“Transitory inflation”, again?

US Rates Update

AUB Group | Financial Markets Sales Team

March 2025

Executive summary

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Background

Key takeaways from the Federal Open Market Committee's rate decision on 19 March 2025:

- The Fed left its policy rate unchanged in a range of 4.25%-4.50%, as was broadly expected.

- Markets were more eager to assess the dot plot which showed downward revisions to growth forecasts and upward revisions to inflation and unemployment projections. Policymakers also noted higher risks to their economic projections and higher uncertainty about the path of the economy.

- The median dot plot continued to show that FOMC members forecast 2 rate cuts in 2025. Despite that, the dot plot shifted to a significantly more hawkish stance compared with that of December. Eight members now see just one or no cuts at all this year, while only two members see three cuts.

- The FOMC decided to slow the pace of runoff of its securities holdings beginning next month by cutting the monthly cap on Treasury securities redemption to $5bn from $25bn. Governor Chris Waller dissented from the QT decision but supported the rate hold decision.

Profit rate strategy

In the midst of a heightened uncertainty, we keep seeing selective opportunities in the current market environment:

- Hedge medium to long-term risk via Profit Rate Swap. Swap rates are at their highest since 2007 and tighter financial conditions are expected to remain;

- Forward-starting PRS seem to offer decent value given the relatively inverted yield curve;

- Alternative hedging strategy structured via options (like Profit Rate Collar);

US Rates Markets

March Fed meeting update

Fed holds rates as expected

- The Federal Open Market Committee held rates steady as expected in a range of 4.25%-4.50%.
- The committee's decision accompanied the description of the labor market as "solid" and an acknowledgement of inflation expectations ticking up.
- The FOMC decided to slow the pace of quantitative tightening by cutting the monthly cap on Treasury securities redemption to $5 billion from $25 billion. It was a decision with broad support, Powell said, noting that participants preferred doing that to stopping quantitative tightening altogether.

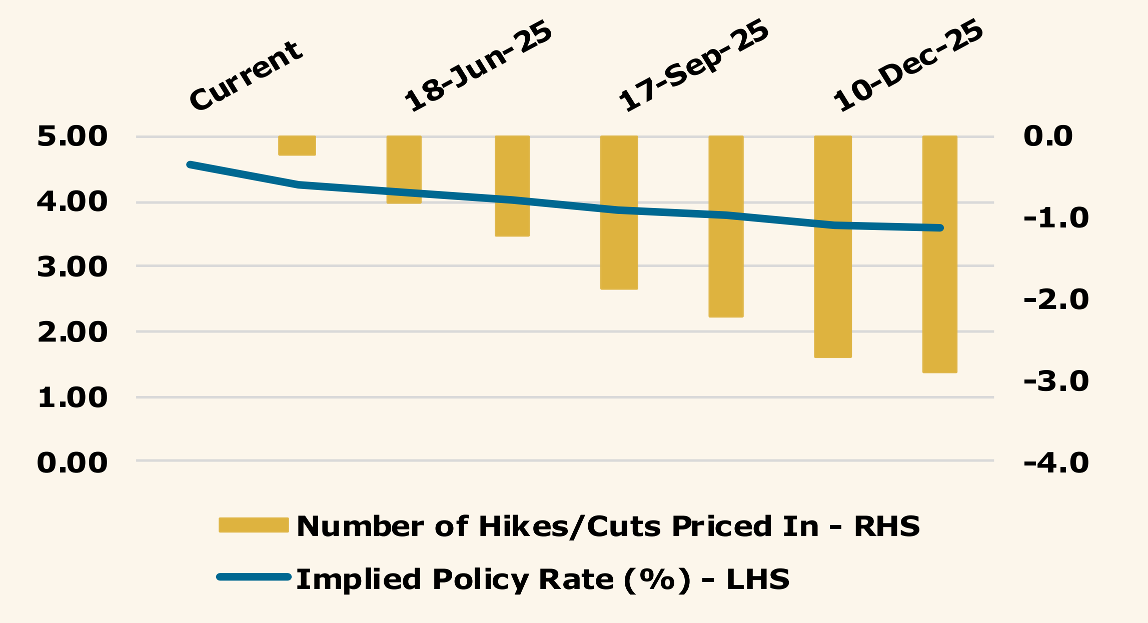
Stagflationary "Dot Plot"?

- A new FOMC dot plot was provided after this meeting as projections are typically provided quarterly. Fed officials reckon they will cut rates by 50 basis points this year. The median estimate of the Fed's 19 policymakers is for GDP to grow 1.7% this year. That's down from a forecast of 2.1% in December. The 2026 and 2027 forecasts were also revised lower. The unemployment rate forecasts nudged up slightly to 4.4% this year from 4.3% in December last year.
- The latest dot plot showed the median projection for core PCE inflation increased to 2.8% by end of 2025 (vs 2.5% in Dec.). The 2026 inflation forecast at 2.2% remains near the Fed's target of 2%.

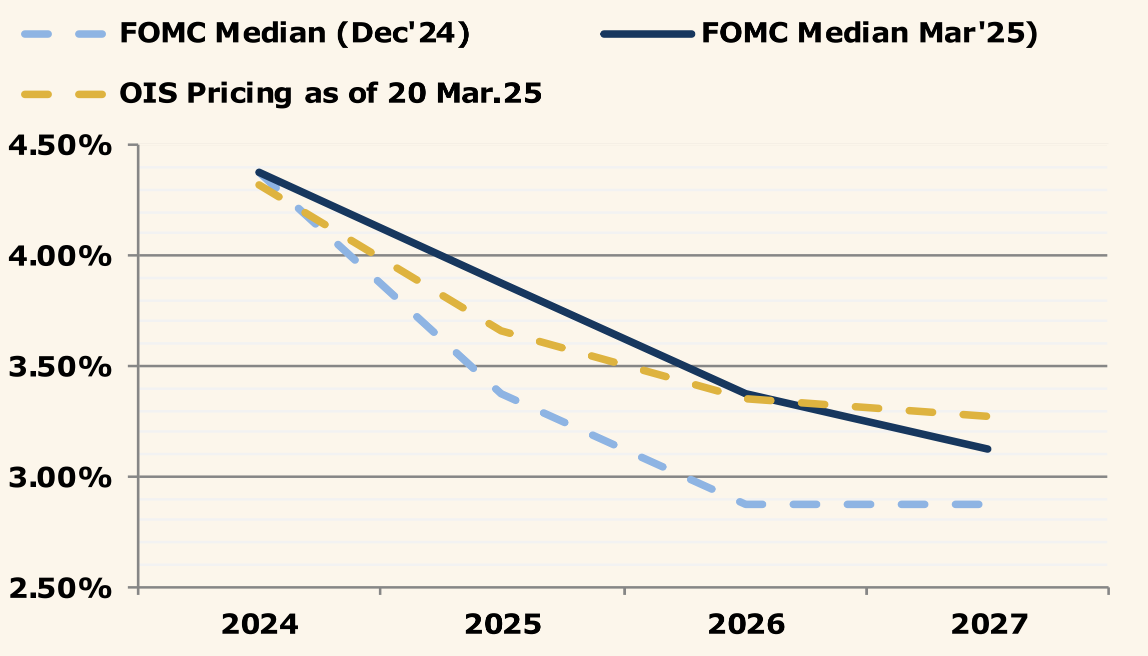
Market reaction

- Stocks rallied in relief that the FOMC retained an expectation for 2 rate cuts this year. The S&P 500 was up 1.1%, and Nasdaq up 1.4% for the day. Asked how a stock market selloff may affect business confidence and household spending, Powell confirmed that what matters to the Fed are material and consistent changes in broader financial conditions.
- Treasuries rallied on Fed day with 2-year yields down 6.8bps to 3.97% and 10-year yields down 4.0bps to 4.24%. The dollar also gained by 0.2%.

