RateCap Advisors

Flash Update: US Rate Markets – Tuesday 4/2/2024

- **US Treasury and SOFR swap rates continue to climb higher**
- **Friday's disappointing PCE and strong manufacturing data released yesterday pushed swap rates higher**
- **We see a broad range of economic data released this week**
- **Forward curve is repricing on shifting FOMC rate cut expectations**
- **Highlight is Friday's Employment Report**
- **There are a number of Fed officials scheduled to speak this week**
- **The market will be listening – speculation is growing that the Fed will not cut three times this year**

Good Morning!

The first headline I saw this morning was "June Rate Cut In Doubt". I think that perfectly sums up what is impacting rates the most at the moment. The cumulative effect of "neutral" Fed-speak, positive economic data and an uptick in inflation has pushed rates higher this week as the market reprices forward rate expectations. For a brief moment last week, market pricing and the Fed dot-plot were aligned – that did not last long. Friday's disappointing PCE data series and better-than-expected manufacturing data yesterday were the catalysts the market needed to reprice the forward curve. The market is now pricing in fewer rate cuts than the Fed's dot-plot shows (See Chart 3). Behind the data, we have heard a constant chorus of Fed officials preaching patience and a reluctance to cut rates too soon. In some cases Fed officials have stated outright that they do not think they will be able to cut rates three times this year. That has definitely contributed to the shift in forward pricing. The market is still grappling with the timing of the first rate cut – the odds for a June rate cut are currently sitting at 50/50.

US Treasury and SOFR swap rates opened higher again this morning (See Chart 1). The short-end of the swap curve is up ~1-4 bps. The increase on the long-end of the curve continues to outpace shorter tenors. Swap rates 5-years and out are up ~4-7 bps today. The swap curve is flattening from the back-end, as continued positive economic data is giving the market confidence a "soft-landing" can be achieved.

The remainder of the week will be busy – there are a host of Fed officials on the tape and a broad range of economic data due for release. That said, the main event for the week is Friday's Employment Report, scheduled for release at 8:30 AM. We know the Fed is keeping a close eye on the jobs market. We also know they are prepared to cut rates should the jobs market deteriorate before inflation reaches 2.00%. Expectations are calling for a decline in the unemployment rate to 3.8%. From my perspective, 3.8% would not indicate a labor market under pressure!

Prepare for rate market volatility this week. We see a constant flow of economic data and Fed-speak all week and an important economic number on Friday. Right now, market pricing is just behind the Fed – they have not yet fully removed the possibility of a third 25 basis point rate cut. If the market continues to shift toward fewer than three rate cuts, rates will rise across the curve.

The 10:00 AM data this morning was mixed, but overall a bit better than expected (See below). The JOLTS jobs report did suggest wage pressures may be easing. That is something the Fed watches closely – they want to see wage pressure ease prior to cutting rates. Also of note, the Atlanta Fed's "GDP Now" has raised the projected Q1

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GDP to 2.8%. That is higher than the recent FOMC projections and only adds to speculation the FOMC will *not* be cutting rates three times this year.

ECONOMIC DATA RELEASED TODAY:

Date Time	A	M	R	Event	Period	Surv(M)	Actual
04/02 10:00				JOLTS Job Openings	Feb	8730k	8756k
04/02 10:00				Factory Orders	Feb	1.0%	1.4%
04/02 10:00				Factory Orders Ex Trans	Feb	0.5%	1.1%
04/02 10:00				Durable Goods Orders	Feb F	1.4%	1.3%
04/02 10:00				Durables Ex Transportation	Feb F	0.5%	0.3%
04/02 10:00				Cap Goods Orders Nondef Ex Air	Feb F	0.7%	0.7%
04/02 10:00				Cap Goods Ship Nondef Ex Air	Feb F	--	-0.6%

