Flash Update: **US Rate Markets – Friday 4/19/2024**

- **Middle-East pressure mounts as Israel launches retaliatory strike against Iran**
- **Iran appears to downplay the attack and risks of an immediate retaliation**
- **Rates initially drop, then quickly recover as situation seen as "contained"**
- **Geopolitical risk remains at elevated levels for the foreseeable future**
- **Market bracing for important economic numbers next week, followed by the FOMC meeting on 5/1**
- **1Q GDP prints on 4/25 and the Fed's preferred inflation gauge, PCE, prints on 4/26**

Overnight Israel launched a retaliatory strike against Iran. Initially, US Treasury yields dropped significantly as a "safe-haven" shift immediately followed the attack, albeit in light overnight volume. 2Y swap rates were down almost 10 basis points immediately after the attack was announced. The Iranian response, however, seemed to downplay the severity of the attack and the risk of an immediate response. Markets viewed that favorably and the situation was quickly assessed as "contained". Rates quickly reversed course and moved back to levels close to last night's close. It was almost as if nothing happened, which from a geopolitical risk perspective, is encouraging. The threat of a wider and more severe regional conflict in the Middle-East has dominated market attention this week. The muted market response is encouraging, but there is still a high level of geopolitical risk for the markets to monitor and consider.

The other main theme this week has been the hawkish comments from a broad range of Fed officials. For several months, the Fed has maintained a "neutral" tone in most public remarks. They have stressed they would hold rates higher-for-longer if necessary, but also gave the impression they were preparing to cut rates and shift to an easing monetary policy bias. However, stubborn inflation has been trending the wrong way, and the economy shows no signs of slowing down. Next week's GDP may show just the opposite.

The Fed's tone the past two weeks has gradually shifted to the hawkish end of the spectrum. That has pushed rates higher as market uncertainty around rate cuts increased. Here's a sample of the most recent Fed-speak: New York Fed President John Williams said that it isn't his baseline expectation, but a rate *hike* is possible if warranted! Williams comments were the primary catalyst to the higher rates we saw yesterday. The Fed's Bostic said he does not believe it will be appropriate to ease until "toward the end" of 2024. Minneapolis Fed chief Neel Kashkari said the Fed may hold rates steady "all year". The Fed is entering the "silent period" – after today, no more comments until after the 5/1 meeting. That said, they have definitely set a different tone heading into this meeting.

The FOMC will see 1Q GDP and PCE inflation data next week. Two *huge* numbers that will be highly anticipated by the markets and the Fed. We will delve into market expectations and the possible impact on rates in next week's updates. Stay tuned!

