AST DEFEASANCE RATE MARKET UPDATE

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

RATE MARKET UPDATE 12/8/2023:

- **Employment Report stronger than expected; Jobs market remains resilient**
- **Unemployment Rate drops to 3.70%; Wage inflation slightly higher than forecast**
- **Treasury and SOFR swap rates move higher on strong employment report**
- **Traders reassessing FOMC rate cut expectations**
- **CPI released next week on Tuesday, 12/12 at 8:30 am – the day before the FOMC rate decision**
- **Next FOMC Rate Decision: December 13, 2023 at 2:00 pm**

US Treasury and SOFR swap rates moved higher this morning on a stronger than forecast jobs report (see Chart 1). The US labor market unexpectedly strengthened in November with increases in employment and wages, deflating hopes the FOMC will be prompted to cut interest rates early next year. Nonfarm payrolls increased, bolstered by the return of striking auto workers. The unemployment rate fell to 3.7% and workforce participation ticked higher. Monthly wage growth rose more than forecast. The FOMC keeps a close eye on wage inflation, so the increase in wages is unwelcome news for the market. Market participants were hoping for lower wage growth. Average hourly earnings rose 0.4%, matching the biggest monthly advance this year. SOFR swap rates immediately moved higher following the data release – traders are now dialing back rate cut expectations (see Chart 1A & Chart 2).

The surprise job market strength supports the Fed's desire to keep borrowing costs elevated to ensure inflation returns to their target level. Fed officials are widely expected to keep borrowing costs unchanged when they meet next week. Chairman Powell has repeatedly pushed back against growing bets of rate cuts early next year, stressing that policymakers will move cautiously but retain the option to hike again. Market participants expect the Fed to hold rates steady next week and Fed officials have signaled that as well. The market will be focusing more on the Fed's economic outlook for next year and for hints on the timing of rate cuts. Market prognosticators are split – some believe Chairman Powell will need to talk tough (read: hawkish) in order to tone down market expectations for rate cuts, while others feel he may be more neutral in his comments. Either approach could create rate volatility.

Thus far, the market is almost outright ignoring the Chairman – he has repeatedly stated that rate cuts are not imminent and he has been clear they are prepared to hold rates higher for as long as it takes to stifle inflation. He has gone so far as to say the FOMC would not rule out another rate *hike* should conditions warrant. Market participants are hoping for some clarity from the Fed, but as we have seen recently, the market seems prepared to take matters into their own hands, regardless of what the FOMC communicates. Today the market definitely backed off, but nowhere near the scale of the massive bond rally witnessed in recent weeks. It will be interesting to see if Chairman Powell can reign in the rate cut speculation.

Next week will be dominated by the FOMC meeting and rate decision on 12/13, but we do see some critical data released prior to the meeting, highlighted by the CPI report on 12/12. Next week's CPI may be the most important inflation data we have seen all year. The FOMC begins their meeting on 12/12, so they will have the CPI data in hand for the meeting. We will also see PPI released on 12/13 and Retail Sales prints on 12/14.

CHART 1: Employment Report Highlights: Data Stronger Than Expected

US EMPLOYMENT REPORT DATA: Key Highlights

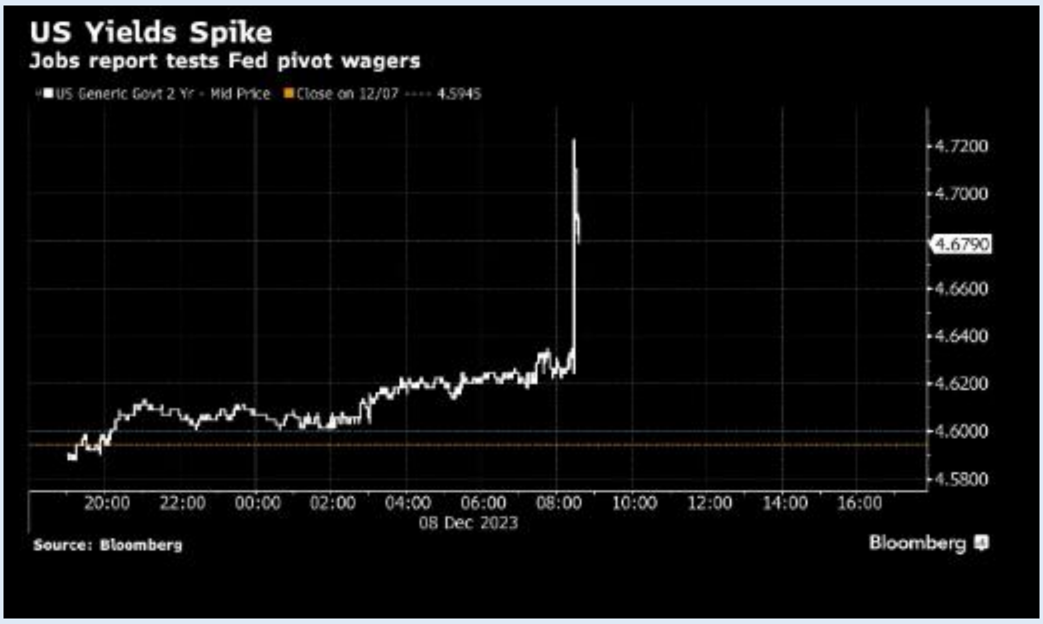
Metric	Actual	Median estimate
Change in payrolls (MoM)	+199k	+185k
Unemployment rate	3.7%	3.9%
Average hourly earnings (MoM)	+0.4%	+0.3%

