Flash Update: US Rate Markets – Wednesday 3/20/2024

- **FOMC Meeting today, March 20 at 2:00 PM Eastern**
- **FOMC Chairman Powell's press conference (and Q&A) to immediately follow at ~2:30 PM Eastern**
- **FOMC will also release a revised "Dot-Plot" and fresh economic projections post-meeting – both are *highly* anticipated by the market**

Rates remain quiet ahead of today's FOMC rate decision at 2:00 PM (See Chart 1). There is no economic data scheduled for release this morning – the Fed meeting is the big show today. I do not expect rates to move materially ahead of the Fed meeting, but market participants should prepare for elevated rate volatility after the Fed meeting and during Powell's press conference. *Today's FOMC meeting is highly anticipated.* Powell's comments will be closely scrutinized and the market will also have a revised "dot-plot" and fresh economic projections from the Fed in hand. It is a lot of information for the market to digest. While the central bank is expected to hold, investors will be parsing commentary to assess how quickly it might start to ease. That remains the *big* question for the market. Make no mistake: *The market is waiting for guidance and information from the Fed.*

Chart 1: *US RATES SNAPSHOT: 9:30 AM Eastern*

UST YIELDS | SOFR SWAP SPREADS | SOFR SWAP RATES

GV Ask/Chg			SOFR/GV		SOFR OIS	
2Y	4.687	+0.004	-10.1400	-0.5100	4.5864	-0.0031
3Y	4.470	-0.001	-15.7000	-0.1300	4.3142	-0.0008
4Y	4.390	+0.001	-22.8800	+0.0900	4.1556	+0.0005
5Y	4.297	+0.000	-23.8800	+0.1200	4.0594	+0.0014
7Y	4.307	+0.001	-34.1800	+0.1700	3.9665	-0.0001
10Y	4.289	-0.004	-37.2100	+0.1700	3.9173	-0.0023
20Y	4.541	-0.006	-66.1300		3.8800	-0.0064
30Y	4.434	-0.008	-74.1100	+0.0500	3.6933	-0.0077

Source: Bloomberg, LLP | 9:30 AM NY Rates Snapshot

Chart 2: *SOFR Futures Imply Long-Term Fed Funds Rate of 3.50%*

Currently, 3-Month SOFR futures contracts are implying a long-term Fed Funds rate of ~3.50%, to be reached at some point during the first half of 2025. The Fed has also been communicating that they would like to see a "neutral" or terminal Fed Funds rate of ~3.50%. At the moment, SOFR futures and the FOMC are on the same page. That said, you can clearly see that expectations for the terminal Fed Funds rate have shifted *dramatically* from one year ago. This is a good reminder that *forward curves rarely manifest as forecast*. From my perspective, the 2.00% neutral rate Fed Funds projection from a year ago was far too optimistic. A neutral rate of 3.50% seems more realistic and it provides the Fed the opportunity to pivot rates higher or lower as monetary policy and economic conditions dictate. This is also tangible evidence that the futures market has removed at least 3 rate cuts from forward pricing. We will hopefully get more clarity today on the Fed's longer term outlook for the benchmark rate.

Long-Term Implied Fed Funds Rate

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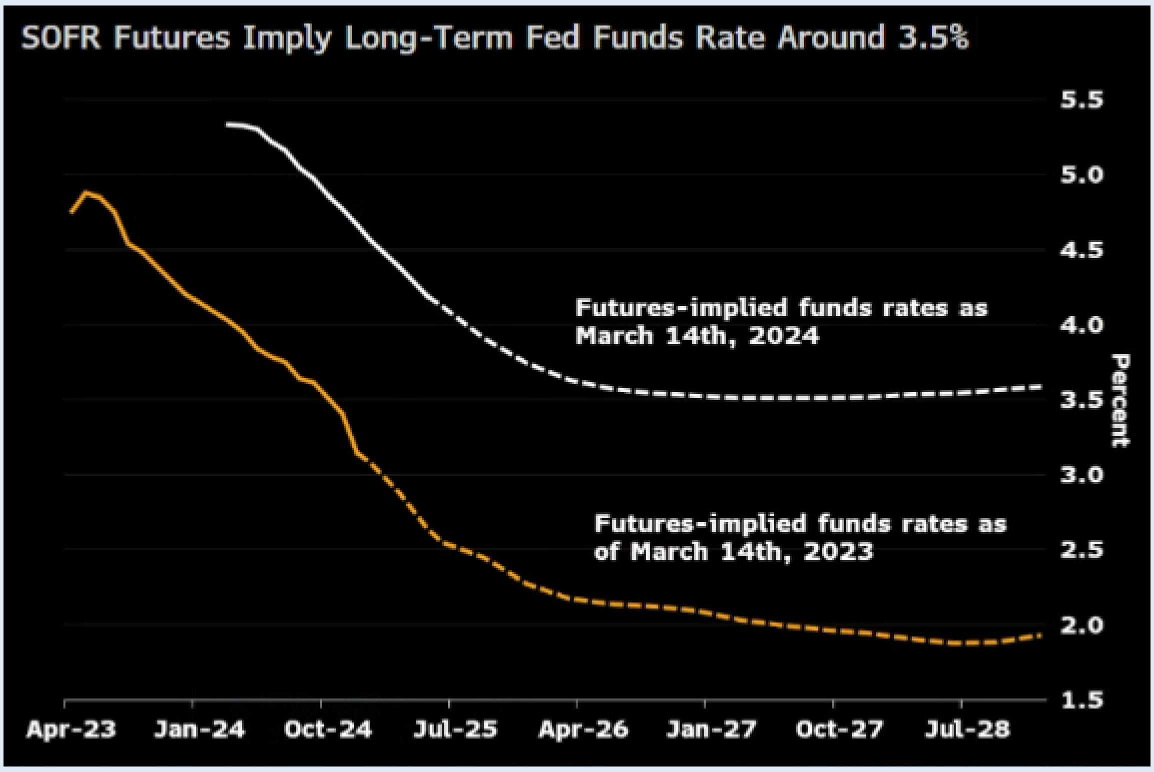