Implied Overnight Rate & number of hikes / cuts (as of 20 Mar. '25)



"Dot plot" in Mar'25 vs Dec'24 meeting



Data source: Bloomberg

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Overview of the FOMC press conference

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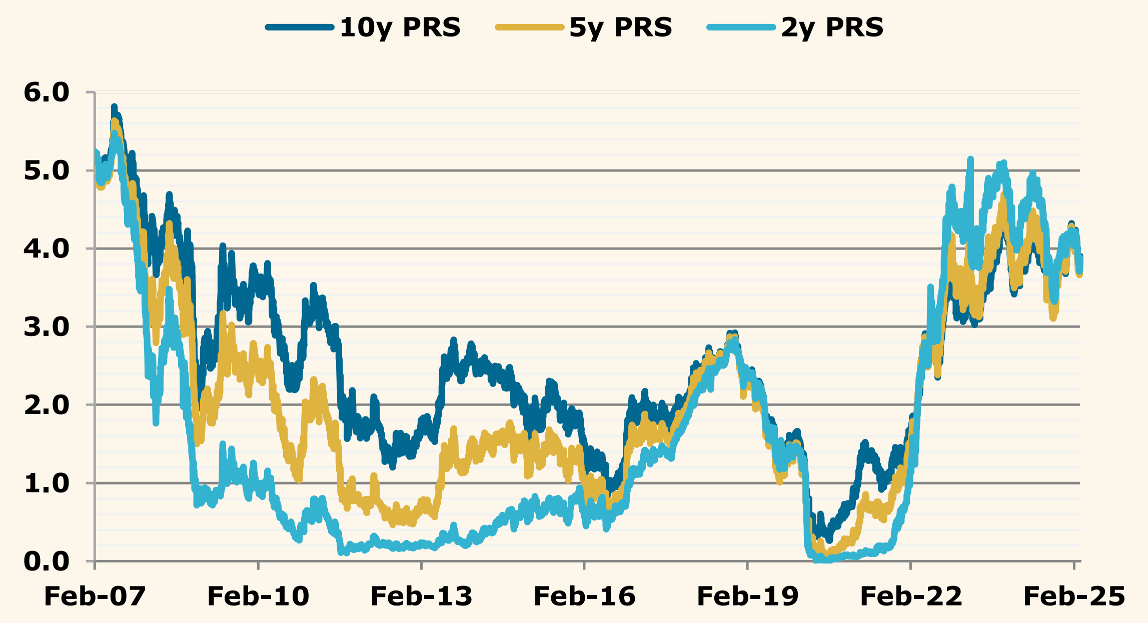
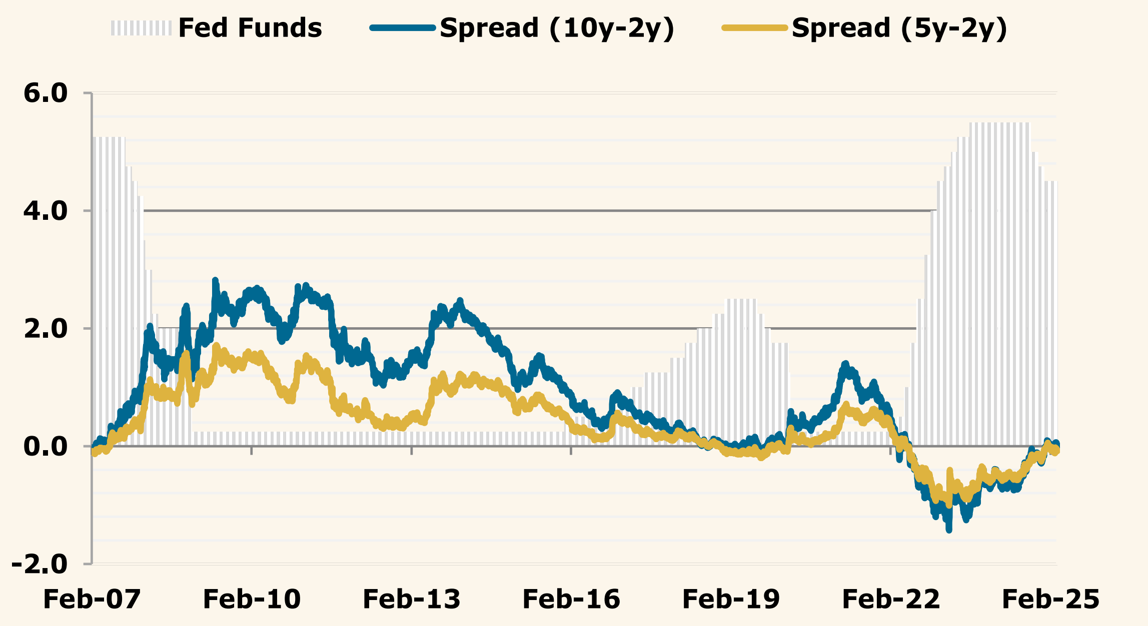
"Transitory inflation" reemerges

- The Fed chair noted a moderation in consumer spending and heightened uncertainty among households evident from hard data. Powell described the lower revised forecast of 1.7% GDP growth as "somewhat lower" than before. Powell delivered his usual message reaffirming the Fed's patience "We do not need to be in a hurry to adjust our policy stance".
- Powell affirmed that conditions remain solid in the labor market, noting "We do see pretty solid hard data". He also noted that the US is in a "low firing, low hiring" environment and that's been "in balance" for the last 6 months or so. Powell clarified that should layoffs increase meaningfully, it would translate "fairly quickly" to unemployment, due to the low hiring rate. On wages, he noted that they are growing faster than inflation and at a "more sustainable pace" and that the labor market isn't a major source of inflationary pressures.
- The Fed Chair acknowledged that some measures of inflation expectations have moved up but stressed that beyond the next year or so "most" measures of longer-term expectations remain consistent with the Fed's 2% target. Powell pointed to five-year forward to show long-term inflation expectations have been steady. He somewhat dismissed the University of Michigan inflation expectations data as "an outlier" but noted that the Fed takes notice of it.
- On the Fed's outlook the Fed Chair made it clear that various policy changes are going to impact the economy. "It's the net effect of these policy changes that'll matter for the economy and for the path of monetary policy."
- Powell was asked about the higher inflation forecasts and how much of it is due to tariffs. He said it's hard to parse how much of inflation is driven by tariffs but added "clearly some of it, a good part of it is coming from tariffs."
- He also added that it's appropriate sometimes to look through a one-time shocks to inflation if it's going to go away quickly without action by the Fed, if it's **transitory**.
- When asked about recession odds Powell said the Fed doesn't make such forecasts but noted recession risks have "moved up, but it's not high."
- In the case of a stagflationary situation Powell said the Fed would look at how far from each of its goals (stable prices and maximum employment) it is and ask how long it will take to get back to each of those. He reiterated that it would be a very challenging situation but that we're not there yet.

Swap rates - Historical Data



10s2s and 5s2s (vs. SOFR) – Historical Data



Data source: Bloomberg

Historical perspective

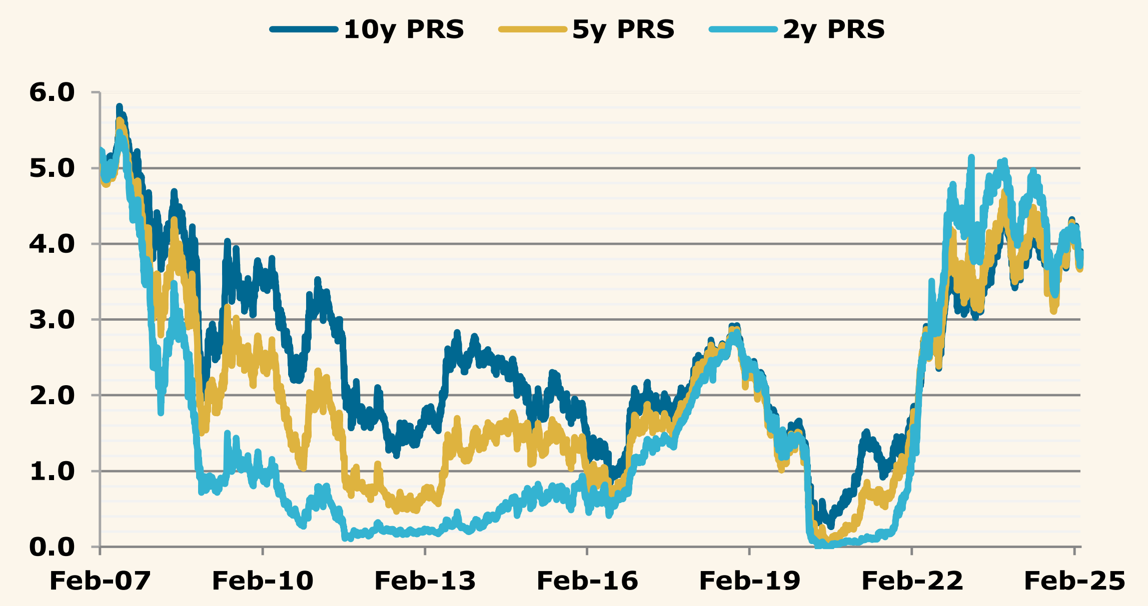
Markets pricing in earlier rate cuts vs. dot plot

- The Treasury market drove short term yields lower on the day of the FOMC decision. Treasuries rallied on Fed day with 2-year yields down 6.8bps to 3.97% and 10-year yields down 4.0bps to 4.24%. Treasuries continued rallying on Thursday in Asian and European trading.
- The Fed's March median dot plot showed 50bps of rate cuts only in 2025 in line with December 2024 projections.
- Fed-dated OIS pricing indicates market expectation of the next cut to be delivered in July (vs June as first cut expected in January). A total of 65.8bps of further easing are being priced in for 2025 vs 48bps in January. A second-rate cut is fully priced in for October 2025. Fed-dated OIS showed only 33.9bps of expected easing in 2026.

