AST DEFEASANCE RATE MARKET UPDATE

Good Morning! Please see below for the RCA | AST Defeasance *Rate Market Update* for January 17, 2024. 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 1/17/2024:

- **Retail Sales data released at 8:30 am was *much* stronger than expected**
- **Rates move higher as traders adjust rate cut expectations**
- **1Y and 2Y SOFR swaps are up over 20 basis points this week, putting pressure on cap premiums**
- **Fed Governor Waller pushed back on the market's rate cut timetable in comments made yesterday**
- **Odds of a March rate cut continue to drop – now ~50/50**

UST yields and SOFR swap rates rose this morning after hotter-than-expected Retail Sales data added to speculation that market pricing for FOMC rate cuts is overdone. December Retail Sales rose at the fastest pace in three months due to a resilient US consumer powering a strong Holiday season. The strong consumer data, coupled with the recent encouraging inflation data continues to support a "goldilocks" economic scenario – lower inflation with sustained growth, stable employment and a strong consumer. Fed officials have echoed that sentiment in recent comments and seem to be content to hold rates where they are for the foreseeable future. Over the weekend, Atlanta Fed President Bostic said he doesn't expect rate cuts until the summer and yesterday Fed Governor Waller pushed back against market expectations for a March rate cut in his comments. He cautioned the Fed would stay "methodical" and "careful" with respect to rate cuts.

Yes, we are seeing a deceleration in certain sectors of the economy and it is plausible that the Fed will need to cut rates at some point this year. However, the Fed appears in no hurry to cut rates – they cannot risk fanning inflation by cutting rates too soon. In addition, the Fed has thus far signaled three potential rate cuts for 2024. Traders may also be realizing that the 6 rate cuts currently priced into the curve is too aggressive. The rate move we have witnessed this week feels like the market is finally adjusting the timing of the first rate cut.

We will continue to see economic data this week, including Housing Starts and Existing Home Sales, and there are a host of Fed officials on the tape.

I do not expect this week's rate move to signal a shift toward higher rates – I simply think the market went too far too fast in terms of rate cut expectations, specifically, the timing of the first cut. As a result, short term rates adjusted to reflect a longer horizon for the first rate cut.

Expect elevated rate volatility this week and a near-term bias toward higher rates. The big picture for rates this year is unchanged – the economy is expected to gradually slow during the year prompting the Fed to begin cutting interest rates. *What has changed is that it may be a longer and more volatile path to rate cuts than the market anticipated!*

CHART 1 & 1A: Retail Sales Recap: The Consumer Roars On!

The table below recaps the highlights from this morning's Retail Sales data release. US Retail Sales rose at the strongest pace in three months in December, capping a solid holiday season that signals consumer resilience heading into the new year. Increases in Retail Sales were spread across most sectors, further evidencing broad consumer strength. Headline Retail Sales rose 0.6% in December and sales ex-autos increased 0.4%. Motor-vehicle sales were up 1.1%, matching the biggest increase since May.

