AST DEFEASANCE RATE MARKET UPDATE

Friday, August 11th 2023

Please see below for the RCA | AST Defeasance *Rate Market Update* for August 11, 2023. 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, swaps, swaptions or other derivative hedging products. Please feel free to reach out to us anytime!

RATE MARKET UPDATE:

- **Headline CPI better than forecast at 3.2% (3.3% forecast)**
- **PPI prints a bit hotter than expected, causing rates to drift a touch higher.**
- **Monthly Core CPI prints 0.2%; the smallest back-to-back increase in 2 years**
- **Core CPI prints as expected at 4.7% YoY**
- **Treasury and Swap rates slide slightly lower on the better than expected inflation news**
- **Jobless Claims higher than anticipated; US job market may be slowly cooling off**

On Wednesday, headline CPI printed slightly lower than expected this morning and Core CPI came in right at expectations. The “core” consumer price index, which excludes more volatile food and energy costs, rose 0.2% for a second month, the smallest back-to-back gains in more than two years. YoY Core CPI was up 4.7%. Headline CPI also increased 0.2% in July and 3.2% from a year ago. While still elevated, inflation has slowed almost every month since peaking at 6.6% in September. In contrast, Jobless Claims were slightly higher than expected, signaling the US jobs market may finally be cooling off.

The initial market reaction on Wednesday was lower rates – swap rates were down as much as 8 basis points immediately following the numbers, but enthusiasm for the Treasury rally quicky faded. At the moment swap rates are down from Wednesday’s closing levels ~3-5 basis points across the curve. Thursday’s data was definitely viewed as positive by market participants. As we have discussed, the market wants to believe that the Fed is done raising rates and are waiting (hoping?) for the data to back that up. However, given the numbers were pretty much as expected, trader’s seem reluctant to get too carried away with rates in either direction – they need more data. It is too early to draw a conclusion on FOMC monetary policy for the remainder of the year. Market pricing now puts the odds of a 25 bp hike in September at ~7%, indicating the market thinks the Fed will take a breather. However, the odds for a 25 bp November rate hike remain at ~30%, indicating the market thinks a rate hike could be in play.

We will see the FOMC July meeting minutes on 8/16. This will give the Fed the opportunity to emphasize if next month’s meeting remains live or not. The Federal Reserve still hasn’t ruled out another rate increase this year, though markets seem to be leaning that way. The market will now look ahead to Retail Sales on 8/15.

CHART 1: 2Y, 3Y & 5Y SOFR SWAP RATES – PRIOR 30 DAYS

PPI prints a bit hotter than expected, causing rates to drift a touch higher. Like the CPI Data yesterday, the market has basically shrugged off this number too (so far). Despite some intra-day volatility, short term swap rates have not really moved much the past two weeks.


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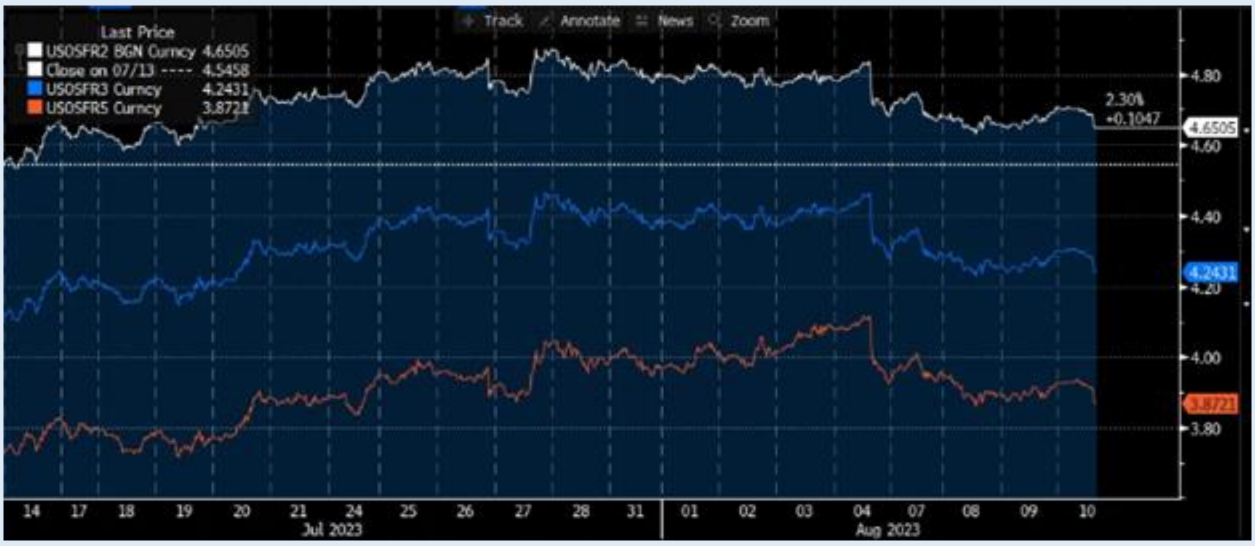
GV Ask/Chg			SOFR/GV		SOFR OIS	
2Y	4.869	+0.027	-11.3100	+0.0700	4.7575	+0.0276
3Y	4.541	+0.031	-15.8400	-0.0400	4.3830	+0.0314
4Y	4.386	+0.028	-23.5700	+0.1800	4.1682	+0.0339
5Y	4.264	+0.032	-22.0000	-0.0600	4.0450	+0.0325
7Y	4.214	+0.034	-29.4600	+0.0500	3.9206	+0.0334
10Y	4.139	+0.033	-28.1300	+0.1200	3.8585	+0.0321
20Y	4.450	+0.027	-64.3400	+0.5900	3.8084	+0.0319
30Y	4.274	+0.033	-67.7000	+0.8000	3.5995	+0.0315