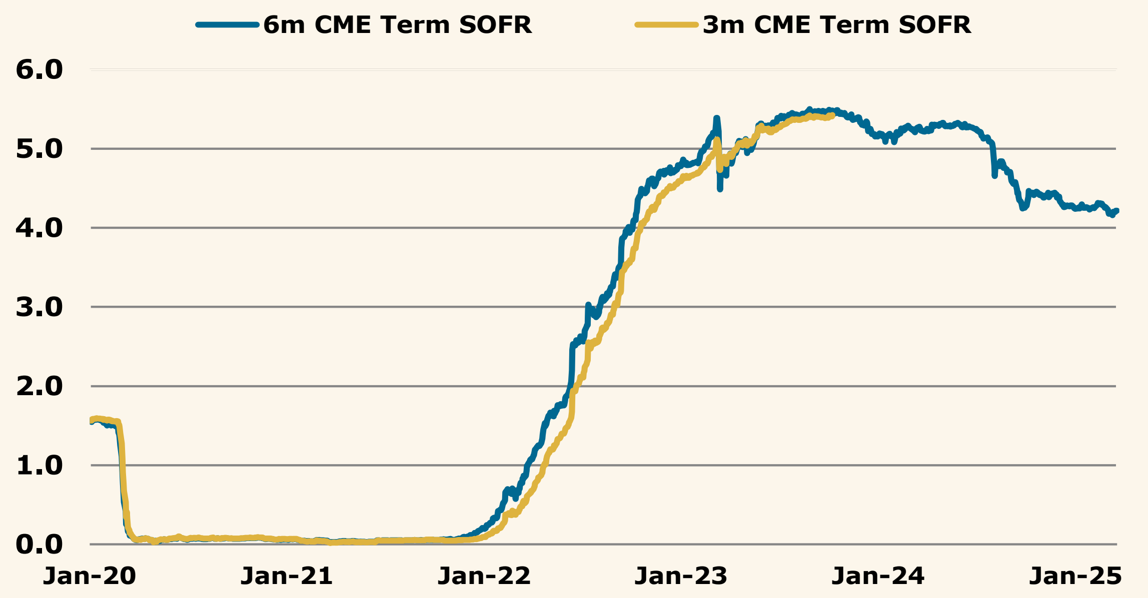
US Rates monitor: statistics

(January 2007 – PRESENT)		10yr PRS	5yr PRS	2yr PRS
Historical	Average	2.51	2.04	1.63
	Max	5.82	5.64	5.48
Δ	Min	0.26	0.02	-0.01
	Current	4.06	4.03	4.05
	From Average	1.55	1.99	2.43
	From Max	-1.75	-1.61	-1.42
	From Min	3.80	4.01	4.06
(January 2019 – PRESENT)		**6M CME Term SOFR**	**3M CME Term SOFR**	**Daily SOFR**
Historical	Average	2.54	2.51	2.43
	Max	5.50	5.43	5.40
	Min	0.02	0.02	0.01
Δ	Current	4.24	4.29	4.35
	From Average	1.70	1.78	1.92
	From Max	-1.26	-1.14	-1.05
	From Min	4.21	4.27	4.34

Swap rates (vs. SOFR)



CME Term SOFR



Data source: Bloomberg

Market forecast

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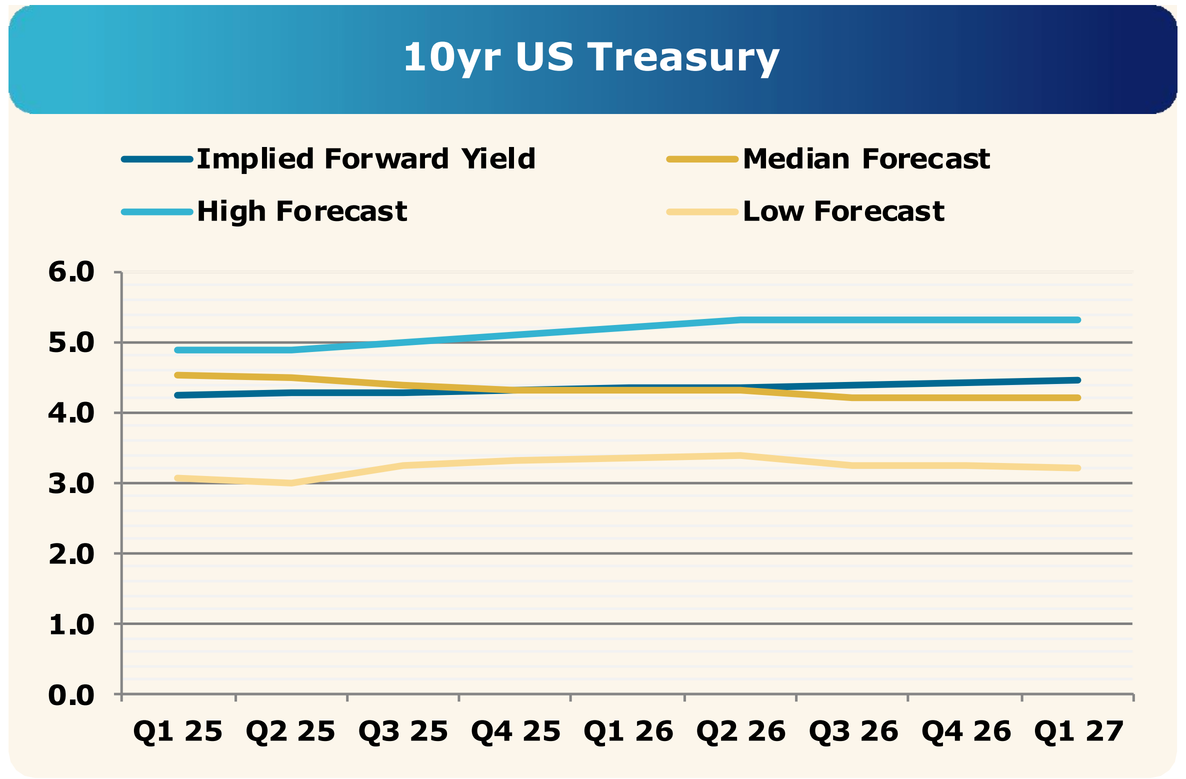

