AST DEFEASANCE RATE MARKET UPDATE

Good Morning! Please see below for the RCA | AST Defeasance *Rate Market Update* for October 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 10/12/2023:

- **CPI and PPI report released showed US inflation remains stubborn**
- **Mixed but primarily Hawkish Fed-speak has increased market uncertainty about forward rates**
- **FOMC September meeting minutes released yesterday at 2:00 PM**
- **Middle-East tension continues; Attack on Israel has disrupted financial markets and led to a global flight to quality**
- **As a result, term SOFR swap rates have been volatile since Monday**

CHART 1: CPI Inflation Report

US Treasury and swap rates reversed their decline overnight and elevated rate volatility continues after a hotter than expected CPI report showed inflation remains sticky. The PPI & CPI numbers keep one more 25 bp rate hike in play this year. There are several wildcards however, that could disrupt the market – further destabilization in the Middle East (or oil production impact), the lengthening UAW strike and the dysfunctionality in Washington DC that could lead to a government shutdown. The situation with Israel is the most volatile and unpredictable. A nervous tension will hang over the markets until more clarity and stability occurs. (As we have seen, a deterioration in the region would lead to a flight to quality and lower rates.) Investors are wary of an escalation which would create ripple effects throughout the Middle East, endangering Israel's fragile coexistence with its neighbors and increasing the risks that hostilities spiral into a broader regional war with implications for crude oil supplies and the global economy.

The shorter end of the yield curve has moved lower as well, but not to the magnitude of longer-term rates given the increased uncertainty concerning the path forward for the FOMC. Note that although yields have dropped noticeably since Hamas' assault on Israel, they are still ~30 bps higher than at the time of the last FOMC meeting. The September meeting also took place just after the United Auto Workers (UAW) strike began, and there was an imminent risk of a government shutdown at the end of September. The UAW strike is now closing in on a month and a shutdown may still happen in November or December. There are *many* factors impacting the market right now and adding to the uncertainty concerning forward rates and the outlook for the economy.

US TREASURY YIELDS / SOFR SWAP SPREADS / SOFR SWAP RATES

GV Ask/Chg			SOFR/GV		SOFR OIS	
2Y	5.067	+0.084	-11.0600	-1.1100	4.9565	+0.0715
3Y	4.826	+0.080	-17.4000	-0.9100	4.6510	+0.0680
4Y	4.725	+0.071	-24.6500	-0.6500	4.4873	+0.0639
5Y	4.639	+0.063	-23.7500	-0.2500	4.4023	+0.0588
7Y	4.643	+0.050	-32.2100	-0.2700	4.3240	+0.0486
10Y	4.595	+0.037	-30.7500	+0.1300	4.2885	+0.0375
20Y	4.921	+0.023	-68.1000	+0.2000	4.2430	+0.0272
30Y	4.715	+0.022	-69.0000	+0.2500	4.0245	+0.0220

Source: Bloomberg, LLP

SEPTEMBER CPI

Indicator	Actual change	Median estimate
CPI (MoM)	+0.4%	+0.3%
Core CPI (MoM)	+0.3%	+0.3%
CPI (YoY)	+3.7%	+3.6%
Core CPI (YoY)	+4.1%	+4.1%

Source: Bloomberg, LLP

CHART 2: PPI Inflation Report

The Bloomberg graph below details yesterday's PPI results. Stronger than expected PPI inflation data bolstered speculation the FOMC may in fact need to hike rates 25 bps once more this year and be forced to keep rates higher-for-longer. Treasury two-year yields, which are the most sensitive to imminent fiscal policy moves, approached 5% after the report was released. Prices paid to US producers rose by more than forecast in September, bolstered by higher energy costs that continue to complicate the path toward sustainably lower inflation. Headline PPI advanced 0.5% from a month earlier and the cost of gasoline increased 5.4%. Core PPI climbed 0.3%. Market participants were hoping that yesterday's PPI would be lower than anticipated and set the stage for a lower CPI print this morning – and, hopefully no more rate hikes. That was not the case – inflation remains stubborn and still far from the Fed's 2% target.

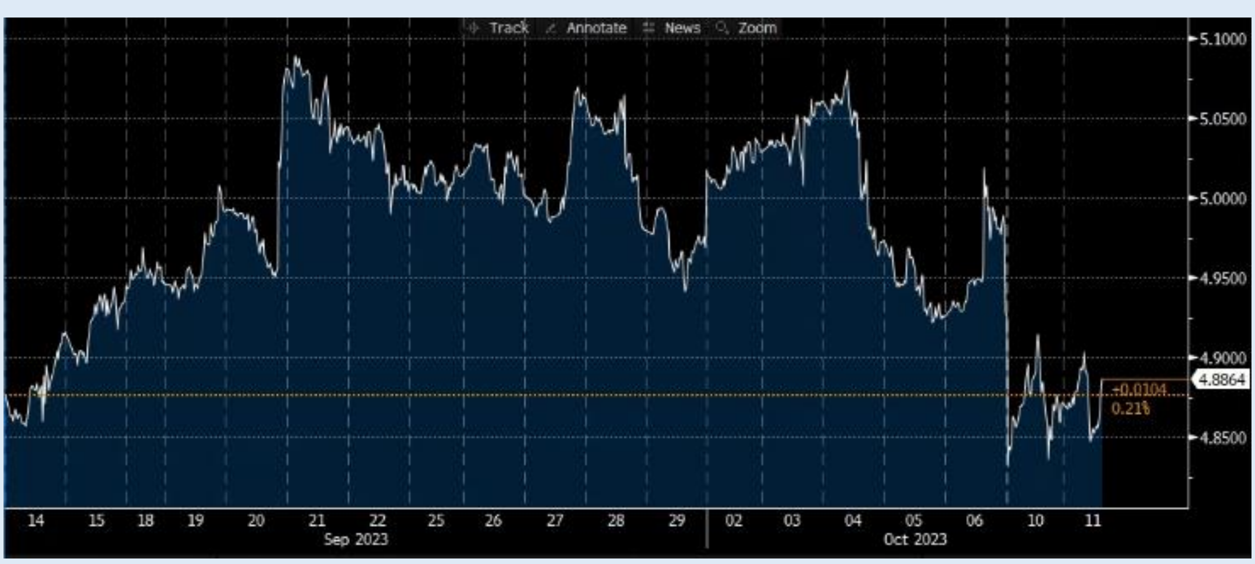
Indicator	Actual	Median estimate
PPI (MoM)	+0.5%	+0.3%
PPI excl. food & energy (MoM)	+0.3%	+0.2%
PPI (YoY)	+2.2%	+1.6%
PPI excl. food & energy (YoY)	+2.7%	+2.3%

