Associated Bank

INTEREST RATE UPDATE

Capital Markets Department
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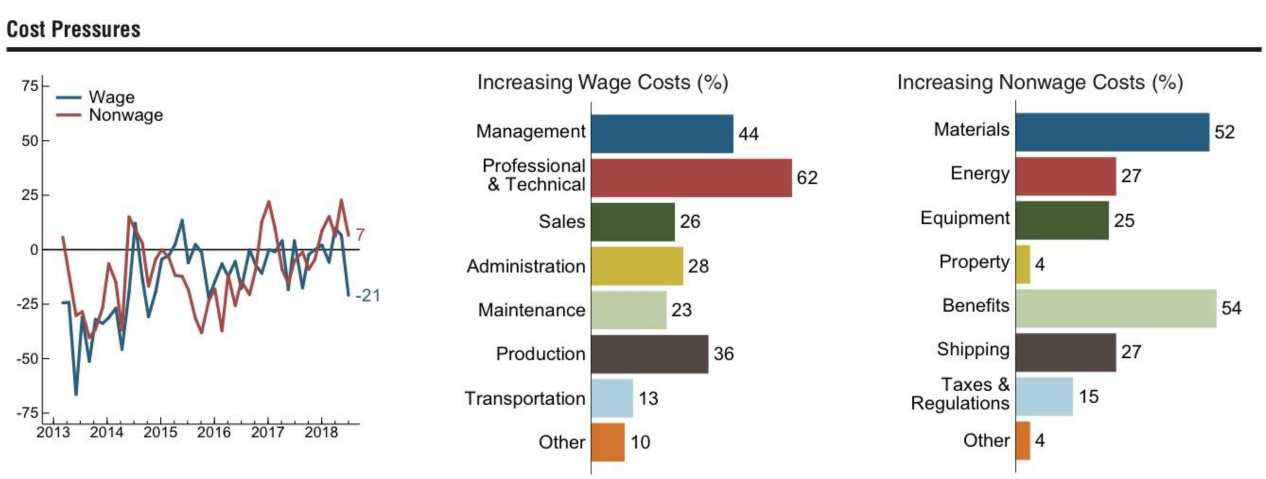
JOBS, CAPEX AND POLITICAL UNCERTAINTY

Economic fundamentals remain strong in spite of the political uncertainty that pervades both domestic and international politics. Stable interest rates, strong corporate profits, a job market near full employment and accommodative financial markets offer a friendly environment for economic growth. Real GDP rose at a 4.1 percent annualized rate in the second quarter, the best since the second and third quarters of 2014, unemployment dropped back below 4.0 percent last month, the S&P 500 is up 7 percent year to date, and ten year US Treasury yields remain below 3.0 percent despite rising deficits.

Still, the Administration's unpredictable policies appear to be taking a toll. Tariffs – which are simply taxes on US consumers and businesses – along with retaliatory duties imposed by our biggest trading partners, have started to increase the cost of a range of products from steel and aluminum to soybeans, semiconductors and ginseng. Notably, the Federal Reserve and the financial press are reporting that businesses have been hesitant to expand hiring and capital spending until they have a better handle on the potential cost and revenue impact of the unfolding global trade war (see graphs on page 3).

Beyond trade, oil markets have been volatile in response to reimposition of sanctions on Iran, with the price of a barrel of oil up 13 percent year to date. Add to that the long, contentious negotiations on NAFTA, Brexit and immigration policy, plus the noise of social media in the run-up to midterm elections, and a US economy in its 9th year of expansion is facing headwinds that are difficult to quantify or predict.

The Federal Reserve Bank of Chicago conducts regular surveys of business owners and managers to evaluate economic conditions in its Midwest district. In its July 18 release, several clear trends are in evidence. First, materials costs are clearly on the rise, in part due to the anticipated impact of tariffs. Second, the tight labor market, especially for professional, technical and management talent, is putting upward pressure on labor costs. Notably, much of the cost increase seems to be in the form of benefits rather than wages. The resulting inflationary pressures (CPI hit 2.9 percent last month) suggest that the Fed will continue to raise interest rates about once a quarter through 2019.