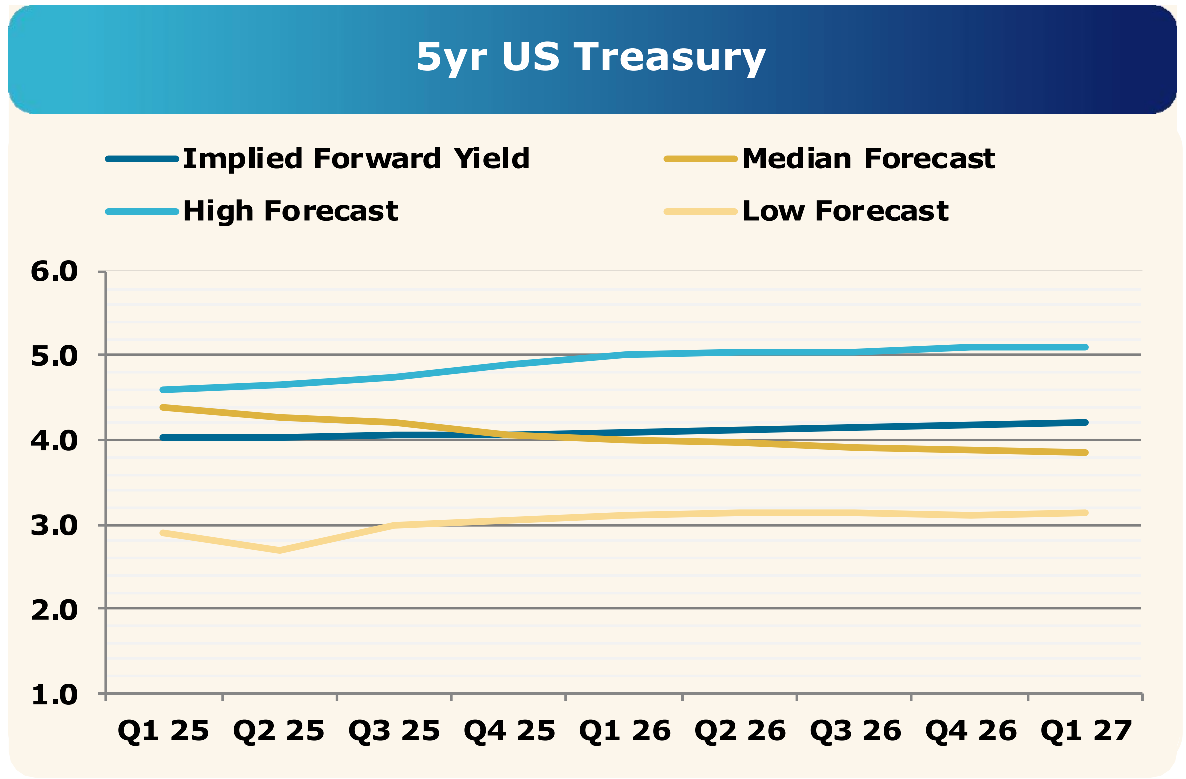

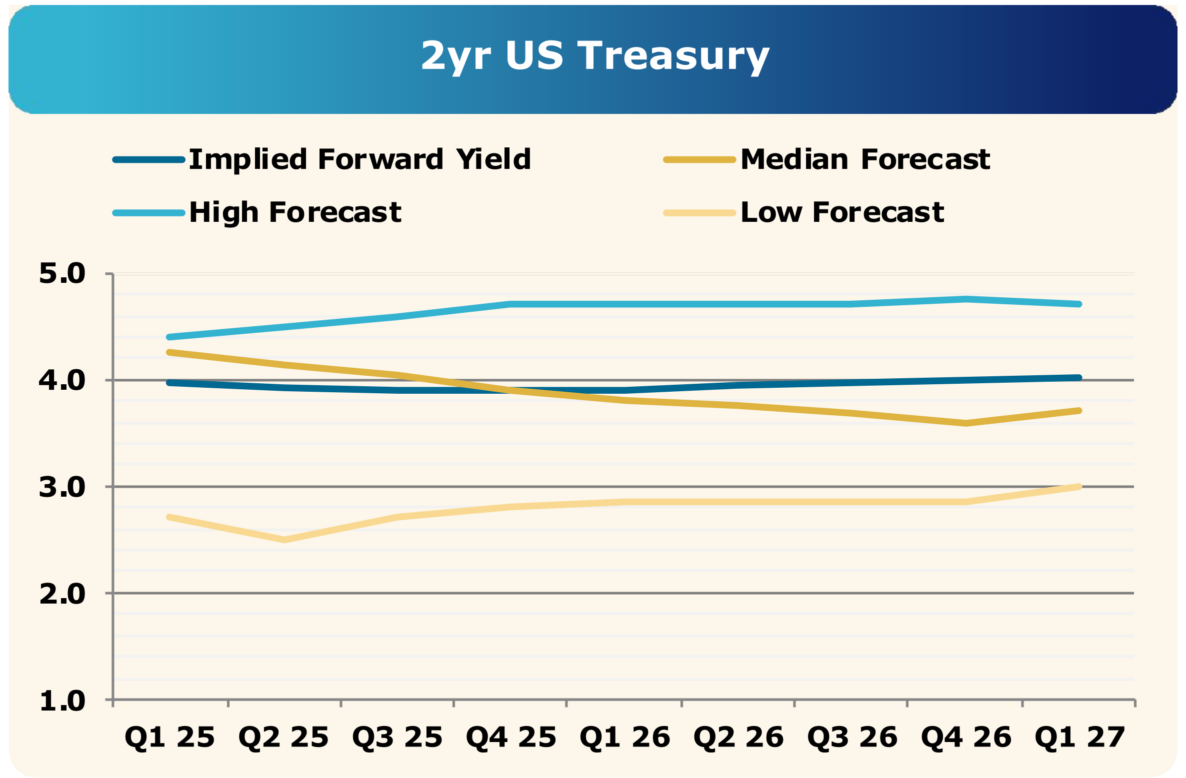

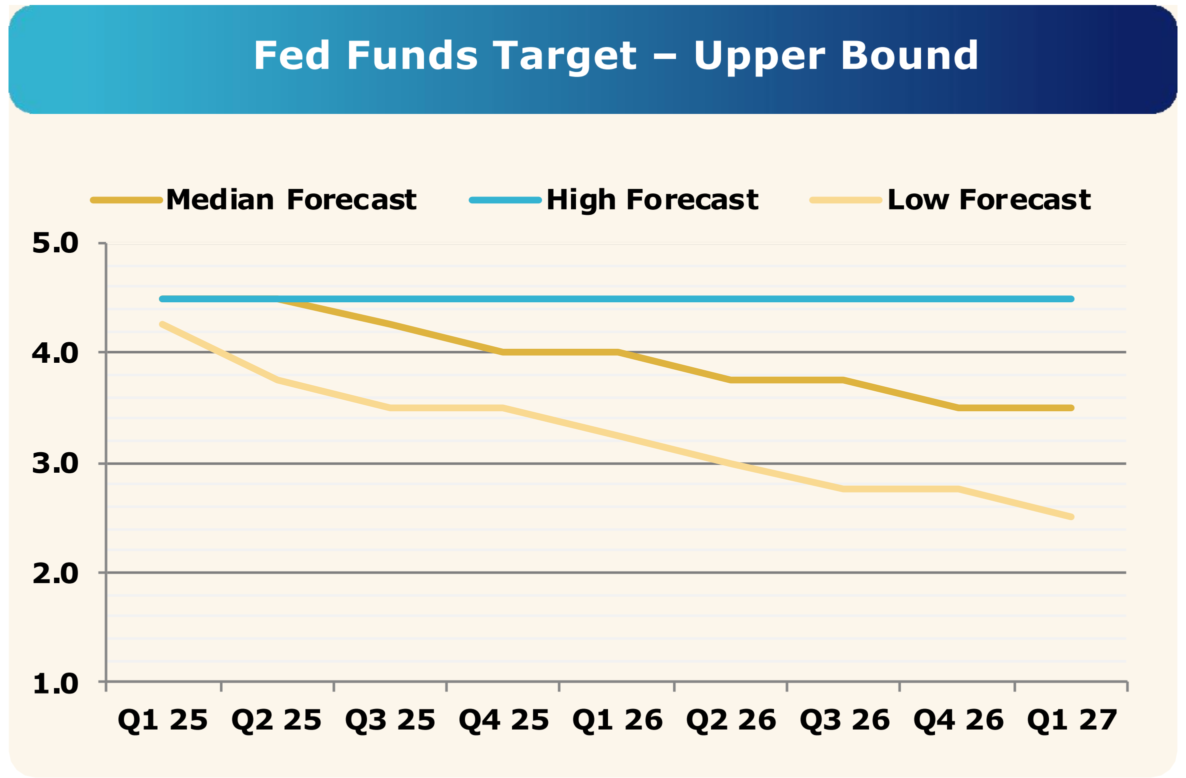

All forecast updated as of 30 January 2025
Data source: Bloomberg

Main Economic Indicators

Economic activity: Consumers and Business

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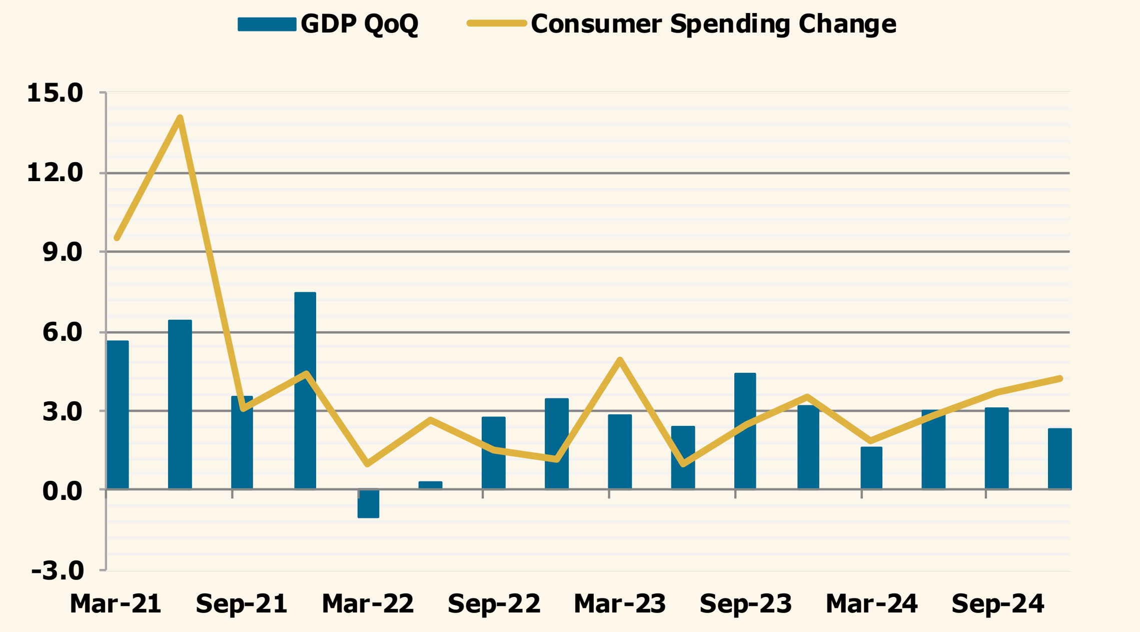
US fourth-quarter GDP growth steady but below expectations

- US GDP increased at an unrevised 2.3% annualized pace in the fourth quarter. Economists surveyed by Dow Jones had expected an increase of 2.5% after a growth of 3.1% in the third quarter.
- Inflation-adjusted consumer spending fell 0.5% in Jan., the biggest monthly decline in almost four years, driven by a decline in motor vehicle purchases and recreational goods.
- Bloomberg Economics' now forecasts an annualized growth of 1.7% for 1Q25 US GDP, down from 2.3% in 4Q24. The economy is expected to expand 2.3% this year, down from 2.8% last year, as cooler job growth tempers consumer demand and cautious about future rate cuts as inflation proves sticky.

