AST DEFEASANCE RATE MARKET UPDATE

Friday, July 28th 2023

Good Morning! Please see below for the RCA | AST Defeasance *Rate Market Update* for August 8, 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! *-RCA | AST Interest Rate Hedging Desk*

RATE MARKET UPDATE:

- **Rates move lower on negative bank news and global economic concerns**
- **Market grappling with the uncertain path forward for rates**
- **CPI inflation data released Thursday 8/10 at 8:30 am**
- **Fed-Speak remains Hawkish**

US Treasury and SOFR swap rates continued to move lower this morning on negative bank news. Rating agencies are reviewing bank credit ratings after the mini-crisis experienced in March and April. Rating agencies are concerned about bank loan loss reserves, balance sheet pressure created by a massive FOMC rate hiking campaign and concerns about commercial real estate exposure. We will be keeping a close eye on this situation and will report any developments as they manifest. In general, bank downgrades tend to make lending more restrictive and tighten credit which drives up borrowing costs and makes funding more difficult to procure as banks become more selective.

Overall, the US rate market reaction to the banking sector ratings news has been fairly muted (See Chart 1). Rates did move lower this morning in a mini flight-to-quality created by negative global bank news overnight. However, rates quickly stabilized and SOFR swap rates are only down 3-6 basis points at the moment. Fed-speak has also been hawkish recently, with several Fed officials mentioning the possible need for “additional” rate hikes to get inflation to the 2.00% target. As you can see, that message is once again in direct contrast to the market, who are hoping for a Fed pause or halt to rate hikes altogether. Market participants are now once again worried about a US recession caused by the massive rate hikes we have witnessed. Pressure on the banking sector is only adding to this concern.

The market will likely shift focus to Thursday’s CPI release at 8:30 am. The market will be watching the inflation data *closely* – this is a *huge* number and it may set the tone for rates for the remainder of the year. Will CPI show lower inflation or will the data still be too high for the Fed’s taste? Stay tuned. Right behind CPI we see PPI inflation data on Friday 8/11 and Retail Sales next week on 8/15.

CHART 1: 2Y, 3Y & 5Y SOFR SWAP RATES – PRIOR 30 DAYS: SOFR Swap Rates Lower Since Monday

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, rates had been trading in a fairly narrow channel since the July FOMC meeting – the market had a muted reaction to the FOMC rate decision and press conference and seemed to shift into a data dependent mode in tandem with the FOMC. As the market received news of the Fitch downgrade, followed by negative bank ratings news, rates began to drift lower. Despite a seemingly still-hawkish Fed, market participants are slowly removing the possibility of another rate hike this year. At the moment, market trading suggests a 15% chance of a 25 bp rate hike in September and a 30% chance of one in November. The market is hoping the Fed will wrap up the rate hikes, but are reluctant to go too far down that path without additional economic data.

Source: Bloomberg, LLP

CHART 2: Property Values Under Pressure

As you can see from the below Bloomberg bar-chart, property values have come under significant pressure over the past 12 months, driven primarily by the FOMC's aggressive rate hiking campaign. You can clearly see the most impacted areas are office space and apartment buildings. I found this chart interesting as it underscores one primary reason behind the recent bank downgrades and negative ratings outlook. It is also a significant reason the market has renewed concerns on the health of the US economy and the possibility of a significant recession on the horizon. In addition, banks and other lenders in the sector are finding that the secondary loan market for commercial property loans has become increasingly illiquid, making it difficult for them to sell loans. Finally, property sales have dried up, making it difficult to value what loans are worth – banks are reluctant to sell loans at a loss, as it impacts solvency and capital ratios. These factors are likely to continue to put pressure on bank lending, loan spreads and access to funding for the foreseeable future.

