Associated Bank

INTEREST RATE UPDATE

Capital Markets Department
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TOO EARLY TO TALK RECESSION?

The yield curve continues to flatten, leading some analysts to warn of a rising risk of recession. The spread between two- and 10-year Treasury yields dropped as low as 0.24 percent (24 basis points) this week, a post-recession low. Yet, while recessions are typically preceded by a flattening yield curve, the two-10 spread is not an infallible predictor. A better index is the three-month/10-year spread. And even there, in the last two economic cycle spreads actually inverted (short term rates higher than long term) more than a year before recession hit, so a flatter curve by itself is not of immediate concern.

That's not to say the current expansion is guaranteed to continue. The automotive industry is a bellwether for the broader U.S. economy, both as an employer and a large-ticket consumer purchase. At a recent automotive conference sponsored by the Federal Reserve Bank of Chicago, industry participants forecast a continued tapering of auto sales through 2020 to a seasonally adjusted annual rate of 16.6 million vehicles, down nearly 1 million from the 2016 peak. Among the cautionary signs:

- Sales incentives have risen to 10.1 percent of average transaction price, near levels reached during the Great Recession.
- Average auto loan payments have risen to $520 per month, despite the fact that average loan length has extended to 67 months.
- A pullback in subprime auto financing, indicating increased risk aversion from auto lenders.

This sense of caution is consistent with consensus estimates from economists surveyed by Bloomberg. The table below shows a softening of GDP growth in 2019 and 2020 despite low unemployment and moderate increases in interest rates:

						Consensus forecast		
	2013	2014	2015	2016	2017	2018	2019	2020
Real GDP growth	1.7%	2.6%	2.9%	1.5%	2.3%	2.9%	2.5%	1.8%
Consumer spending	1.5%	2.9%	3.6%	2.7%	2.8%	2.5%	2.4%	2.2%
Government spending	-2.9%	-0.6%	1.4%	0.8%	0.1%	1.8%	2.0%	1.0%
Private investment	6.1%	5.5%	5.2%	-1.6%	3.3%	5.9%	4.6%	3.1%
Industrial production	2.0%	3.1%	-1.0%	-1.9%	1.6%	3.7%	2.6%	2.0%
Inflation (CPI)	1.5%	1.6%	0.1%	1.3%	2.1%	2.5%	2.3%	2.2%
Inflation (Core PCE)	1.5%	1.6%	1.3%	1.8%	1.5%	1.9%	2.1%	2.2%
Unemployment	7.4%	6.2%	5.3%	4.9%	4.4%	3.9%	3.6%	3.7%
Fed Funds	0.25%	0.25%	0.50%	0.75%	1.50%	2.45%	3.05%	3.05%
2yr Treasury note	0.38%	0.67%	1.05%	1.19%	1.89%	2.81%	3.23%	3.23%
10yr Treasury note	3.03%	2.17%	2.27%	2.45%	2.41%	3.13%	3.44%	3.42%

Similarly, a Wall Street Journal survey shows two-thirds of forecasters expect the current expansion to end by 2020. The implications for interest rates are clear: the markets are priced for the Fed to continue pushing short term rates up into mid-2019 until their Fed funds target rate tops 3 percent. Meanwhile, longer term rates are expected to remain under 4 percent. Of course, the market has been wrong before. Should the economy grow more robustly than expected in the next two years, inflation, wages and interest rates are likely to break out to the upside.

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Key Statistics: Interest Rates, Unemployment and Inflation

	Year-end 2014	Year-end 2015	Year-end 2016	Year-end 2017	CURRENT Jul-18-18
10 yr Treasury yield	2.17%	2.27%	2.44%	2.41%	2.87%
2 yr Treasury yield	0.66%	1.05%	1.19%	1.88%	2.61%
Spread	1.51%	1.22%	1.25%	0.53%	0.26%
1m LIBOR	0.17%	0.43%	0.77%	1.56%	2.09%
5 yr swap	1.82%	1.84%	2.11%	2.43%	3.06%
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%	1.96%
TIPS (market breakeven)	1.21%	1.28%	1.87%	1.88%	2.02%
U-3 Unemployment	5.6%	5.0%	4.7%	4.1%	4.0%
Avg weekly earnings (chg)	2.9%	2.6%	1.8%	3.0%	3.0%
Annual change in NFP jobs	3,015,000	2.744,000	2,157,000	2,188,000	2,184,000

