected PCE print would not necessarily mean lower rates, and probably does not change anything for the Fed in terms of the timing of the "first" rate cut. Instead, rates are likely to pause as the market waits for Powell's testimony and perhaps even another series of economic data next month.

We do see some critical economic data the remainder of the week – the "big" numbers discussed above and a host of secondary economic data as well. There is certainly the potential for elevated rate volatility this week. That said, the market is not likely to move too far in either direction given Chairman Powell's testimony to Congress next week on 3/6 & 3/7 at 10:00 AM. Make no mistake, given the current market uncertainty Powell's testimony is highly anticipated and definitely a "risk-event" for the market. Powell is likely to stick to the script and further endorse the Fed's current "wait-and-see" approach. Recent economic data certainly supports that approach. The risk is that he is more *hawkish* than the market expects, given the recent inflation data. If Powell hints the Fed is leaning toward *less* than 3 rate cuts, rates will move higher.

Chart 1: ***US RATES SNAPSHOT: 11:00 AM Eastern***

UST YIELDS | SOFR SWAP SPREADS | SOFR SWAP RATES

GV Ask/Chg			SOFR/GV		SOFR OIS	
2Y	4.681	-0.014	-11.4000	+1.8900	4.5685	-0.0200
3Y	4.466	-0.023	-18.7100	+0.1600	4.2818	-0.0182
4Y	4.376	-0.013	-25.8000	+0.7000	4.1222	-0.0143
5Y	4.290	-0.005	-26.3800	+1.0600	4.0276	-0.0094
7Y	4.310	-0.002	-37.1700	-0.3900	3.9412	-0.0035
10Y	4.283	+0.004	-38.3000	-0.0100	3.9012	+0.0054
20Y	4.537	+0.008	-66.6800	+0.1300	3.8717	+0.0133
30Y	4.409	+0.014	-72.6500	-0.0200	3.6828	+0.0133

Source: Bloomberg, LLP | 11:00 AM NY Rates Snapshot

Chart 2: ***2Y, 3Y & 5Y SOFR SWAP RATES, PRIOR 6-MONTHS***

The graph below details 2Y and 3Y SOFR swap rates for the prior 30 days. Swap rates have stalled as the market waits for important economic data tomorrow and Thursday. Although rates have increased significantly in recent weeks, market levels are still well below the highs we saw in the 4th quarter of

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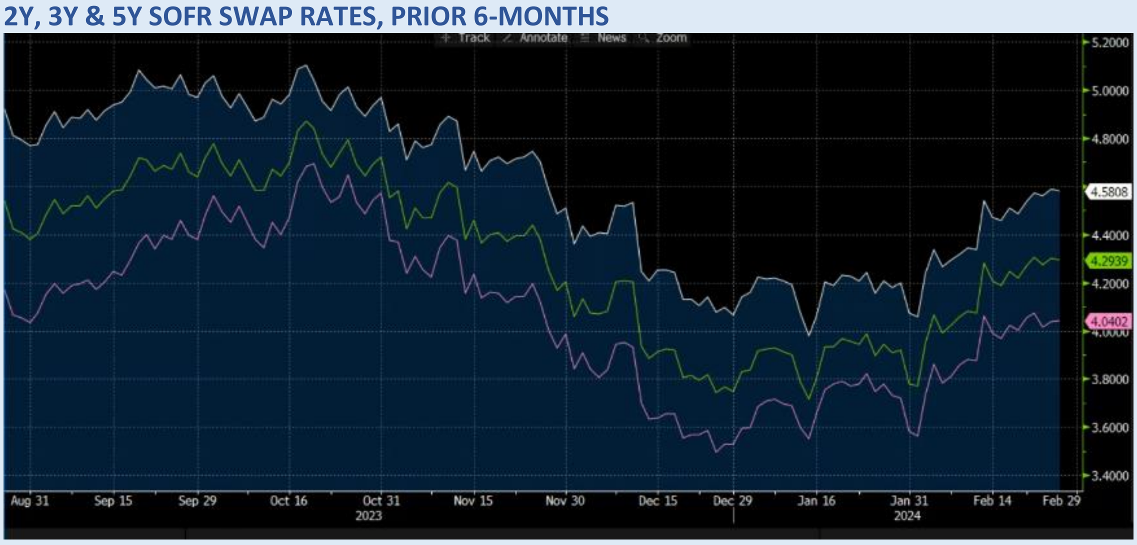
2023. The bond rally that ended the year has not yet been completely unwound – far from it. That said, there is a risk swap rates move higher on hawkish Fed-speak or unexpected data results. On the other hand, we have also been given a glimpse of where the market wants to take rates should the Fed signal they are ready to start cutting in the near future. SOFR swap rates are likely to bounce around in a volatile range as the market reacts to data, Fed-speak and the big event, Powell's Congressional testimony next week.