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Key Statistics: Interest Rates, Unemployment and Inflation

	Year-end 2014	Year-end 2015	Year-end 2016	Year-end 2017	CURRENT Aug-08-18
10 yr Treasury yield	2.17%	2.27%	2.44%	2.41%	2.96%
2 yr Treasury yield	0.66%	1.05%	1.19%	1.88%	2.67%
Spread	1.51%	1.22%	1.25%	0.53%	0.29%
1m LIBOR	0.17%	0.43%	0.77%	1.56%	2.06%
5 yr swap	1.82%	1.84%	2.11%	2.43%	3.09%
CPI (y/y change)	0.80%	0.50%	1.70%	2.20%	2.90%
Core PCE (monthly)	1.37%	1.33%	1.65%	1.50%	1.90%
TIPS (market breakeven)	1.21%	1.28%	1.87%	1.88%	1.98%
U-3 Unemployment	5.6%	5.0%	4.7%	4.1%	3.9%
Avg weekly earnings (chg)	2.9%	2.6%	2.1%	3.0%	3.0%
Annual change in NFP jobs	3,015,000	2.744,000	2,157,000	2,188,000	2,400,000

10 Year Generic Government Bond Yields

Source: Bloomberg LP

- Throughout the past nine years of economic expansion, US growth has outpaced other developed economies. Global interest rates continue to reflect this relative strength as the Fed ended its quantitative easing program and started tightening monetary policy much earlier than its peers.
- Continued tightening by the Fed takes place against a backdrop of a softer economic numbers in Europe and a more dovish European Central Bank. And rate differentials are driving a weakening of the Canadian dollar and Japanese yen vs. the US currency.

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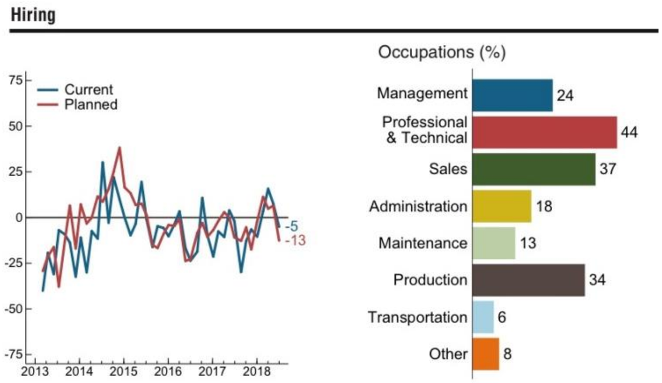
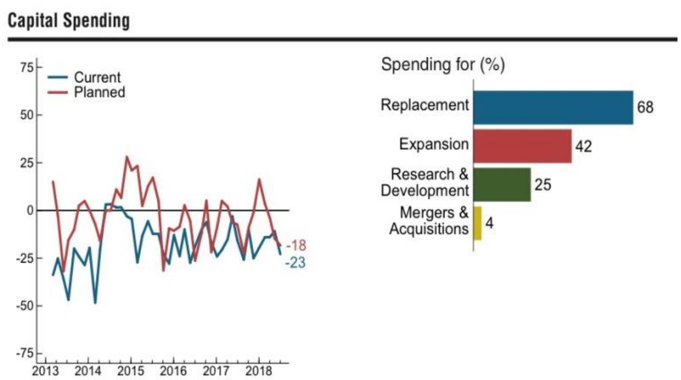


The Chicago Fed Survey of Business Conditions (CFSBC) showed a slowing, yet positive business environment in the Midwest for the first half of 2018 as the index fell from +20 to +7. The chart at the left isolates the hiring data from the survey. Hiring softened below trend in June (-5 index value in blue), and hiring plans declined even further (-13). The focus of workforce expansion, where it does occur, seems to be focused on skilled positions like technical and production areas, along with sales.



Similarly, the CFSBC survey highlights the softness in capital spending. Despite changes to the tax code that encourage capital spending, businesses have curtailed their capex plans, and focused much of their investment on replacing existing industrial and IT equipment rather than expansion. In part, this is driven by potential disruptions to the North American supply chain as trade and tariff negotiations continue.

Data on interest rates and economic indicators is obtained from Bloomberg, LP . Survey data and charts from the Federal Reserve Bank of Chicago. Employment and wage data from the Bureau of Labor Statistics, bls.gov.

Associated Bank offers a wide range of instruments for hedging interest rate, commodity and foreign currency risk, including foreign exchange in more than 75 currencies. Companies interested in learning more about these instruments should contact their Associated Bank Relationship Banker or the bank's Capital Markets Department at 866-524-8836.