RateCap Advisors

Flash Update: US Rate Markets – Tuesday 6/11/2024

- **Rate Markets brace for FOMC rate decision expected tomorrow at 2:00 PM**
- **Chairman Powell's press conference will immediately follow tomorrow's FOMC rate decision**
- **Powell's comments could be critical in setting the tone for rates for the remainder of the year**
- **Traders are also waiting for the release of the new FOMC consensus "dot-plot" tomorrow**
- **May CPI inflation data prints tomorrow at 8:30 AM**
- **Rates slide lower this morning on "flight-to-quality" ahead of tomorrow's data and Fed meeting**
- **European political unrest is leading to increased rate volatility and adding to the risk-off sentiment**

US Treasury and SOFR swap rates slid lower this morning, as unease over political upheaval in Europe intensified and traders anxiously await tomorrow's CPI data and FOMC rate decision. We will also hear Chairman Powell's comments immediately following tomorrow's FOMC meeting and see the most recent Fed "dot plot". Prior to the FOMC meeting, the market will see the release of the May CPI data. Tomorrow could potentially be a big day for the rate markets, and there is definitely the potential for some intra-day rate volatility.

The flight-to-quality started as traders were focused on speculation that French President Emmanuel Macron has been discussing resigning if his party performs poorly in upcoming legislative elections. Macron subsequently refuted those comments and said his position will not be affected. The French legislative vote slated for later this month risks becoming a showdown over Macron's trademark economic policies, which had largely reassured investors since he took office in 2017. The global rate markets remain jittery, hence the drop in US Treasury yields this morning.

The June FOMC meeting will likely be one of the most pivotal this year as Federal Reserve Chair Jerome Powell may provide the clearest hint yet to the rate-cut timetable. Market consensus also indicates the new consensus "dot-plot" will likely show two 25-basis-point cuts this year, compared with three in the March version. At the moment current market pricing reflects ~40 bps of rate cuts this year. Should the Fed clearly signal two, 25 bp rate cuts this year, rates are likely to slide lower as market pricing corrects.

We will also see the May CPI inflation data tomorrow – this is a critical number ahead of the FOMC rate decision tomorrow afternoon. Tomorrow's CPI expectations are as follows: Headline CPI MoM, 0.1%; Headline CPI YoY, 3.4%; Core CPI MoM, 0.3%; Core CPI YoY, 3.5%. That is still a good distance from the Fed's stated 2.00% inflation target. There is still significant trepidation concerning the path forward for US inflation. Ideally, traders would like to see proof that the disinflation trend is back on track, making it more likely the Fed will be prompted to cut rates this year. A tweak to the official meeting statement, a dovish Powell speech and a new dot plot that reflects two rate cuts would go a long way toward calming market anxiety on interest rate cuts. Should CPI print higher than expected, rates could potentially move higher as market fears on inflation linger heading into tomorrow's Fed rate decision.

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

UST YIELDS	SWAP SPREADS	SOFR SWAP RATES

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2Y	4.857	-0.024	-12.8189	-0.4439	4.7295	-0.0286
3Y	4.625	-0.024	-15.5440	+2.0185	4.4714	-0.0275
4Y	4.527	-0.026	-23.1230	+1.0260	4.3113	-0.0253
5Y	4.459	-0.023	-24.5650	+0.0600	4.2135	-0.0226
7Y	4.451	-0.022	-33.3050	+0.2087	4.1193	-0.0188
10Y	4.451	-0.016	-38.0500	+0.0750	4.0716	-0.0154
20Y	4.672	-0.015	-64.9960	+0.3170	4.0227	-0.0124
30Y	4.582	-0.013	-75.6250		3.8268	-0.0142

