AST DEFEASANCE RATE MARKET UPDATE

Good Morning! Please see below for the RCA | AST Defeasance *Rate Market Update* for September 21, 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:

- **FOMC holds rates steady (5.25% lower bound/5.50% upper bound); Signals another rate hike possible this year**
- **Chairman Powell reiterates fight against inflation is not over**
- **Powell said monetary policy is currently "restrictive" but stressed Fed will "proceed carefully"**
- **Rate market viewed Powell's comments as more hawkish than expected**
- **Rates moved higher during and after Powell's presser in anticipation of an additional rate hike this year (See Chart 1)**

As anticipated, the FOMC held the overnight benchmark rate steady at yesterday's policy meeting (5.25% lower bound/5.50% upper bound). However, the Fed made it *clear* it may not be done raising rates. The Fed cautioned that the fight against inflation is *not over* and that further monetary policy tightening could occur, "if appropriate". Chairman Powell stressed that the Fed is pleased with the inflation results to date and strength of the economy and said several times during his press conference that policy makers will "proceed carefully" from here. Here are a few highlights from yesterday's meeting statement and Powell's press conference.

- FOMC is prepared to raise rates further if appropriate; will "proceed carefully"
- Fed will be data driven going forward; Is also cognizant of the lagging effects of rate hikes to date
- FOMC counsels patience on rates; stressed "higher for longer" mantra
- Fed acknowledged a strong consumer is driving the economy and contributing to inflation "stickiness"
- Powell acknowledged possibility of one more rate hike this year in Nov or Dec "if appropriate" – data will be key
    - Nov or Dec rate hike likely contingent on whether or not the FOMC feels one more 25 bp hike would cement the disinflation trend and increase Fed "confidence" that the 2.00% goal is on track.
- FOMC wants to see sustained evidence inflation is under control – view inflation as still "too high"
- FOMC increased projections for economic growth
- Powell said he is encouraged by the "improvements" and "rebalancing" in the labor market and was encouraged by easing wage growth
- Powell acknowledged they are watching the energy markets but are not overly concerned at the moment
- **FOMC Core inflation projections:** 3.30% 2024 / 2.50% 2025 / 2.00% 2026
    - These projections tell me that the FOMC will hold rates until they are "convinced" inflation is headed to 2.00%
    - Powell hinted that "convincing" may take up to 6 months, perhaps longer
- **FOMC FF projections:** 5.60% YE 2023 / 5.10% YE 2024 / 3.90% YE 2025
    - 5.10% for next year implies the Fed *may* need to cut rates at the back end of 2024. If they do not *hike* rates again (this year or next) then a 5.10% implies the "possibility" one of 25 bp rate *cut* next year.
    - Powell's exact words were: "at some point, the time will come to cut rates" but he refused to provide any insight into possible timing of a rate cut.

