AST DEFEASANCE RATE MARKET UPDATE

Please see below for the RCA | AST Defeasance *Rate Market Update* for December 12, 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, floors, swaps, swaptions or other derivative hedging products. *Please feel free to reach out to us anytime!*

RATE MARKET UPDATE 12/12/2023:

- **CPI data prints largely "as expected", but shows inflation remains sticky at current levels**
- **Headline CPI ticked-up 0.1% MoM - expectations called for an unchanged headline CPI**
- **Traders shrugged off the number; SOFR swap rates are mostly unchanged this morning**
- **All eyes are focused on tomorrow's FOMC meeting and Powell's press conference**

US Treasury and SOFR swap rates are holding steady this morning, after the November CPI report underwhelmed market participants. Rates opened the day lower, but drifted higher after CPI printed basically unchanged. Currently, rates are ~1-2 bps higher across the yield curve.

Headline CPI picked up in November (see Table 1), reinforcing the FOMC's intent to hold interest rates elevated in the near term. Core CPI, which excludes more volatile food and energy costs, increased 0.3% in November, following a 0.2% rise in October. YoY Core CPI held steady at 4.00%. Today's CPI data underscores the difficult task of getting inflation back to the FOMC's target 2.00% level. While price pressures have largely retreated from multi-decade highs, a resilient labor market continues to power consumer spending and the broader economy. The FOMC begins a two-day meeting Tuesday that is expected to culminate with them holding interest rates steady again.

The market will be focusing on the post-meeting press conference, held tomorrow at ~2:30pm eastern. Powell's comments will be carefully dissected by the market. He will likely reiterate he and his colleagues want to see a more sustainable pullback in price growth before easing policy. Market participants want to hear the Fed's view on rate cuts, a topic Powell has steadfastly avoided discussing to date. As we know, there is a clear dichotomy between the Fed and the market. The market wants rate cuts and has priced at least *three* rate cuts into the 2024 forward curve. The Fed, thus far, has signaled they do not see the need for rate cuts. Expect Chairman Powell to get numerous questions about rate cuts and the potential timing of the "first cut". Will he shut down rate cut talk or leave the door open for a rate cut early next year? Most market participants believe he will probably stay as neutral as possible in his comments, but they are definitely hoping for clear direction from the Fed. Expect rate volatility tomorrow afternoon as the market reacts to the FOMC rate decision and Powell's press conference.

PPI inflation data is released tomorrow morning at 8:30 am. Core PPI is expected to rise 0.2% MoM. The PPI number is not expected to move the market significantly given the FOMC meeting announcement at 2:00 pm. However, if PPI diverges from expectations, it could set the market tone heading into the Fed meeting. If PPI shows the same stubborn plateau as CPI, rates could be biased higher heading into the Fed. If PPI prints lower, the mixed inflation data could lead to slightly lower rates prior to the meeting. It is also important to note that inflation forecasts call for a core CPI level of ~3.00% by the end of 2024 (see Chart 1). If the Fed's inflation forecast is similar, will they really be compelled to lower rates in the near future? Stay tuned!

TABLE 1: CPI Report Highlights: Stubborn Inflation Mostly Unchanged; Core CPI Ticks Higher

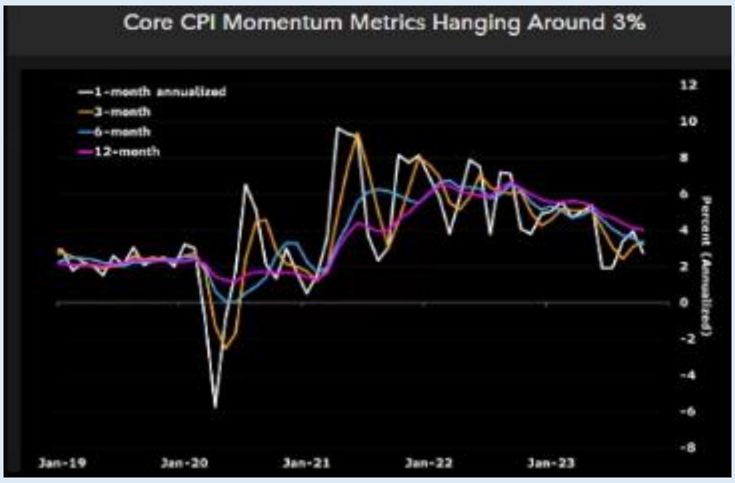
November CPI Data: Key Highlights

Metric	Actual	Estimate
CPI MoM	+0.1%	0.0%
Core CPI MoM	+0.3%	+0.3%
CPI YoY	+3.1%	+3.1%
Core CPI YoY	+4.0%	+4.0%

