AST DEFEASANCE RATE MARKET UPDATE

Thursday, March 23, 2023

RATE MARKET UPDATE: MARCH 23, 2023 | FOMC Hikes 25 bps; Now What??

- **FOMC raises benchmark rate 25 bps to 4.75%-5.00%**
- **Market currently pricing 50% chance for a 25 bp hike at the May 3rd meeting**
- **Chair Powell says banking system "sound, liquid and well capitalized"**
- **Powell said the Committee "does not see rate cuts this year"**
- **Rates dropped in reaction to the rate decision and Powell's press conference comments**
- **This morning SOFR swap rates opened flat (~-1-3 bps)**

The FOMC raised the benchmark rate 25 basis points at yesterday's meeting and signaled an ongoing commitment to cooling inflation. Policy makers also dialed down the terminal rate target and reset their dot plot forecasts. Additionally, the committee removed the "ongoing increases in the target range will be appropriate" language from their official statement and replaced it with "*some* additional policy firming *may* be necessary". That implies the FOMC may raise rates again if they feel the inflation outlook warrants it but they may not depending on future data and economic conditions. Market participants viewed the rate decision as a "dovish rate hike" and Powell's comments mostly supported that assessment. Yes, the Fed did raise rates and are poised to hike again if price pressures continue. However, the change from 'will be necessary' to 'may be necessary' signals the FOMC is approaching the end of this historic tightening cycle. Chair Powell also highlighted that he feels the "disinflation process is still intact" – that is an optimistic view. On the other hand, Powell also made it clear they will be watching the data, the banking sector and the economy closely over the next 6 weeks and are prepared to raise rates further to continue the fight against inflation. There is also a disconnect currently between the FOMC and the rate market. The market is calling for rate cuts this year – the FOMC does not see it that way. Powell said in response to questioning that officials "just don't" see cuts this year and that they will raise higher than expected if that is needed. "Rate cuts are not in our base case," he said.

Regarding the banking sector, Powell tried to reassure a jittery market that U.S. financial institutions are in good shape. He said that banks are "sound, liquid and well capitalized". Powell also highlighted action taken to date by the Treasury Department and FDIC and pointed out the special lending program that was created to assist banks. He also mentioned that the Fed is prepared to assist in any way possible via the Fed discount window. Overall, Powell tried to instill confidence in the banking sector and made it clear the committee feels the U.S. banking sector is in good shape overall. The Fed's view is that the bank failures to date are outliers and that the broader banking system remains on firm footing. They acknowledged they are watching the situation closely and will continue to do so going forward.

The Fed's current dot plot shows rates peaking in the 5.10-5.25% range implying room for another 25 basis point rate hike this year. The swap market shows traders are split 50/50 on the chances that Fed officials will add another 25 basis points to their benchmark in May. Despite Powell's guidance to the contrary, expectations for cuts have deepened, with the market suggesting that the effective fed funds rate will drop to around 4.1% by December 2023. The FOMC sees rates staying at current levels (or perhaps a bit higher) and then plateauing there for at least the remainder of 2023. It is too early to forecast what will happen in the upcoming 6 weeks ahead of the next FOMC meeting on May 3rd - we will see another series of key economic data over that time period and macro events domestically and abroad will remain in focus in the coming weeks as well. Fed officials will emerge from the blackout period and begin giving speeches again, which is likely to shed more light on the meeting and their thought process going forward. Powell summed up the committee's thinking as follows: "At the end of the day we will do enough to bring inflation down to 2%". *Given the current dichotomy between the market and the FOMC regarding rate cuts this year and the heightened uncertainty created by banking sector woes, elevated rate volatility is likely to continue for the short term.*

CHART 1: FED Dot-Plot Shows Peak Fed Funds Rate Projection Unchanged

The dot-plot included in the SEP left the median expectation for the terminal rate unchanged at 5.1%, which the committee expects to reach in 2023. During the last inter-meeting period, Fed speakers had hinted at a higher terminal rate, and the new dot-plot shows some participants continue to expect a higher terminal rate despite the banking crisis. You can see from the chart that committee members do not expect rates to drop until sometime in 2024. At the moment the FOMC sees the benchmark rate in the 2.50% - 3.00% range at some point during

2025/2026. As we know, this forecast can change frequently – forward curve forecasts rarely, if ever, manifest as predicted.

