AST DEFEASANCE RATE MARKET UPDATE

Please see below for the RCA | AST Defeasance *Rate Market Update* for November 3, 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 11/03/2023:

- **FOMC holds benchmark rate steady at 5.25% lower bound / 5.50% upper bound**
- **Powell signals "meeting-by-meeting" bias going forward**
- **Powell says FOMC "not focused on rate cuts"; Timeframe for "higher-for-longer" still uncertain**
- **Market participants viewed rate decision and Powell's comments as "neutral" or "neutral-dovish"**
- **October Jobs report weaker than forecast, supporting the market view that the FOMC is done raising rates**
- **SOFR Swap rates significantly lower across the curve this week**

US Treasury and SOFR swap rates dropped this morning after a weaker than forecast Employment Report signaled the mighty US jobs market may finally be cooling off. Rates decreased after Wednesday's FOMC rate decision and they have continued to move lower in each successive trading session. The FOMC held the benchmark overnight rate unchanged and signaled that going forward they will make monetary policy decisions on a "meeting-by-meeting" basis. Given the reaction, it is clear that market participants believe the Fed is done raising rates – the tightening cycle is over. The question will be whether or not the market has overreacted.

At best, the Fed statement, including Powell's comments, sounded more "neutral" than "dovish" to me. They cautioned patience and were clear that they were by no means satisfied that the fight against inflation is done. Yes, they admitted they are encouraged by the direction of inflation and economic conditions, but were clear they still fear stopping too quickly and rekindling inflation. When asked about rate cuts, Powell said "the FOMC is not focused on rate cuts". That does not sound like the FOMC is planning to cut rates anytime soon. Rather, they are likely to hold rates here for *as long as possible* to ensure that inflation continues to move toward their 2.00% target. The timeframe for "as long as possible" is the key question for traders to contemplate going forward.

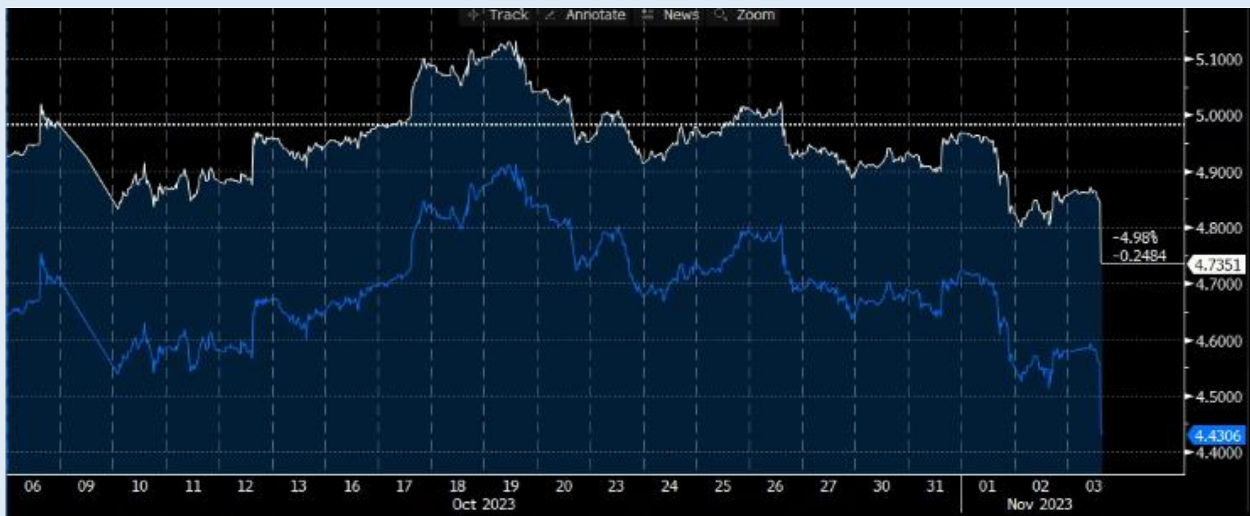
The path forward for rates remains uncertain – economic data will be the main driver for Fed policy, but there are many other factors that could also impact rates and monetary policy. Powell acknowledged they are tracking geopolitical events and that they are closely monitoring changes in "financial conditions". Until Wednesday, that meant the large run-up in term rates we had witnessed over the prior 30 days. When the term structure of rates shifts dramatically as it has recently, the Fed pays attention – in short, the yield curve can do the Fed's job for them! This rate drop clearly signals the market does not think the Fed will be raising rates in December or anytime thereafter. Now that rates have adjusted to account for an FOMC on "hold", we will see if the market goes too far, or if rates stabilize at or near these levels and then wait for further economic data and/or FOMC direction. Reminder, Fed officials are no longer blacked out – Fed officials are already back on the tape today. I am sure Fed officials will have plenty to say in the coming weeks. *We expect continued elevated rate volatility as the market sorts out what is next for rates.*