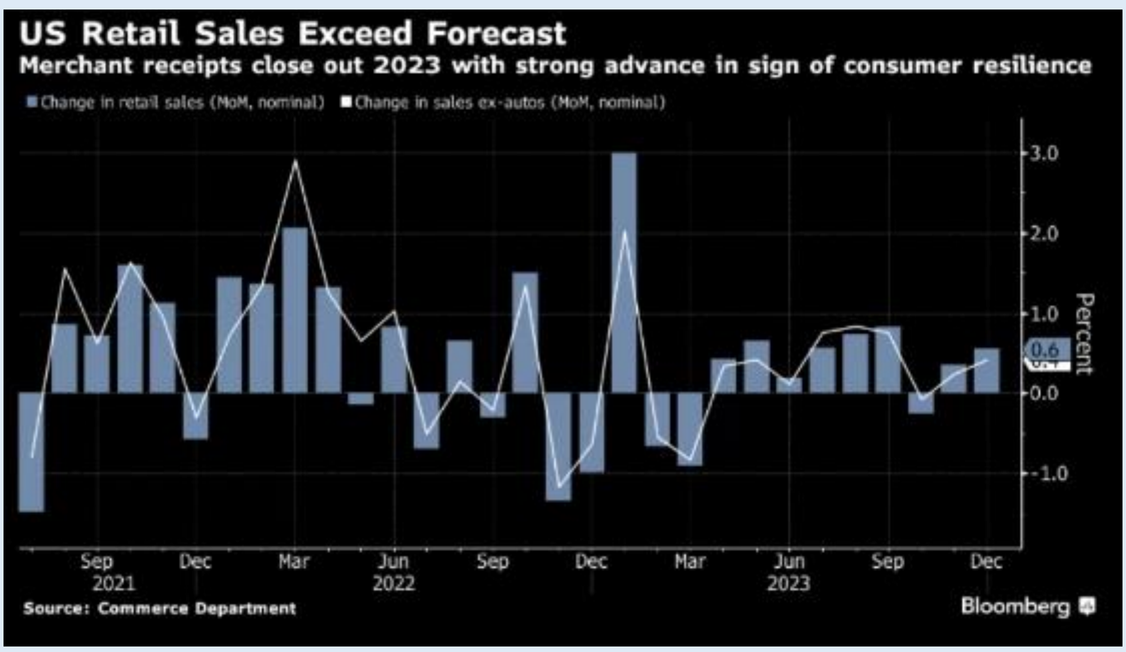
The Retail Sales figures cap a year in which consumer spending consistently surprised to the upside, confounding economists' calls for a recession. The consumer remains resilient, but forecasters see that momentum fading in 2024 as consumers contend with lingering inflation, elevated borrowing costs and waning savings. That scenario would call for the Fed to begin cutting rates in order to prop up the economy, lower borrowing costs and maintain maximum employment – precisely what the FOMC has been signaling since the December meeting.

Chart 1: RETAIL SALES DATA RECAP

Metric	Actual	Estimate
Retail sales (MoM)	+0.6%	+0.4%
Sales ex. autos (MoM)	+0.4%	+0.2%
'Control group' sales (MoM)	+0.8%	+0.2%

Source: Bloomberg, LLP – Retail Sales Recap

Chart 1A: RETAIL SALES PRIOR 18 MONTHS HISTORIC



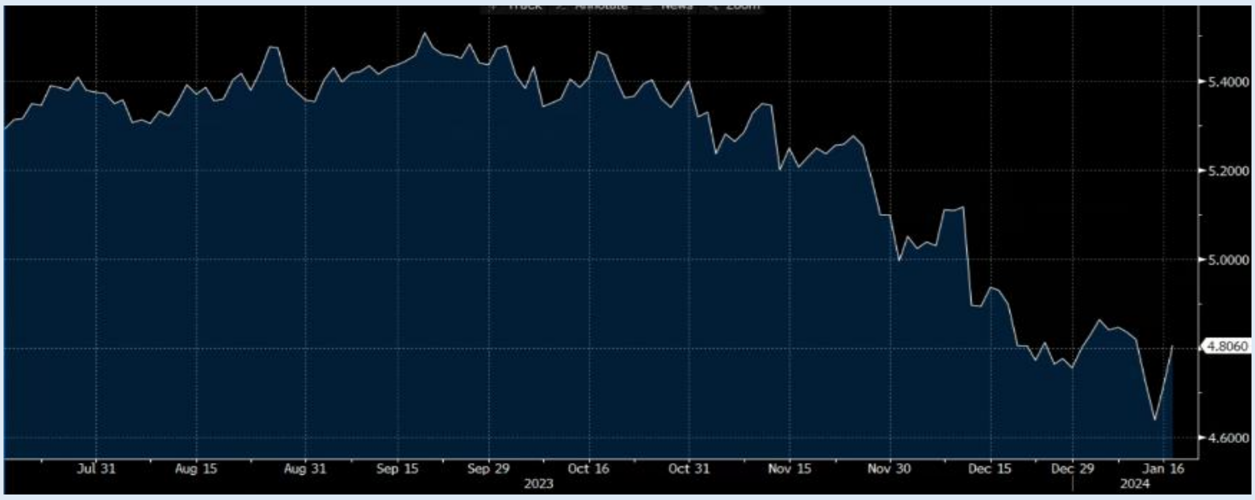
Source: Bloomberg, LLP – Retail Sales Historical