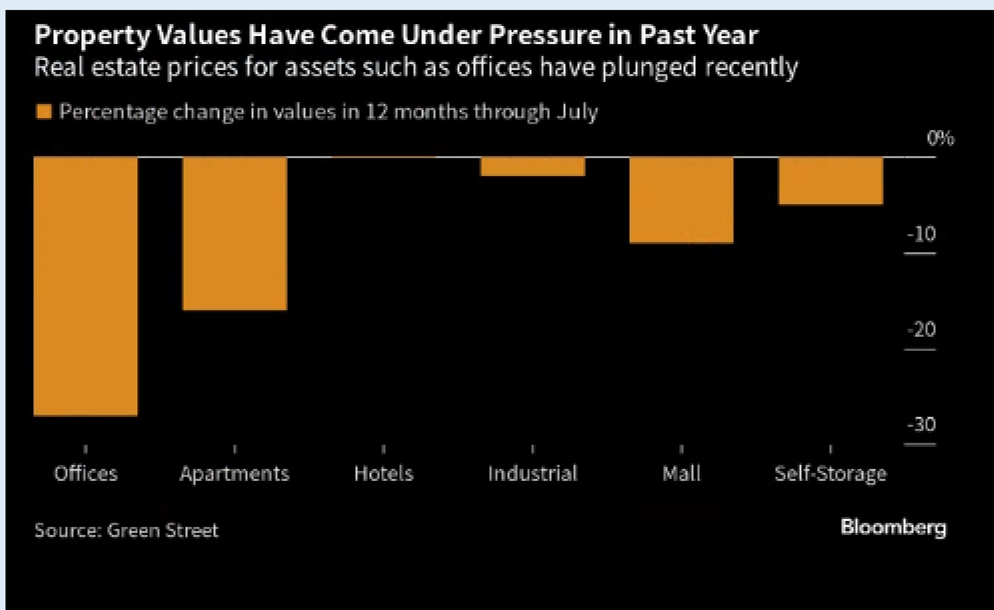

CHART 3: Market Volatility May Come After Fitch's US Downgrade

In an unexpected move on 8/1, the market got the news that Fitch had downgraded the US government from AAA to AA+, citing expected fiscal deterioration over the next three years. Despite cries of protest from pundits and commentators, the market largely shrugged of the news. Fitch's downgrade was likely symbolic in nature, but underscores the quiet concerns about the economy that have existed since the Fed began raising rates. I am more concerned with what happens from here on out. Market reactions to news like this tends to lag the actual announcement and that may be the case here – note again we saw Moody's negative news on banks this morning, which only added to market jitters. I found the below Bloomberg chart compelling – although it focuses on the equity market, it details the volatility witnessed in the US equity market after S&P's US downgrade in 2011. You can clearly see the volatility spike that occurred in the two months *after* the downgrade announcement. Active rating agency periods tend to create and/or exacerbate volatility – for equities *and* for the rate market. There is still tremendous uncertainty in the market surrounding the FOMC outlook, forward rates, the US economy and the underlying health of the US Banking sector. All of these factors can lead to increased rate volatility. At the moment, the market remains cautious – Fed officials sound hawkish and economic data still looks ok – so they are reluctant to gap the market in either direction. That could change with Thursday's CPI or more unexpected domestic or global financial news. Thus far, rate volatility has remained relatively stable since the Fitch announcement.

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.*

***

AST Defeasance Consultants, one of the nation's leading commercial real estate consulting firms, was founded in 2007. We have extensive experience in commercial real estate defeasance, hedging, derivatives, and financial instruments. More than $50 billion worth of transactions have been executed by the AST team. Only AST can combine innovation, expertise, and exceptional customer service.

Rate Cap Advisers was established in 2015 that focus on providing commercial real estate interest rate cap solutions. Our innovation and desire to explore new possibilities that benefit our clients have allowed us to save our clients millions of dollars. No matter the service or product, we take great pride in our pursuit of perfection with a unparalleled closing track record.

***

To unsubscribe from our mailing list, please reply to this email.