RateCap Advisors

Flash Update: US Rate Markets – Friday 4/12/2024

- **Short-term market focus shifts to the Middle-East as regional tensions flare**
- **US Treasury yields drop as nervous investors seek safe-haven**
- **Inflation is trending the wrong way; Price pressure continues to mount**
- **Import-Export prices exceed forecasts; Commodity prices rise**
- **FOMC officials concerned, but believe inflation will continue to drop, just more slowly than anticipated**

Good Morning!

US Treasury yields dropped this morning on renewed fears that tensions in the Middle-East will flare-up into a wider conflict. Rumors of an “imminent” attack on Israel by Iranian military forces spooked the market and caused a rapid flight-to-quality. US Treasuries are still the “go to” safe-haven asset. SOFR swap rates dropped in tandem with UST’s. At the moment, swap rates are down ~7-9 basis points across the curve (See Chart 1). An escalation in the Middle-East conflict could have a dramatic impact on the short-term global economy. Supply lines could be disrupted and crude oil prices could skyrocket. Market participants will be watching the situation in the Middle-East very closely. It will be the key focus for equity, rate and commodity markets for the near-term. A deterioration in the situation over the weekend would likely push rates even lower as asset managers and investors seek safe haven. Should this turn out to be “grandstanding” or empty threats, the market focus will shift back to the Fed – in that case rates may creep higher.

Traders and investors are also continuing to assess if the market “overreacted” to Wednesday’s CPI data. At one point Treasury yields touched the highs for the year – traders could be tempted to snap up yields at these levels – particularly with rising geopolitical pressures which could further suppress UST yields. That may also be contributing to today’s drop in rates.

The other main theme developing in the rate markets is the uptick in inflation. This week’s inflation data disappointed to the upside, particularly CPI. PPI also came in above market estimates. This morning’s Import/Export price indices both printed higher than expected. The FOMC has acknowledged the last mile of this “phase” of monetary policy could be bumpy. Inflation was trending lower, but then stalled before reaching the Fed’s 2.00% target. Recently, however, inflation has been trending the wrong way. Market pricing has adjusted – forward pricing now shows ~2 rate cuts, beginning in July. The big risk to those two rate cuts is rising inflation. Should inflation continue to drift higher, the Fed will be in no hurry to cut rates, and the market will be forced to adjust forward pricing to account for even fewer rate cuts. Rising commodity prices are also a growing concern for the market. *Shifting expectations around the timing and pace of the first cuts are likely to create further rate volatility in the near term.*

CHART 1: ***US RATES SNAPSHOT: 11:30 AM Eastern***

UST YIELDS | SOFR SWAP SPREADS | SOFR SWAP RATES

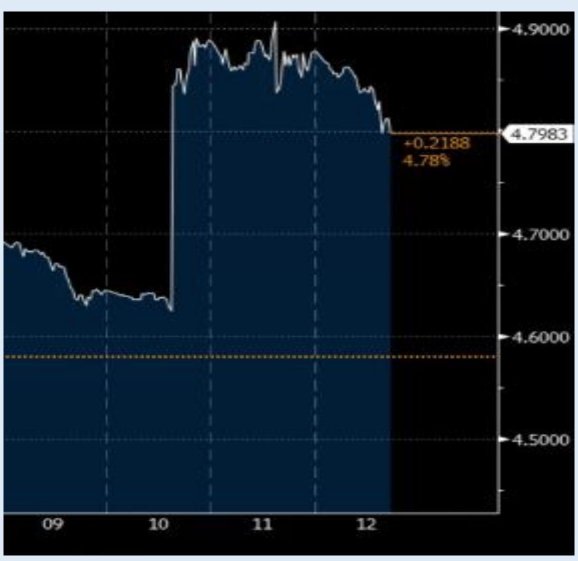
GV Ask/Chg			SOFR/GV		SOFR OIS	
2Y	4.882	-0.079	-7.7045	+0.7955	4.8065	-0.0702
3Y	4.712	-0.087	-15.0200	+0.6050	4.5628	-0.0823
4Y	4.624	-0.091	-22.7000	+0.2350	4.3997	-0.0878
5Y	4.539	-0.092	-24.5000	+0.1250	4.2948	-0.0912
7Y	4.532	-0.091	-34.2235	+0.3365	4.1898	-0.0892
10Y	4.505	-0.081	-37.9901	-0.2312	4.1269	-0.0842
20Y	4.728	-0.071	-66.8850	-0.2200	4.0610	-0.0736
30Y	4.609	-0.069	-75.2000	+0.0750	3.8577	-0.0693

