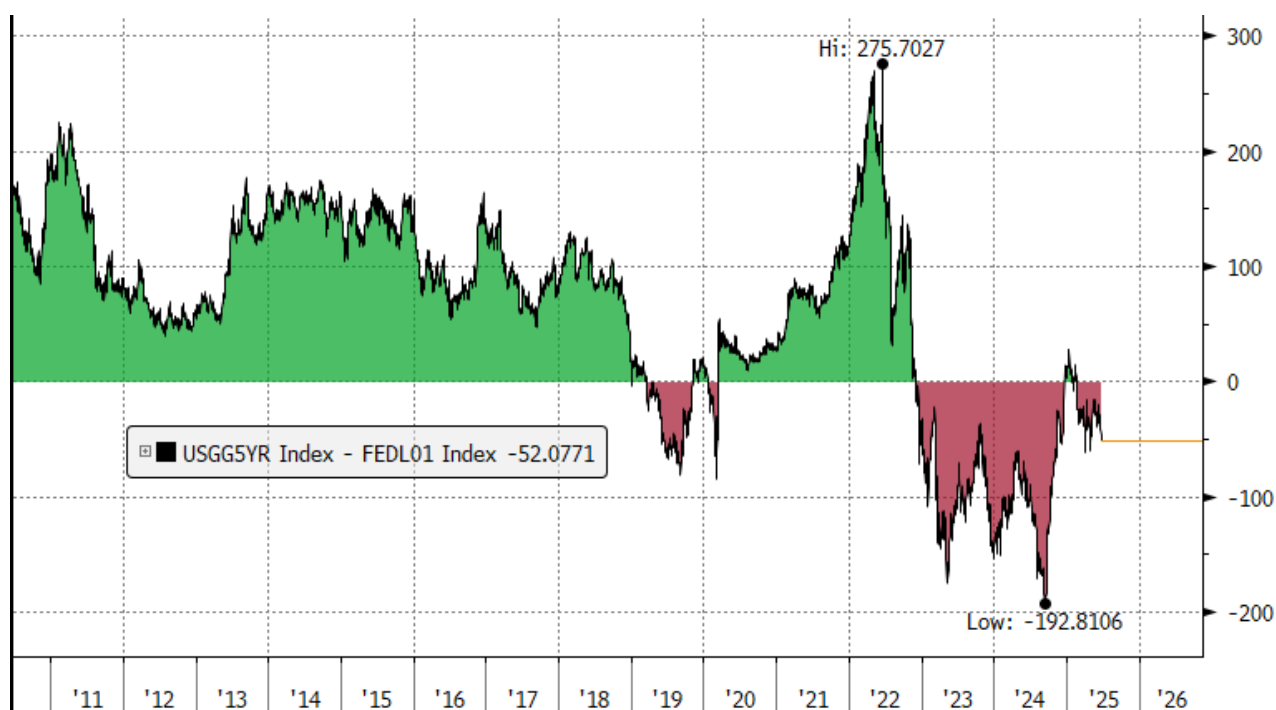


Three pertinent observations for lenders and borrowers

1. Carry trade has disappeared

The graph below shows the difference between the 5yr Treasury and Fed Funds yield from 2010 to the present. This graph represents the benefit of a carry trade – a bank's additional income gained by making 5yr loans and funding with organic deposits (vs. matched-funding). Historically, this carry trade earned banks an average of 93bps additional yield. Today this trade earns banks a negative 47bps in yield. There is no benefit to adding loan duration to the balance sheet because banks are taking liquidity and interest rate risk for a lower yield – a poor risk/return tradeoff for lenders.



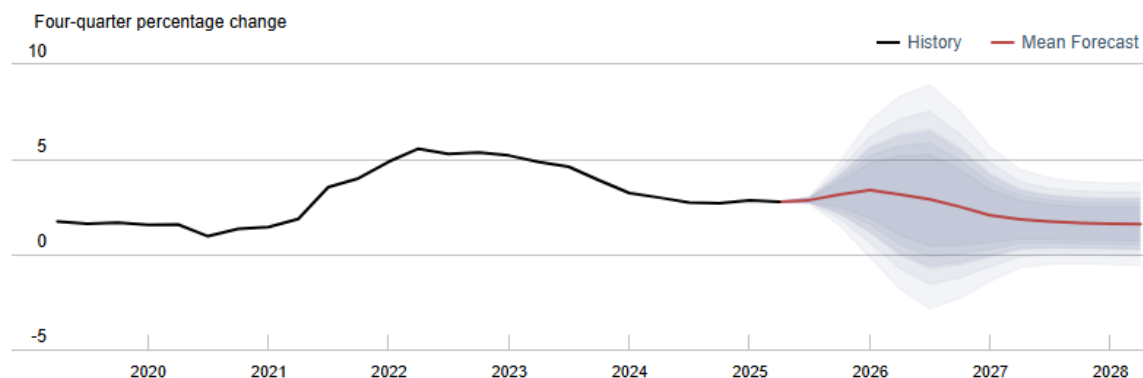
2. Divergence between interest rate forecasts and the Federal Reserve inaction

How do we explain to borrowers that the futures market has been calling for lower rates for all of 2025, but Fed has not acted? We believe that probabilistic outcomes explain much of this disconnect.



The futures market is the collective insight of many participants who assume various outcomes and attribute probability to each. An example is shown below for PCE expectations. The average forecast for PCE may be 3.4%, but there are top and bottom outcomes that vary greatly. The market uses the same dispersion for projected interest rates. However, the Federal Reserve rate setting and forecasting does not work the same way. Each FOMC member submits the most likely outcomes for GDP, inflation, unemployment and future projected interest rate. Therefore, FOMC projections are set based on each individual participants' assessment of the most likely outcome with the absence of further downward or upward shocks. This helps explain why the interest rate market projections and the Federal Reserve rate setting have diverged in the last few quarters.

Forecasts of Core PCE Inflation



3. Policy Inertia

Another phenomenon worth discussing with borrowers is the inherent hesitancy for the Fed to act prematurely. The futures market reflects constant changes in economic, political and social changes. The FOMC only meets 8 times per year and maintains a strong tendency to avoid policy mistakes because reversals undermine policy makers' credibility and require more forceful actions than the initial incorrect response. Therefore, the Fed's natural propensity is to wait to digest incoming information (such as the effect of tariffs) – and this level of clarity may take longer than many expect.

Action Item

Contact the ARC Team to obtain a borrower presentation specific to your client.