AST DEFEASANCE RATE MARKET UPDATE

Good Morning! Please see below for the RCA | AST Defeasance *Rate Market Update* for August 28, 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:

- **Market shakes off Powell speech; Rates remain range bound**
- **However, odds of an additional rate hike this year increased after Powell's comments**
- **Powell's speech basically reiterated his July post-meeting comments – FOMC still in the inflation fight**
- **Market will now look ahead to the key US jobs report on Friday morning (9/1)**
- **GDP (8/30) and PCE (8/31) data releases also on tap for this week**

US Treasury and SOFR swap rates opened *slightly* lower this morning as traders weighed Powell's Jackson Hole comments and looked ahead to the key US jobs report set for release Friday morning (9/1) at 8:30 am. Although the market initially moved higher after Powell's speech, rates quickly plateaued and remained range bound the remainder of the day. As mentioned, rates opened slightly lower this morning, possibly due to a reallocation from equities to bonds.

The market, however, did reprice FOMC expectations after Powell's speech – overall, he was not as dovish or upbeat as the markets would have preferred. At the moment, odds for a 25 bp September rate hike sit at ~ 20% and odds for a 25 bp increase at the November meeting have moved back up to ~ 52%. *(See Chart 1)* As mentioned, Powell did not provide much new information, but he clearly reiterated that the Fed's bottom-line stance has not changed: The Fed is targeting 2.00% inflation and will not be deterred from that goal, nor are they planning to revise the 2.00% inflation target. Although the Chairman's comments were certainly "cautiously optimistic" and he made it clear he was encouraged with progress made to date, he made it *abundantly* clear that they are not yet done in the fight against inflation. Policy makers are prepared to raise rates further, but will move *carefully* from here on out.

More importantly, he stressed that rates will likely need to stay at the current restrictive levels for *some time* until they are *certain* inflation is adequately curtailed. Here is a quote from the Chairman's speech Friday which summarizes his steadfast position: "Although inflation has moved down from its peak — a welcome development — it remains too high. We are prepared to raise rates further if appropriate, and intend to hold policy at a restrictive level until we are confident that inflation is moving sustainably down toward our objective." Make no mistake however – Powell sounded like a man who knows they are done or almost done raising rates - he just wants to proceed *very, very* carefully from here.

The market will now look ahead to the critical US jobs report set for release on Friday (9/1) at 8:30 a.m. Powell wants to see the labor market cool down – it is essential for restraining inflation longer term. Expectations call for a 3.50% unemployment rate. Prior to the employment data, we do see two other important numbers. 2Q GDP is released on Wed 8/30 at 8:30 a.m. – a 2.4% annualized GDP is forecast. The market will see PCE inflation data released on Thursday 8/31 – YoY Core PCE is expected to print at +4.2%. PCE is the preferred inflation gauge for the Fed, so even if PCE prints at expectations, it is still far away from the FOMC's stated 2.00% inflation target.

CHART 1: FOMC Outlook – CME Data

I ran across the below chart in Bloomberg and thought it was worth showing in today's update. The chart details FOMC expectations based on futures trading data provided by the CME. You can see from the chart that futures trading right now still shows the market expects the Fed to hold at the September meeting (78.5%) but the odds for a 25 bp hike jumped up to 52% for the November meeting. (The market is divided almost 50/50 between a pause and a rate hike for November). Based on futures trading data, a rate hike at the December meeting is still in play, especially after Powell stressed how "cautious" the Fed would be moving forward. I think it is also significant to point out that market consensus for a rate cut (consensus would be > 50%) does not occur until June of 2024. Powell has not even *hinted* at rate cuts – Friday he seemed much more concerned with clearly communicating that rates will be held at or near these levels for *some time*. (How long is another question altogether!). A rate cut is not likely to be considered by the Fed until the second half of next year, assuming inflation remains subdued and the economy remains healthy. The FOMC (and the market) will be even more data driven going forward as they navigate the final stages of this monetary policy phase. I expect the rate market to remain susceptible to headline "noise" for the near term and we could see increased volatility as traders react to US economic and geoeconomic data.