CHART 2: 2Y, 3Y & 5Y SOFR SWAP RATES – PRIOR 30 DAYS

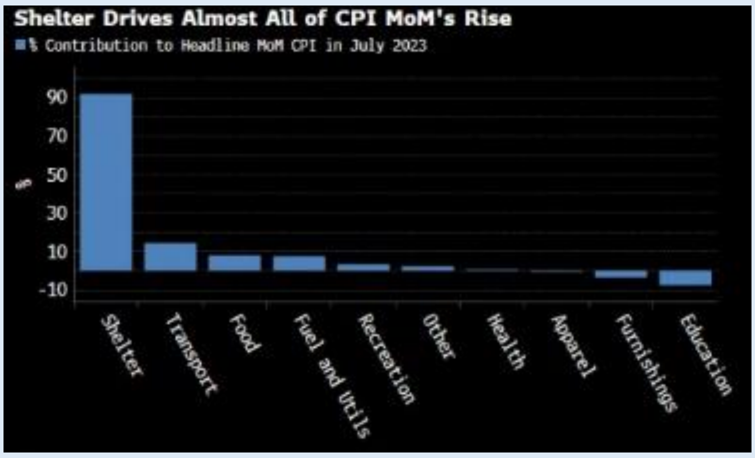
The Bloomberg chart below shows the movement in 2Y, 3Y and 5Y SOFR swap rates over the prior 30 days (Key: 2Y white, 3Y blue, 5Y orange). As you can see from the graph (far right), the market had a muted reaction to this morning’s CPI and jobs data and rates still remain in a relatively tight range. 2-year SOFR swap rates are ~10 basis points higher than they were a month ago and 3-year and 5-year SOFR swap rates have trades similarly.



Source: Bloomberg, LLP

<u>CHART 3:</u> Components of July Headline MoM CPI

The below Bloomberg chart details the components of July month-on-month Headline CPI. As you can see, increases in "shelter" costs were the primary driver of MoM headline inflation. Housing costs will need to drop and shelter will need to become more affordable before we can expect inflation to drop to or below the FOMC's 2.00% target. This is a tricky one for the FOMC – each rate hike puts more pressure on "shelter" costs, the exact opposite of what is needed to curtail housing sector inflation.

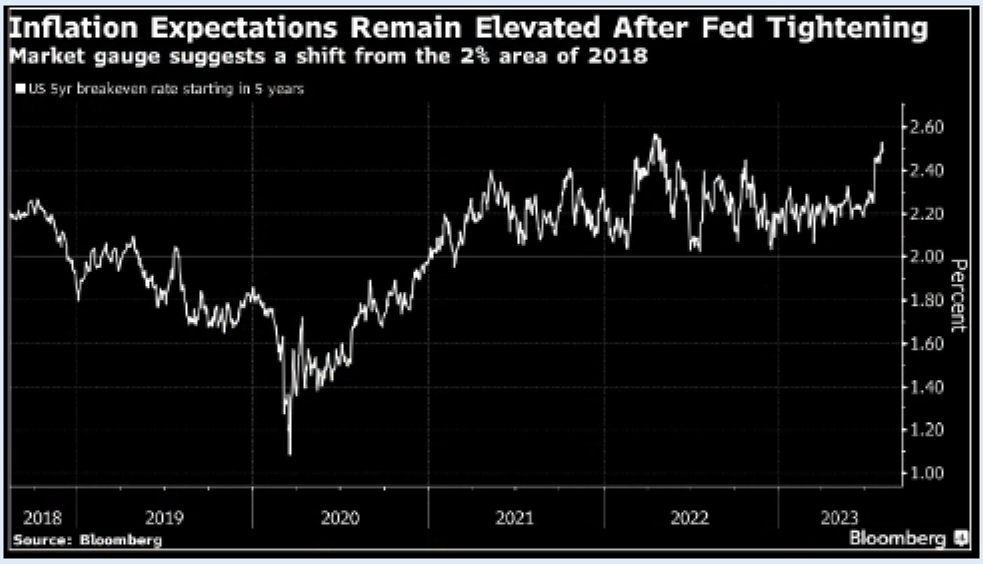


Source: Bloomberg, LLP

<u>CHART 4:</u> Bond Market Forward Inflation Expectations Remain Elevated

One of the reasons that rates did not move dramatically this week is that the slightly better than forecast CPI was tempered by elevated forward inflation expectations. The below Bloomberg graph shows the bond market's 5-Year forward inflation expectations (for example, the 2023 data forecasts inflation for 2028 – a 5-year horizon). From the graph we can see that expectations currently see inflation remaining above the 2.00% threshold over the next 5-years. That indicates inflation may remain sticky and elevated – that could mean more rate hikes or at the very least, a prolonged period of higher rates. (That said, long-dated forecasts *rarely* manifest as predicted, so please take this as information only! It will change.)

As we have discussed the rate market now *(just about)* believes the FOMC is done raising rates and is once again flirting with pricing-in rate cuts for early next year. Hopefully the Fed meeting minutes can shed some light on the policy path forward or alternately, we see economic data that makes it difficult for the FOMC to continue raising rates. The Fed has been vocal about doing what is necessary to see the inflation fight to the end, in contrast to an optimistic market waiting for the signal from the Fed that they are done hiking rates. Thus far, the Fed has been able to engineer dramatically lower inflation without pushing the US into recession. The next few months will determine if the Fed has accomplished the objective or not.



Source: Bloomberg, LLP

Upcoming Market Data to Watch For:

8/15 - Retail Sales
8/16 – Release of highly anticipated FOMC minutes
9/20 – FOMC Meeting

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