CHART 2 & 2A: Short-Term SOFR Swap Rates Move Higher but Still Near 6-Month Lows

The Bloomberg graphs below detail the 1Y and 2Y SOFR swap rates for the prior 6-months. Despite the data induced increase in swap rates this week (see far right of below graphs), it is important to note that swap rates remain near 6-month lows. Most of the massive bond rally we saw heading into year-end is still intact. Short-term swap rates are likely to remain volatile as traders recalibrate FOMC rate cut expectations. Although expectations for rate cuts are being toned down, market pricing is still *way* ahead of the Fed's dot-plot. That said, the market is still pricing in a 50/50 chance of a rate cut in March! Traders can be stubborn and reluctant to change prevailing market pricing without firm proof in hand. With that in mind, expect 1Y and 2Y swaps to remain vulnerable to economic data prints and Fed-speak as we head towards the next FOMC meeting.

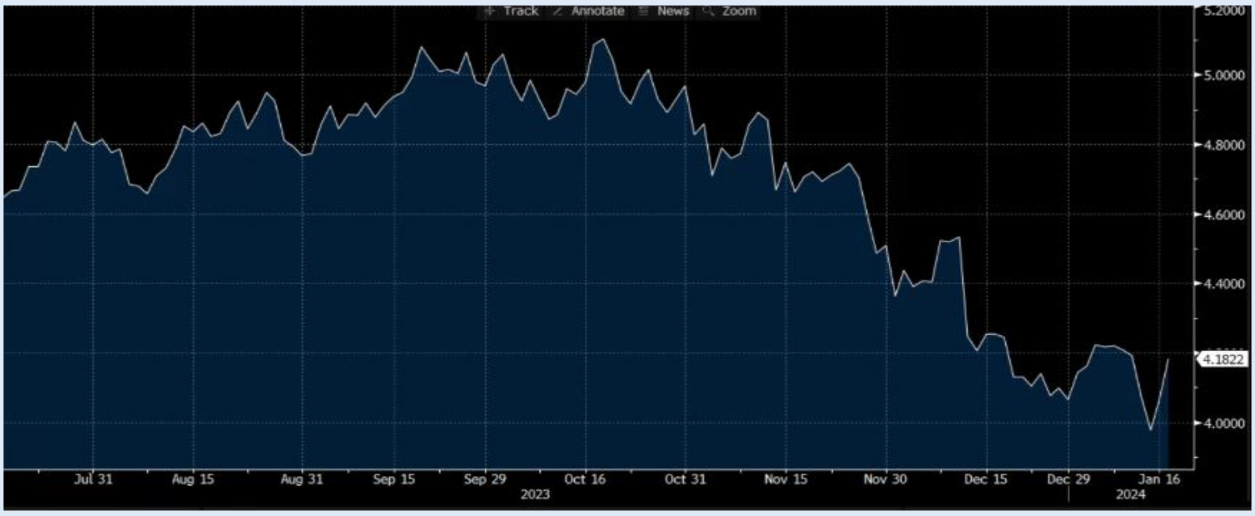
I would also note that there is still *a lot* to monitor from a geopolitical standpoint. Destabilization in the Middle East could threaten US inflation gains and any number of other geopolitical "hot spots" could threaten US economic stability. Geopolitical developments will be closely watched by the Fed.

