RateCap Advisors

Flash Update: US Rate Markets – Tuesday 4/9/2024

- **All eyes on tomorrow's key CPI release; PPI to follow on Thursday**
- **Rates drop as current yields attract buyers**
- **Market still grappling with the pace and magnitude of Fed rate cuts for 2024**
- **Geopolitical tensions back in focus; Oil prices near 5-month highs**

Good Morning!

US Treasury yields dropped slightly this morning as higher yields attracted buyers. SOFR swap rates also edged lower in tandem with US Treasuries (See Chart 1). Despite the intraday volatility we have experienced recently, SOFR swap rates are unchanged from Friday's close. Rates moved higher after the robust jobs report and then paused as the market awaits tomorrow's critical CPI inflation data. 1Y, 2Y and 3Y SOFR swap rates are virtually unchanged since Friday's close. On the day, SOFR swap rates are lower by ~5 basis points across the curve.

We also have another busy week for Fed-speak (See Table 1). Market participants will be listening closely. Recent Fed-speak has hinted at less than three 25 bp rate cuts this year, but that is by no means a foregone conclusion. The other major event we have this week is the release of the March CPI inflation data tomorrow at 8:30 AM (See Chart 2A & 2B).

Expectations are calling for unchanged or slightly lower CPI data. Despite the recent uptick in rates, the market has not yet fully adjusted the forward curve to reflect two 25 bp rate cuts this year. Current market pricing remains at ~2.5 rate cuts (or about 60-65 bps of rate cuts). That tells me the market is still prepared to go either way on rate cuts anticipated for this year. A stronger-than-expected CPI would likely push rates higher, as the market further removes the potential for a June rate cut. Weaker inflation data could embolden the market to shift back toward three 25 bp rate cuts, leading to a decline in swap rates, particularly on the short end.

TABLE 1: ***FED SPEECH CALENDAR FOR WEEK OF 4/8/2024***

Date Time	A	M	R	Event
04/10 08:45				Fed's Bowman Discusses Basel Capital Requirements
04/10 12:45				Fed's Goolsbee, Barkin Participate in Panel Discussion
04/10 14:00				FOMC Meeting Minutes
04/11 08:45				Fed's Williams Gives Keynote Remarks
04/11 10:00				Fed's Barkin Takes Audience Questions
04/11 12:00				Fed's Collins Speaks at Economic Club of New York
04/11 13:30				Fed's Bostic Participates in Moderated Conversation
04/12 13:00				Fed's Schmid Gives Speech on Economic Outlook
04/12 14:30				Fed's Bostic Gives Speech on Housing
04/12 15:30				Fed's Daly Participates in Fireside Chat
04/15 02:30				Fed's Logan Speaks on Panel in Tokyo
04/15 20:00				Fed's Daly Gives Keynote Remarks

Source: Bloomberg, LLP | Fed Speech Calendar For April 8-15, 2024

Chart 1: ***US RATES SNAPSHOT: 11:30 AM Eastern***

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UST YIELDS | SOFR SWAP SPREADS | SOFR SWAP RATES

GV Ask/Chg			SOFR/GV		SOFR OIS	
2Y	4.743	-0.046	-10.4000	-0.5900	4.6394	-0.0534
3Y	4.554	-0.049	-16.9400	-0.4000	4.3875	-0.0524
4Y	4.457	-0.051	-23.5000	-0.1300	4.2323	-0.0522
5Y	4.379	-0.051	-24.2000	+0.0200	4.1374	-0.0517
7Y	4.379	-0.052	-33.6500	+0.0700	4.0460	-0.0502
10Y	4.374	-0.046	-37.6700	+0.0200	3.9965	-0.0477
20Y	4.610	-0.047	-65.6600	+0.6800	3.9540	-0.0411
30Y	4.511	-0.040	-74.6800	+0.1000	3.7650	-0.0380

Source: Bloomberg, LLP | 11:30 AM NY Rates Snapshot

Chart 2A & 2B: ***March CPI Expectations Call For A Modest Improvement***

Market participants and economists are calling for a slight reduction in March CPI. That would be a welcome development after two straight months of higher-than-expected inflation data. However, the expectations are somewhat deceiving. Core CPI, one of the Fed's preferred inflation gauges, is expected to *increase* to 3.4% vs. 3.2% the prior month. An increase in Core CPI makes it more likely the Fed will remain in "wait-and-see" policy mode. If the CPI figures come in at or below expectations, it may stabilize yields or even pull them back from recent levels. On the other hand, a higher-than-expected Core CPI reading could drive another round of selling. Currently the 10Y Treasury is trading at 4.37%. Many investors see 4.50% as a key upside level for the 10-year Treasury, should tomorrow's numbers disappoint. Stronger-than-expected data could see Treasury rates move higher but investors and portfolio managers are likely to snap up bonds at those attractive levels, so that could help limit upside risk.