CHART 1: ***US RATES SNAPSHOT: 10:45 AM Eastern***

UST YIELDS	SWAP SPREADS	SOFR SWAP RATES

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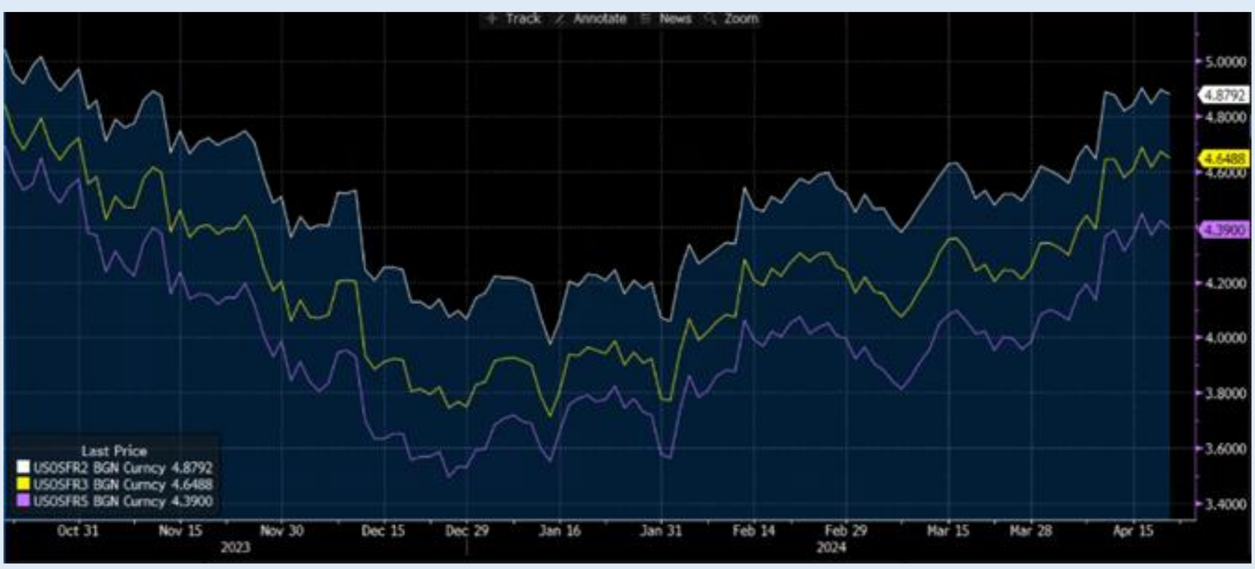
2Y	4.973	-0.013	-8.9550	+0.2950	4.8834	-0.0104
3Y	4.807	-0.013	-14.9800	+0.1923	4.6589	-0.0123
4Y	4.734	-0.018	-22.7675	+0.2075	4.5060	-0.0148
5Y	4.657	-0.018	-25.2485	+0.2514	4.4063	-0.0169
7Y	4.640	-0.018	-34.0800	+0.1130	4.3024	-0.0177
10Y	4.615	-0.018	-38.1250	+0.1250	4.2341	-0.0174
20Y	4.839	-0.014	-67.9790	-0.1240	4.1610	-0.0165
30Y	4.714	-0.017	-76.4992	+0.0008	3.9495	-0.0164

Source: Bloomberg, LLP | 10:45 AM NY Rates Snapshot

<u>CHART 2:</u> ***SOFR Swap Rates Carve Out A New Range***

The below Bloomberg graphs shows the change in 2Y, 3Y and 5Y SOFR swaps rates for the prior 6-months. At the far right of the graph you can see that swaps are carving out a new trading range. Traders seem reluctant to take rates lower, even in the face of elevated geopolitical tensions. Fears of rising inflation are spooking the market and shifting FOMC rate cut expectations. This graph also illustrates how dramatically rate cut expectations have shifted over the past 6-months – another reminder that forward curve expectations rarely manifest as forecast. Next week's GDP and PCE data, and the upcoming FOMC meeting will be the next litmus test for rate cuts. Market still clinging to hopes that the Fed will cut rates twice this year. Given the recent uptick in inflation and seeming reacceleration of the economy, those hopes are fading fast. If the Fed makes it clear rate cuts are unlikely to occur in 2024, swap rates will likely move higher in response.

Chart 2: 2Y (White), 3Y (Gold) & 5Y (Purple) SOFR Swap Rates – Prior 6-Months



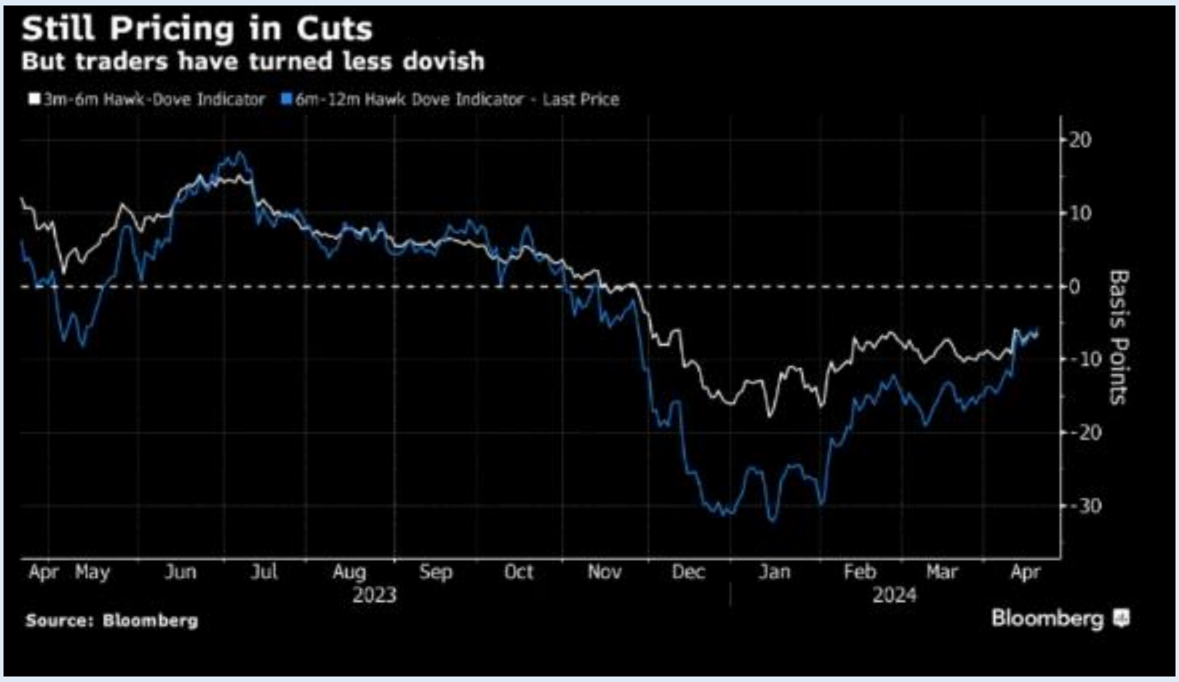
Source: Bloomberg, LLP | 2Y, 3Y & 5Y SOFR SWAP RATES – PRIOR 6-MONTHS