2Y, 3Y & 5Y SOFR SWAP RATES, PRIOR 6-MONTHS



Source: Bloomberg, LLP | 2Y, 3Y & 53Y Swap – Prior 6-MONTHS

Chart 3: ***The Path For FOMC Rate Cuts Remains A Mystery – Can the data and/or Chairman Powell point the way forward?***

The chart below shows FOMC rate decisions since 1984. The chart provides good historical context but more importantly, it shows that the Fed prefers to proceed in an orderly fashion when it comes to monetary policy. However, there were times when the Fed proceeded on a more irregular and uncertain basis (See: 1994 – 1998). This may also be one of those times. The Fed faces two tough challenges at the moment. If they cut rates too soon, they risk fanning inflation and undoing the progress made to date. If they wait too long, they could accelerate a recession. You can see the challenge for the Fed. On the one hand, the Fed would love to wait, hold rates here and finish the fight against inflation. On the other, higher rates are hurting corporate and commercial real estate borrowers. The Fed would also love to cut rates, even 25 bps, to help alleviate that pressure and open the lending markets. We will see what Chairman Powell has to say next week, but this is shaping up to be a unique and unprecedented cutting cycle. Right now, we are still stuck in the Fed's higher for longer policy approach.

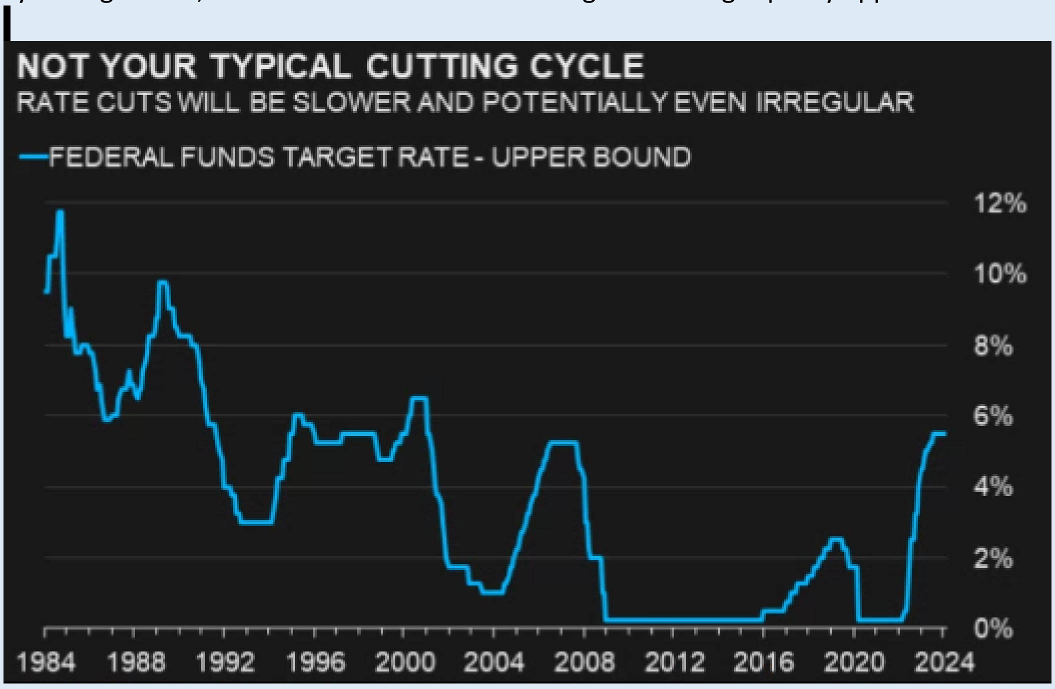


Chart 4: ***Calendar of Upcoming Fed Speeches***

The table below details the calendar of Fed speaking engagements through March 8, 2024. You can see the schedule is jam packed this week and next, culminating in Chairman Powell's semi-annual testimony to Congress. Fed-speak always has the potential to create volatility as the market reacts real-time to the comments. The market may also have a delayed reaction to Fed comments made after market hours. Fed-speak will be front and center this week and next – prepare for a jumpy market.

