Hi «Name»,

Good morning! Please see below for the RCA Rate Market Update for January 12, 2023. **In addition to the recap on the CPI inflation data released this morning at 8:30 a.m. *we are pleased to feature a concise 2022 Year In Review and 2023 Preview.***

Please let us know if you would like additional market color or have any questions. We are also always happy to provide indications for Caps, Swaps or other derivative hedging products. Please feel free to reach out anytime! *-RCA Interest Rate Hedging Desk*

RCA MARKET FLASH REPORT: December U.S. CPI

- **CPI prints better than anticipated, shows inflation continues to cool down**
- **Encouraging inflation data may give FOMC room to downshift on rate hikes**
- **Excluding food and energy, the consumer price index rose 0.3% last month and was up 5.7% from a year earlier**
- **Today's number builds a strong case for a 25 basis point hike at the Feb meeting**
- **Average Hourly and Weekly earnings also print lower, another positive sign for the Fed**
- **MoM consumer inflation has now printed flat or lower for the past 6 months**
- **U.S. Treasuries and SOFR Swap rates *lower* in reaction to the inflation numbers**
- ***Next Fed meeting February 1, 2023***

December CPI Results:

(Source: Bloomberg)

R	Event	Period	Surv(M)	Actual
	CPI MoM	Dec	-0.1%	-0.1%
	CPI Ex Food and Energy MoM	Dec	0.3%	0.3%
	CPI YoY	Dec	6.5%	6.5%
	CPI Ex Food and Energy YoY	Dec	5.7%	5.7%
	CPI Index NSA	Dec	296.699	296.797
	CPI Core Index SA	Dec	300.746	300.974
	Real Avg Hourly Earning YoY	Dec	--	-1.7%
	Real Avg Weekly Earnings YoY	Dec	--	-3.1%

US consumer inflation continued to slow in December, adding to evidence price pressures have peaked and potentially offering the Federal Reserve room to slow the pace of interest-rate hikes next month.

Today's data, when paired with the prior months' lower-than-expected CPI readings, point to more consistent signs that inflation is easing and may pave the way for the Fed to downshift to a quarter-point hike at their next meeting ending Feb. 1. That said, the central bank's work is *far from over*. Resilient consumer demand, particularly for services, paired with a tight labor market threaten to keep upward pressure on prices. We emphasize that monetary policymakers have stressed the need to hold rates at an elevated level for "some time" and have *cautioned against underestimating their will to do so.* Nonetheless, the rate market saw today's data as a positive and encouraging sign that the FOMC is succeeding in their fight against inflation.

We now expect the FOMC to do a more modest 25 basis point hike at the next meeting – today's number should eliminate any speculation for a larger rate hike in February. Federal Reserve Bank of Philadelphia President Patrick Harker supported that view in comments this morning, stating that the central bank should lift interest rates in quarter-point increments "going forward" as the FOMC approaches the end point in its most aggressive tightening campaign in decades. He also said that, "I expect that we will raise rates a few more times this year, though, to my mind, the days of us raising them 75 basis points at a time have surely passed". He further stated that, "in my view, hikes of 25 basis points will be appropriate going forward." Fed officials lifted rates by a half-point last month, slowing the pace of rate increases after four straight 75 basis-point moves. Fed officials see interest rates rising above 5% this year and staying there until 2024, according to projections released by policymakers last month. Other Fed officials have also said they are open to making a more incremental 25 basis-point rate increase at their next meeting on Feb. 1, depending on the data. However, policymakers underscore that the central bank still has more work to do to tame prices and *are not anticipating rate cuts this year*.

U.S. Treasury and SOFR swap rates dropped immediately after the CPI print, but the rate move has been modest in comparison to prior market reactions to inflation or employment data. Short term swaps dropped ~5-7 basis points and the medium to long end of the swap curve was down ~3 basis points. This could be a sign the market is actually *listening* to the Fed and avoided the temptation to modify forward rate expectations too much based on one data point. While this morning's number by no means halts the Fed from further rate hikes, it certainly builds a case for a 25 basis point hike in February and portends the FOMC may indeed be hearing the end of this historic tightening cycle.

