INTEREST RATE UPDATE

Capital Markets Department
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BACK TO BUSINESS

Immediately after the predictable (if hard-fought) midterm election results, equities rebounded while interest rates barely moved. As political pundits debate the near-term impact of a (re)divided Federal government, it's worth remembering that the United States economy has continued to flourish for nearly a decade under a regime of "serial bipartisanship." Since the expansion began in 2009, we have had periods of full Democratic control of the executive and legislative branches, full Republican control, and a variety of partisan splits among the Presidency, the Senate and the House. In addition, during that period we have had Federal Reserve Chairs from both parties, a shifting mix of governorships, and a fully bipartisan judiciary. And at the state level, Texas and California show that the country's economic engines drive growth whether the government in charge is bright blue, bright red or somewhere in between.

As the markets look ahead to the end of the year and into 2019, let's take a look forward:

- The FOMC meets tomorrow, and is widely expected to hold its Fed Funds target in a range of 2.0 percent to 2.25 percent. Futures markets currently anticipate only a 13 percent chance of a rate hike tomorrow. Meanwhile, a quarter-point upward move is priced in at the 80 percent level for the December 19th meeting, with another hike (the tenth increase of this cycle) predicted for March.
- Looking at the full yield curve, forward rates are pricing only a modest upward shift over the next year, with an 80 basis point move on the short end of the curve, and less than 10 basis points on the long end. This complacency is echoed in the median forecast from Bloomberg's most recent survey of economists, though the range of expectations reflects far greater uncertainty. Current forecasts of the ten year Treasury yield for 2019 range from 2.2 percent to 4.4 percent.
- Regarding economic fundamentals, consensus forecasts call for stable unemployment near the current 3.7 percent range, strong consumer spending through 2019, and modest slowdowns in job growth and private investment. Again, these sanguine forecasts imply a steady-as-she-goes economy in the tenth year of expansion, consistent with the broad trend since 2010.
- Even in a "Goldilocks" macro environment, there are potential areas of concern. Corporate borrowing has been rising even as the housing and mortgage markets have softened. The Fed's steady tightening since 2015 continues to put upward pressure on the US dollar, and creates real challenges for emerging market policymakers whose economies support global growth. On top of this, trade tensions with major trading partners (many of whom also hold our growing pile of Treasury bonds) are having negative impacts both domestically and internationally.

Where does that leave business owners and managers? As the Fed continues to pursue a highly predictable monetary policy over the next six to 12 months, and the interest rate and inflation environment remains calm, borrowers should take advantage of this period of stability to protect against future risks. One of the lessons of the Great Recession is that an economy that seems to be firing on all cylinders can turn unexpectedly. Consensus forecasts notwithstanding, oil prices, market interest rates, foreign currency values and equity prices can shift quickly without warning. Prudent financial policies, along with a disciplined approach to risk management, will allow companies large and small to contribute to a growing economy no matter how the political or macroeconomic winds blow.

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Key Statistics: Interest Rates, Unemployment and Inflation

	Year-end 2014	Year-end 2015	Year-end 2016	Year-end 2017	CURRENT Nov 7 2018
10 yr Treasury yield	2.17%	2.27%	2.44%	2.41%	3.20%
2 yr Treasury yield	0.66%	1.05%	1.19%	1.88%	2.95%
Spread	1.51%	1.22%	1.25%	0.53%	0.25%
Fed Funds Target (mid)	0.125%	0.375%	0.625%	1.375%	2.125%
1m LIBOR	0.17%	0.43%	0.77%	1.56%	2.32%
SOFR	NA	NA	NA	NA	2.22%
CPI (y/y change)	0.80%	0.50%	1.70%	2.20%	2.30%
Core PCE (monthly)	1.37%	1.33%	1.65%	1.50%	2.00%
TIPS (market breakeven)	1.21%	1.28%	1.87%	1.88%	1.92%
U-3 Unemployment	5.6%	5.0%	4.7%	4.1%	3.7%
Avg weekly earnings (chg)	2.9%	2.6%	2.1%	3.0%	3.4%
Annual change in NFP jobs	3,015,000	2.744,000	2,157,000	2,188,000	2,516,000

LIBOR, US Treasury Yields and S&P 500 since 11/2013

Source: Bloomberg LP

- Despite recent stock market volatility and an essentially flat market year to date, the long run trend in equities remains positive.
- At the same time, the Federal Reserve's steady rate hikes are driving rates up across the yield curve. After a period of flattening through the spring, the FOMC has engineered a parallel upward shift. This careful tightening avoids an inversion and may help the US economy avoid a monetary policy-induced recession.

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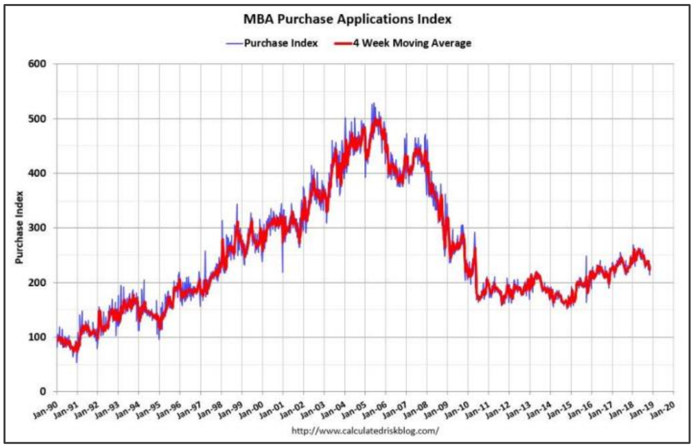
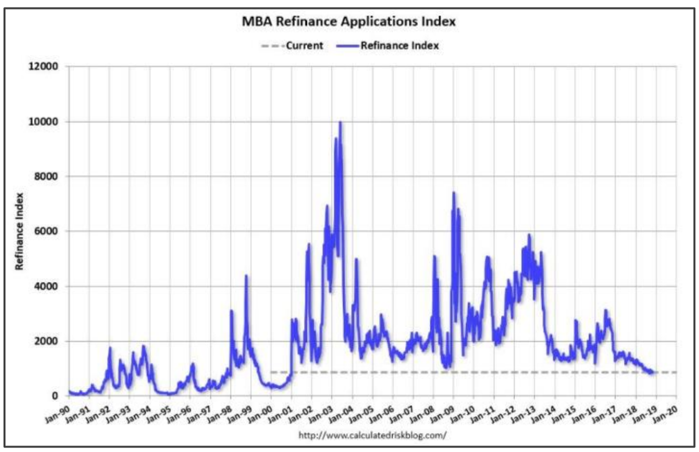


This long run view of mortgage purchase applications clearly reflects the impact of the housing bubble. Leverage building up in the housing sector over half a decade fueled unsustainable home price inflation, and led to a bust that lasted another five years. Since 2015, the trajectory of recovery in mortgage volumes has been positive but choppy. The recent softening bears watching.



Mortgage refinancing is more tied to interest rates than to underlying trends in the housing market. The spikes in refinancing volumes, including in late 2016, generally coincides with significant dips in mortgage rates. The US central bank has been in a clear tightening mode for nearly two years and mortgage rates have risen by more than a percentage points, so refinancing volumes have now dropped to a 17 year low.

Data on interest rates and economic indicators were obtained from Bloomberg, LP . Employment and wage data from the Bureau of Labor Statistics, bls.gov and the Federal Reserve Bank of St. Louis's FRED database. Mortgage data from the Mortgage Bankers Association via calculatedrisk.com.

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