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

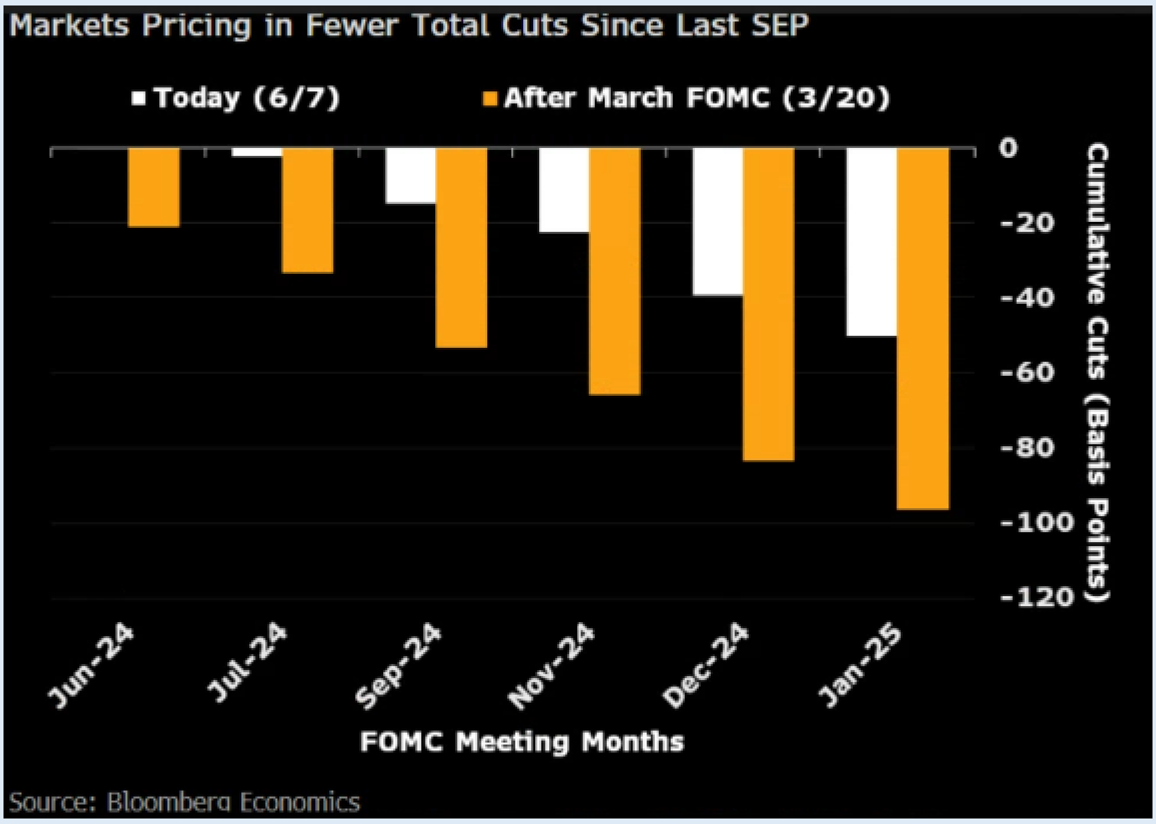
***Note:* First column is the current market level, second column is the change on the day; 'Red' = Lower; 'Green' = Higher; 'White' denotes active trading**

CHART 2 & 2A: ***FOMC Preview***

The June FOMC meeting is shaping up to be one of the most important meetings of the year. The market is at a crossroads, and there is tremendous uncertainty as to which path the Fed will walk down. On the one hand, economic growth seems to be weakening, as does the mighty US consumer. On the other hand, the labor market has been resilient, and inflation is not consistently dropping as fast or as far as the FOMC would like to see before beginning interest rate cuts (See Chart 2A). Market participants are hoping tomorrow's full plate of information from the Fed will help to clear up that uncertainty, or at least to point them in the right direction.