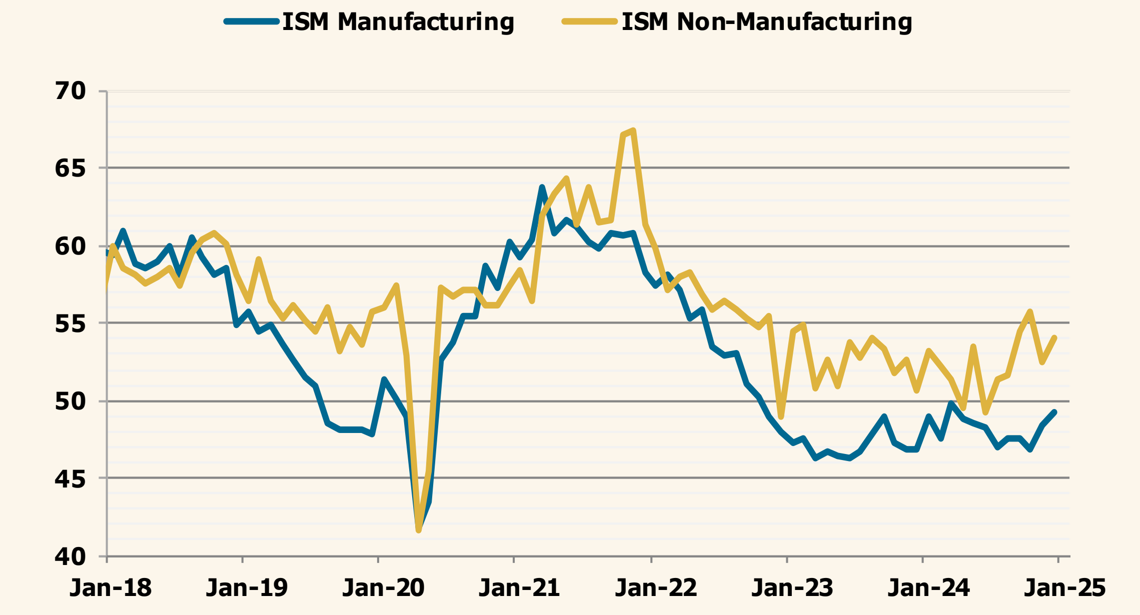
Q3'24 GDP and Consumer Spending



ISM Manufacturing disappoint while Services advance

- The headline ISM Manufacturing PMI decreased to 50.3 in February from 50.9 in January, remaining in modestly expansionary territory for a second month. The reading came below market expectations of 50.7.
- The survey data suggested that manufacturers are struggling with price pressures and uncertainty regarding tariffs, with some industries reporting growth while others contracted, and employment and production softened.
- Empire Manufacturing Index dropped in March to -20.0 from 5.7 in February, the lowest level since early 2024. The sharp pullback suggests policy uncertainty is weighing on a manufacturing sector that is struggling for traction.
- The Institute of Supply Management's gauge of services advanced to 53.5 in February from 52.8 in January, exceeding economists' expectations and signaling growth.
- A measure of costs paid for materials and services increased to one of the firmest readings since early 2023, underscoring the challenge of inflationary pressures.

Business sector



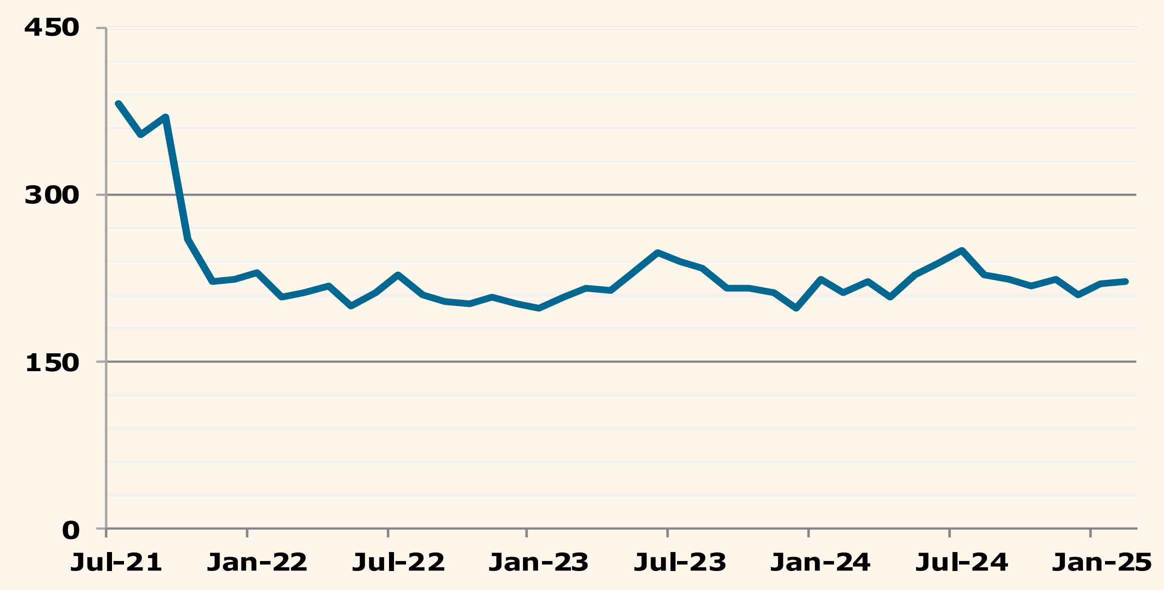
Data source: Bloomberg

Labor market

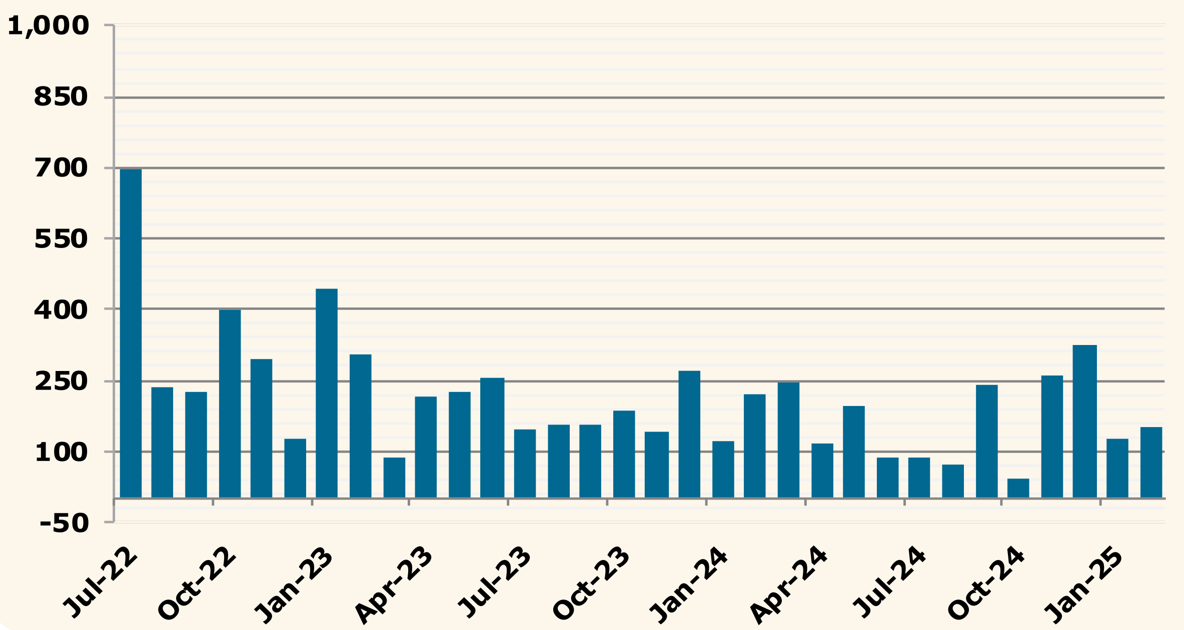
Solid labor market gives the Fed time to assess

- Nonfarm payrolls increased by a seasonally adjusted 151,000 in February, better than the downwardly revised 125,000 in January but less than the 160,000-consensus forecast.
- Health care led the way in job creation, adding 52,000 jobs, in line with its 12-month average. Other sectors that posted gains included financial activities (21,000), transportation and warehousing (18,000), and social assistance (11,000). Retail posted a decline of 6,000 workers.
- On wages, average hourly earning climbed 0.3% MoM as expected, though the annual increase of 4.0% was a bit softer than the 4.2% forecast.
- The unemployment rate edged up to 4.10% in February from January's 4.00%. The sharp decline in government roles, which comes as Elon Musk's Department of Government Efficiency effort pursues deep cuts to the federal workforce. it is the first time that federal employment has fallen since June 2022.

