AST DEFEASANCE RATE MARKET UPDATE

Good Afternoon! Please see below for the RCA | AST Defeasance *Rate Market Update* for January 4, 2024. Please let us know if you would like additional market color or have any questions. We are also always happy to provide indications for your defeasance needs, or for interest rate caps, floors, swaps, swaptions or other derivative hedging products. *Please feel free to reach out to us anytime!*

RATE MARKET UPDATE: 2023 Year-In-Review

- **2023 was the Year of the FOMC; Market participants were reminded that we live in a volatile world**
- **Despite tremendous rate volatility throughout the year, term rates ended the year in close proximity to where they began**
- **Economic sentiment shifted from major recession fears to an acceptance we are headed for a "soft landing"**
- **FOMC rate hikes have subdued inflation and the Fed's target 2.00% inflation rate is within reach**
- **2024 has the potential to be another volatile year as the market prepares for a monetary policy pivot**

2023 was indeed the Year of the FOMC. Monetary policy and it's perceived impact on the US economy were the front and center topics for most of 2023. There was also a mix of domestic and geopolitical factors which exacerbated interest rate volatility, including the Silicon Valley Bank led "mini-crisis", the war in Ukraine, OPEC production cuts and the current turmoil in the Middle East. Adding to the uncertainty was the dysfunctionality displayed by US politicians – this culminated in another government "shut-down" standoff which was only narrowly averted at the last minute. Fortunately, none of the geopolitical or domestic disruptions grew to the magnitude of a "crisis". Yes, *all* of the above mentioned geopolitical factors are still a concern and will continue to be tracked closely by market participants, but none reached a global crisis level that could have potentially derailed the rate market. These factors, coupled with an active FOMC, created periods of tremendous rate volatility in 2023. Despite the elevated rate volatility we saw all year, rates ended 2023 within shouting distance of where they began the year. As such, the very short end of the yield curve is where we saw the most dramatic rate movement during 2023.

The FOMC remained active in 2023. Fed officials faced the difficult task of continuing strategic rate hikes to quell inflation without derailing a resilient US economy. The "mini" banking crisis and geopolitical factors only added to the Fed's challenge. In retrospect, the Fed did a commendable job with the timing and magnitude of rate hikes during 2023. Inflation steadily and consistently decreased during 2023 and current projections point to inflation reaching the Fed's 2.00% target at some point during 2024. As fears of a severe recession abated during the year, the inverted yield curve began to unwind and the back-end of the curve flattened considerably. Although much changed for the rate market in 2023, term interest rates ended the year very close the where they began (See Table 1 below). The main reason for this was the massive bond rally witnessed the last 6-8 weeks of the year. The bond rally dramatically lowered rates as expectations for rate cuts were aggressively priced into the curve.

TABLE 1: SOFR Swap Rates | 2023 Recap – Net Change in SOFR Swap Rates YoY

The table below details the movement in SOFR swap rates and 1-Month Term SOFR during 2023. As we discussed above, despite tremendous pockets of elevated volatility through the year, SOFR swap rates ended the year very close to where they began 2023. Market sentiment, particularly concerning the US economy, shifted back and forth throughout the year, but the market was never able to reach a unanimous conclusion. That uncertainty was the primary reason for the elevated rate volatility we saw for most of 2023.

Swap Tenor	December 30, 2022 Rate	December 29, 2023 Rate	YoY Difference:

1 Year	**4.901%**	**4.756%**	**-14.5 bps**
2 Year	**4.446%**	**4.066%**	**-38.0 bps**
3 Year	**4.069%**	**3.748%**	**-32.1 bps**
5 Year	**3.746%**	**3.530%**	**-21.6 bps**
10 Year	**3.356%**	**3.474%**	**-11.8 bps**
1M CME Term SOFR	4.35806%	5.35472%	**+99.7 bps**