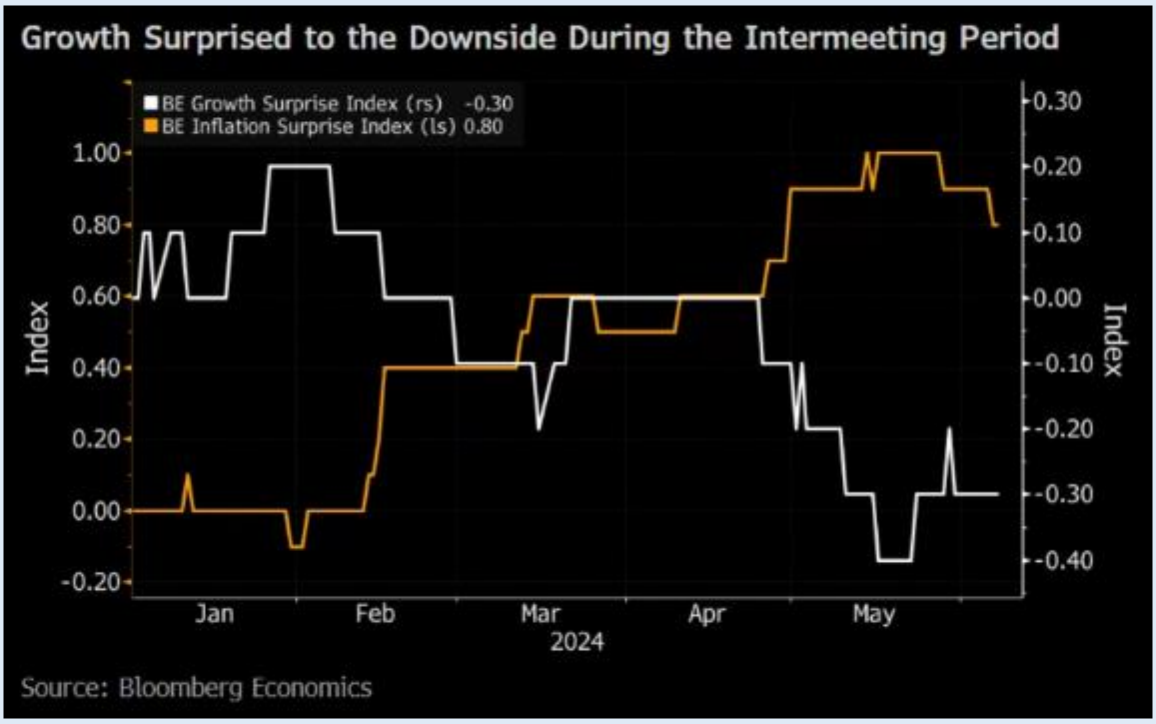
Market pricing currently reflects ~40 bps of rate cuts priced into the curve for 2024 or somewhere between one and two 25 basis point interest rate cuts. Clearly the FOMC is not going to cut 1.5 times, so current pricing tells me there is still a high level of uncertainty surrounding potential Fed rate cuts for 2024. Should tomorrow's events show the Fed is planning for two, 25 bp cuts, SOFR swap rates are likely to drop in response – traders will want to adjust pricing to reflect the full 50 bps of "anticipated" rate cuts into the forward curve. Conversely, if Chairman Powell and the new "dot-plot" point to only one potential rate cut for 2024, SOFR swap rates are likely to increase as the possibility of a second rate cut is removed from market pricing.

Chart 2: Traders See Two Interest Rate Cuts In 2024…Will the FOMC Agree?



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

Chart 2A: Growth and Inflation Currently Sending Two Different Messages



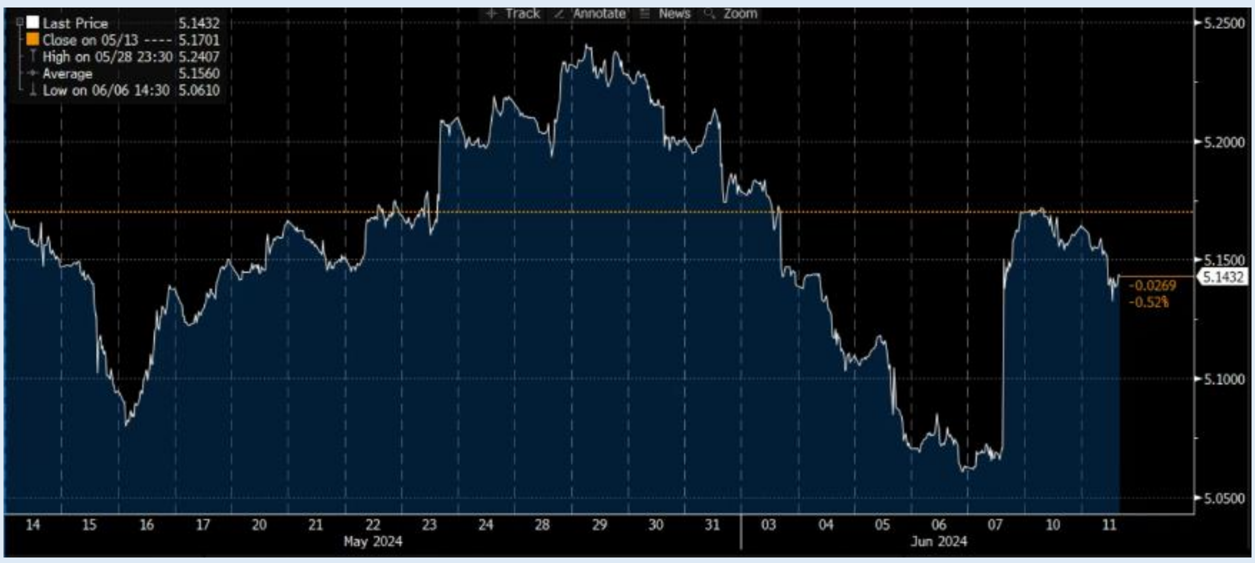
Source: Bloomberg, LLP | Growth Surprise Index vs. Inflation Surprise Index