In this type of market environment we recommend you be *on-boarded and ready to be nimble in your trade execution*. Proactively preparing for an upcoming trade enables borrowers to benefit from favorable intra-day volatility that may present opportunities to execute at lower cap premiums or lower swap rates. Timing the market is difficult, if not impossible. Be ready to execute and you can avoid market surprises – rate volatility can work for you *and* against you.

CHART 1A: 2Y & 3Y SOFR Swap Rates - Prior 30 Days

The below Bloomberg graph details 2Y and 3Y SOFR swap rates over the prior 30 days. SOFR swap rates are down *significantly* since the FOMC rate decision and Powell's press conference Wednesday and that trend lower continued this morning after the jobs data posted weaker than forecast. As I prepared this report, 2Y SOFR swap rates were down ~25 basis points since the Fed meeting. Coincidence, or the market removing that lingering 25 bp rate hike that had been priced into the curve? Probably the latter! We do expect the short end of the curve to stabilize, but there is certainly the possibility of elevated volatility as we heard into year-end. The next FOMC meeting happens on December 13th. It is an important meeting and as the *last* meeting of the year, it will set the tone for 2024.

2Y & 3Y SOFR Swap Rates: Prior 30 Days – Short Term Rates Drop on Fed "Hold", Softer Employment Report



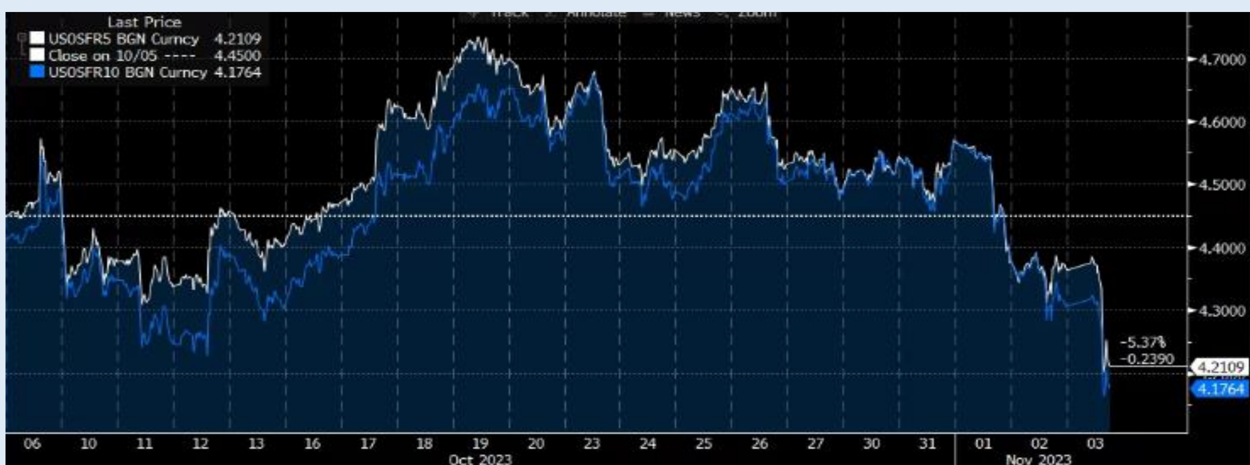
Source: Bloomberg, LLP

CHART 1B: 5Y & 10Y SOFR Swap Rates - Prior 30 Days

The Bloomberg chart below shows the rate movement in the "belly" of the swap curve – 5-Years and 10-Years – for the prior 30-days. There has been tremendous volatility in that sector of the curve and the jump in volatility continues this week. Term rates surged in recent weeks and the curve inversion continued to quickly unwind. You can see from the graph that 5Y and 10Y swap rates are essentially right on top of each other!