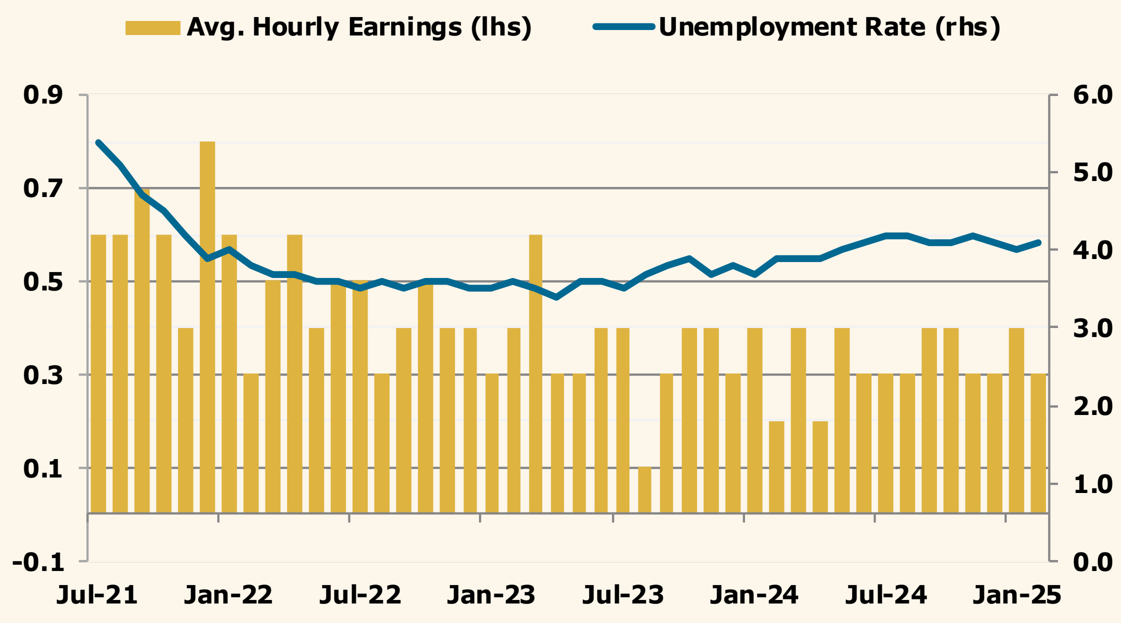
Initial Jobless claims



Non-Form Payrolls



Unemployment and wages



Data source: Bloomberg

Inflation outlook

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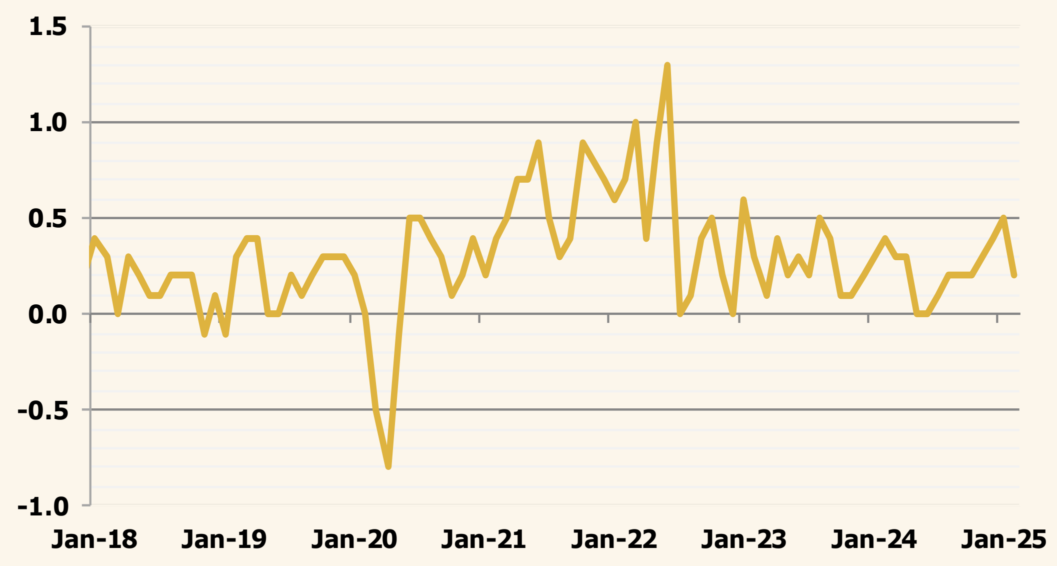
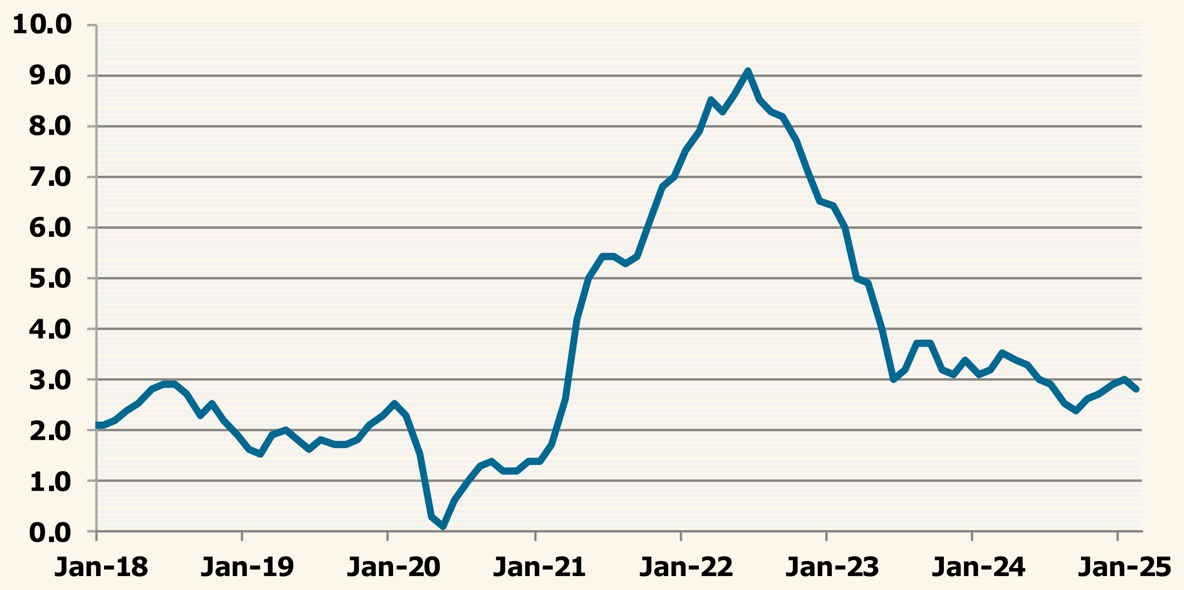
CPI lower than expected, but higher PCE forecasted

- Headline CPI inflation fell to 2.8% YoY in Feb. (vs. 3.0% in Jan.), and core CPI similarly moderated to 3.1% in Feb. (vs. 3.3% in Jan.). On a MoM basis headline CPI inflation eased to 0.2% in Feb. (vs. 0.5% in Jan.), and core CPI fell to 0.2% (vs. 0.4% prior).
- Energy costs contributed 1 bp to Feb.'s CPI headline. Seasonally adjusted gasoline prices fell 1.0% MoM (vs. +1.8% prior) in Feb., while electricity costs rose 1.0% (vs. -0.04% prior). Natural gas costs increased 2.5% (vs. 1.8% prior).
- Food at home fell to 0.0% MoM (vs. 0.5% prior), easing the overall headline figure as prices of dairy, fruits and vegetables eased.
- Both core categories fell compared to Jan. readings, as core goods prices rose 0.2% MoM (vs. 0.3% prior) and core services rose 0.3% (vs. 0.5% prior).
- The easing witnessed in core goods was attributed to car prices. Consumers front-loaded purchases in non-core goods before tariffs could boost prices, as such, inflation was higher for furnishings and apparels.
- For core services, slower price gains were seen in hotels and airfares – reflecting reduced consumer demand for discretionary spending. Primary rents and owners' equivalent rent (OER) held constant at 0.3%.
- Details of the CPI report showed core inflation was more prevalent in Feb. The share of core spending categories with an annual inflation rate above 4% increased to 45% from 42% in Jan. The share of core spending categories that witnessed outright deflation decreased to 36%, from 37% in January.
- Based on CPI and PPI components that feed into the PCE index, analysts estimate core PCE rose 0.35% MoM in February (vs. 0.28% prior). On a YoY basis, PCE is estimated at 2.76% (vs. 2.65% prior). The February PCE won't print till March 28, but the FOMC could have calculated it from the CPI and PPI prints — and incorporated the hot number in their forecasts.