Source: Bloomberg, LLP

CHART 1: SOFR Swap Rates | 2023 Recap Graph – 2Y, 3Y, 5Y, 10Y SOFR Swaps

The Bloomberg graph below shows 2Y (white), 3Y (blue), 5Y (orange) and 10Y (purple) SOFR swap rate movement for 2023. The periods of elevated volatility are easy to spot – March to June 2023 was the most volatile part of the year. You can then see a period of market uncertainty. Was a recession looming or could the Fed pull-off a soft landing “goldilocks” scenario? Over the summer, the market once again grappled with the question of how far should the FOMC raise rates? As we headed into the final quarter of 2023 the market got some answers. Inflation dropped and the economy, including the jobs market and the consumer, remained resilient. This emboldened the market to expect an FOMC monetary policy pivot to an easing bias. At the last Fed meeting of the year, the Fed signaled that they are likely done raising rates and were preparing to pivot to a more neutral monetary policy.

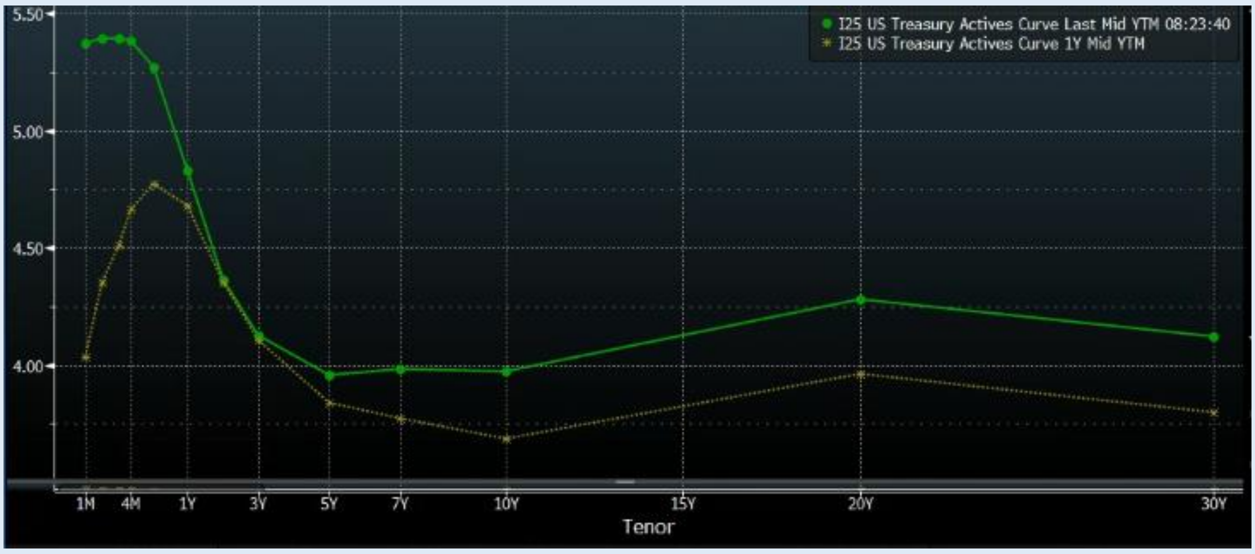
2Y, 3Y, 5Y, 10Y SOFR Swap Rate Movements During 2023

Source: Bloomberg, LLP

CHART 2: US Treasury Yield Curve | 2023 Recap

The following Bloomberg graph depicts the current U.S. Treasury yield curve (green line) vs. the UST yield curve from one year ago (gold line). This graph clearly illustrates that despite periods of elevated volatility, the back end of the curve only experienced modest increases YoY. The very short-end of the curve experienced the most dramatic movement during 2023. As we know, the short-end of the yield curve is where the Fed primarily dwells and where they can have the most impact on rates.