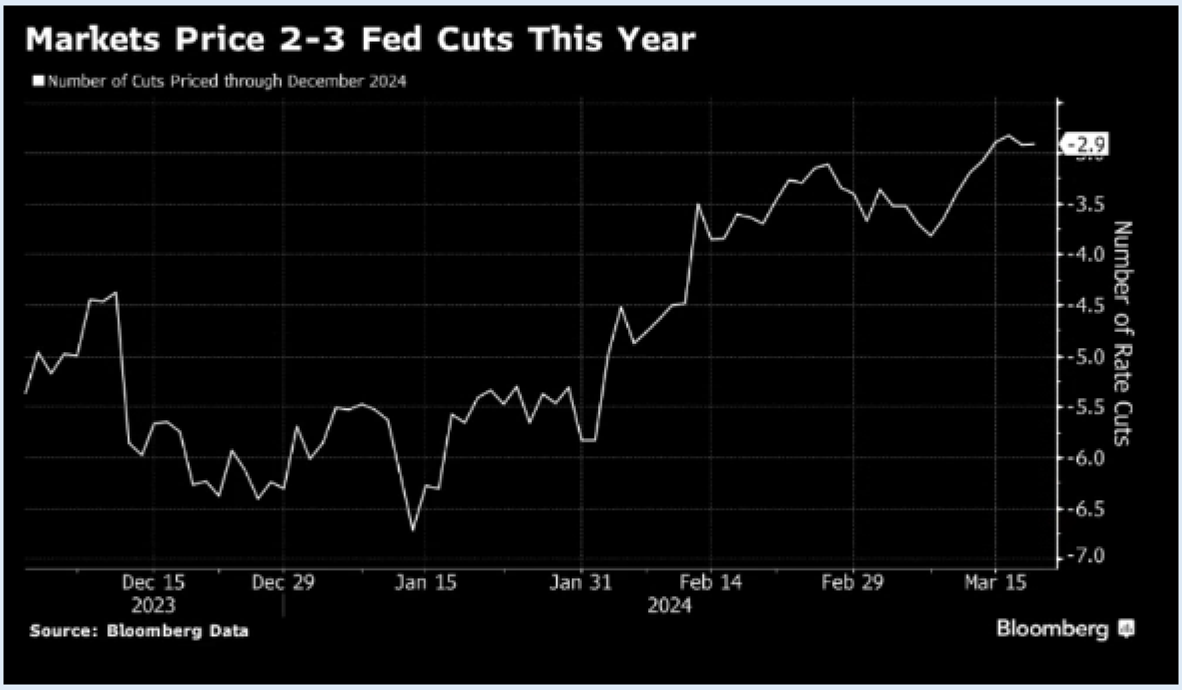
Source: Bloomberg, LLP | SOFR Futures Implied LT Feds Funds

Chart 3: ***Market Pricing Holding On To Three 25 bp FOMC Rate Cuts This Year***

As we have been discussing, the market is concerned that the Fed may dial-back rate cut expectations this year and revise the "dot-plot" to reflect two and not three potential rate cuts. Over the past month or so we have witnessed a market that has grudgingly accepted a longer horizon for the initial Fed rate cut this year. As a result, Treasury and swap rates moved higher as the forward curve was repriced to reflect fewer rate cuts. The chart below (far right) reflects the number of rate cuts currently priced into the forward curve. At the moment, the market has priced in just under 3 rate cuts (2.9 to be precise). You can also see that as recently as January 31, the market had priced in over *6* rate cuts this year. This has been the primary reason behind the rate volatility we have seen thus far in 2024. If the Fed's revised "dot-plot" reflects fewer than 3 potential rate cuts, swap rates are likely to move higher, particularly short-term swap rates. My gut tells me the Fed will leave the "dot-plot" unchanged – from my perspective that offers the FOMC the greatest monetary policy flexibility and also helps prevent the market from whipsawing back and forth as they contemplate future monetary policy decisions.

Current Market Pricing: Projected 2024 FOMC Rate Cuts

RateCap Advisors



Source: Bloomberg, LLP | Current Market Pricing – FOMC Rate Cuts / 2024

<u>Chart 4:</u> ***Economists Expect Unchanged "Dot-Plot"***

Given the recent higher-than-expected inflation data, speculation increased this week that the Fed may update the "dot-plot" to reflect fewer than 3 possible rate cuts this year. Forward pricing adjusted to reflect just under 3 rate cuts this year (2.9), but economists still believe the Fed will stick with 3 rate cuts this year. The graphic below shows the breakdown of the Fed's December "dot-plot" by individual member. Voting and non-voting FOMC members are also delineated. That distinction can be important, as only the "voting" members can directly impact monetary policy decisions. *Stay tuned!*

FOMC December "Dot-Plot"

Source: Bloomberg, LLP | Fed December "Dot-Plot"

Product Update:

Week of 3/18/24 - *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 ~3 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.

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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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