Source: Bloomberg, LLP | 11:30 AM NY Rates Snapshot

CHART 2A & 2B ***SOFR Swap Rates Drop As Investors Seek Safe-Haven***

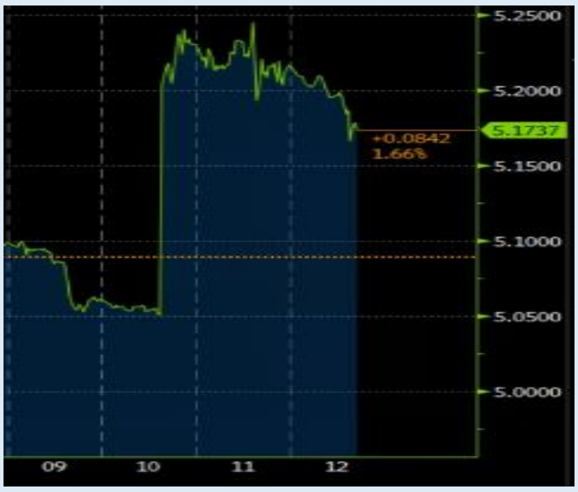
The below graphs shows 1Y and 2Y SOFR swap yields since 4/9. Rates surged after CPI, then stabilized and bounced around as the market digested PPI and carved out a new range. Or tried to. The flight to US Treasuries overnight and this morning pushed SOFR swap rates lower across the curve. You can see that 2Y SOFR swaps touched 4.91% yesterday, then traded sideways until the flight-to-quality started. 1Y swap rates are also lower today given the drop in Treasury yields.

Chart 2A: 2-YEAR SOFR SWAP RATES SINCE 4/9



Source: Bloomberg, LLP | 2Y SOFR Swap Rates Since 4/9

Chart 2B: 1-YEAR SOFR SWAP RATES SINCE 4/9



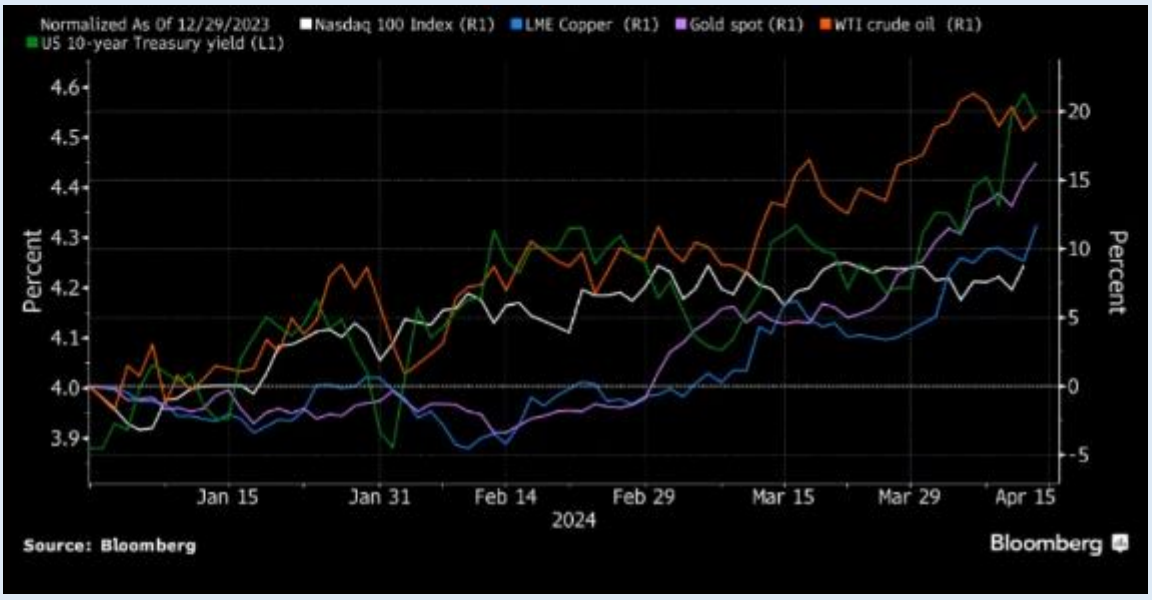
Source: Bloomberg, LLP | 1Y SOFR Swap Rates Since 4/9

CHART 3: ***Geopolitical Tensions, Inflation Outlook Capture Market's Attention***

Rising commodity prices are catching the market's attention. We will be keeping an eye on commodity prices. An increase in commodity prices can increase production costs and consumer prices. Commodity prices have been steadily rising in recent months, along with equity markets and bond yields. That type of market can create a "bubble" and at some point the pressure will have to be relieved. In that scenario (one or more markets "backs-up" significantly), we could see rates decline further as the possibility of rate cuts would increase. Market participants and the FOMC will also be monitoring the commodity prices. The FOMC will be most concerned with the possible impact on inflation.

Further evidence of rising political tensions is the increase in spot gold prices. Spot gold touched a record high today as investors moved assets into gold and silver markets. Gold is becoming an increasingly popular "safe-haven" investment. The increase in gold to a record high is definitely a warning signal that markets are extremely nervous about short-term geopolitical risks.

Chart 3A: Rise In Commodity Prices Concerns Market Participants



Source: Bloomberg, LLP | Commodities, Bond Yields, Nasdaq Since January 1, 2024

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Chart 3B: Gold Hits Record Highs as Investors Hedge Geopolitical Risk

Source: Bloomberg, LLP | Spot Gold; Spot Silver Since January 1, 2021

<u>Product Update:</u>

Week of 4/8/24 - *What We Are Seeing In The Rates Market*

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 ~3 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.*