US Treasury Yield Curve Change: DEC 2022 – DEC 2023

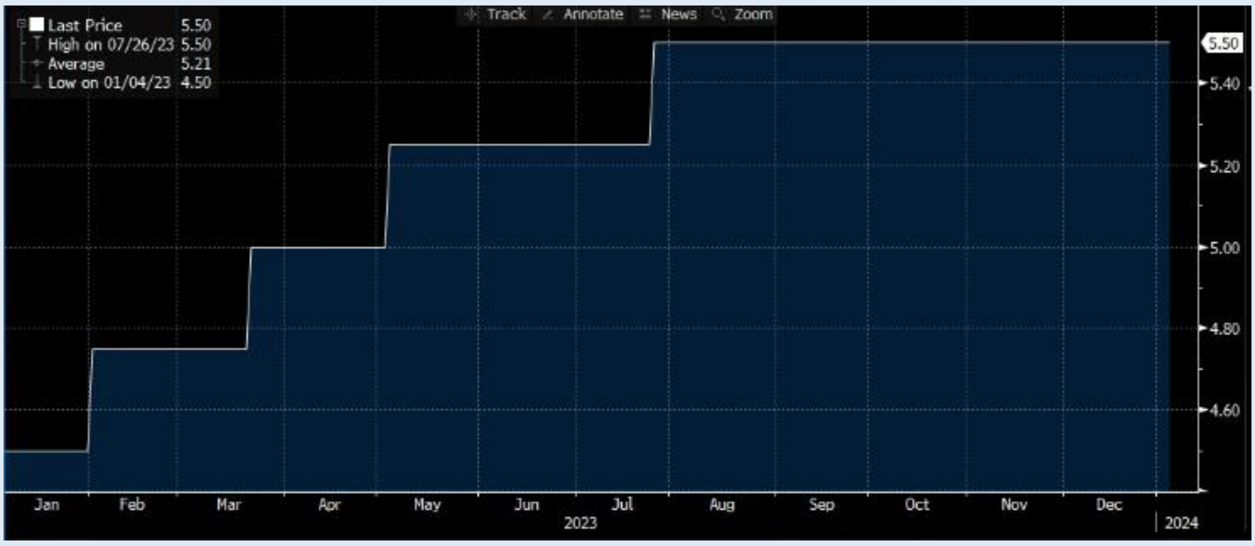


Source: Bloomberg, LLP

CHART 3: FOMC | 2023 Recap

The Bloomberg graph below details the timing and magnitude of FOMC rate increases during 2023. You can clearly see the Fed started the year in aggressive hiking mode, but gradually slowed the pace of rate hikes as the year progressed. Since the July 2023 meeting, the Fed has been on hold as inflation continues to drop and the economy chugs along. More recently, due to some weaker than expected economic data, the FOMC has hinted they see rate cuts coming at some point this year, signaling a potential shift in monetary policy to an easing, or "rate cut" bias.