The run up in term rates halted this week and reversed *substantially*, due to a surprisingly neutral FOMC and a softer than anticipated jobs report. Expect term rates to be volatile as traders try to weigh go-forward monetary policy against mixed economic data and a wide-range of shifting economic projections. The remainder of the 2023 could be a rocky ride!

5Y & 10Y SOFR Swap Rates: Prior 30 Days – Tremendous Volatility; Rates Drop



Source: Bloomberg, LLP

CHART 2A: Employment Report Recap | Key Data Table

The below table highlights the October Jobs Report. Average hourly earnings, the Unemployment Rate and the Change in Payrolls all printed weaker than expected, indicating the labor market may finally be cooling off. From an FOMC perspective, this is *exactly* what they want to see: Near full employment, but a cooling labor demand and stable wages. This further supports the market view that the Fed has done enough to reduce inflation and will not need to raise rates again. Rates across the curve immediately gapped lower after the number was released and held, continuing the drop in rates we have seen since Powell's press conference. Right now rates are clearly biased lower. Geopolitical tensions, mixed US economic data, a cooling labor market and a seemingly "paused" FOMC all tilt the scales toward a lower rate bias for the near term.

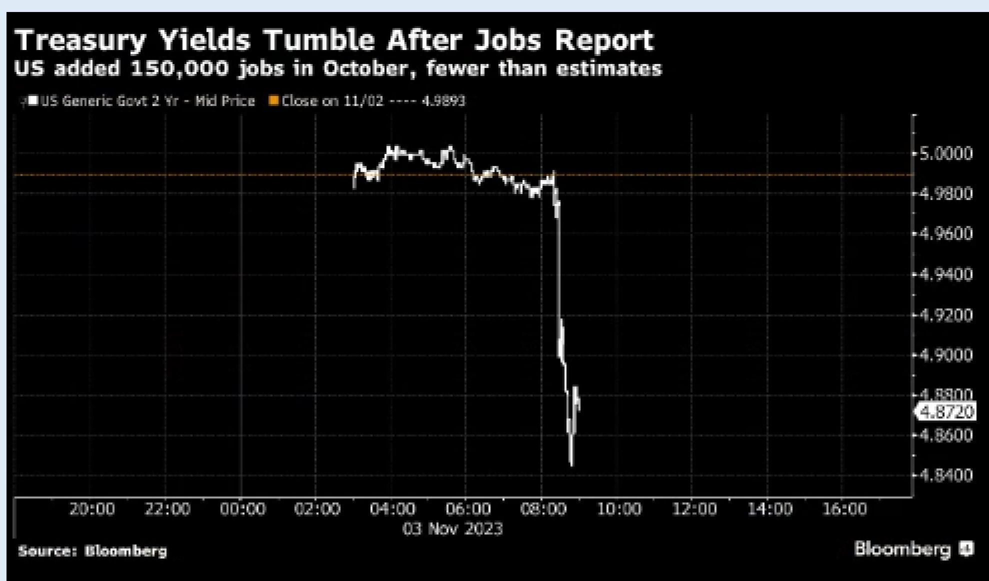
October US Employment Report Highlights

Metric	Actual	Median estimate
Change in payrolls (MoM)	+150k	+180k
Unemployment rate	3.9%	3.8%
Average hourly earnings (MoM)	+0.2%	+0.3%

Source: Bloomberg, LLP

CHART 2B: 2Y Treasury Note Reaction To Jobs Report – Yields Lower

FOMC rate decisions and monetary policy changes have the most impact on the 2Y T-note. The Bloomberg graph below shows the initial 2Y T-note reaction to this morning's weaker than expected jobs report. The 2Y Treasury yield *immediately* dropped after the jobs number printed, as weaker than expected data fortified the market's view that the Fed is done raising rates. Today's sustained drop in 2Y yields further backs up that view – we will see if short term Treasury rates hold here, or continue to move lower. The risk now is that the market goes too far and yields drop too much – there is a growing market chorus calling for rate cuts in the first half of next year. Chairman Powell tried to reiterate that rate cuts are *not on horizon at the moment* – we will see if the market heard him or not.

