## Flash Update: US Rate Markets – Thursday 8/1/2024

- **SOFR swap rates gap lower this morning, extending yesterday's decline in rates**
    - **2Y SOFR swap rates are down ~20 bps since Powell's remarks yesterday**
- **FOMC holds benchmark rate steady at 5.25% - 5.50%**
- **Chairman Powell hints at September rate cut in post-meeting comments**
- **Dovish tone of Powell's remarks pushed rates lower**
- **Forward pricing now reflects three, 25 bp rate cuts this year, beginning in September**
- **Next Up: July Employment Report released tomorrow at 8:30 AM**

**Good Morning –** US Treasury yields and SOFR swap rates opened lower this morning, extending the decline in rates we saw yesterday after Chaiman Powell's dovish post-meeting remarks. Weaker-than-expected economic data released this morning also contributed to the significant drop in swap rates today. Yesterday, the FOMC voted to leave the benchmark rate unchanged, but FOMC Chairman Powell said an interest-rate cut could come as soon as September. *"If we were to see, for example, inflation moving down quickly — or more or less in line with expectations — growth remains reasonably strong, and the labor market remains consistent with its current condition, then I would think that a rate cut could be on the table at the September meeting,"* Powell said Wednesday. Powell's comments encouraged market participants that the long-awaited rate cuts are finally on the immediate horizon – rates moved lower in response. From this point on, markets are likely to be *heavily* data-driven. FOMC officials will also be back on the tape beginning tomorrow, albeit on a lighter "summer" schedule.

***We have seen a material drop in rates over the past 30 days.* SOFR swap rates have dropped significantly since the beginning of July: Since July 1st, 1-year SOFR swap rates are down ~45 bps and 2-year SOFR swap rates are down ~58 bps. The material drop in rates over the prior 30 days has significantly improved cap and cap-extension premiums.** Keep in mind, rate cuts are already priced into the forward curve, so cap premiums already reflect the improved rate cut odds. From my perspective, unless the market starts to contemplate a 50 bp rate cut at one of the 2024 Fed meetings, rates are not likely to move significantly lower in the near term. Rate markets are likely to experience pockets of elevated intra-day volatility based on the data at hand. Next up for "data" – tomorrow's release of the July Employment Report.

Tomorrow's Employment report is highly anticipated by the market. Chairman Powell was clear that the Fed is looking at the jobs market as closely as it is the inflation outlook. From the market's perspective, a weaker jobs report would green-light a September rate cut and provide additional confidence the Fed will cut rates at each of the next three meetings. A stronger than expected employment number could cast some doubt on a third rate cut, causing rates to tick higher. Tomorrow's Employment Report is forecast to show a 4.1% Unemployment Rate and Average Hourly Earnings of 3.7% (YoY). Last month's jobs data printed at 4.1% and 3.9% respectively.

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

**UST YIELDS     SWAP SPREADS     SOFR SWAP RATES**

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TELEPHONE 212.500.0922 FAX 310.856.9495

| | | | | | | |
|---|---|---|---|---|---|---|
| 2Y | 4.195 | -0.062 | -15.9500 | -0.8746 | 4.0371 | -0.0704 |
| 3Y | 3.995 | -0.062 | -21.5050 | -0.1250 | 3.7800 | -0.0647 |
| 4Y | 3.897 | -0.066 | -27.9375 | +0.0825 | 3.6454 | -0.0602 |
| 5Y | 3.853 | -0.062 | -27.3100 | +0.5485 | 3.5799 | -0.0551 |
| 7Y | 3.888 | -0.057 | -34.6500 | +0.7250 | 3.5428 | -0.0499 |
| 10Y | 3.980 | -0.049 | -42.1000 | +0.7600 | 3.5595 | -0.0435 |
| 20Y | 4.338 | -0.047 | -71.7710 | +1.5243 | 3.6215 | -0.0322 |
| 30Y | 4.269 | -0.034 | -79.0000 | +0.7500 | 3.4800 | -0.0270 |