FOMC Rate Decisions: 2023



Source: Bloomberg, LLP

RATE MARKET UPDATE: 2024 Preview – FOMC Will Drive Rate Market

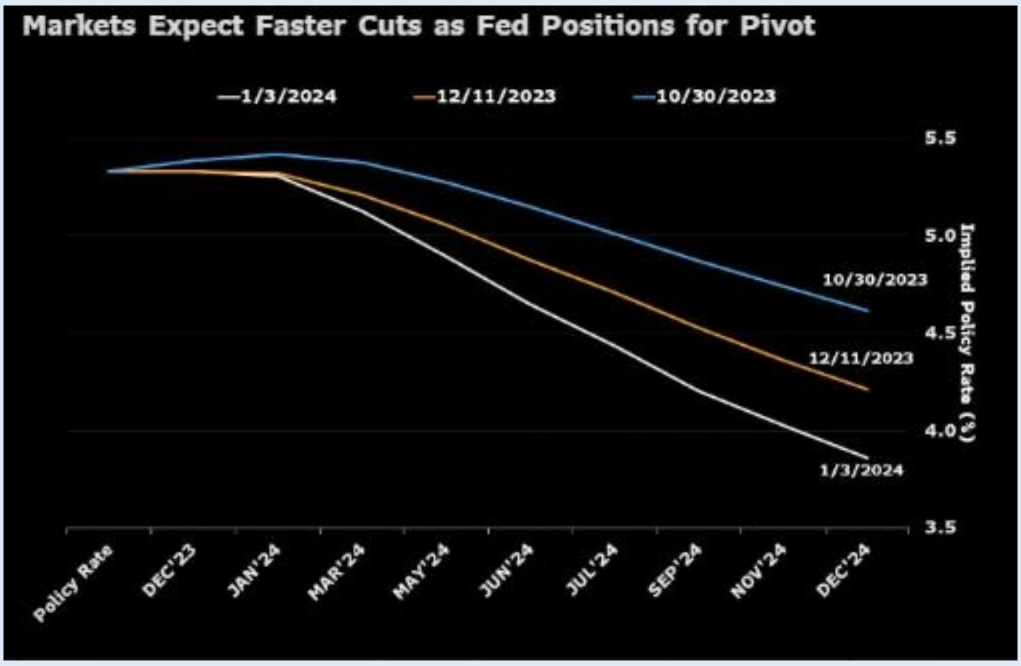
2024 will likely also be a year where the FOMC will be the primary focus of the market, with the health of the US economy and geopolitical concerns not far behind. We start the year off with a bang – the Employment Report is scheduled for release tomorrow at 8:30 am. Make no mistake, the FOMC will be data driven this year, so the jobs, inflation, GDP and consumer data will be the deciding factors in determining the Fed's next move. At the moment, the market is calling for significant rate cuts this year – as much as 150 basis points of cuts beginning as early as March. Recent Fed-speak and strong economic data have caused the market to pause and rethink the timing and magnitude of rate cuts this year, but so far the market has not yet materially adjusted expectations. The FOMC has repeatedly called for caution and patience with respect to rate cuts.

The current disconnect between the Fed's new "dot plot", which calls for 3 potential rate cuts during 2024 and the market's more aggressive expectations will need to be reconciled. As a result, the first quarter of 2024 has the potential to be volatile, as the market and the Fed digest data and attempt to map out the path for rates in 2024. It is also likely that the yield curve inversion continues to unwind as the Fed contemplates rate cuts. It is also certainly possible that we move toward a more "normally" sloping yield curve as the year progresses, especially once the Fed begins to cut rates. The main risk for the first half of this year is that the market realizes they were too far ahead of the Fed and need to adjust rates higher to compensate.

CHART 4: Market Expects Faster Cuts in 2024 than the FOMC is Signaling

Currently, there is a dichotomy between the Fed and the market concerning the pace and magnitude of rate cuts for 2024. The Bloomberg graph below details how far market expectations have moved since October 30, 2023. At that juncture, market participants were still on the fence regarding rate cuts and they had *barely* priced in any for 2024. Fast forward two months: inflation continued to abate and the jobs market showed signs of a slowdown. As a result, rate cuts expectations were significantly ramped up, as market participants took the economic data as a sign the Fed would need to cut rates sooner rather than later. At the moment the market remains well ahead of the FOMC on rate cut projections for 2024.