Source: Bloomberg, LLP | Economic Release Calendar 4/2/24

Chart 1: ***US RATES SNAPSHOT: 10:00 AM Eastern***

UST YIELDS | SOFR SWAP SPREADS | SOFR SWAP RATES

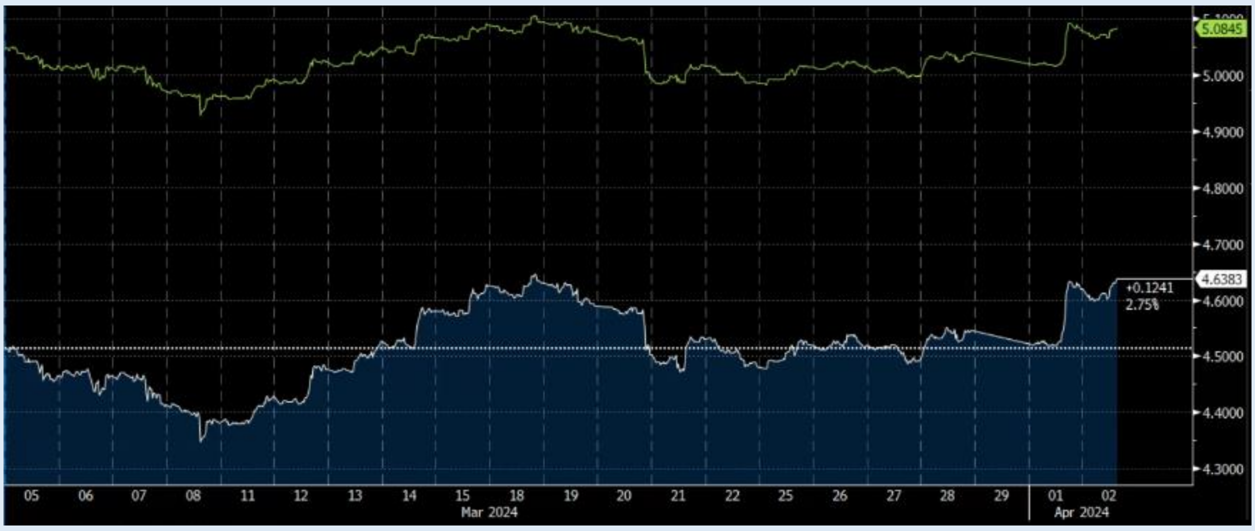
GV Ask/Chg			SOFR/GV		SOFR OIS	
2Y	4.710	+0.005	-8.8800	-0.1900	4.6232	+0.0034
3Y	4.530	+0.020	-16.6800	+0.1300	4.3658	+0.0227
4Y	4.438	+0.036	-23.3800	+0.0600	4.2177	+0.0367
5Y	4.369	+0.049	-24.0000	-0.1100	4.1304	+0.0483
7Y	4.384	+0.066	-33.5900	-0.5800	4.0499	+0.0600
10Y	4.383	+0.075	-37.3800	-0.3800	4.0096	+0.0681
20Y	4.639	+0.086	-66.8800	-1.6700	3.9720	+0.0700
30Y	4.524	+0.075	-74.0000	-0.7400	3.7853	+0.0690

Source: Bloomberg, LLP | 10:00 AM NY Rates Snapshot

Chart 2: ***Short-End SOFR Swap Rates Increase (1Y Swap = Green; 2Y Swap = White)***

Short-term swap rates are significantly impacted by FOMC policy decisions. Swap rates have climbed higher as speculation has increased that the Fed will not cut three times this year. You can see from the graph below that the bulk of the forward curve repricing happened yesterday. Currently, the market is shifting toward two 25 bp rate cuts, but they are by no means totally convinced that will happen. They are reluctantly adjusting market pricing to reflect fewer than three rate cuts this year. Should Fed-speak signal less than two rate cuts this year (via Fed-speak or at the next meeting), expect rates to continue to climb higher.