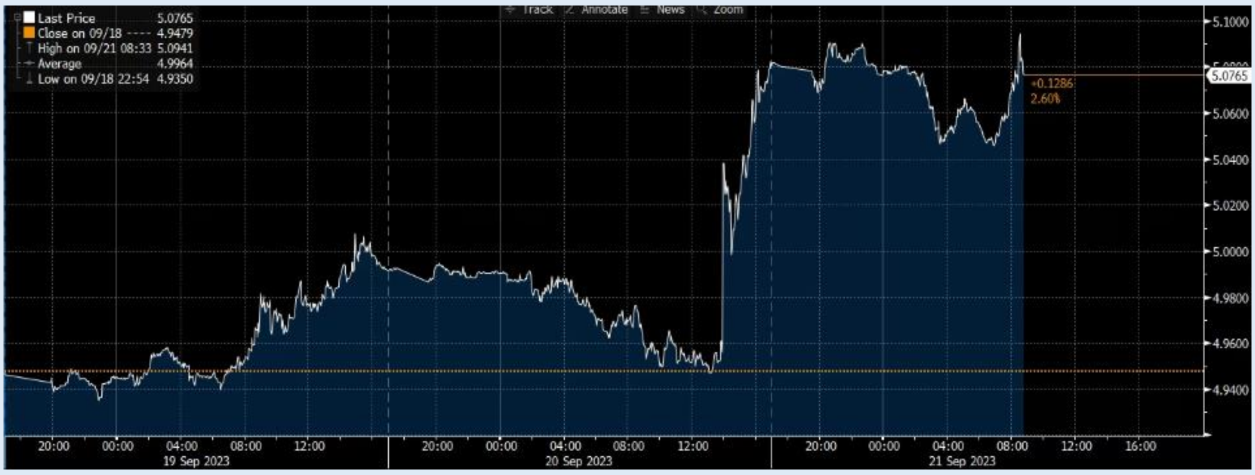
SOFR swap rates had a delayed reaction to the FOMC rate decision and Powell presser. Initially, the market took a "more of the same" conclusion and rates crept a bit higher. As the press conference wore on, rates began to move higher by approx. 10 basis points. This morning the short end of the curve (2Y, 3Y) is basically unchanged to last night's close, but rates in the belly of the curve (5 years to 10 years) continue to move higher as fears of a severe recession recede and are replaced by optimism the Fed can engineer a soft landing *and* lower inflation.

CHART 1: 2Y SOFR Swap Rates – Prior 3 Trading Sessions

The below Bloomberg graph details the 2y SOFR swap rate for the prior 3 trading sessions. As you can see from the graph below, 2Y SOFR swap rates have been volatile since the meeting. Initially they popped up on the revised Fed economic projections released after the meeting, but then started to drift down as traders initially read “more of the same” from Powell. However, Powell was, in retrospect, far more Hawkish than the market anticipated. Rather than the Fed victory lap the market had hoped for, they got a stark reminder the battle against inflation is not over. The rate move detailed below reflects the market (reluctantly) repricing FOMC expectations for the remainder of the year.

At the moment current market pricing implies a **30%** chance for a 25 bp rate hike in November and a **55%** chance for a rate hike in December. Market participants now feel it is increasingly likely that the next 25 bp rate hike will happen at the December meeting. Given Powell used the phrase “proceed carefully” many times yesterday, the market believes the FOMC is likely to hold again in November, unless the economic data strays radically from expectations. The Fed is *definitely* data dependent and will want to see as much data as possible before making the decision to raise rates another 25 bps. Powell stressed they would only raise rates, “if appropriate” so it is by no means a forgone conclusion that the Fed will hike again this year. We will see how forward pricing adjusts over the next week or two. Also, Fed officials are no longer blacked-out: “Fed-Speak” returns and the market will be paying attention. Reminder: there is no FOMC meeting in October.

2Y SOFR SWAP PRIOR 3 TRADING SESSIONS



Source: Bloomberg, LLP

CHART 2: 2Y, 3Y, 5Y & 10Y SOFR Swap Rates, Prior 30 Days

The below Bloomberg chart shows SOFR swap rates for 2, 3, 5 and 10 year tenors. I wanted to show this chart to illustrate that the back end of the curve is increasing more than the short end – the swap curve is flattening. This is likely due to the health of the US economy and favorable forward economic forecasts, from both the market and the Fed. As a result, the curve inversion we have seen for the past year or so will gradually start to unwind – it is becoming more likely we have a soft landing and less likely we have a severe recession. As such, the curve will typically flatten until the market gets a better feel for forward monetary policy. Higher term rates erode the carry benefit of interest rate swaps and increase the cost of longer term caps. We will be tracking the shape of the yield curve and the impact on cap pricing. We do expect some rate volatility in the near term as the market sorts out what is next for rates. Rates have definitely broken out of the range to the upside as a result of the Fed meeting and Powell press conference comments.

