AST DEFEASANCE RATE MARKET UPDATE

Good Morning! Please see below for the RCA | AST Defeasance *Rate Market Update* for October 17, 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 10/17/2023:

- **Retail Sales data prints significantly stronger than forecast**
- **Thus far, the US retail consumer remains *resilient***
- **US Treasury yields and SOFR Swap rates move higher post data release**
- **Yield curve inversion continues to unwind**
- **Market participants are keeping a close eye on geopolitical (and other) factors that could quickly impact rates**
- **Expect elevated rate volatility for the near term**

Retail sales data released this morning printed much stronger than forecast in a broad advance that suggests *durable* US household demand. The advance in retail sales showcases a consumer that is still powering ahead, despite recent energy-driven price pressure. While US wage growth is starting to slow, the labor market remains generally strong, presumably offering consumers the breathing room to keep spending. The data also increased expectations of stronger economic growth in the third quarter. Sustained strength in US consumer demand coupled with the recent price data (which showed stubborn inflation) has once again increased the odds that the FOMC will raise interest rates again before the end of the year.

US Treasury yields and SOFR swap rates increased as soon as the retail sales data was released, and continued higher after some secondary data was released at 9:15 am. Most market prognosticators had called for *softer* than expected retail sales data, so the red hot data print caught the market somewhat off-guard. Short term swap rates moved immediately higher on speculation another Fed rate hike is firmly back in play for this year. As mentioned, the strong consumer and sticky inflation are going to be tough for the Fed to ignore. Medium-to-long term rates are also moving higher and outpacing the increase on the short end of the curve – as the economy shows continued strength, the yield curve "recession" inversion is slowly unwinding *(See Chart 3).* That said, there are many *significant* factors impacting the market and adding to increased uncertainty at the moment: continued major geopolitical turmoil, the lingering and increasingly acrimonious UAW strike, a volatile energy market heading into winter, increasing US political drama and earnings season.

We expect continued rate volatility as the market digests today's data and nervously monitors the numerous factors that can impact the market in the very near term. Treasury and swap rates are probably biased higher, but given everything traders have to monitor at the moment, the upside for yields may be temporarily curtailed by investors snapping up higher yields and a lingering uncertainty on the path for forward rates.

CHART 1: US Retail Sales: The Consumer Roars On!

The Bloomberg table and graph below detail this morning's Retail Sales data release. The value of retail purchases increased 0.7% after an upwardly revised 0.8% gain in August. Excluding gasoline, September retail sales advanced 0.7%. The "control group" component of retail sales (which is used to calculate gross domestic product and excludes food services, auto dealers, building materials stores and gasoline stations) rose a better than expected 0.6%. As you can see from Chart 1b, this morning's retail sales data showed a broad based increase. *Most* of the

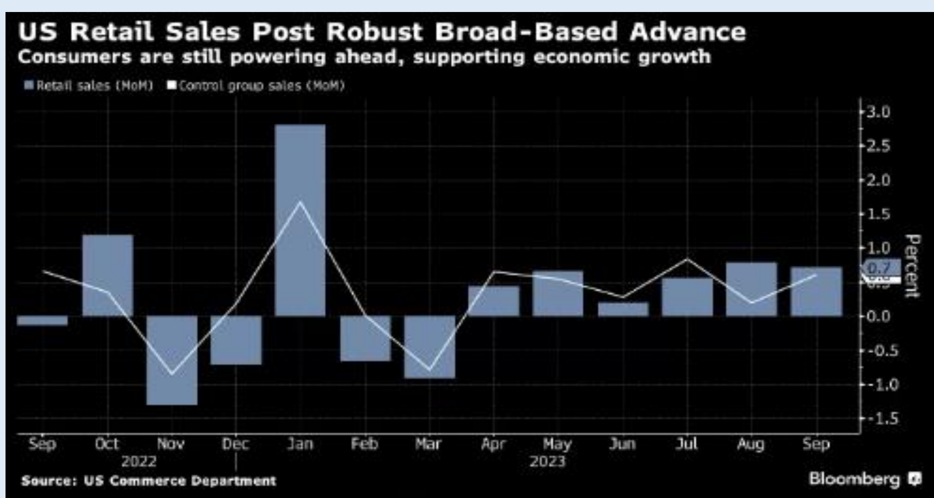
retail sales component sectors showed increases significantly higher than expectations. As we discussed, this morning's strong consumer data, coupled with the higher than expected PPI and CPI data we saw last week, makes it highly likely the Fed will raise rates 25 bps one more time this year. Market pricing still leans toward a December rate hike being more likely than a November rate hike. I think that makes sense as the Fed may try to keep some dry powder and hold off on the "last" rate hike for as long as possible. The FOMC may want to give the prior hikes yet more time to have the "lag" effect and also digest another round of data before year-end.