Headline CPI is expected to hover around 3.00% for the remainder of the year. That is still materially above the 2.00% target inflation established by the Fed. If that prognostication holds up, it would likely take a significant deterioration in economic conditions to get the Fed off the sidelines and into the rate cut game.

Chart 2A – March CPI Expectations *(March Expectations – left column; Prior Month – right column)*

CPI MoM	Mar	0.3%	--	0.4%
CPI Ex Food and Energy MoM	Mar	0.3%	--	0.4%
CPI YoY	Mar	3.4%	--	3.2%
CPI Ex Food and Energy YoY	Mar	3.7%	--	3.8%

Source: Bloomberg, LLP | March CPI Expectations

Chart 2B – Headline CPI Expected to Hit 3.00% by Year-End; Fed's Target Remains 2.00%.

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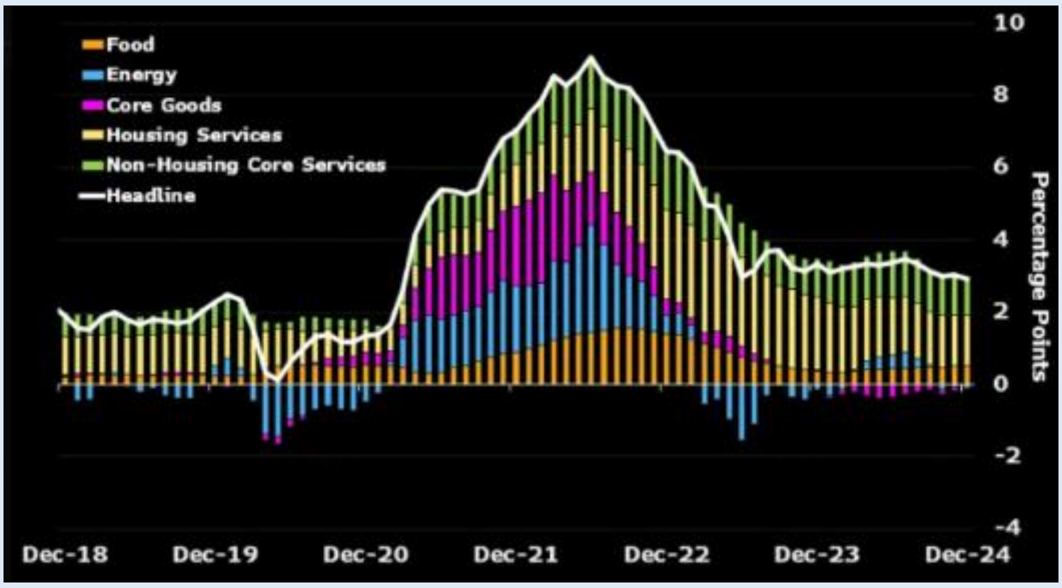


Source: Bloomberg, LLP | Employment Report Historical Detail

Chart 3: ***Geopolitical Tensions Back In Focus***

Simmering Middle-East tensions, surging oil prices and Treasury Secretary Janet Yellen's high profile visit to China have put geopolitical tensions square back in focus for market participants. We are also starting to see the US election season heating up. We will also see the ECB rate decision on Thursday. All of these factors are contributing to heightened geopolitical tensions.

Most disconcerting for US rate markets is the recent surge in crude oil prices. Large increases in crude oil prices can be an indication for increased global economic unease or uncertainty. In this case, simmering tension in the Middle East is putting unwanted price pressure on energy prices. As we know, energy prices can be extremely volatile and move quickly and dramatically, only to quiet down just as quickly. However, I cannot imagine that prolonged higher crude oil prices will be a good thing for US inflation in the short term. It could definitely create price pressure for US consumers. The main risk is a sustained increase in oil prices – that can create more lasting damage to the economy and/or drive inflation higher.

