Flash Update: US Rate Markets – Thursday 5/2/2024

- **FOMC holds overnight Fed Funds rate steady; Keeps door open for rate cuts this year**
- **Chairman Powell noted the "lack of further progress" on inflation, but downplayed any immediate concern**
- **Powell's remarks calmed market fears that the next rate move could potentially be a rate *hike***
- **Overall, Chair Powell was more dovish in tone than the market had anticipated**
- **The Fed remains data driven – they will be closely watching employment, inflation and growth**
- **The next FOMC meeting will be held on June 12, 2024**
- **Next up: April Employment Report due tomorrow at 8:30 AM**

US Treasury and SOFR swap rates opened a touch lower this morning, as the market digests yesterday's FOMC meeting results and prepares for tomorrow's critical April Jobs Report. Yesterday, the FOMC held the overnight Fed Funds rate steady and signaled they are prepared to hold rates steady for longer than they anticipated. However, there were a few notable tweaks to the Fed statement that encouraged market participants that rate cuts are still on the table for 2024. There were two notable changes in the Fed's official meeting statement. (Keep in mind that even the most minor changes to the Fed's statement, even changing one word, can be significant.) One was they added a sentence noting the "lack of progress" toward the 2.00% inflation target that has occurred during the past few months. The Fed is definitely paying attention to the uptick in inflation. The second was they announced a significant tapering to Quantitative Tightening (QT) beginning in June. Despite the slightly "hawkish" slant to the statement tweaks, market participants appear to have taken the overall tone of the meeting statement and Powell's post-meeting remarks as dovish.

The market had feared Powell would be more hawkish yesterday and perhaps even signal that a rate *hike* could be under consideration, given stubborn inflation. Powell threw cold water on that notion, at least for the time being. Powell was asked repeatedly about rate hikes – reporters gave him every opportunity to hint at a possible rate hike, but Powell resisted the bait. In fact, when directly asked if the next FOMC rate move would be a hike, Powell said that "it is unlikely the next policy rate move would be a hike. I would say it is unlikely". That calmed market fears and led to lower rates while Powell was speaking. From my perspective, Powell's comments are certainly not an iron-clad guarantee the FOMC will not hike rates. However, I do feel it emphasizes the Fed's willingness to hold rates higher for as long as necessary and also indicates that the Fed is as unsure of the outlook as the rest of us are! Powell also once again underscored that the Fed will be approaching monetary policy on a meeting-by-meeting basis and they will be heavily data-dependent going forward.

The announcement that the Fed would be significantly tapering QT beginning in June also calmed market fears and led to lower rates during and after the Fed meeting. In summary, the QT tapering should enhance bond market liquidity and help hold bond rates in check. Think of it this way: the less Treasury debt that rolls off the Fed's balance sheet, the less debt that has to be absorbed by the market. The market was also encouraged that the Fed would likely not be announcing a tapering if they were preparing to raise rates.

In summary, market participants overall think that Powell did a good job yesterday. Volatility during and after his comments was minimal and the shape of the forward curve was little changed. From my vantage, Powell clearly communicated that due to "sticky" inflation, rates would need to stay higher for longer than anticipated. The market had *already* capitulated and repriced rate cut expectations, so there was a muted reaction there as well. The market still has two 25 basis point rate cuts priced into the forward curve, possibly beginning in September. (Powell did hint yesterday that a June rate *cut* is unlikely.) Finally, and most importantly from my perspective, he calmed market fears about a potential rate *hike*. Whew!

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Tomorrow we will see the first major "number" in the next economic data series the Fed and the market will see. The April Employment Report will be released tomorrow at 8:30 AM. Estimates are calling for a 3.8% unemployment rate (unchanged) and a 0.3% uptick in MoM Average Hourly Earnings. The 0.3% expectation would also be unchanged from the prior month. Remember, the Fed's dual mandate is for full employment and low inflation. They will be paying close attention to the employment data. *The economic data the Fed will see over the next two months is likely to set the rate tone for the remainder of the year.*

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

	UST YIELDS		SWAP SPREADS		SOFR SWAP RATES	
2Y	4.918	-0.042	-6.1650	+0.1600	4.8571	-0.0404
3Y	4.763	-0.044	-13.6900	+0.3486	4.6275	-0.0405
4Y	4.686	-0.036	-21.1425	+0.0885	4.4799	-0.0369
5Y	4.618	-0.031	-22.9885	-0.1135	4.3884	-0.0324
7Y	4.620	-0.019	-32.2200	-0.3200	4.2980	-0.0240
10Y	4.618	-0.011	-37.0926	-0.3426	4.2480	-0.0142
20Y	4.860	+0.000	-66.2800	-0.3140	4.1974	-0.0031
30Y	4.759	+0.009	-75.9774	-0.4774	3.9992	+0.0036