Source: Bloomberg, LLP

CHART 1: Core CPI Forecasts For 2024: Drifts To 3.00%, Then Holds

The below Bloomberg graph details core CPI forecasts for 2024. The Bloomberg economist's composite forecast is in line with other forecasts we have seen for next year. Core CPI is expected to gradually drift down to 3.00% and to hold there for the second half of 2024. If the Fed's inflation forecasts are similar to economists, that supports a "higher-for-longer" monetary policy. However, if the Fed does shift gears to a more neutral policy, that would imply they are satisfied with the disinflation momentum. That may open the door for a rate cut in the second half of next year. Keep in mind, however, that *economic weakness, not a decrease in inflation, is more likely to prompt the FOMC to cut rates.* As we mentioned earlier in the update, US economic data has remained strong. Unless we see a significant deterioration in economic conditions, the Fed is unlikely to be compelled to cut rates in the near term. We will certainly know more tomorrow afternoon!

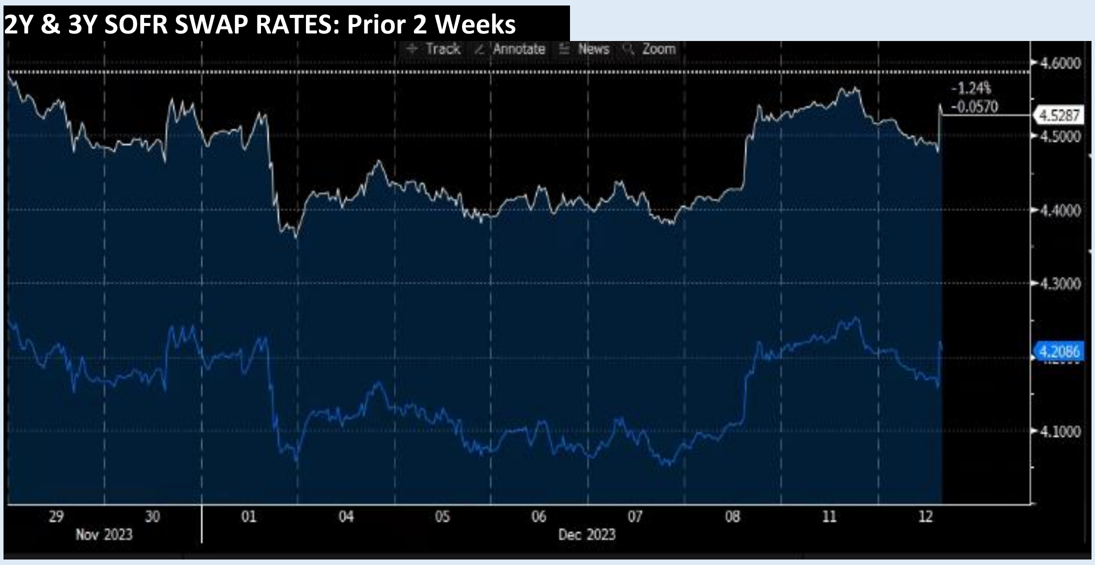


Source: Bloomberg, LLP

<u>CHART 2:</u> SOFR Swap Rates Prior 2 Weeks

The Bloomberg graph below details **2Y** (white) and **3Y** (blue) SOFR swap rates for the prior 2 weeks. Swap rates shrugged off the CPI data this morning and are now trading in a tight range. Despite intraday volatility, 2Y and 3Y swap rates are basically unchanged to where they opened December 1. This underscores the uncertainty in the market regarding the FOMC and forward rates. You can see where the recent bond rally paused on Dec 1. 2Y swap rates are up ~14 bps since then, reflecting market fears the massive bond rally may have dropped rates too far, too fast.