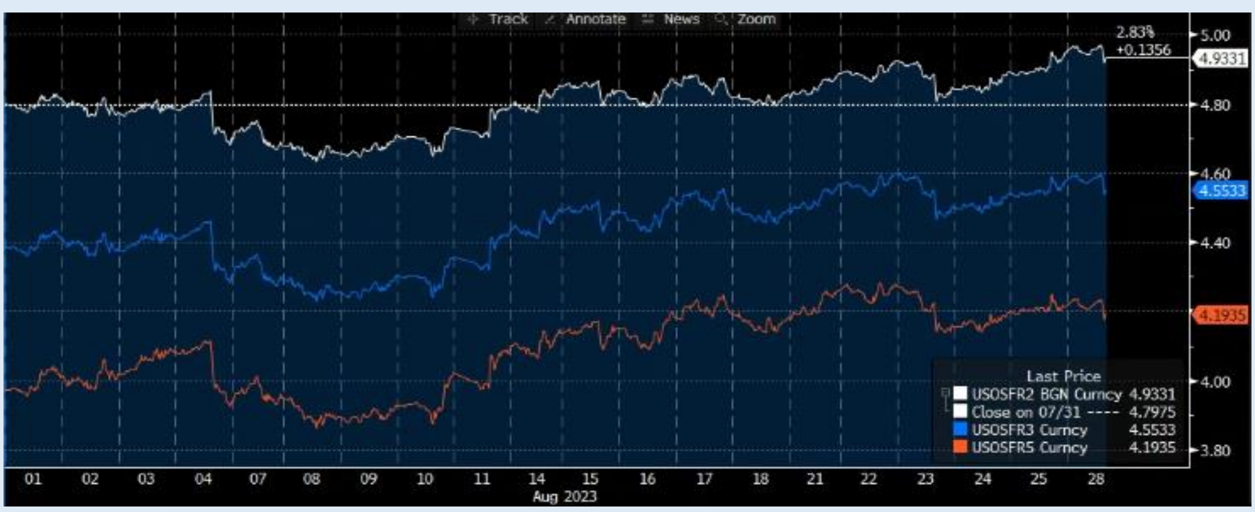
MEETING DATE	DAYS TO MEETING	EASE	NO CHANGE	HIKE
09/20/2023	26	0.00%	**78.50%**	21.50%
11/01/2023	68	0.00%	47.92%	**52.08%**
12/13/2023	110	3.09%	47.65%	49.26%
01/31/2024	159	10.48%	46.68%	42.84%
03/20/2024	208	26.35%	43.12%	30.52%
05/01/2024	250	44.97%	35.80%	19.23%
06/12/2024	292	**66.35%**	24.42%	9.23%
07/31/2024	341	82.25%	13.88%	3.87%
09/18/2024	390	92.94%	5.90%	1.16%
11/07/2024	440	96.93%	2.64%	0.43%
12/18/2024	481	98.76%	1.09%	0.15%

Source: CME Group

Source: Bloomberg, LLP

CHART 2: 2Y, 3Y & 5Y SOFR Swap Rates – Prior 30 Days

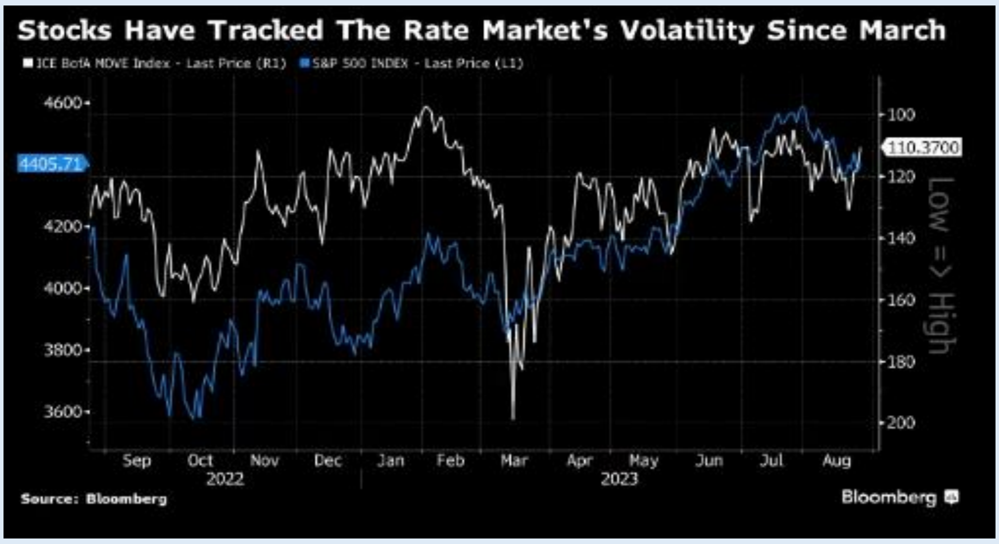
The below Bloomberg graph details 2y (white), 3y (blue) and 5y (orange) SOFR swap rates for the prior 30 days. As we have been discussing in the updates, SOFR swap rates have *slowly* moved higher since the July FOMC meeting. We have seen a lot of data since the July meeting – we have heard from all manner of FOMC officials, including the Chairman – we have watched the global economic situation come under increased scrutiny during that time as well. However, rates have *barely* moved – the 2y SOFR swap rate is ~2.8% higher (or +13.5 bps) over the prior 30 days. This signals that there is still a *tremendous* amount of uncertainty present in the rates market – uncertainty surrounding forward monetary policy (and the *timing* of it!), uncertainty on the US economic outlook, US political uncertainty and uncertainty and concerns about global economic growth. All of those factors are combining to keep swap rates range bound as traders navigate an uncertain path forward. As mentioned, the market will remain susceptible to headline and data reaction risk and we will soon be heading out of the traditionally slower "summer" market. *September could be a volatile month for rates.*



Source: Bloomberg, LLP

<u>CHART 3:</u> Equities Track Rate Volatility Since March 2023

I found the below Bloomberg chart intriguing and thought I would include it in today's piece. The white line depicts the rate market "MOVE" volatility index and the blue line details the S&P 500's performance. Since March, stocks have directionally tracked rate volatility. This chart may indicate that equities are nearing their peak for the year and that bonds will become the preferred investment in a "higher for longer" rate scenario. It also evidences that the bond market and the equity market are watching rates closely – rates are a main driver of both markets currently. At the moment, uncertainty and attractive bond yields are causing investors to reallocate from equities to bonds. *Stay tuned!*



Source: Bloomberg, LLP

<u>Disclaimer:</u> *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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