Chart 1a – Retail Sales Summary

Metric	Actual	Median Estimate
Retail sales (MoM)	+0.7%	+0.3%
Sales ex. gas, autos (MoM)	+0.6%	+0.1%
'Control group' sales (MoM)	+0.6%	+0.1%

Source: Bloomberg, LLP

Chart 1b – Retail Sales Breakdown

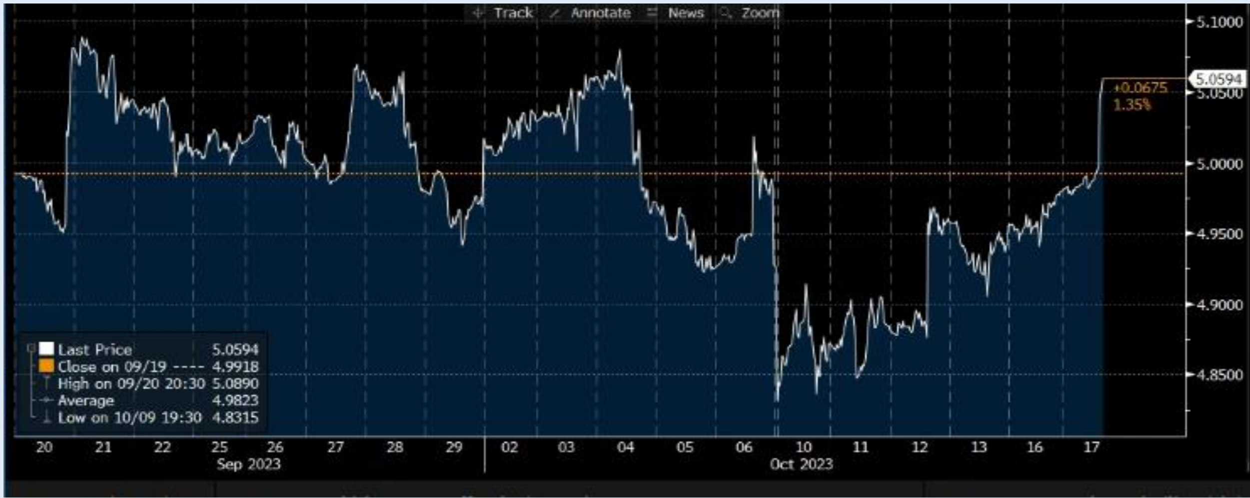


Source: Bloomberg, LLP

CHART 2: 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 and you can see how the market has slowly unwound the initial flight to quality prompted by the heinous attack on Israel. This situation is still *definitely* front and center for the market, but they cannot ignore the inflation numbers we saw last week or the strong consumer data received this morning. However, traders are seemingly reluctant to push yields too high – as we have discussed, there is simply too much uncertainty in the market at the moment. Although swap rates have moved higher on the data, we are still below the recent highs. Expect short end rate volatility to continue as the market grapples with the FOMC outlook and *significant* external factors. The market will also be saturated by Fed-speak and a host of economic data set for release – the remainder of this week's economic data focus primarily on the US housing market.

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

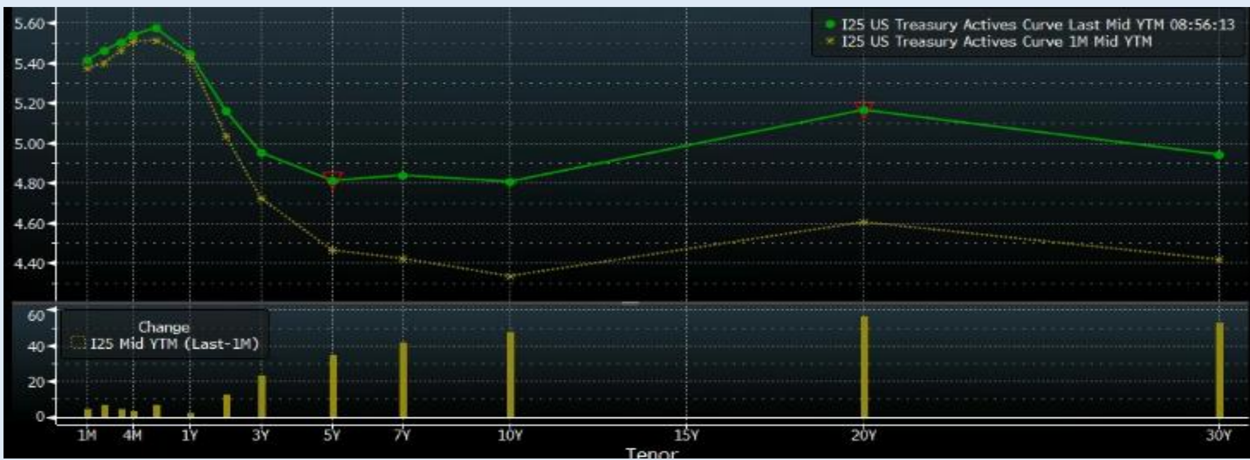


Source: Bloomberg, LLP

CHART 3: US Treasury Yield Curve – Yield Curve Continues to Flatten

The Bloomberg graph below shows the shape of the US Treasury yield curve today (green line) versus one month ago (gold line). We mentioned earlier that the yield curve inversion has been unwinding recently. The graph below shows that medium and long-end T-yields are moving significantly faster than short term T-yields. The yellow bars at the bottom of the graph illustrate the recent curve move best (the yellow bars represent how many basis points the associated Treasury rate has moved over the prior 30 days). You can clearly see that short end yields have been relatively flat in comparison to longer term yields which have risen more dramatically (particularly 10-year yields). Given the overall strength of the US economy and a somewhat favorable economic outlook for 2024, we expect the curve inversion to continue to unwind and the curve continue to flatten, driven by medium and long term yields.

US Treasury Yield Curve: One Month Change



Source: Bloomberg, LLP

Product Update:

Week of 10/16/23 - What We Are Seeing In The Market…

New cap volume has actually increased somewhat 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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