RCA RATE MARKET UPDATE: 2022 Year In Review

If I were to use just one word to describe the rate market during 2022, the word would be ***volatility***. 2022 witnessed unprecedented rate volatility and we finally saw the first major shift in many years to the term structure of interest rates and the shape of the yield curve. Rates were near all-time lows at the beginning of 2022 as the country and economy were emerging from the effects of the pandemic. The major catalyst for the 2022 rate move was inflation, initially thought to be transient due to the economy "re-opening" post-pandemic. A sustained surge in inflation quickly led the FOMC to realize that inflation was *not* transient and was in fact entrenched in almost every sector of the economy. The surge in inflation ushered in an active FOMC that embarked on an unprecedented aggressive tightening cycle that as we know, is still underway as we begin 2023. The other significant development during 2022 was the tremendous uncertainty created by geopolitical turmoil and augmented by the aforementioned extremely hawkish FOMC monetary policy. As the Fed implemented monetary policy changes, current and forward rates continued to climb higher throughout 2022. Market participants were fearful that the global unrest and aggressive Fed rate hikes would prompt a severe U.S. (and perhaps, global) recession. Thus far the "severe" recession has not materialized, but the uncertainty remains and as a result we are still seeing an inverted U.S. Treasury yield curve (short term rates higher than long term rates). The significant increase in rates, coupled with record volatility were at the root of the significant increase in cap premiums during 2022.

2022 YEAR IN REVIEW

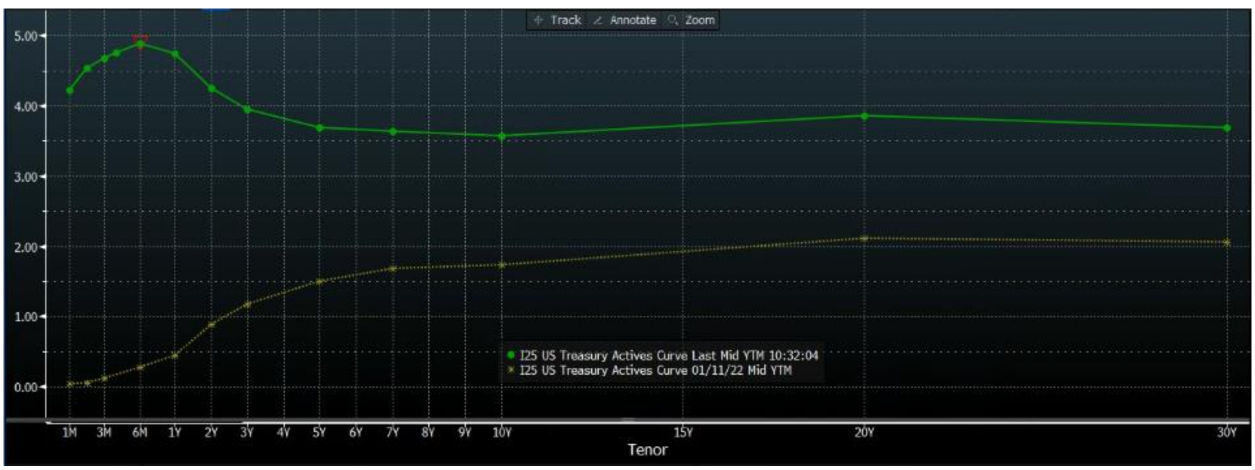
CHART I: *Movement in Term SOFR Interest Rate Swaps*

Swap Tenor	January 2022 Rate	January 2023 Rate	Difference:
2 Year	**.8735%**	**4.2606%**	**+338.7 bps**
3 Year	**1.1261%**	**3.8126%**	**+268.6 bps**
5 Year	**1.3397%**	**3.4339%**	**+209.4 bps**
10 Year	**1.5390%**	**3.2480%**	**+171.2 bps**
1M CME Term SOFR	**.05936%**	**4.43445%**	**+427.5 bps**

The Bloomberg graph below illustrates the above detailed movement in SOFR swap rates for 2022. As you can see from the above table and below graph, there was a *dramatic* move higher in SOFR swap rates throughout 2022. You can clearly see that the swap curve started the year as a "normal" upwardly sloping curve. Initially, the market welcomed the Fed rate hikes – you can see the curve was relatively flat (rates were bunched together) from March 2022 through June 2022. As the year progressed, an extremely aggressive Fed fueled fears that the FOMC would "over-tighten" and push the U.S. into a recession. This led to the inverted yield curve we see currently. As the FOMC nears the end of this tightening cycle and if the economy can avoid a full scale recession, we expect the curve to flatten in 2023, led by the longer end of the yield curve. We may see the curve begin to flatten as early as the second half of 2023. However, even with some curve flattening, it is certainly possible that the yield curve remains inverted throughout 2023.