<u>CHART 3:</u> ***Market Participants Less Dovish, But Still Pricing In Rate Cuts For 2024***

Since March, the market has dramatically repriced Fed rate cut expectations. Since the March meeting, market implied rate cuts for 2024 went from ~80 bps after the meeting, to ~61 bps after a hot CPI print, to ~40 bps after Powell's hawkish comments. The market is hovering at those expectations currently, but it is clear that market participants are leaning far less dovish than in recent months. From my perspective, current pricing feels precarious – the market lacks conviction at the moment. That could open the door to a further unwinding of forward rate cut expectations and that could push rates higher, particularly on the short end of the curve.

The Bloomberg graph below tracks “trader sentiment” – are they leaning hawkish, neutral or dovish? The input is rather detailed, but it is based on actual market pricing and trading patterns – the takeaway is readings lower than “zero” denote a dovish trader sentiment – you can see that sentiment has shifted significantly since January. Sentiment has shifted toward “neutral” territory – that could imply traders are skeptical the Fed will cut rates anytime soon and they are prepared to adjust forward pricing if necessary.

Chart 3: Market Still Pricing In Rate Cuts…For Now



Source: Bloomberg, LLP | Bloomberg Market “Hawk-Dove” Indicator

CHART 4A & 4B: ***Geopolitical Update: Market Implications***

Despite the uncharacteristically muted reaction to today’s flare-up, geopolitical risk in the Middle-East will remain elevated for the short term. Market participants are hoping the unprovoked Iranian attack and the Israeli response will amount to nothing more than “posturing” and things will continue to settle down between the two nations. That may be the primary reason we did not see more of a reaction this morning. Chart 4A details the real-time 2Y swap rate reaction to the overnight strike. A quick drop in rates, followed by a slow drift higher as tensions eased. Chart 4B shows how Middle-East tensions and increasing US inflation concerns are impacting global stock markets. That “one-two” punch can cause disruption in equity markets and lead to higher rate volatility as well.