Source: Bloomberg, LLP

CHART 1A: Market Reaction To Jobs Report: 2Y Treasury Note

The Bloomberg graph below shows the 2Y Treasury yield's reaction to the release of the jobs data. Treasury rates immediately popped higher, especially the Fed-sensitive 2Y note. Rates stabilized somewhat after the market digested the data, but rates are holding at approximately 8-12 basis points higher across the Treasury curve. SOFR swaps have moved higher this morning in tandem with Treasuries. *Prepare for rate volatility next week as we see another round of key economic data (CPI, PPI, Retails Sales) and wait for a very important FOMC meeting.*

2Y T-NOTE REACTION TO EMPLOYMENT DATA: Higher Rates



Source: Bloomberg, LLP

CHART 2: SOFR Swap Rates Prior 30 Days

The Bloomberg graph below details **1Y** (green), **2Y** (white) and **3Y** (blue) SOFR swap rates for the prior 30 days. You can see today's pop in rates at the far right of the graph. 2Y and 3Y SOFR swap rates jumped higher (~10 bps) after the number printed and held. 1Y SOFR swaps showed less volatility, but edged higher. Uncertainty surrounding the FOMC's next "move" - and the timing of it – pushed swap rates higher today as traders reassessed FOMC rate bets. In short, rates climbed this morning on renewed speculation that the market's bets on Federal Reserve rate cuts next year may have gone too far.

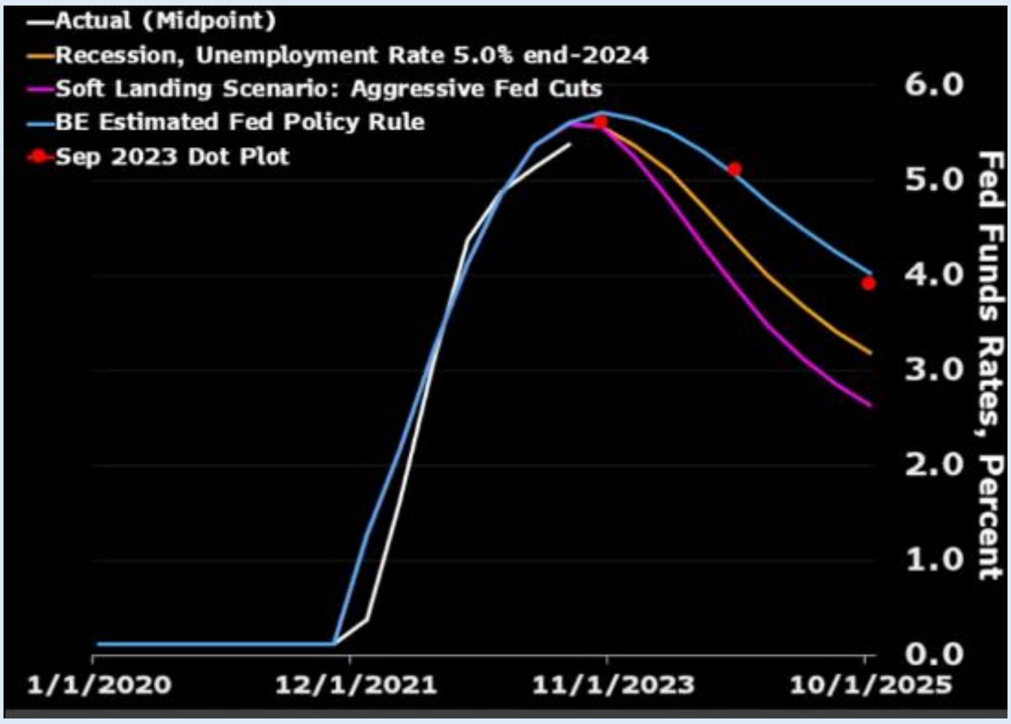
1Y, 2Y & 3Y SOFR SWAP RATES, PRIOR 30 DAYS: Swap Rates Move Higher

Source: Bloomberg, LLP

CHART 3: FOMC Preview: *To Cut, or Not To Cut? That Is The Question!*

The Bloomberg graph below shows various forward Fed Funds projections. I wanted to show this chart to underscore the dichotomy between the market and the FOMC regarding forward rate projections. The red dots represent the most recent Fed "dot plot" and the white line is the current Fed Funds "mid". If you focus on the second red dot on the chart, you will notice it is *very* close to the white line, implying the Fed is not signaling any rate cuts until, potentially, the back end of next year. Economists surveyed are in line with the Fed dot plot. Although the market has slightly dialed back rate cut expectations for next year, market pricing currently calls for *at least* three 25 basis point rate cuts next year (purple, gold lines). Thus far, that forecast does not foot to what the FOMC has signaled: rate cuts are not currently on the table. Traders will also be keen to hear the Fed's outlook for the economy. One of the main reasons the market is ahead of the Fed on rate cuts is the outlook for the economy. The FOMC is optimistic on the economic outlook and *cautiously* optimistic on inflation. At the moment it definitely feels like the market has the reverse view – pessimistic on the economic outlook and optimistic that inflation has been vanquished. We will find out what the Fed is thinking soon enough. *Stay tuned!*

FOMC Update: Rate Cut Scenarios



Source: Bloomberg, LLP

Product Update:

Week of 12/4/23 - *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.

***

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.

***