<u>CHART 3 & 3A:</u> ***SOFR Swap Rates Drift Lower; Market Poised For Increased Volatility***

SOFR swap rates have been bouncing around in a narrow range this week after gapping higher on last week's stronger-than expected jobs data. After a significant move higher in rates, traders seemed reluctant to go "too far" with the FOMC meeting and CPI data looming on the immediate horizon. Most of the rate move lower we have witnessed since Monday has been related to geopolitical concerns. Compared to the rate increase we saw after the jobs data printed, this week's move has been muted as traders wait for tomorrow's big market events.

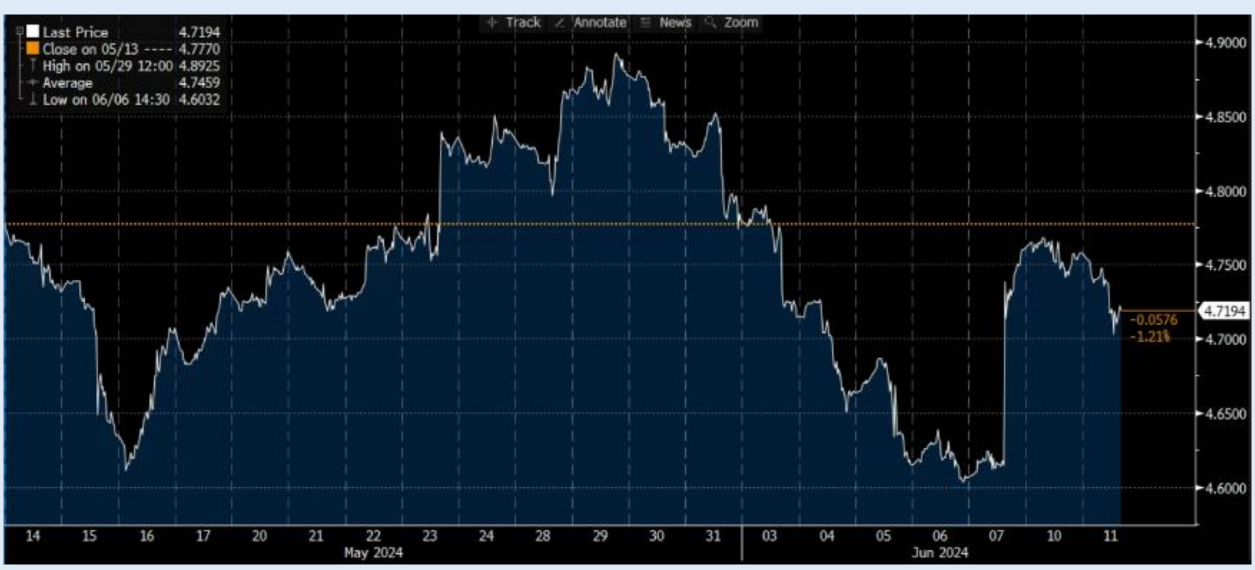
MoM, 1Y SOFR swap rates are down ~5 bps, and 2Y swaps are only lower by ~2.5 bps over the last 30 days. That is not a major move, despite the intraday volatility we have witnessed over the prior 30 days. From my perspective that volatility underscores the market uncertainty that exists in the market. It also demonstrates that the market is still somewhat optimistic that the FOMC will be able to cut rates more than once this year. We will see what the data and the Fed have to say about that tomorrow!

Chart 3: 1Y SOFR SWAP RATES, PRIOR 30 DAYS



Source: Bloomberg, LLP | 1Y SOFR SWAP RATES, PRIOR 30 DAYS

Chart 3A: 2Y SOFR SWAP RATES, PRIOR 30 DAYS



Source: Bloomberg, LLP | 2Y SOFR SWAP RATE PRIOR 30 DAYS

RCA Product Update:

<u>Week of 6/3/2024</u> - *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.

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.

Disclaimer: *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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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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