Month-on-Month Change in Inflation



Year-on-Year Change in Inflation



Data source: Bloomberg

Asset prices and the wealth effect

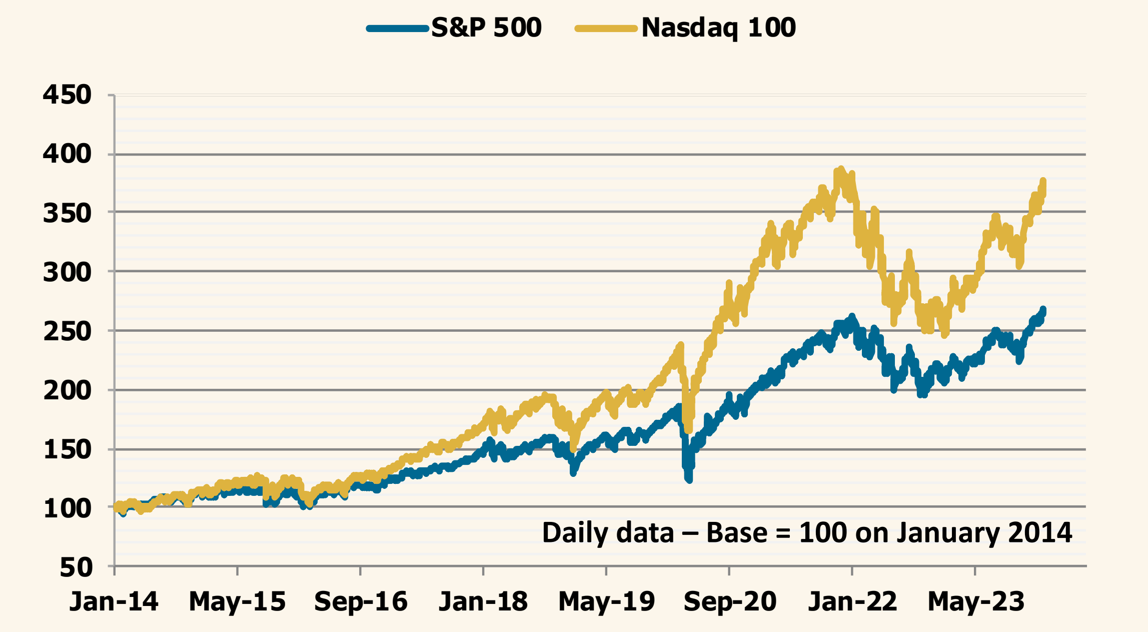
A bear market may drag consumer spending

- Wall Street witnessed a stellar performance in 2024 as the S&P500 ended the year up by 23.3%, almost matching 2023's gains. Tech led the gains and tech-heavy indices such as the Nasdaq posted stronger returns at 28.6% for 2024.
- As a share of total gross household wealth, equity exposure is at a historically high level. In the past month, some $5trln in value was wiped off the U.S. stock market, the sharpest monthly selloff since the bear market of 2022. Year to date S&P 500 fell 3.5% and the Nasdaq was down 8.1%. Oxford Economics' chief U.S. economist Ryan Sweet has warned that "a stronger wealth effect has proven to be a tailwind for overall consumer spending, but it could just as easily turn into an outsize drag in the event of a bear market".

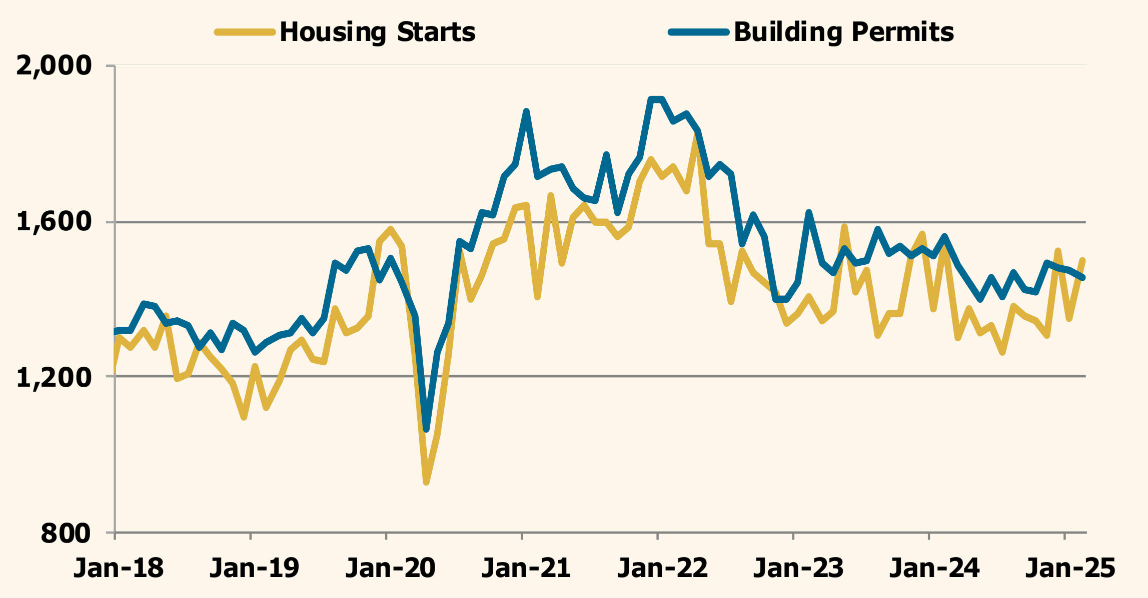
High rates and prices challenge housing affordability

- The average US 30-yr mortgage rate rose for the first time in 9 weeks in the week ending March 14 from the lowest level in 2025. Rates rose 5 basis points to 6.72% and caused a pullback in refinancing and purchase transactions.
- The National Association of Realtors' index of pending home sales fell 4.6% MoM to 70.6 in Jan., an all-time low, vs an estimated drop of 0.9%. New home sales also declined 10.5% in Jan. to an annual pace of 657k, after rising 8.1% in Dec. Much of the downside surprise was attributed to the upward revision to December data.
- The number of new homes available for sale increased to 495,000 in Jan., the highest since Dec. 2007. Despite the increase in inventory, prices still rose with the median sale price increasing 3.7% YoY to $446,300 in Jan., the highest for Jan. on record and indicated more activity at the higher end of the market.
- Jan.'s dramatic drop in housing starts, largely driven by cold weather, reversed in Feb., but a decline in housing permits reflected dampened builder sentiment. Housing starts increased 11.2% in February (vs. -11.5% in Jan.). Building permits, an indicator of future construction, decreased 1.2% to an annual pace of 1.46mn.

Equity markets



Housing Sector



Data source: Bloomberg

Beyond the headlines

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A continued pause…

- Upside inflation risks remain, particularly showing up in survey data expectations.
- Trump’s tariff policies and the retaliatory tariffs may prove to have a non-transitory effect or at the very least urge the Fed exercise patience.
- Despite some moderation lately, financial conditions remain eased especially with stocks and other assets at elevated levels.

Lingering inflationary pressures may prevent the cautious Fed from hastily declaring victory over inflation

… with a possibility of resuming easing

- As reiterated by Powell, a deterioration in the labor market would demand a rate cut as the Fed would focus its attention on the labor market mandate.
- Policymakers may see the need for lower real rates to aid in the servicing of mounting private and public debt.
- Inflation, particularly core figures, may follow a downward trend and print closer to target, the Fed’s policy would then be deemed too restrictive.

Cracks in the economy, especially on the labor front, may force a resumption of the easing cycle

What’s your view?

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Profit Rate Hedging & Investment Products

Hedging – Vanilla Profit Rate Swap

Description

- A PRS is a highly liquid and very wide-spread derivative instrument used as the basic tool to hedge profit rate risk.
- It is an agreement between two parties to exchange periodic profit rate payments based on a fixed profit rate against payments based on a floating profit rate (e.g. Compounded SOFR), calculated on a notional amount and for a specified tenor.
- If coupled with a floating rate financing, the PRS eliminates the exposure to rising profit rate payments by creating a "synthetic" fixed profit rate financing.

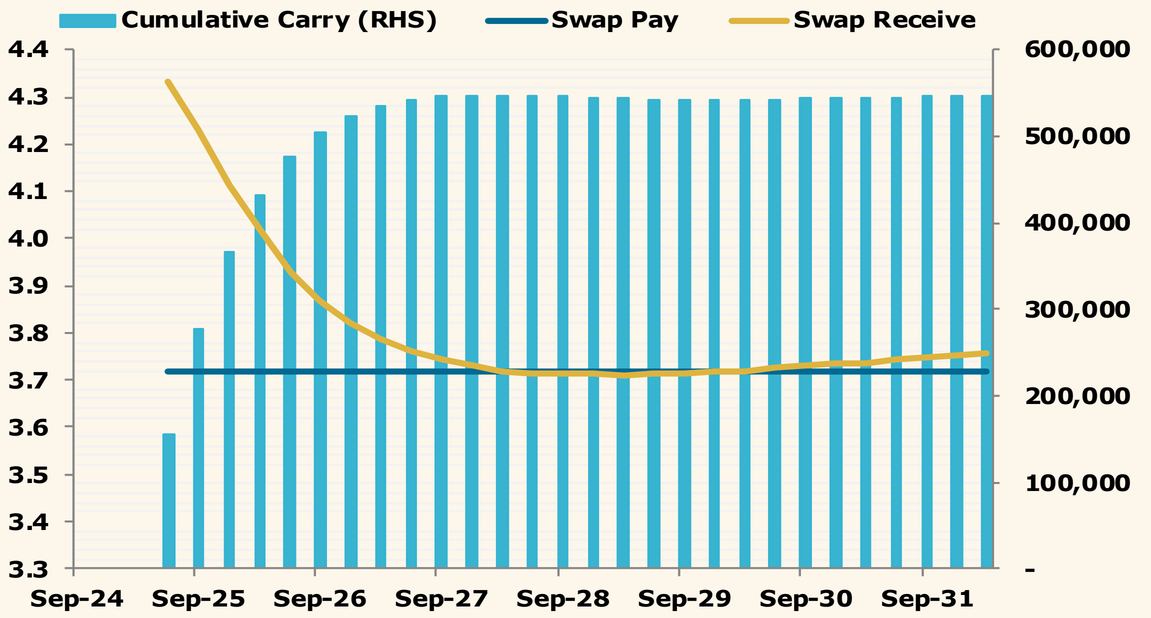
Main features / drawbacks

- Absolute certainty over future cash flows, supporting budgeting and planning exercise and easy accounting treatment (hedge accounting – no impact on P&L under certain assumptions).
- Flexibility over the financing amount (also with an amortizing profile) and tenor to be hedged, allowing for partial notional and shorter tenor than the full one.
- Can be structured in a fully Islamic format.
- The borrower cannot benefit if Compounded SOFR drops as they have locked in a fixed rate through the PRS.
- Should Compounded SOFR rise less than current market expectations (forward rates), the overall cumulative carry would be negative.