Chart 2: 1Y SOFR SWAP RATE - Prior 6-Months



Source: Bloomberg, LLP – 1Y SOFR Swap

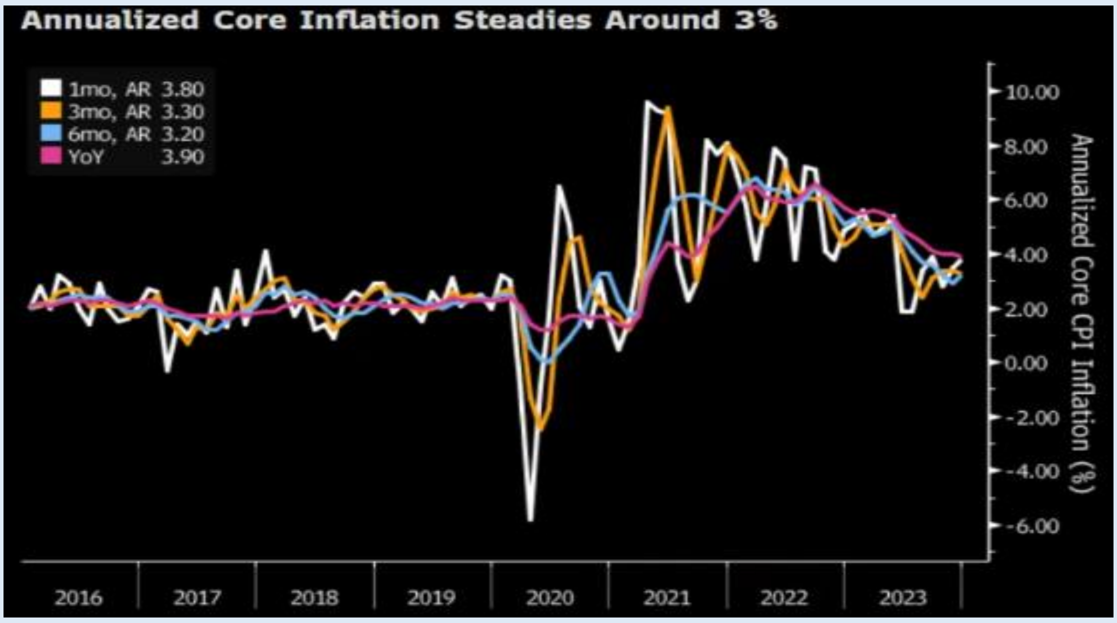
Chart 2A: 2Y SOFR SWAP RATE - Prior 6-Months



Source: Bloomberg, LLP – 2Y SOFR Swap

CHART 3: Inflation Goal Within Reach…But Not There Yet!

Currently, economists expect Core CPI to hover at ~3.00% for the next 12 months. I included this graph as a reminder that, despite the encouraging data and long-term inflation outlook, core CPI has been sticky and continues to present a challenge for the Fed. It also provides further evidence that the FOMC will likely be in no hurry to cut interest rates. The Fed has carefully orchestrated what appears to be the dream scenario – crushing inflation without inducing a severe recession. From a monetary policy standpoint, they will likely continue to proceed with caution and patience, rather than risk undoing all that they have accomplished to date by cutting rates too soon.



Source: Bloomberg, LLP, Bloomberg Economics – CPI Annualized Core Inflation

Product Update:

Week of 1/15/24 - *What We Are Seeing In The Rates Market*

New cap volume increased recently and we continue to see our clients looking at cap extensions. The massive bond rally that ended 2023 is still largely intact - we saw a significant improvement in cap premiums as we moved toward year-end. In addition, despite a shift in market pricing regarding Fed rate cuts, the forward curve is still pricing in ~5 rate cuts for 2024 – just starting a bit later in the year. That said, the market is still seeing a 50/50 chance the Fed will cut rates in March. *Despite the uptick in rates this week, cap premiums remain at the most attractive levels in several months.*

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.

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 Swaps or Floors.

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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 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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