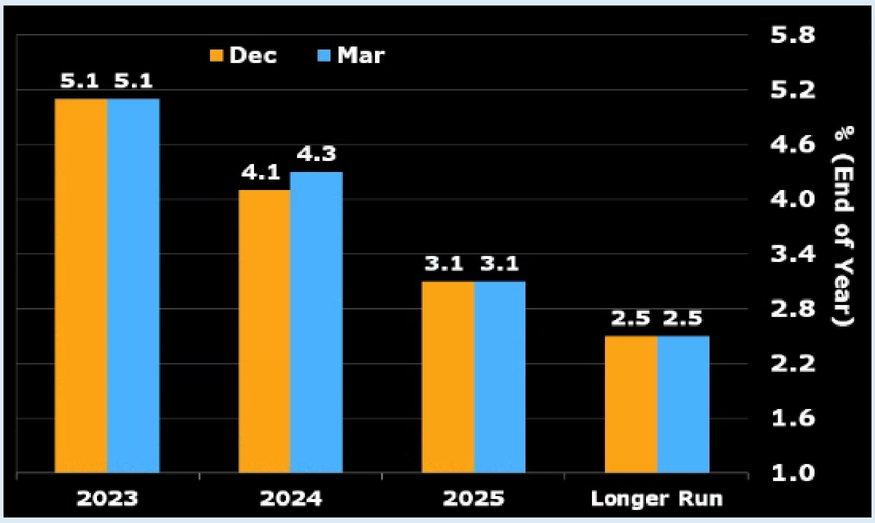


CHART 2: Rate Market vs. FOMC

The Bloomberg chart below shows current market pricing for Fed swaps vs. the revised Fed dot-plot expectations. This chart is interesting in that, although the market and the Fed agree on the end point, the market sees rates dropping much quicker than the FOMC currently does. This dichotomy has the potential to create increased volatility and further steepen the yield curve inversion. The market cannot ignore the potential that short term rates may continue to rise, but they remain convinced of a pending recession, hence the split with the Fed's view and still very inverted yield curve. This is situation that will keep volatility elevated as the market and the FOMC grapple over forward monetary policy.

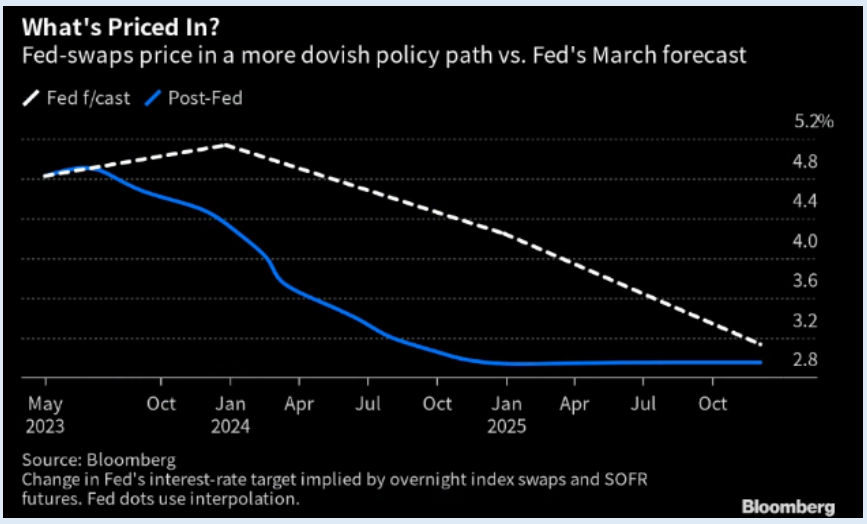
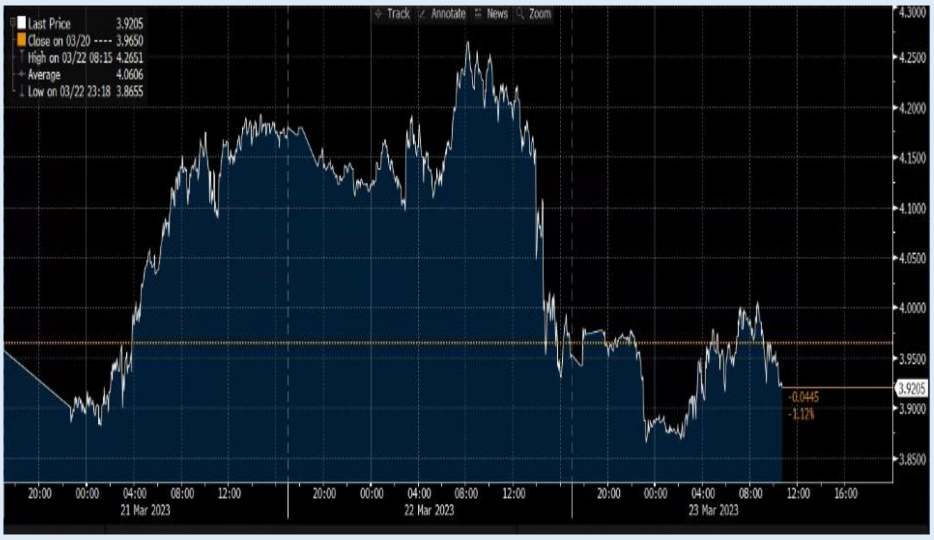


CHART 3: U.S. 2Y SOFR SWAP MOVEMENT – PRIOR (3) DAYS

The following Bloomberg chart details 2-Year SOFR swap rate movement the prior 3 days. You can see the initial reaction after the FOMC meeting was a drop in short term rates. The "dovish rate-hike" affirmed market expectations that the FOMC was nearing the end of the tightening cycle and relief the Fed did not raise rates by 50 bps. A deep dive into Powell's comments and a rate hike this morning by the Bank of England pushed rates higher as the market begins to understand the Fed may not be finished raising rates. At the moment, rates are currently flat to slightly lower across the yield curve (~-3bps or <).



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