Chart 4A: 2Y SOFR Swap Reaction To Israel’s Strike Against Iran

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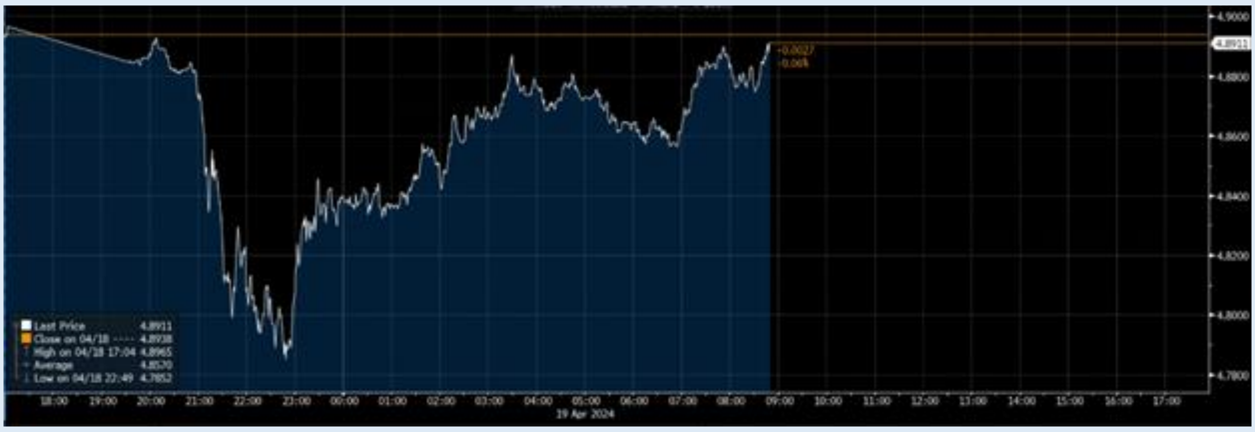
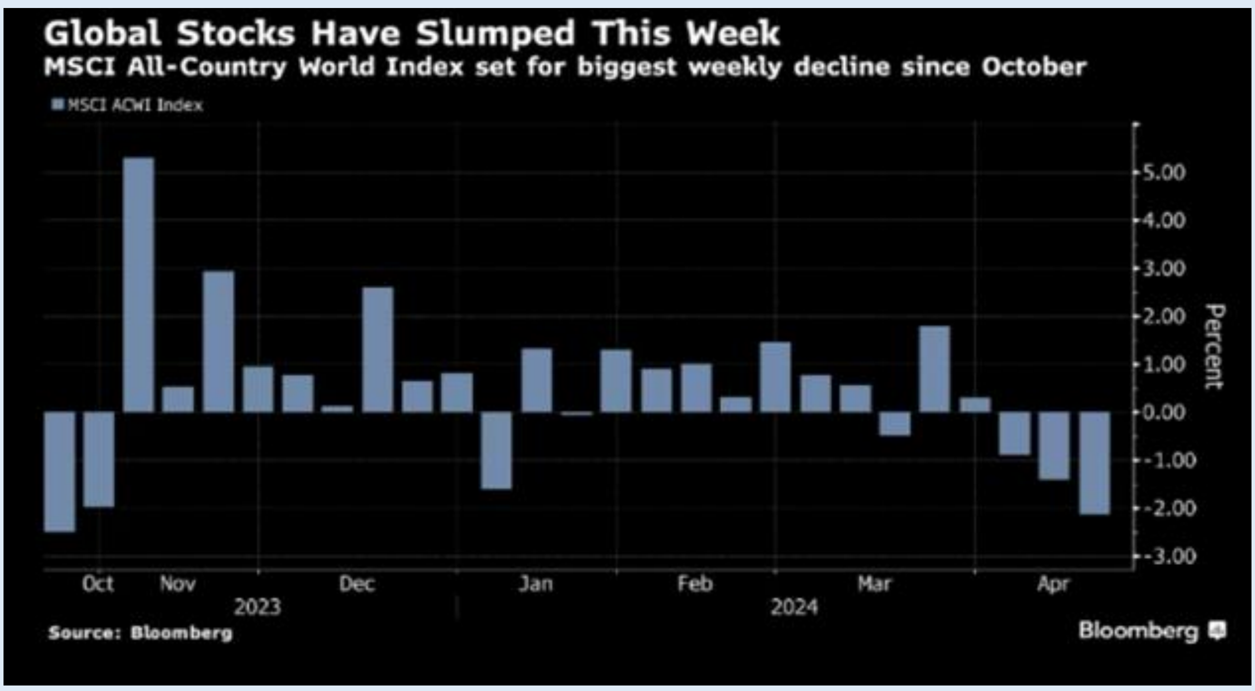


Source: Bloomberg, LLP | 2Y SOFR Swap Response – Middle-East Turmoil 4/19

Chart 4B: Global Stocks Feeling "One-Two Punch" – Renewed Inflation Threat *and* Geopolitical Turmoil



Source: Bloomberg, LLP | MSCI ACWI Global Stock Index

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