Flash Update: US Rate Markets – Friday 6/28/2024

- **May PCE inflation data released this morning prints "as expected"**
- **Market participants viewed the data as "rate cut friendly"**
- **Odds for a September rate cut increase, but not dramatically**
- **SOFR swap rates drift slightly lower after PCE release**
- **Consumer Spending dips, but Personal Income ticks higher**

The May PCE data released this morning printed exactly as forecasted (See Chart 2). Market participants viewed the PCE result as a signal that the Fed will be able to cut rates twice in 2024. The overall market reaction to the data was muted – short-and-medium-term SOFR swap rates are only down~1-3 basis points this morning (See Chart 1). The market reaction to the data this morning felt more like a sigh of relief. Traders were looking to this morning's PCE data for validation that forward pricing is appropriate. The "as expected" PCE data provided that validation. The real fear was that PCE would be hotter-than-expected and jeopardize the possibility for a second rate cut this year. Although Fed officials have hinted recently that they still see upside risks to inflation, the May PCE data should help calm those fears. Fed officials have also been saying that they are prepared to cut rates prior to inflation hitting their 2.0% target, should economic weakness or a significant deterioration in the labor market occur. Today's number increased market confidence that the Fed will be prompted to cut rates twice this year.

Despite the relief felt after today's as expected PCE data, the market does not get much of a breather. There is a full plate of economic data scheduled for release next week. The highlights include: ISM Manufacturing data on 7/1, JOLTS jobs report on 7/2, ADP jobs and ISM Services data on 7/3, and the "big" number for the week, the May Employment Report on Friday, 7/5.

We could see increased intra-day rate volatility next week given the copious amounts of data on tap. However, as long as the data does not *decrease* rate cut odds, rates are likely to remain range bound until we see the Employment Report next Friday. Additionally, markets are starting to take a more "big picture" view to the economic data. The big picture for the economy right now seems to show that a soft-landing scenario is within reach and is the likely outcome for the US economy. If that is the case, it would make a strong case for two, 25 bp rate cuts in 2024.

CHART 1: ***US RATES SNAPSHOT: 10:30 AM Eastern***

	UST YIELDS		SWAP SPREADS		SOFR SWAP RATES	
2Y	4.681	-0.032	-13.3750	+0.2640	4.5480	-0.0287
3Y	4.462	-0.028	-18.9500	+0.1900	4.2751	-0.0268
4Y	4.350	-0.025	-26.1350	+0.2350	4.1117	-0.0206
5Y	4.280	-0.017	-26.7505	+0.2495	4.0138	-0.0149
7Y	4.271	-0.005	-34.9044	+0.7146	3.9222	-0.0080
10Y	4.284	-0.003	-40.6250	+0.1134	3.8787	-0.0010
20Y	4.544	+0.011	-69.9237	-0.1342	3.8459	+0.0102
30Y	4.443	+0.018	-78.5378	-0.2978	3.6584	+0.0149

Source: Bloomberg, LLP | 10:30 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: ***PCE Recap; Rates Move Slightly Lower As Key Inflation Data Prints "As Expected"***

PCE, the FOMC's "preferred" measure of underlying US inflation decelerated in May, bolstering the case for lower interest rates later this year. All components of PCE posted as expected. Headline MoM PCE was flat (0.0%) and

Core MoM PCE increased 0.1% from the prior month. That marked the smallest advance in six months. On an unrounded basis, Core PCE was up just 0.08%, the least since November 2020. From a year ago, Headline PCE rose 2.6%, and Core YoY PCE also increased 2.6%, the least since early 2021. Inflation-adjusted consumer spending posted a solid advance in May after a pullback in April, driven by goods and fueled in part by a jump in incomes.