FED SPEECH CALENDAR THROUGH MARCH 8, 2024

	Date Time	A	M	R	Event
22)	02/28 12:00				Fed's Bostic Participates in Fireside Chat
23)	02/28 12:15				Fed's Collins Gives Remarks, Fireside Chat
24)	02/28 12:45				Fed's Williams Delivers Keynote Remarks
25)	02/29 10:50				Fed's Bostic Participates in Fireside Chat
26)	02/29 11:00				Fed's Goolsbee Gives Remarks on Monetary Policy
27)	02/29 13:15				Fed's Mester Speaks on Financial Stability and Regulation
28)	02/29 20:10				Fed's Williams Participates in Moderated Discussion
29)	03/01 10:15				Fed's Waller, Logan Discuss Paper at US Monetary Policy Forum
30)	03/01 12:15				Fed's Bostic Speaks on Economic Outlook, Real Estate
31)	03/01 13:30				Fed's Daly Participates in Panel Discussion w/ Fed's Schmid
32)	03/01 15:30				Fed's Kugler Speaks on the Dual Mandate
33)	03/04 11:00				Fed's Harker Remarks on Economic Impact of Higher Education
34)	03/06 10:00				Fed Chair Powell Testifies Before Congress
35)	03/06 12:00				Fed's Daly to Give Keynote Address
36)	03/06 14:00				Federal Reserve Releases Beige Book
37)	03/07 10:00				Fed Chair Powell Testifies Before Congress
38)	03/07 11:30				Fed's Mester Gives Speech on Economic Outlook
39)	03/08 07:00				Fed's Williams Participates in Moderated Discussion

Product Update:

Week of 2/26/24 - *What We Are Seeing In The Rates Market*

New cap volume continues to increase as do borrowers seeking to extend existing caps. The massive bond rally that ended 2023 is still *somewhat* intact. In addition, despite a shift in market pricing regarding Fed rate cuts, the forward curve is *still* pricing in ~4 rate cuts for 2024 – just starting a bit later in the year. Should inflation continue to trend higher, rate cut expectations may be reduced further.

Given the uncertainty that still remains about forward rates, many clients are grappling with when or if to extend. This is a difficult question – our advice has been to monitor the market closely and be on-boarded and ready to trade, should the market move in your favor. We also advise borrowers to check the market pricing for extensions, similar to how you purchased the original cap. Market pricing discovery is a key component to any cap transaction – new caps, extensions or terminations.

We also encourage our clients to speak to their lenders. In some cases recently we have seen lenders approve shorter term extensions (i.e. 3 months) – some borrowers may need to extend, but not for the *full* year. Other borrowers are simply looking to dynamically manage hedging rate risk by entering shorter term caps and hoping cap premium costs will drop ahead of the next cap purchase. This is not without risk, but could be a viable strategy if you believe rate are going down next year.

There is an increasing interest in exploring interest rate swaps as a possible hedge alternative. IR Swaps lock in a synthetic fixed rate and do not require an upfront premium. Unlike an interest rate cap, swaps are secured derivatives, so the counterparty selection process is more challenging with a swap. There are also additional variables that factor into the decision to pursue an interest rate swap, or to unwind an existing swap. *Please let us know if you would like to learn more about interest rate swaps.*

On another front, borrowers who have "floors" embedded in their loan have been considering purchasing a separate, stand-alone interest rate floor to *offset* the loan floor. Borrowers with a loan floor will *not* be able to benefit from floating rates that drop below the loan floor rate. They will miss out on the benefit of lower floating rates, which depending on the rate environment can be significant. To offset the loan floor, borrowers can purchase an interest rate floor which will payout should floating rates drop below the floor's strike rate. Details vary depending on the individual situation – some borrowers prefer to choose a strike on the floor that matches the floor rate on the loan, whereas others look to use a strike rate below the loan floor. (For example: Your loan floor is 3.50% - the floor you purchase can be priced at the loan floor of 3.50%, or you could look at a strike of 3.00%). The lower the floor strike, the cheaper the premium cost of the floor. Pricing ultimately depends on the individual situation and objective.

We also continue to see clients grappling with ways to manage burdensome replacement cap escrow costs. In certain cases there *may* be a way to restructure the existing cap to extract value which can offset escrow created cash-flow pressure. Short of biting the bullet and purchasing the replacement cap and ceasing escrow deposits, restructuring the cap can add risk. Many of the solutions are designed to alleviate short term cash flow pressure but as mentioned, often create additional rate risk.

Please contact us if you would like to discuss an upcoming rate cap extension, explore ways to reduce or eliminate escrow deposits for replacement caps or learn more about interest rate Swaps or Floors.

Disclaimer: *The information provided in this communication is intended for discussion purposes only. Nothing presented in this communication should be taken as a recommendation. All market data shown is indicative only and subject to change depending on current market conditions.*

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Rate Cap Advisors was established in 2015 that focus on providing commercial real estate interest rate cap solutions. Our innovation and desire to explore new possibilities that benefit our clients have allowed us to save our clients millions of dollars. No matter the service or product, we take great pride in our pursuit of perfection with a unparalleled closing track record.

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