AST DEFEASANCE RATE MARKET UPDATE

Good Morning! Please see below for the RCA | AST Defeasance *Rate Market Update* for September 26, 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 9/26/2023:

- **Market rates drift higher as market awaits economic data; intraday rate volatility likely to continue**
- **Market participants *gradually* accepting Fed will hold rates higher for longer and may need to tighten rates further**
- **Recent hawkish Fed-speak hints at possibility of additional rate hikes and emphasizes higher for longer mantra**
- **US Government shutdown looms in the background and is becoming an increasing market concern**

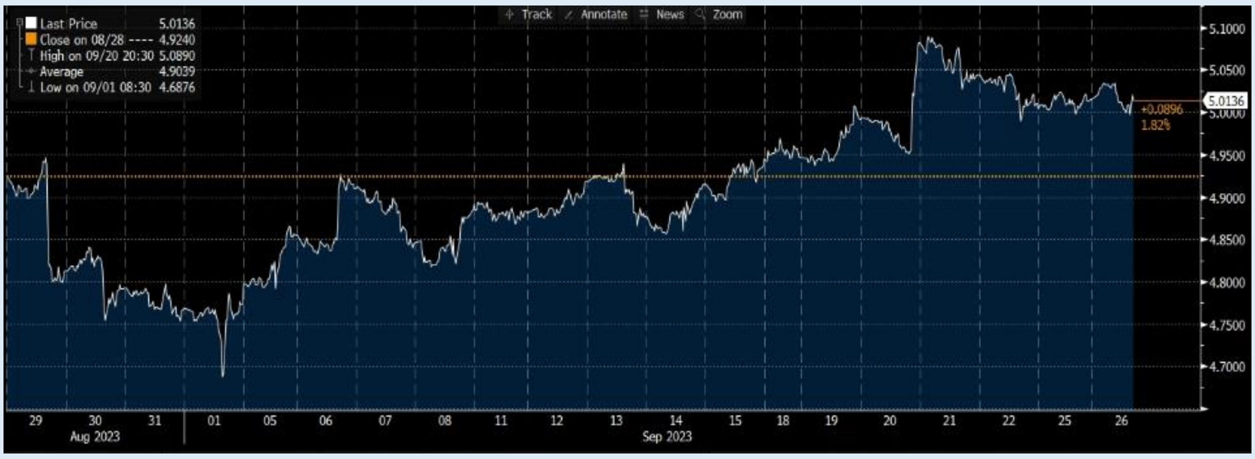
US Treasury and SOFR swap rates drifted higher this week as market participants gradually realize that the FOMC is likely not done raising rates and more importantly, is likely to hold rates "higher for longer". As with any dramatic shift in the term structure of interest rates, it takes time for market participants to adjust to a new rate environment. Market participants, traders and investors are slowly coming to grips with the fact that we may be in a "new normal" for interest rates. As such, rate hike expectations have been ratcheted up and expectations for near-term rate cuts have been scaled back significantly. Recent Fed-speak has leaned hawkish – officials have said that additional rate hikes may be necessary to keep inflation trending in the right direction. Furthermore, policy makers have all emphasized recently that, depending on economic conditions, rates may need to be held at these levels for the foreseeable future. If the economic data remains strong, the Fed is likely to keep rates elevated for as long as necessary – they cannot risk fueling inflation by prematurely cutting rates.

The looming US Government shutdown is beginning to get the market's attention. Speculation is that the situation will be resolved and a shutdown averted. However, the mere threat of a shutdown tends to add to rate market volatility and create additional market uncertainty. We will be tracking this situation and will report back on any meaningful developments. In our next update we will highlight the upcoming economic data that the market will be watching. On the immediate horizon, we will see Durable Goods data on Wednesday and GDP data on Thursday – also of note, Chairman Powell speaks at 4PM on Thursday. He will be speaking/hosting at a Town Hall event for educators, but will take Q&A, so his comments could have a market impact.

CHART 1: 2Y SOFR Swap Rates – Prior 30 Days

The below Bloomberg graph details the 2y SOFR swap rate for the prior 30 days. We continue to witness intra-day volatility as the market sorts through the economic data, Fed-speak and the other factors impacting the market. The rate market has grudgingly accepted the FOMC may need to raise rates one more time (*hopefully*, one more time) and will probably hold rates at or near current levels. However, they just aren't *convinced* yet that a rate hike will be needed and they are even less certain on the timing of that rate increase. The chart below shows a 2Y SOFR swap rate that has bounced around since the FOMC meeting, but is only ~9 bps higher than it was one month ago – that does not sound like a market that has reached any firm conclusions on forward rates. Expect volatility as we head into an uncertain 4th quarter.

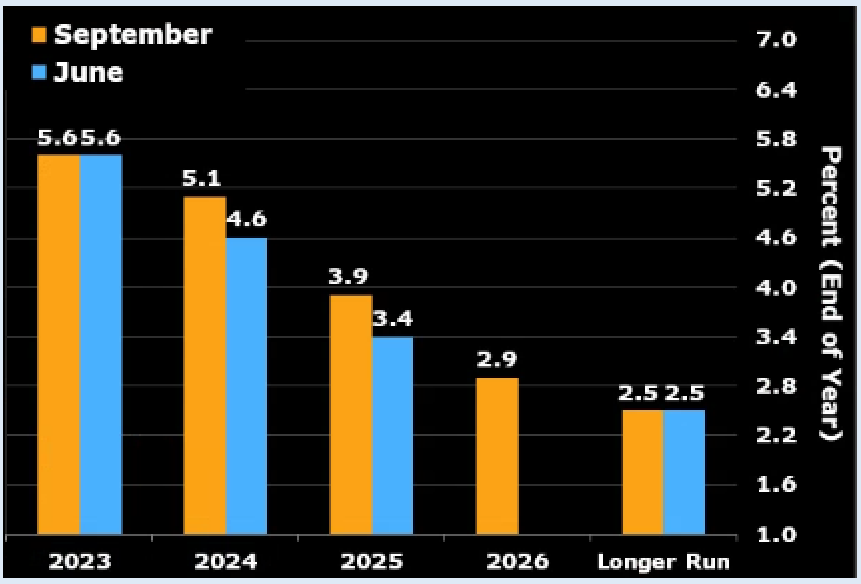
2Y SOFR SWAP PRIOR 30 DAYS



Source: Bloomberg, LLP

[CHART 2:]() Fed Funds Rate Median Projections

The Bloomberg table below details the projected median fed funds rate through 2026 and beyond based on data from economists and market participants. It also displays the change in projections from the June survey (blue bar) to the September survey (gold bar). You can see the market is still reluctant to call for more rate hikes this year or beyond – the 5.60% projection through year end signals the market thinks there could be an additional rate hike, but they are not convinced. That sentiment has not changed much since June. What did stand out was the change in projections for *2024*. Market participants have adjusted rate expectations for next year and seem to be embracing the higher for longer possibility for overnight rates. That said, they have still forecasted at least one rate *cut* next year, which is in stark contrast to the FOMC who have thus far steadfastly refused to provide a timetable for rate cuts. As we discussed earlier in the update, market participants are starting to accept that unless there is a *compelling* reason to cut rates, rates will likely not move significantly lower next year.



Source: Bloomberg, LLP

Product Update:

Week of 9/26 - What We Are Seeing

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.

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