Spread between 3m T-Bill and 10y U.S. Treasury

Source: Bloomberg LP

- In the prior cycle, the yield curve as measured by the spread between 3M and 10Y Treasury rates inverted in July 2006, more than a year before the recession began.
- Today, that spread is a positive 87 basis points, suggesting we are about three rate hikes away from a potential inversion of the curve.
- Assuming the Federal Reserve continues to tighten monetary policy at the current pace and long term rates remain unchanged (not necessarily a good assumption based on fundamentals), this indicator could be signaling a recession in mid-2020.

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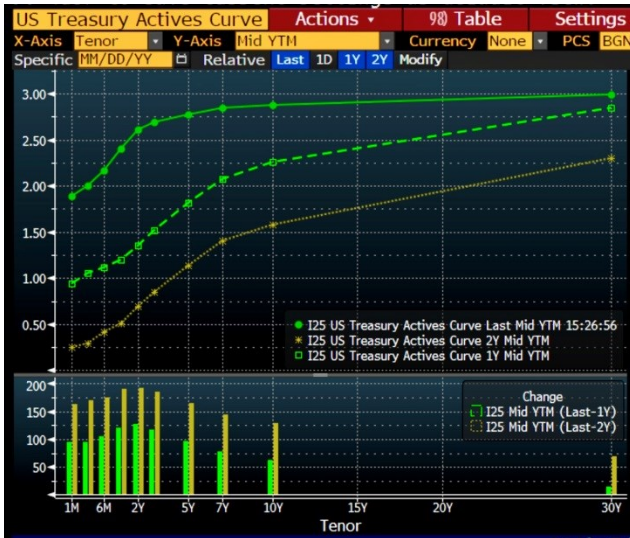
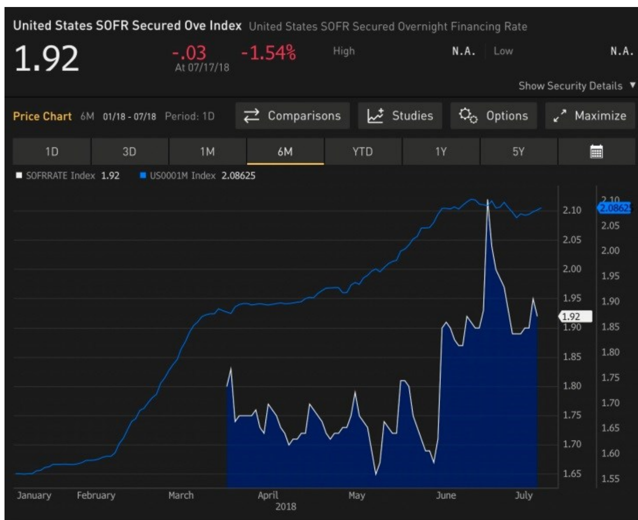


Over the past two years, the Treasury curve has flattened significantly, with the short end rising faster than the long end. Two year yields have risen the fastest, nearly 200 basis points, while the yield on the 30-year bond is up less than 75 basis points. The spread between 10- and 30-year yields dropped below 10 basis points this month, suggesting the markets expect a permanent downward shift in the so-called neutral rate of interest.



The SOFR index, which was introduced as a potential successor to LIBOR earlier this year, has shown more volatility than one-month LIBOR in its first three months of trading. The index is a basket of overnight repo rates that trade in the market. Notably, a quarter-end spike in SOFR suggests this index may respond more dramatically to market conditions such as period-end liquidity concerns. The CME has begun constructing hedging instruments which will, over time, allow for the creation of long term SOFR benchmarks. The development of a viable SOFR swap market is likely to be a slow and methodical

Interest rates, economic indicators and survey information is obtained from Bloomberg, LP. Additional data from the Federal Reserve Bank of Chicago.

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