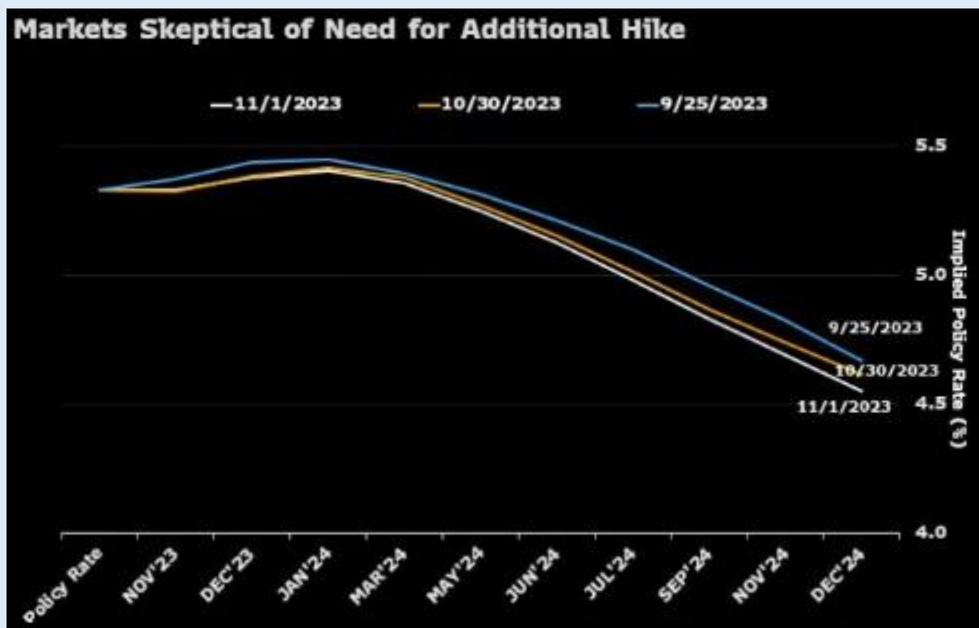


Source: Bloomberg, LLP

CHART 3: FOMC Recap: November 1st Meeting & Press Conference Analysis

The FOMC held rates steady at Wednesday's monetary policy meeting, keeping the benchmark overnight rate unchanged at 5.25% / 5.50%. By all accounts and based on the substance and tone of Powell's comments, the Committee moved to a "neutral" bias. That was not "officially" announced, but they made it clear that they have shifted to a "meeting-by-meeting" approach that will be heavily data dependent. Powell was clear the fight against inflation and full employment remain their key mandates. He was also clear that if inflation were to tick-up due to strong economic conditions, the Fed was prepared to tighten monetary policy further. However, his comments and tone were far more neutral than they have been after recent meetings. He projected a feeling that rate hikes were done unless things changed drastically. As we have discussed, the market welcomed the rate "hold" but went a bit further – some market participants and pundits described the Fed as now in a "dovish-hold". I am not quite in that camp yet – as mentioned, Powell basically ruled out rate cuts. When asked "rate cut" questions at the press conference, Powell almost seemed surprised that someone would ask about rate cuts. The Fed does not simply cut rates based on a predetermined schedule or because the tightening cycle is over. They need a compelling reason to cut rates and do not have one. At the moment it is difficult to see one on the horizon either.

The Bloomberg graph below highlights the market reaction to the FOMC meeting and the impact on forward Fed Funds forecasts – market participants are now clearly skeptical of the need for any further rate hikes in this cycle. Market pricing now shows the odds of a December rate hike at less than 5% - virtually no chance! The day prior to the FOMC meetings odds were holding at between 25% and 30%. Has the market gone too far? Probably not in the short term – the Fed is not likely to raise rates in December. The risk is that the market drops rates too far, too soon and needs to correct higher. Should economic data, an up-tick in inflation or macro events shift again, the Fed will be ready to tighten policy further. If the data continues to show a softer job market, stable-to-lower inflation, solid economic growth and macro events don't deteriorate significantly, then the outcome is likely a "hold" on the benchmark rate at 5.25%-5.50% for at least the first half of 2024. Despite the conviction of the market the past few days, uncertainty regarding the forward path for rates remains high. *Stay tuned!*



Source: Bloomberg, LLP

Product Update:

Week of 10/30/23 - 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.

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.

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.

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.*

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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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