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

CHART 2: ***FOMC Meeting Recap***

The Bloomberg chart below contrasts current market rate cut expectations (Fed Funds Futures) against economists' "Consensus Expectations" and the Fed's March "Dot Plot". You can clearly see that the market expects fewer rate cuts than the Fed or market consensus. Currently, FF futures are pricing in just *under* two 25 bp rate cuts this year. The Fed's dot plot and economists' projections are largely in-line, calling for three potential 25 bp rate cuts this year. Powell did not rule out rate cuts yesterday by any means – he actually went out of his way to emphasize the Fed understands how critical it is that they do not wait too long to cut rates and damage the economy. He also quickly cautioned that cutting rates too soon could be equally damaging. That gave the market confidence that the Fed is still planning (or at least ready) to cut rates, probably at the back-end of the year. As such, forward "rate cut" pricing did not change significantly after Powell's remarks.

We will see a new Fed dot plot at the June meeting – that will be eagerly anticipated by market participants. Until then, we will have to rely on the data and Fed-speak, which will resume tomorrow now that the blackout period is over. That could certainly create elevated intra-day volatility as the market reacts to economic data and tries to determine the Fed's next move, and the timing of it. Concerning the upcoming US Presidential Election, I will leave you with this food for thought: With one exception, the FOMC has made a monetary policy move (a cut or a hike) in every presidential election year since 1980. If they feel they need to adjust monetary policy, they will likely not be deterred, election or no election.

Chart 2: FOMC Rate Cut Expectations

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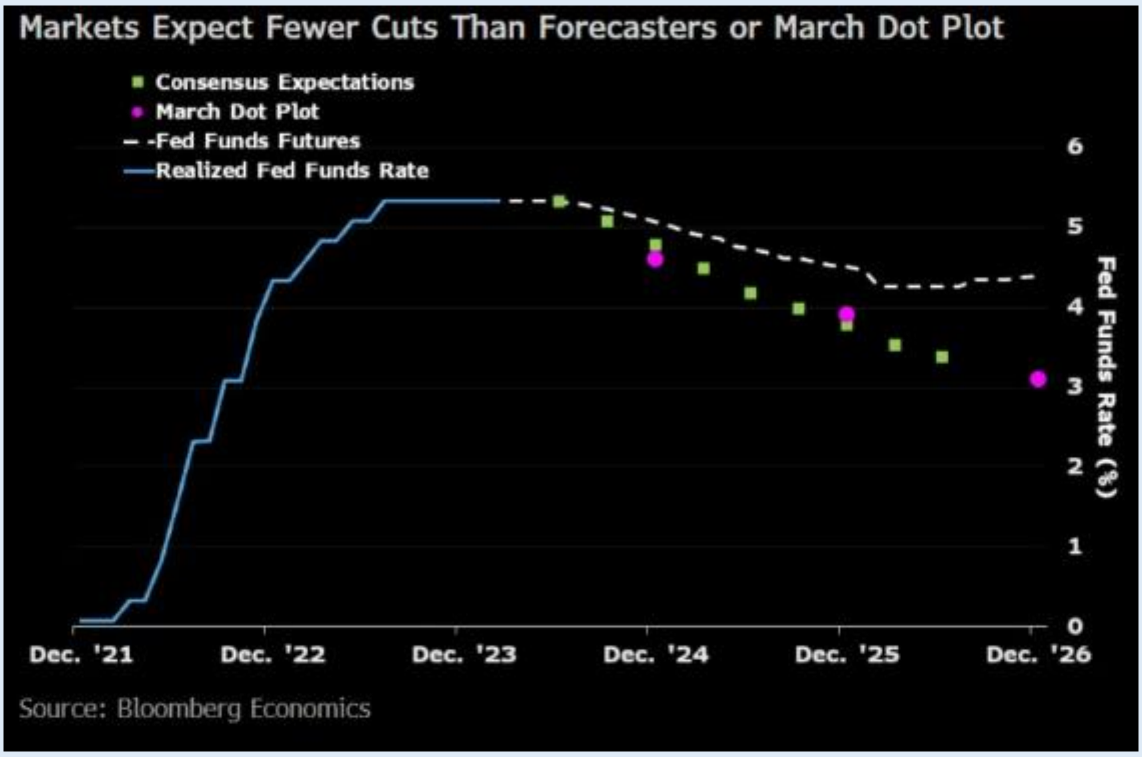
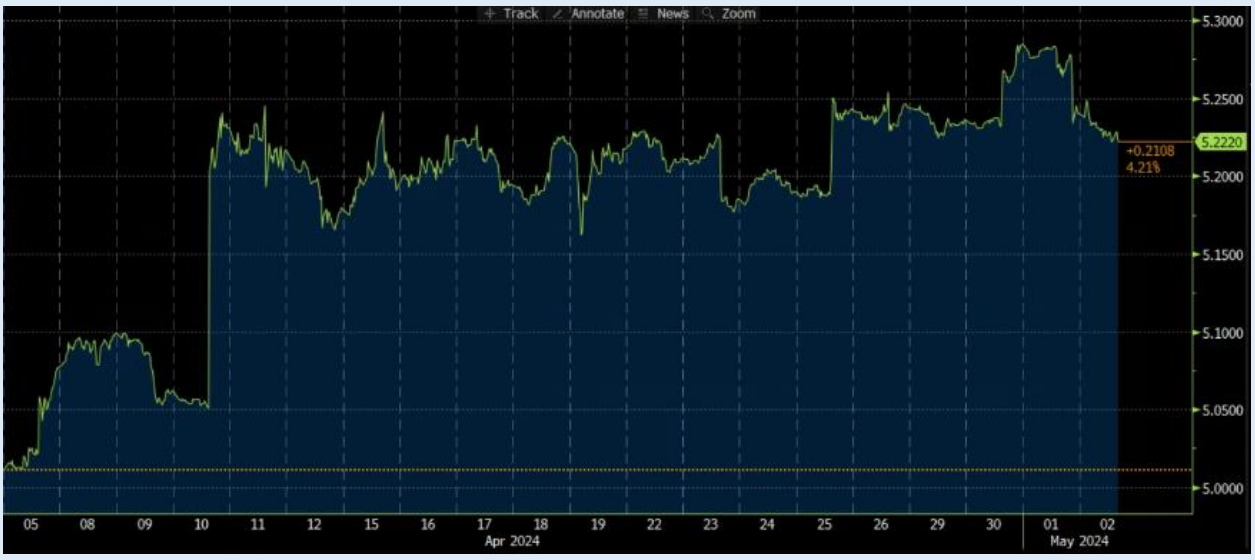