2Y & 3Y SOFR SWAP RATES: Prior 2 Weeks

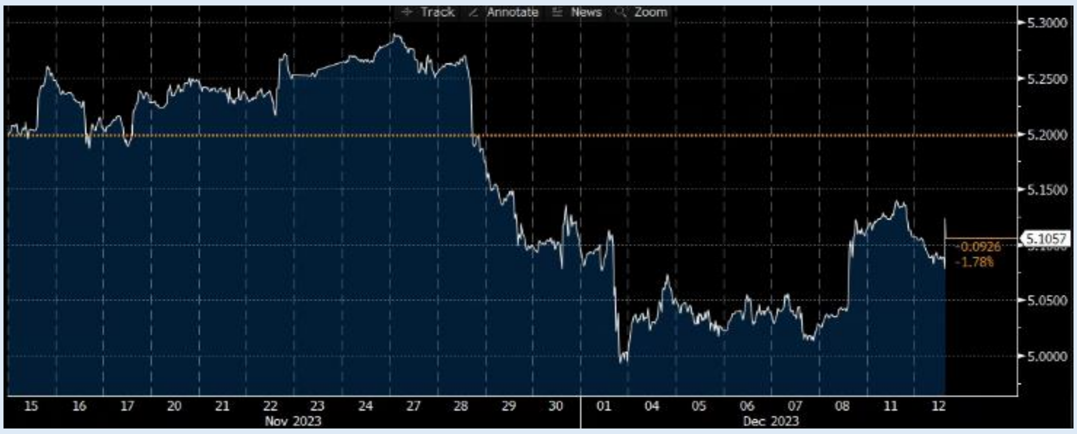


Source: Bloomberg, LLP

<u>CHART 3:</u> 1Y SOFR SWAP RATE: Market Seeks Direction From The FOMC

The Bloomberg graph below shows **1Y** SOFR swap rates for the prior 30 days. The bond rally beginning 11/24 pushed 1Y SOFR swap rates down ~30 bps. 30 basis points is a significant move - you can see the volatility in the 1Y swap rate below. There was a significant decline in the 1Y swap rate until the Employment Report printed last week. Since then it has bounced around in a narrow 10 bp range. FOMC rate decisions can have a pronounced effect on the 1Y swap rate. The current 5.10% level tells me traders are unsure about short term rates and what the Fed will say tomorrow. The fact that it is trading below current SOFR (5.32%) does signal to me that traders are still leaning toward a rate cut sooner rather than later.

1Y SOFR SWAP RATE: Prior 30 Days



Source: Bloomberg, LLP

<u>Product Update:</u>

Week of 12/11/23 - *What We Are Seeing In The Market…*

New cap volume increased recently and we continue to see our clients looking at cap extensions. Given the uncertainty that still remains about forward rates, many clients are grappling with when or if to extend. This is a difficult question – our advice has been to monitor the market closely and be on-boarded and ready to trade, should the market move in your favor. We also advise borrowers to check the market pricing for extensions, similar to how you purchased the original cap. Market pricing discovery is a key component to any cap transaction – new caps, extensions or terminations. *Volatility has softened somewhat during the past two weeks, providing some premium relief for cap purchasers, especially for strikes at or out-of-the-money.*

We also encourage our clients to speak to their lenders. In some cases recently we have seen lenders approve shorter term extensions (i.e. 3 months) – some borrowers may need to extend, but not for the *full* year. Other borrowers are simply looking to dynamically manage hedging rate risk by entering shorter term caps and hoping cap premium costs will drop ahead of the next cap purchase. This is not without risk, but could be a viable strategy if you believe rate are going down next year.

There is an increasing interest in exploring interest rate swaps as a possible hedge alternative. IR Swaps lock in a synthetic fixed rate and do not require an upfront premium. Unlike an interest rate cap, swaps are secured derivatives, so the counterparty selection process is more challenging with a swap. There are also additional variables that factor into the decision to pursue an interest rate swap, or to unwind an existing swap. *Please let us know if you would like to learn more about interest rate swaps.*

On another front, borrowers who have "floors" embedded in their loan have been considering purchasing a separate, stand-alone interest rate floor to *offset* the loan floor. Borrowers with a loan floor will *not* be able to benefit from floating rates that drop below the loan floor rate. They will miss out on the benefit of lower floating rates, which depending on the rate environment can be significant. To offset the loan floor, borrowers can purchase an interest rate floor which will payout should floating rates drop below the floor's strike rate. Details vary depending on the individual situation – some borrowers prefer to choose a strike on the floor that matches the floor rate on the loan, whereas others look to use a strike rate below the loan floor. (For example: Your loan floor is 3.50% - the floor you purchase can be priced at the loan floor of 3.50%, or you could look at a strike of 3.00%). The lower the floor strike, the cheaper the premium cost of the floor. Pricing ultimately depends on the individual situation and objective.

We also continue to see clients grappling with ways to manage burdensome replacement cap escrow costs. In certain cases there *may* be a way to restructure the existing cap to extract value which can offset escrow created cash-flow pressure. Short of biting the bullet and purchasing the replacement cap and ceasing escrow deposits, restructuring the cap can add risk. Many of the solutions are designed to alleviate short term cash flow pressure but as mentioned, often create additional rate risk.

Please contact us if you would like to discuss an upcoming rate cap extension, explore ways to reduce or eliminate escrow deposits for replacement caps or learn more about interest rate Floor pricing.

<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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Rate Cap Advisors 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.

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