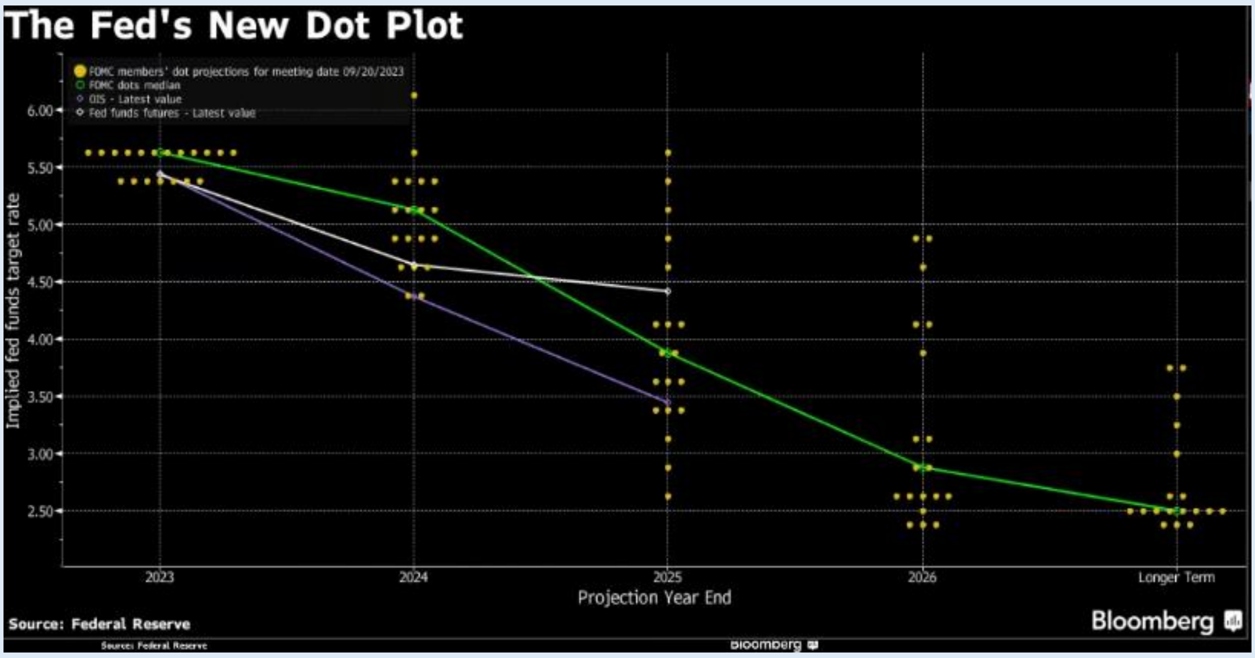
2Y SOFR SWAP = WHITE; 3Y = BLUE; 5Y = ORANGE; 10Y = PURPLE

Source: Bloomberg, LLP

CHART 3: Looking Forward: FOMC "Dot Plot"

The Bloomberg table below details the FOMC "dot plot" released yesterday. The ***"DOTS"*** reflect what each U.S. central banker thinks will be the appropriate midpoint of the fed funds rate at the end of each calendar year. (Full disclosure: the big criticism of the dot plot is that it is anonymous – you cannot be sure whose "dot" is whose on the chart!).

Looking at the chart, you can see the FOMC has revised the dot plot higher – not the terminal rate, just the pace of anticipated rate decreases (cuts). The green line below represents the FOMC median dot – the white line shows Fed Funds futures – you can see the market is still calling for lower rates sooner than the FOMC is signaling. Examining the green line reveals the Fed sees one potential rate cut next year, maybe. Clearly, we do not have a crystal ball and *a lot* can happen between now and the end of 2024. I would just point out that Powell was very, *very* careful not to put even hint of a timetable on rate cuts. He is hammering the "higher for longer" message home as are most Fed officials. Keep in mind there is no set formula or timetable for cutting rates – the FOMC will need a *compelling* reason to begin cutting rates. Right now, the impetus for a rate cut is not on the immediate horizon.



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.

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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 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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