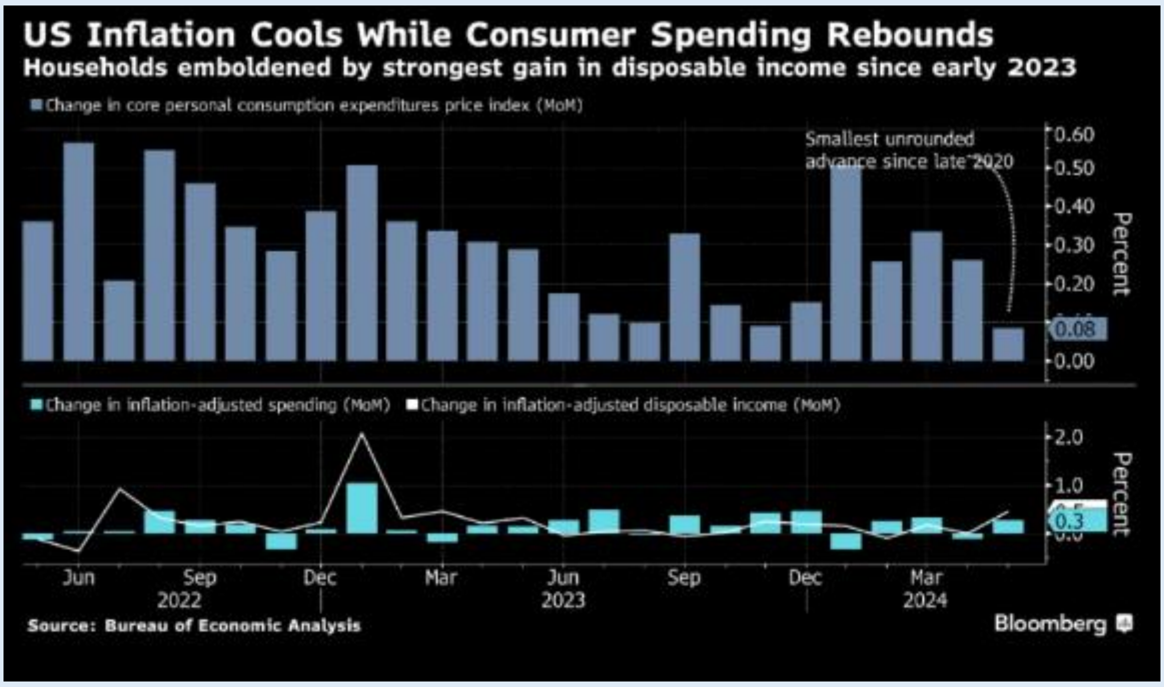
The market took this morning's data as a positive for rate cuts – current forward pricing still shows ~48 bps of rate cuts priced into the curve for 2024. That equates to two, 25 basis point rate cuts later this year.

Chart 2: MAY PCE RECAP

Metric	Actual	Estimate
PCE price index (MoM)	0.0%	0.0%
Core PCE price index (MoM)	+0.1%	+0.1%
PCE price index (YoY)	+2.6%	+2.6%
Core PCE price index (YoY)	+2.6%	+2.6%
Real consumer spending (MoM)	+0.3%	+0.3%

Source: Bloomberg, LLP | MAY PCE RECAP

Chart 2A: HISTORICAL PCE & PERSONAL SPENDING DATA



Source: Bloomberg, LLP | HISTORICAL PCE & PERSONAL SPENDING DATA

<u>CHART 3:</u> ***Rates Drift Lower After Rate Cut Friendly PCE Data***

Rates drifted lower after this morning's as expected PCE data was released at 8:30 AM. Traders viewed the data as a positive for rate cuts and SOFR swap rates drifted lower. Recent hawkish Fed-Speak regarding inflation spooked the markets and pushed rates higher. This morning's data seems to have calmed those fears dramatically. That said, the reaction to the data was muted – there was tremendous hype surrounding this number, but the result this morning proved to be far less dramatic than anticipated.

From my perspective, the benign PCE data validates forward market pricing. A higher-than-expected PCE number would have had traders second guessing two rate cuts this year, and rates would have likely moved higher as the forward curve repriced. That said, traders clearly did not want to overreact to the data. From the market's perspective it just increases the likelihood we will see two rate cuts this year. Also keep in mind that the market does not get much of a breather – we see important ISM Manufacturing and Services Data next week and the critical May Employment Report released on July 5th at 8:30 AM.

Chart 3: 2Y SOFR SWAP RATE - REACTION TO PCE DATA

Source: Bloomberg, LLP | 2Y SOFR SWAP RATE REACTION TO PCE

<u>RCA Product Update:</u>

<u>Week of 6/24/2024</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 seen how fleeting these opportunities can be, so it is important to be ready to execute.

New cap volume continues to increase slightly, as does existing cap extension volume. 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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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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LOS ANGELES, CA NEW YORK, NY BALTIMORE, MD
TELEPHONE 212.500.0922 FAX 310.856.9495

RateCap
Advisors

LOS ANGELES, CA NEW YORK, NY BALTIMORE, MD
TELEPHONE 212.500.0922 FAX 310.856.9495