AST DEFEASANCE RATE MARKET UPDATE

Good Morning! Please see below for the RCA | AST Defeasance *Rate Market Update* for September 15, 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, swaps, swaptions or other derivative hedging products. Please feel free to reach out to us anytime!

RATE MARKET UPDATE:

- **Market shrugs off data this week; rates slightly higher**
- **Consensus is that data did not fundamentally change anything for the FOMC**
- **Market still pricing in one more 25 bp rate hike this year; Fed likely to pause at 9/20 meeting**
- **Rates mostly flat on the week as the market awaits FOMC meeting 9/20**
- **UAW strikes; A lasting or expanding strike could impact the economy**
- **Rising energy prices will also remain in focus – sustained higher energy prices fuel inflation and slow economy**

U.S. Treasury and SOFR swap rates opened slightly higher this morning on stronger than expected import and export price data. This ends a string of numbers this week that continued to show a resilient US economy and sticky inflation. 2-year and 3-year SOFR swap rates have edged higher this week (See Chart 1 for 2-year swap detail), but overall SOFR swap rates generally remain stuck in a range. Rates at the moment are definitely biased higher – continued strong economic data and stubborn inflation will keep another Fed rate hike in play for the remainder of the year. Additionally, although some FOMC officials have been leaning slightly dovish recently, there has been no mention of a rate cut – officials have been hammering home the need for patience on rates and a higher-for-longer monetary policy. The Fed will also be watching the price action in the energy markets. Gasoline prices are now the highest they have been in a year and we are heading into the winter months. Sustained high energy prices would be an unwelcome development for a Fed trying to tamp down inflation to 2.00%. The UAW strike is also worth monitoring – the UAW is one of the largest and most powerful unions in the US. Should the strike expand or drag out, it could put downside pressure on the economy – again, this is the last thing the Fed wants after the success they have had in lowering inflation without tanking the economy.

As mentioned, all eyes will focus on the Fed rate decision announced on Wed 9/20 at 2:00 pm. Per usual, we will get the FOMC Chairman's press conference and Q&A immediately following the meeting. This is an important meeting and the post-meeting comments will be highly anticipated.

CHART 1: Closing 2Y SOFR Swap Rates This Week

	Date	Last Price
Fr	09/15/23	4.9364
Th	09/14/23	4.9137
We	09/13/23	4.8760
Tu	09/12/23	4.9184
Mo	09/11/23	4.8828

Source: Bloomberg, LLP

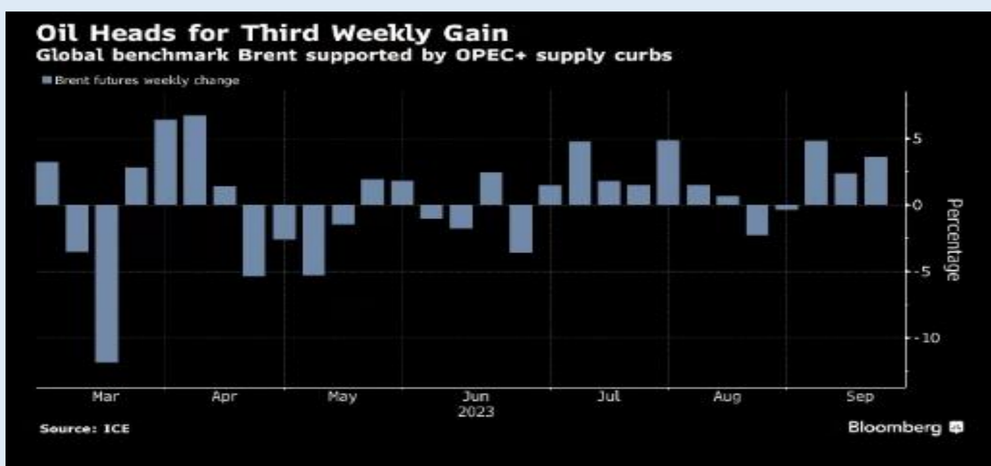
CHART 2: 2Y & 3Y SOFR Swap Rates – Prior 30 Days