Chart 4

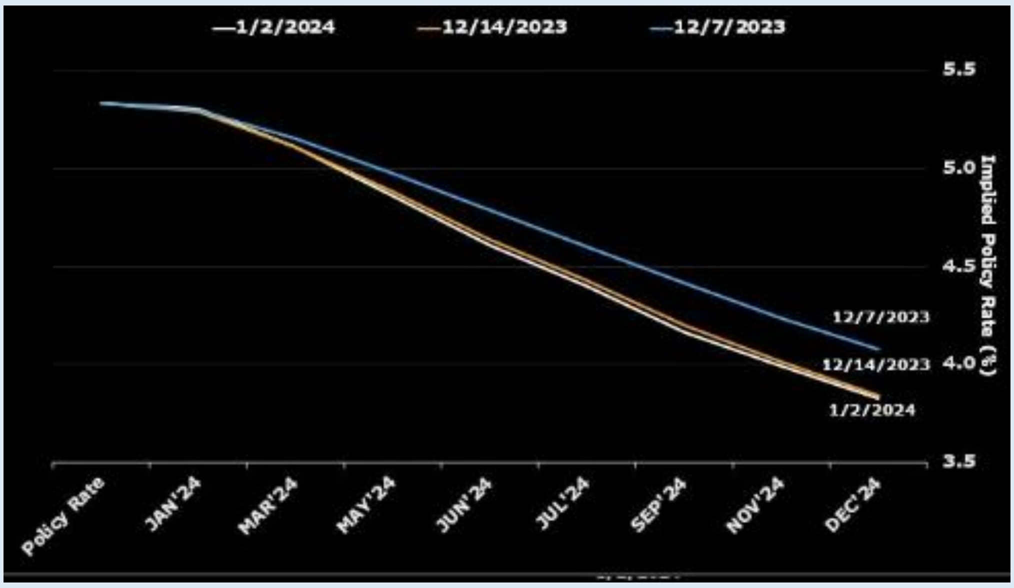


Source: Bloomberg, LLP

CHART 5: Market Expects Faster Cuts in 2024 than the FOMC is Signaling

Market participants are still pricing in *six* 25 basis point rate cuts during 2024, beginning at the March meeting. The FOMC, via their "dot plot" has only signaled three *potential* 25 basis point cuts with no anticipated timetable or launching point. This dichotomy will need to be addressed by the market. Should the market get too far ahead of the Fed (and some would argue they're close!), we may see a period of elevated rate volatility as the market adjusts expectations to reality. What was particularly compelling is the fact that even after the market saw the new Fed dot-plot released after the December meeting and heard caution and patience urge by Fed officials, the market *did not* adjust their rate cut expectations *at all*. The market is once again challenging the Fed to come to them – in many cases that does not typically work out well for the market. The risk is that market rate cut expectations are overdone and the market needs to correct. In this case the correction will likely be higher rates, particularly in the 1 to 3 year sector of the swap curve.

Market Pricing In 150 BPS of Rate Cuts in 2024



Source: Bloomberg, LLP

CHART 5: Market Expects Faster Cuts in 2024 than the FOMC is Signaling

To drive home the point about forward projections, we will leave you with the following Bloomberg chart. The below chart shows the market's 2023 projections as of December 2022 (blue line) and compares that to what actually transpired (white line). Needless to say, the projections were not even close for most of the year. You can see that futures trading was close for the first month or two of 2023, then diverged *significantly* from forecasts. We point this out to once again caution not to put too much faith in forward curves beyond three months out. We are in a fragile time economically, politically, socially and geopolitically and as we have witnessed time and time again, surprises can lurk around any and every corner.

The grey line in the chart below shows 2024 Fed Funds futures projections. As we have discussed, short term interest rates are expected to drop during 2024, perhaps significantly the second half of the year. Take the projections for what they are worth, but keep an open mind!

Forward FOMC Projections Rarely Manifest as Forecast

Source: Bloomberg, LLP

CHART 6: FOMC Meeting Schedule 2024

The Bloomberg chart below details the FOMC meeting schedule for 2024. The next Fed rate decision is due on January 31, 2024 at 2:00 PM. I expect the first two meetings of the year to be highly anticipated and to set the tone for interest rates for the first half of the year.

2024 FOMC Meeting Schedule

	Announcement Date
1)	January 31
2)	March 20
3)	May 1
4)	June 12
5)	July 31
6)	September 18
7)	November 7
8)	December 18

****All FOMC Rate Decisions released at 2:00 PM Eastern.***

Source: Bloomberg, LLP

Disclaimer: *The information provided in this communication is intended for discussion purposes only. Nothing presented in this communication should be taken as a recommendation. All market data shown is indicative only and subject to change depending on current market conditions.*

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