1Y & 2Y SOFR SWAP RATES – PRIOR 30 DAYS

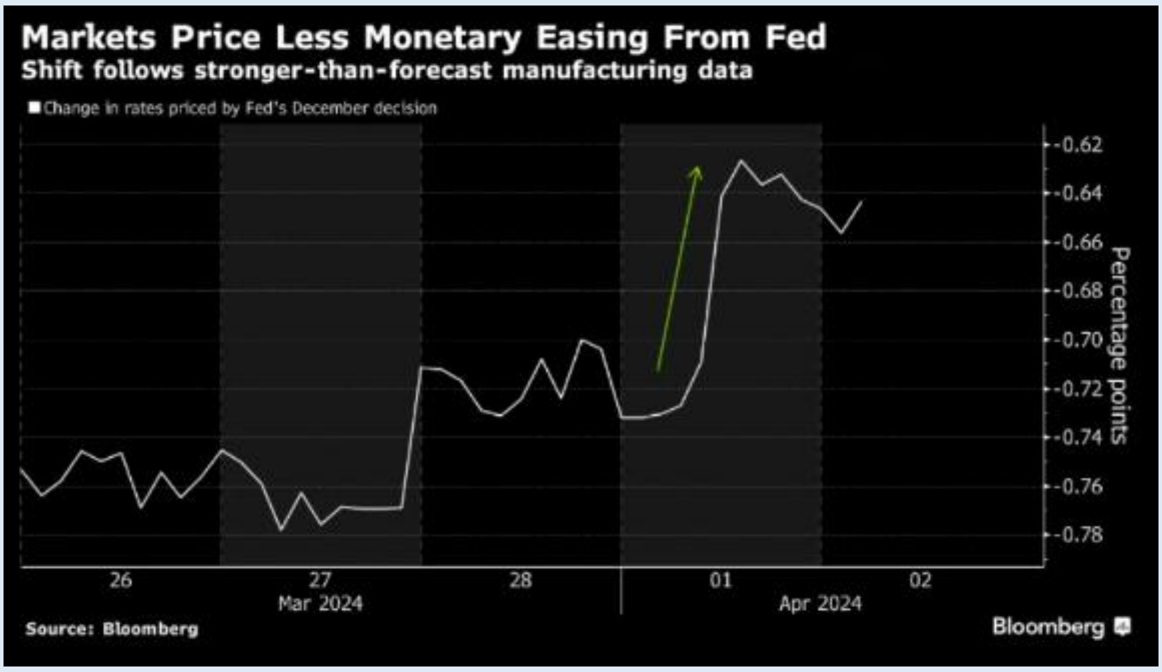


Source: Bloomberg, LLP | 1Y & 2Y SOFR Swap Rate – Prior 30 Days

Chart 3 & 3A: *Market Now "Behind" the Fed on Projected Rate Cuts*

The below charts show the sudden market capitulation we witnessed yesterday. Disappointing PCE results and strong manufacturing data, coupled with an almost constant barrage of neutral Fed-speak were the "final straw" for the market. Traders pushed short-term rates higher as rate cut expectations were dialed-back. That said, the market is definitely not prepared to bet the farm on that just yet. You can see from the charts below that the market now expects ~65 basis points of "rate cuts" this year, or about "two and a half" rate cuts. However, traders are not willing to fully commit to two rate cuts – current market pricing allows them to pivot higher or lower depending on the data and Fed-speak. I expect that to translate to increased rate volatility for the near term.

CHART 3:



Source: Bloomberg, LLP | FOMC vs. Market 1 – Rate Cuts

CHART 3A:

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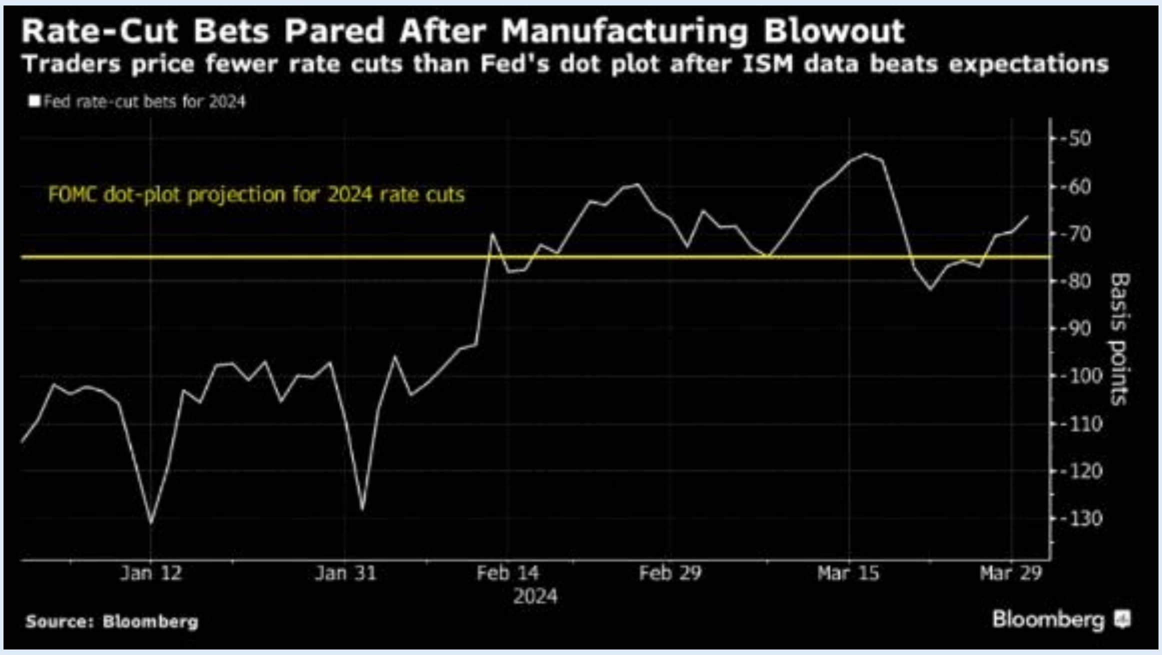
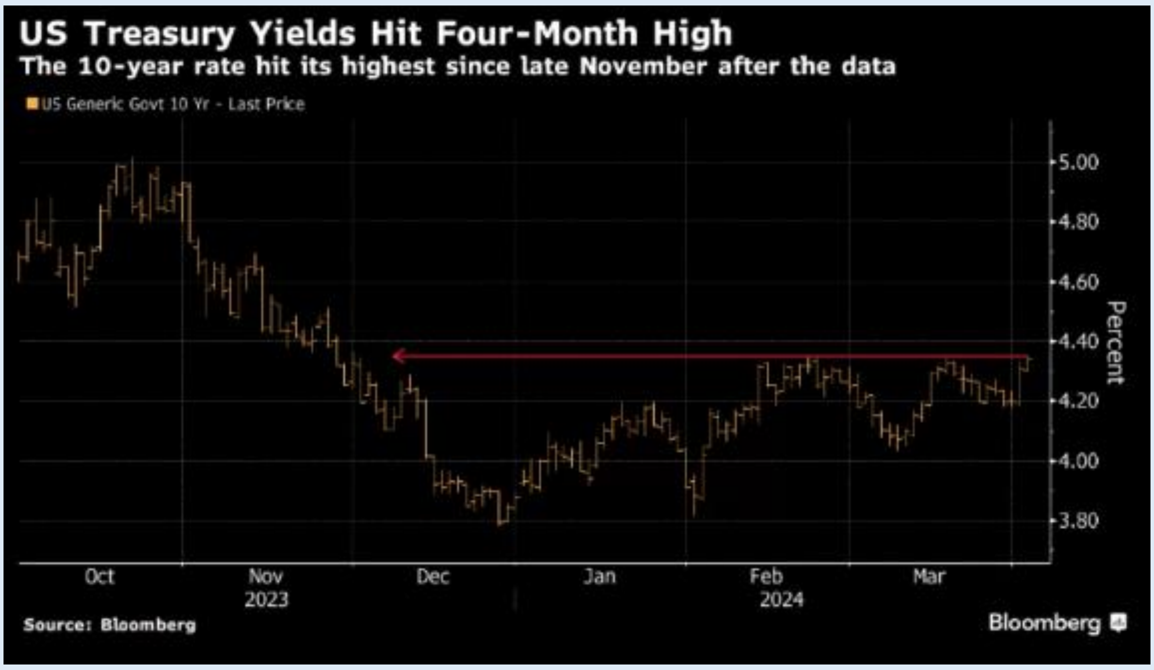


Source: Bloomberg, LLP | FOMC vs. Market 2 – Rate Cuts

Chart 4: ***US Treasury Yields at Four-Month High***

Rates have gradually crept higher since year-end and we are currently sitting at 4-month highs. The US 10Y note is currently trading at levels comparable to early November 2023. Rates are still below the recent highs we witnessed in October 2023. Short-end Treasury yields have risen as Fed-rate cut expectations were significantly dialed-back in recent weeks. Long-end Treasury yields are rising as positive economic numbers provide encouragement we will have a soft landing. At the moment long-end rate increases are outpacing the short-end of the curve, hence the curve continues to flatten.



Source: Bloomberg, LLP | 10Y US Treasury Yield

Product Update:

Week of 4/1/24 - *What We Are Seeing In The Rates Market*

New cap volume continues to increase as do borrowers seeking to extend existing caps. 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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AST Defeasance Consultants, one of the nation's leading commercial real estate consulting firms, was founded in 2007. We have extensive experience in commercial real estate defeasance, hedging, derivatives, and financial instruments. More than $50 billion worth of transactions have been executed by the AST team. Only AST can combine innovation, expertise, and exceptional customer service.

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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