The below Bloomberg graph details 2y (white) and 3y (gold) SOFR swap rates for the prior 30 days. As you can see from the graph below, despite some intra-day volatility, rates remain in a tight range. (Rates are mostly unchanged from one month ago: +2.36% on the 2Y SOFR swap rate, the primary driver of 2Y SOFR cap pricing). You can see from the chart below that rates have moved up toward the top of the recent range in anticipation of next week's Fed meeting. The numbers this week (CPI, PPI, Retail Sales & others) showed a resilient US economy and stubborn inflation. Yes, there has been a dramatic improvement in inflation and the disinflation trend cannot be denied – *yet*, we seem to be "stuck" at these levels and that is what is concerning the FOMC. There is a growing faction of Fed officials who think they have done enough and need to wait for the "lagging" effects of their massive tightening campaign to manifest, but there has not really been a whisper of rate cuts from the Fed. Furthermore, the weak commitment by Fed officials to signal that a "pause for good" is coming, has led to increased speculation the Fed is still nervous about inflation and may need to tighten further. That simply means that another rate hike (and perhaps two!) are still in play for the Fed this year.

Source: Bloomberg, LLP

<u>CHART 3:</u> Energy Prices Rise

Energy and oil prices are typically more volatile than most goods and services. Gasoline prices are now the highest they have been in over a year. It is worth paying attention to the recent increase in oil prices as we head towards the winter months. Recent OPEC supply cuts have put upward pressure on prices and geopolitical tensions are making it unlikely OPEC will increase production anytime soon. The Fed will be paying attention – the last thing they want is for sustained high energy prices to throw cold water on a hot economy and ruin the progress the Fed has made to date. It is true that the Fed is typically less concerned about movement in short term energy prices – they understand the transient, political and volatile nature of the energy markets. However, *sustained* high energy prices can contaminate other sectors of the economy and that is what worries the Fed. We will be keeping an eye on this and the potential impact on forward rates.



Source: Bloomberg, LLP

<u>CHART 4:</u> Bloomberg Economist Survey on Benchmark Rate

The Bloomberg table below details the results of the most recent Bloomberg Economist's Survey on the forward benchmark rate (by upcoming meeting). Similar to current market pricing, economists are also calling for one more 25 bp rate hike this year. (There is currently a 50/50 chance priced-in for a 25 bp rate hike at the Nov or Dec meeting, with a slightly higher chance for a Dec meeting rate hike.) You can see from the table below that economists think the first rate *cut* will likely come in May or June of next year. This is still in stark contrast to a Fed that has stated they *do not* see rate cuts at all next year (or at least not until the 4th quarter). You can also see the adjustments the economists have made from the last survey held in July – they were clearly more dovish in July than they are now. The market is hoping that the Fed meeting statement (and Powell's press conference) will help shape a clearer view of monetary policy for 2024.

Response Count: 46	Median Estimate	July Survey
Sept. 20, 2023	5.50%	5.50%
Nov. 1, 2023	5.50%	5.50%
Dec. 13, 2023	5.50%	5.50%
Jan. 31, 2024	5.50%	5.50%
March 20, 2024	5.50%	5.25%
May 1, 2024	5.25%	5.00%
June 12, 2024	5.25%	4.75%
July 31, 2024	5.00%	n/a
Sept 18, 2024	4.75%	4.50%
Nov. 7, 2024	4.50%	n/a
Dec. 18, 2024	4.25%	4.25%
June 30, 2025	3.63%	3.50%
Dec. 30, 2025	3.25%	n/a
Peak rate this hiking cycle:	5.50%	5.50%

Source: Bloomberg, LLP

Product Update: What We Are Seeing

New cap volume remains slow but steady and we continue to see our clients looking at cap extensions. Given the uncertainty 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.

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 or explore ways to reduce or eliminate escrow deposits for replacement caps.

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 Advisers 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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