**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: FOMC Meeting Recap – Powell Hints At September Rate Cut**

The FOMC left the benchmark rate unchanged at 5.25% - 5.50% at yesterday's policy meeting. However, Fed Chair Jerome Powell sent a clear signal during his post-FOMC news conference that a September rate cut is on the table if the data evolves as he expects. Powell's "signal", however, was countered by a notably less dovish policy statement, which contained only subtle hints of an impending rate cut. The discrepancy suggests most FOMC members are not as optimistic as Powell about the progress of inflation. It also suggests that most committee members want to wait to see the vast amount of upcoming data we will get prior to the September meeting before committing to a rate cut.

Following Powell's news conference, Fed Funds futures continued to fully price an initial 25-bp rate cut in September, with some remaining chance of a 50-bp move. (I should note, when asked at the press conference, Powell shut down any chance of a 50 bp cut in September.) Further out on the curve, expectations for cumulative rate cuts increased. Fed funds futures now expect roughly 72 bps of cuts this year (vs. 64 bps prior to the meeting). The market now expects three rate cuts this year.

**CHART 2:** ***FOMC Meeting Recap – Markets See Three Rate Cuts This Year***

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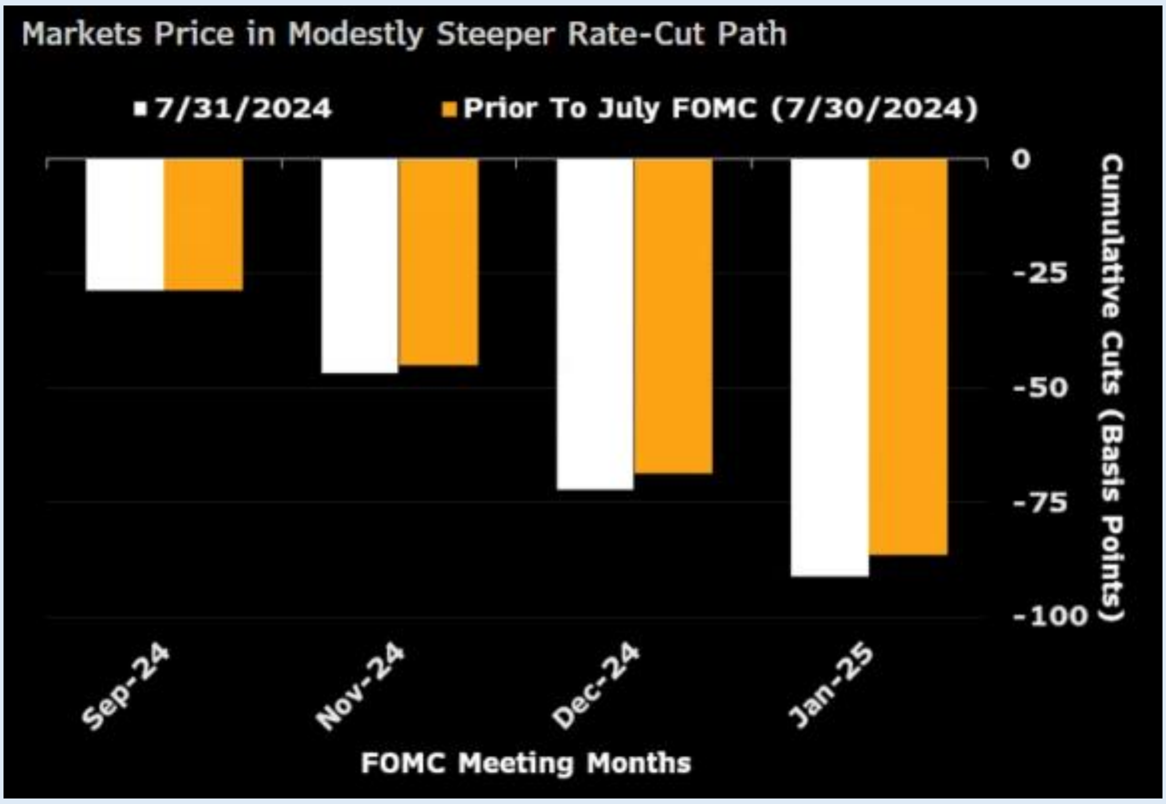