2022 YEAR IN REVIEW CHART II – *U.S. Treasury Yield Curve*

The following Bloomberg graphs depict the current U.S. Treasury yield curve (green line) vs. the UST yield curve from one year ago (gold line). This graph clearly illustrates the massive rate movement and change to the shape of the yield curve witnessed during 2022. As we discussed above, the yield curve started out with a normal, upwardly sloping shape, but quickly inverted as Fed-fueled recession fears mounted.



RCA Rate Market Update: 2023 Rates Preview

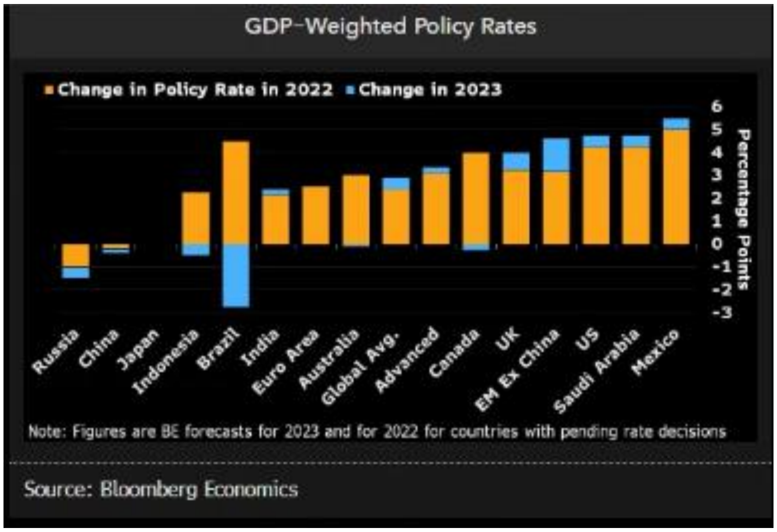
2023 will likely prove to be an interesting year. It may, however, also prove to be a year of two distinct halves. The FOMC is still in tightening mode and have communicated this to the market, so the first half of the year is likely to remain dominated by the FOMC and how much further they need to tighten in order to be satisfied that inflation is sufficiently contained. The second half of the year will more likely be focused on how long the Fed must hold rates at the terminal level and when they may decide to pivot to a more accommodative, dovish monetary policy. In both cases the key drivers will remain inflation and the health of the economy. Geopolitical developments will continue to be a wildcard, as those risks are tough to quantify and can materialize with little warning. Keep in mind most of the world's developed economies are facing inflationary pressures and as such are also susceptible to geopolitical forces.

Barring anything unforeseen (which is wishing for the best!), we do anticipate that rate volatility should soften as the year progresses – the surge in volatility was one of the major reason why cap premiums increased so dramatically this year. (The other reason being the jump in forward rates in reaction the FOMC). The FOMC is perceived to be nearing the end of this rate cycle and once they reach their neutral, or terminal rate, volatility should decline. That said, if this year has taught us anything, it is that rates can and will move quickly. We also learned that economic and geopolitical development can surface quickly and unexpectedly, often with dramatic results. Our conclusion: *Clients with upcoming financings should remain vigilant on market developments, particularly for the first quarter of 2023. Traders and investors, still reeling from a spell of unreliable 2022 predictions, are expecting a volatile first half-year of trading for 2023, and so are we.*

For the very near term, the market will focus on CPI, released tomorrow morning at 8:30 a.m. and the next Fed meeting on Feb 2, 2023. After last week's better than expected wage inflation numbers, If CPI shows lower inflation, the market is once again likely to recalibrate FOMC rate decisions for the first half of this year. Should CPI show continued entrenched inflation, that is likely to spur the Fed to continue their current approach.

2023 PREVIEW CHART I – *GDP-Weighted Policy Rates*

The Bloomberg Economics chart below depicts a GDP-weighted historical perspective on central bank rate moves for 2022 and expectations for 2023. As you can see, most of the world's largest central banks faced the same issue as the FOMC during 2022 – soaring inflation. The gold bars below represent 2022 rate moves and as evidenced below, in most cases the rate hikes were *significant*. However, you can see by the much smaller blue bars (representing projected 2023 moves) that most central banks are perceived to be nearing the end of the aggressive global tightening cycle that transpired in 2022. Looking specifically at the U.S column, you can see that projections are now in line for a Fed terminal rate of approximately 5.00%. Recent Fed-speak supports this, as most Fed officials see a terminal rate of between 5.00% and 5.25%. Barring any major unexpected news, this certainly portends the FOMC should complete the current tightening cycle by May or June of this year.



Best Regards,

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