Indicative Terms*

Notional	"Initial Notional of USD 100mn, Equally amortizing over the tenor"		
Start Date	**Spot**		
Tenor (alternatives)	5 years	7 years	10 years
Fixed rate paid	3.73%	3.72%	3.73%
Floating rate received	Compounded SOFR, quarterly		
Payments	Quarterly, act/360		

7yr PRS-Fixed rate vs. Floating rate scenario



*The levels shown are mid-market levels and do not include any credit and liquidity related charges

Hedging – Forward-start Profit Rate Swap

Description

- While an PRS allows borrowers to eliminate their risk and avoid unwanted fluctuations in their profit payments, client can further reduce fixed rate to be paid by using a forward-start PRS – due to current shape of rates forward curve.
- For example, in a 1yr forward-start PRS the deal is concluded (hence, the rate is fixed) on the Trade Date, but the exchange of flows starts in one year (Start Date).
- Hence, between Trade Date and Start Date – if the borrower hold a view that rates will go further down before rising in future – then they can still benefit from the low Compounded SOFR.

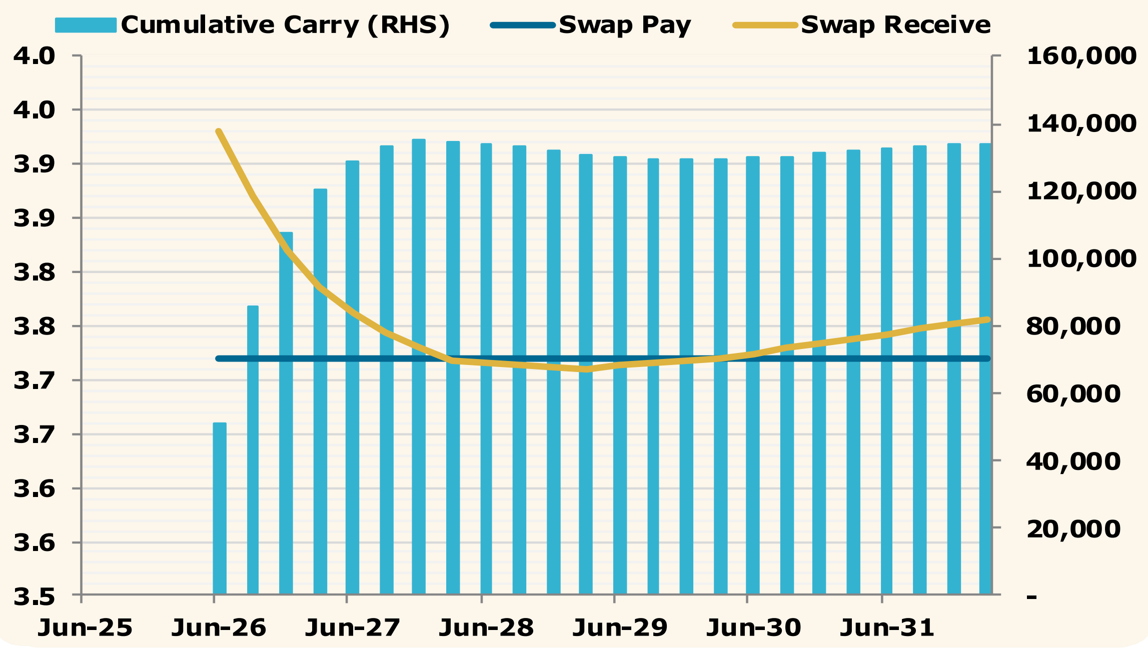
Main features / drawbacks (compared to a vanilla PRS)

- Client can benefit from short term rates remaining low for 1y or 2y and at the same time can be hedged for any rise in rates thereafter.
- The client achieves a slight negative carry initially. The initial difference between the floating rate received and the fixed rate paid is negative – this is offset by later positive cash-flows.
- Client in unhedged for the period between Trade Date and Start Date of the forward PRS.

Indicative Terms*

Notional	"Initial Notional of USD 100mn, Equally amortizing over the tenor"			
Start Date	**1 year**		**2 year**	
Tenor (alternatives)	4 years	6 years	3 years	5 years
Fixed rate paid (%)	3.57	3.61	3.61	3.65
Floating rate received	Compounded SOFR, quarterly			
Payments	Quarterly, act/360			

2yrx5yr PRS - Fixed rate vs. Floating rate scenario



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Hedging – Profit Rate Collar

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Description

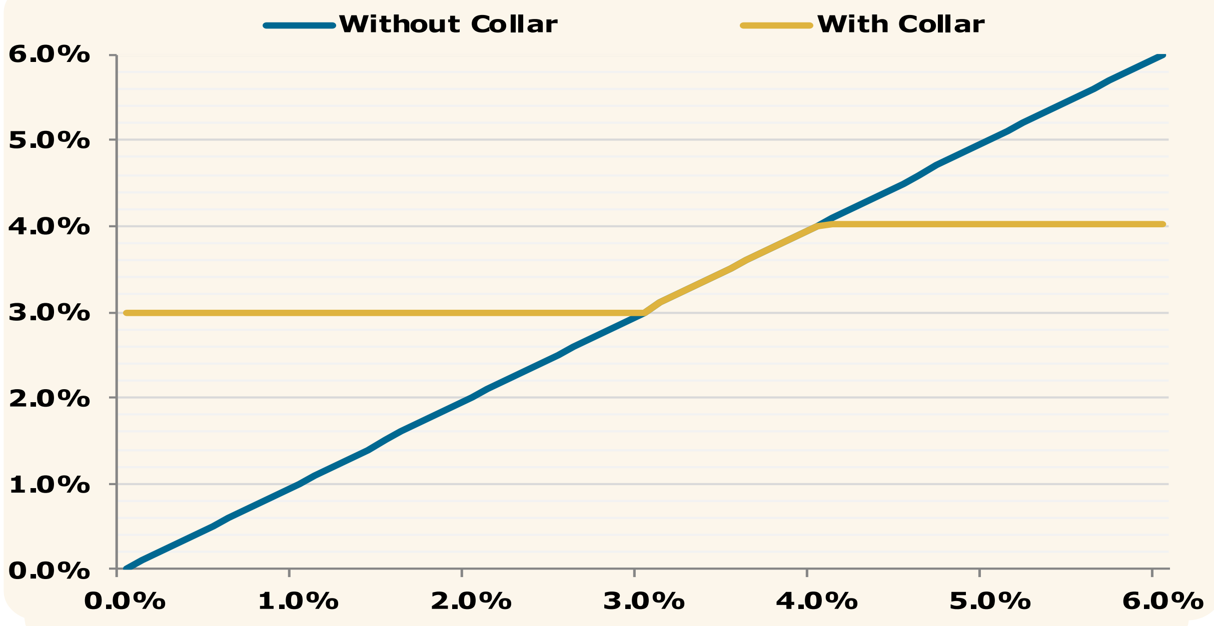
- A Profit Rate Collar is an option on a reference profit rate that would give the buyer a best case and worst-case rate.
- As a hedging tool, it works to protect a floating rate borrower (Collar buyer) should the reference profit rate (e.g. Compounded SOFR) rise above a certain threshold (Cap Strike) but should the reference profit rate (e.g. Compounded SOFR) fall below a certain level (Floor Strike) client has a minimum rate to pay.
- A Profit Rate Collar combines buying a Cap and selling a Floor, the sale of the floor allows the borrower to reduce the cost of the hedge while still allowing him to benefit from lower Profit Rates up to a certain level.

Main features / drawbacks (compared to a vanilla PRS)

- Full protection above the Cap Strike, with the possibility to benefit should Compounded SOFR fall up to the floor level. Worst-case scenario and Best-case scenario is known at inception.
- Current market environment (flat to negative yield curve) allows Collar levels to be attractive.
- No cash flow if markets remain between the cap and floor.
- If Markets fall below floor, client will pay the floor which at the time will be above market levels, yet still it is lower than the current vanilla swap.

Indicative Terms*		
Notional	"Initial Notional of USD 100mn, Equally amortizing over the tenor"	
Start Date	**Spot**	
Tenor (alternatives)	5 years	7 years
Cap Strike (alternative)	4.01%	4.04%
Floor Strike (alternatives)	3.00%	3.00%
Underlying Index	Compounded SOFR, quarterly	
Payments	Quarterly, act/360	

Hedge Rate: 5yr Cap@4.01% Strike and Floor @3.00% Strike



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