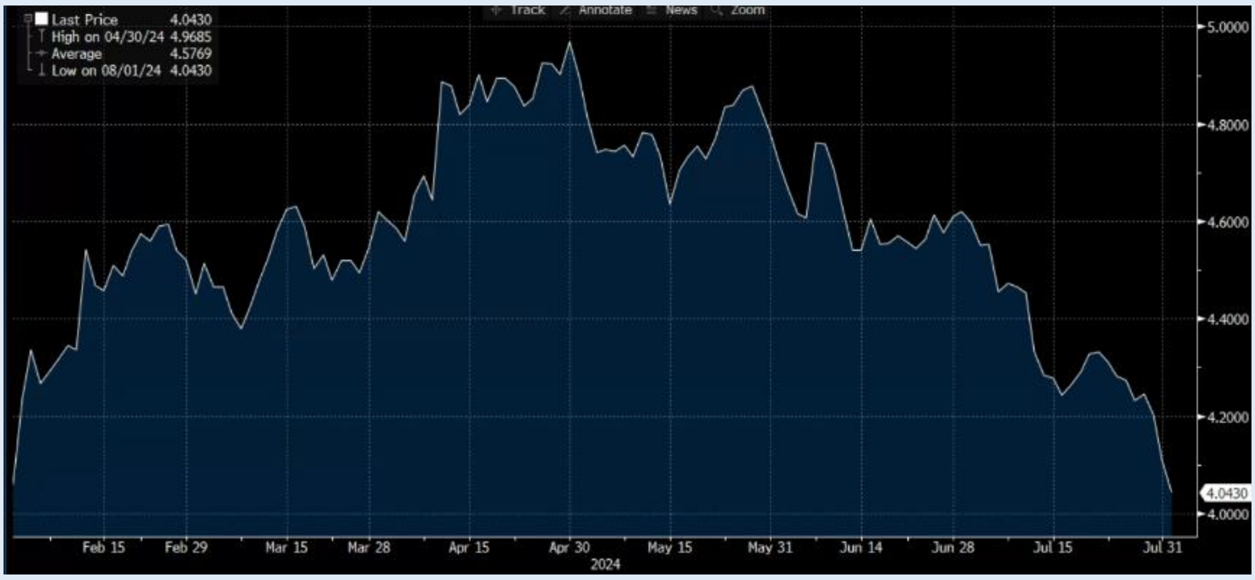



**Source: Bloomberg, LLP | FOMC RATE CUT EXPECTATIONS**

**CHART 3: POWELL'S DOVISH POST-MEETING COMMENTS LEAD TO LOWER SWAP RATES**

The market initially shrugged off the meeting results yesterday – they were clearly waiting for Chaiman Powell's comments. Powell's dovish tone and hints at a September rate cut pushed rates materially lower yesterday afternoon. SOFR swap rates across the curve were down ~10 bps after Powell's comments and continued to decline this morning. *SOFR swap rates are now sitting at the lows for the prior six-months.* Rates are likely to be biased lower until the Fed or the data push back. The risk is that the market takes rates down too far and is forced to correct. Current market pricing will face the first "test" tomorrow when we see the July Employment Report. Powell stressed yesterday that the FOMC is now equally focused on its dual mandate – full employment and low inflation.

**CHART 3:** ***2Y SOFR SWAP RATES SITTING AT 6-MONTH LOWS…***




**Source: Bloomberg, LLP | 2Y SOFR SWAP RATE – PRIOR 6-MONTHS**


LOS ANGELES, CA NEW YORK, NY BALTIMORE, MD
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## ***RCA Product Update:***

### **Week of 7/29/2024** - ***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 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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