Source: Bloomberg, LLP | FOMC Rate Cut Expectations

<u>CHART 3A & 3B:</u> ***SOFR Swap Rates Drift Lower As Market Contemplates What's Next***

SOFR swap rates slid lower after yesterday's FOMC meeting and Powell's presser. Short-end swap rates were down almost 10 bps yesterday before they stabilized – 2Y SOFR swaps closed down ~7 bps on the day. Rates opened a tad lower this morning, but I think it is important to note that 2Y SOFR swaps are trading almost exactly where they were on April 22! Despite a lot to digest and contemplate from the Fed meeting, rates are still stuck in a range. In fact, on April 10th, the day we saw the red-hot CPI data, the 2Y SOFR swap closed at 4.8871% - it is currently trading at ~4.8756! We have certainly seen some intraday activity recently, but we are stuck in a tight range. From my perspective that emphasizes how important the May and June economic data will be in determining the path forward for interest rates this year – short-term rates and swap rates. The data will also influence Fed-Speak, which will be the other primary information source the market will be tracking going forward. Expect one-year SOFR swap rates to remain more volatile than 2Y or 3Y swaps. You can see from Chart 3A that this has been the case recently. More uncertainty surrounding rate cuts equals more short-end swap rate volatility. I am getting the feeling that we may be in store for significant volatility the remainder of the year.

Chart 3A: 1-Year SOFR Swap Rates – Prior 30 Days



Source: Bloomberg, LLP | 1Y SOFR SWAP RATES – Prior 30 Days

Chart 3B: 2-Year & 3-Year SOFR Swap Rates – Prior 30 Days

Source: Bloomberg, LLP | 2Y & 3Y SOFR SWAP RATES – Prior 30 Days

<u>RCA Product Update:</u>

Week of 4/29/2024 - *What We Are Seeing In The Rates & Derivatives Markets*

Markets are extremely volatile and there could be even more volatility on the horizon. Borrowers should be as nimble as possible in this market environment. Cap purchasers should onboard as quickly as possible – there is no cost to onboard. It is important to be in a position where you can take advantage of market opportunities quickly and efficiently. We have all see how fleeting these opportunities can be, so it is important to be ready to execute.

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 ~2 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.

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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 rates 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.

<u>Disclaimer:</u> *The information provided in this communication is intended for discussion purposes only. Nothing presented in this communication should be taken as a recommendation or forecast. 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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