Source: Bloomberg, LLP

CHART 3: 2Y SOFR Swap Rates – Prior 30 Days

The below Bloomberg graph details the 2y SOFR swap rate for the prior 30 days. You can see the reaction to the turmoil in the Middle East at the far right of the graph. Rates initially gapped lower as traders sought a safe haven for assets, then settled as market participants tracked developments in the region and waited for more clarity. Although longer term rates dropped and stayed there, the 2y note has been bouncing around as the market tries to balance geopolitical developments with the US monetary policy outlook. Expect rate volatility across the curve to continue for the near term, with 2y and 3y rates being the most volatile.

2Y SOFR Swap Rates: Prior 30 Days – Expect Continued Volatility

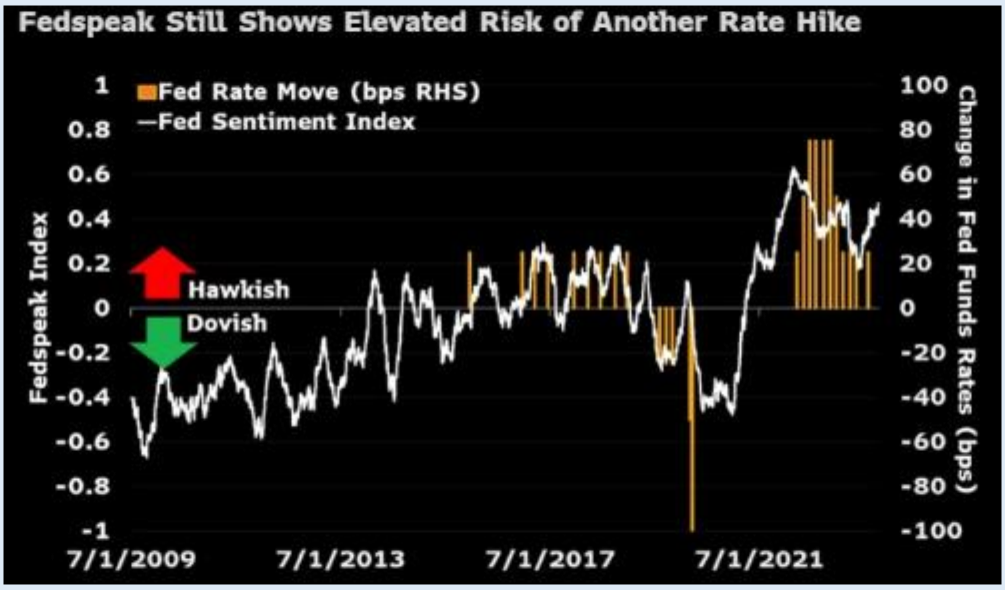


Source: Bloomberg, LLP

CHART 4: FOMC September Meeting Minutes

The Bloomberg chart below shows an interesting metric Bloomberg uses to track Fed "sentiment" – whether they are leaning hawkish or dovish. As you can see, despite more balanced Fed-speak recently, the overall FOMC sentiment remains hawkish. This implies that the FOMC still believes that further monetary policy tightening may be necessary. However, it is becoming increasingly clear that barring any unforeseen "black swan" events, the FOMC is at or near the end of this historic tightening cycle. The Fed has been cautiously optimistic that monetary policy is working to reduce and contain inflation but also warned further rate increases may be warranted. This has been increasingly reflected in recent Fed-speak. To illustrate, Fed Bank of San Francisco President Mary Daly said tighter financial conditions may mean the central bank "doesn't have to do as much," the latest in a string of softer commentary that raised hopes interest-rate hikes may be done for now. Atlanta Fed President Bostic recently said that "I think that our policy rate is at a sufficiently restrictive position to get inflation down to 2%. I actually don't think we need to increase rates anymore." You can see that there is a dovish slant to the above quotes, but certainly not *convincingly* so. Right now, the market seems preoccupied with determining the path forward for the Fed – as such we may see increased rate volatility as the market wrestles with what is next for interest rates.

Bloomberg Fed Sentiment Index



Source: Bloomberg, LLP

Product Update:

Week of 10/09/23 - What We Are Seeing In The Market…

New cap volume has actually increased somewhat, and we continue to see clients looking at cap extensions. Given the uncertainty that remains regarding forward rates, many are grappling with when or if to extend. Our advice has been to monitor the market closely and be onboarded and ready to trade, should the market move in your favor. Also, check the market pricing for extensions, just like when you purchased the original cap. Market pricing discovery is a key component to any cap transaction – new caps, extensions, or terminations.

Speak to your 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 a *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 rates are going down next year.

Separately, 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 pay out if 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.

Many are 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.

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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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