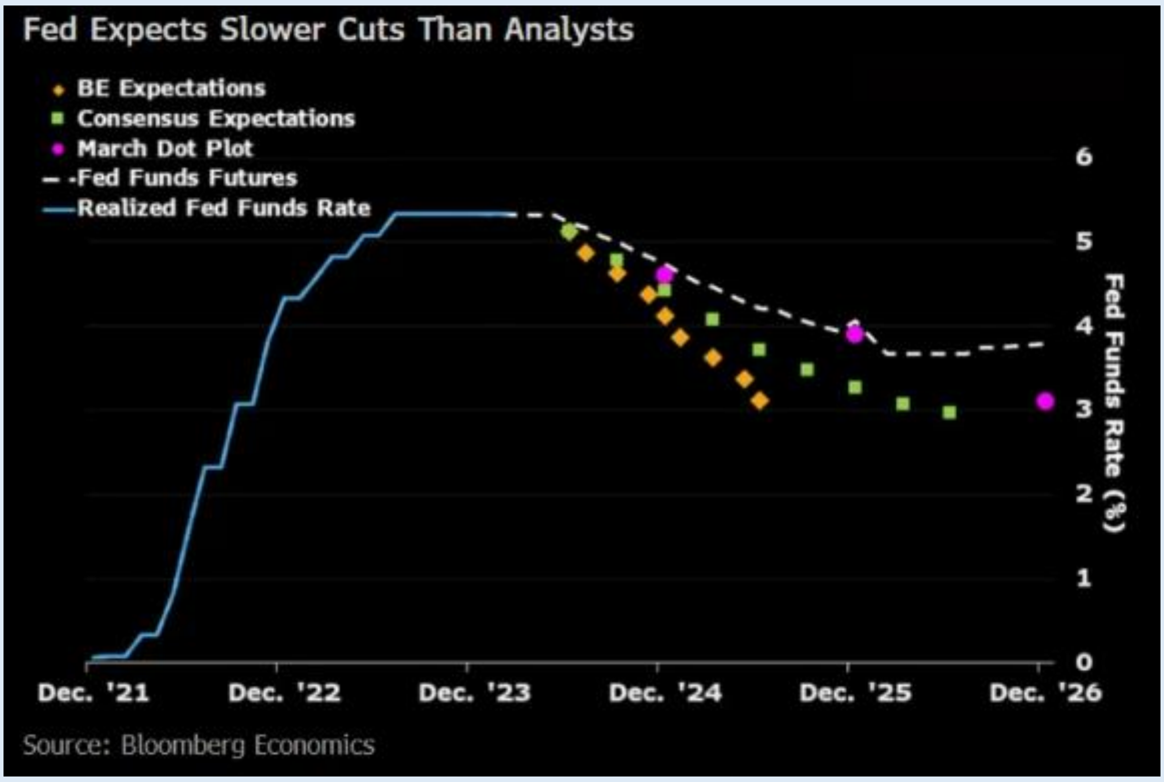
Geopolitical Risk Back In Focus For the Market

Source: Bloomberg, LLP | Oil Prices Data: October 2023 – April 2024

Chart 4: ***Market Pricing Still Ahead of Rate Cuts Beyond 2024***

The recent increase in rates was due to the market repricing forward rate cut expectations. At the moment, forward market pricing and the Fed's dot-plot are mostly aligned. The Fed has been hammering home a message of patience and neutrality. The market heard the Fed's "message" and it has been supported by strong economic data recently. As we discussed, the market is not completely convinced the Fed will cut less than three times this year – market pricing is still hovering between two and three 25 bp rate cuts for this year. Traders are reluctant to go too far and risk getting picked-off by better than expected inflation data or weaker than expected economic data. Current market pricing allows traders to pivot based on the data.

You can see from the below graph that market participants and economists are still ahead of the Fed regarding rate cuts beyond this year. At the moment, all parties are *basically* aligned on rate cuts for this year. I showed this chart to illustrate there are still a wide range of opinions regarding the path for Fed rate cuts, this year and beyond. The lukewarm market support for less than three rate cuts and the differing, uncertain forecasts for this year and next are a recipe for rate volatility. Chairman Powell has said several times that the last leg of this journey may be bumpy. So far, it has been and I expect more of the same going forward. FYI, odds for a 25 bp June rate cut have increased to 56%. Those odds were ~46% yesterday!



Source: Bloomberg, LLP | Fed Funds Expectations Through 2026; Various Sources

<u>Product Update:</u>

Week of 4/8/24 - *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. We are also seeing increased demand for interest rate floor indications – to offset high loan floors or simply to benefit from declining variable rates.

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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