Associated Bank

INTEREST RATE UPDATE

Capital Markets Department
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2018 MID-YEAR CHECK-IN

Now that we're approaching the halfway point of 2018, let's assess where the interest rate markets stand today. The last five weeks have seen some pretty big swings, both up and down, in medium to long term rates, but we've largely ended up where we were in mid-May. Looking back to 2017 year-end, however, the moves have been more pronounced:

- One month LIBOR is up 50 basis points (0.50%) on Federal Reserve Bank tightening, rising above 2 percent for the first time this cycle.
- Two year Treasury yields are 66 basis points higher, and 10 year yields are up 55 basis points.
- The result is a continued flattening of the yield curve, with the spread between two and 10 year yields dropping below 40 basis points. At the same time, the front end of the curve is quite steep as investors expect another three to five rate hikes by the Fed by the end of 2019.

As the Fed meets this week, the economic data is supporting further tightening of monetary policy for the balance of the year. The unemployment rate continues to tick downward, reaching 3.8 percent in May. Since labor markets tend to be a lagging indicator, that downward momentum is likely to continue, potentially bringing unemployment to the low 3 percent range by year-end. GDP growth came in at 2.2 percent in Q1, in line with the trend of the past seven years. Inflation has finally drifted up above 2 percent by most measures, with signs that it could heat up in the next two quarters.

The real challenge for our central bankers – and business managers – is coming next year. There are clear signs that, as unemployment drops into the low 3 percent range, the job market will run out of room for growth in 2019 and inflation will heat up. Recent economic research using city-level data suggests that prices of goods and services typically begin to rise when local unemployment drops below 3.75%. Currently, most Midwest cities, as well as 52 of Wisconsin's 72 counties, have unemployment under that threshold.

Meanwhile, the synchronized global growth we've seen the in the past few years seems to be coming to an end. This decoupling, combined with a stronger US dollar and the threat of reciprocal tariffs, will affect US export industries. And capacity utilization throughout the economy remains low at 78 percent, well below the 85 percent peaks of the 1990s. As these and other factors dampen prospects for a boost in capital spending and long term growth, continued tightening by the Fed to fight inflation may threaten to invert the yield curve and put additional brakes on the economy.

The good news is that the US economy remains resilient, and is well positioned to handle these cyclical pressures. The banking sector is very well capitalized, consumers have maintained very conservative debt service ratios throughout the recovery, energy price increases have moderated, and corporate profits remain healthy. The Federal Reserve has signaled that it will remain flexible and responsive to the economic data as it comes in. Even with the possibility of another four to six rate hikes, both short and long term rates are likely to stabilize in the 3 percent to 4 percent range next year, providing a neutral backdrop for borrowers, investors, consumers and workers to pursue their economic goals.

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Key Statistics: Interest Rates, Unemployment and Inflation

	Year-end 2014	Year-end 2015	Year-end 2016	Year-end 2017	CURRENT Jun-12-18
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%	2.54%
Spread	1.51%	1.22%	1.25%	0.53%	0.42%
1m LIBOR	0.17%	0.43%	0.77%	1.56%	2.06%
5 yr swap	1.82%	1.84%	2.11%	2.43%	3.08%
CPI (y/y change)	0.80%	0.50%	1.70%	2.20%	2.70%
Core PCE (monthly)	1.37%	1.33%	1.65%	1.50%	1.90%
TIPS (market breakeven)	1.21%	1.28%	1.87%	1.88%	2.08%
U-3 Unemployment	5.6%	5.0%	4.7%	4.1%	3.8%
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	2,280,000

Oil Prices vs 5y US Treasury Yield

Source: Bloomberg LP

- Interest rates across the yield curve have raised in line with Federal Reserve rate hikes, although longer term rates have gone up more slowly that short term rates.
- This flatter curve means that borrowers using short term lines of credit or financing rapidly depreciating assets (for example automobiles or production equipment) have faced somewhat higher financing costs. Long term borrowers (homeowners, housing developers, power companies) have seen less significant increases.

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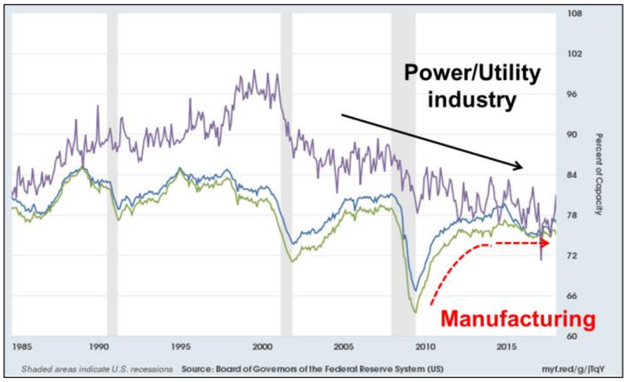
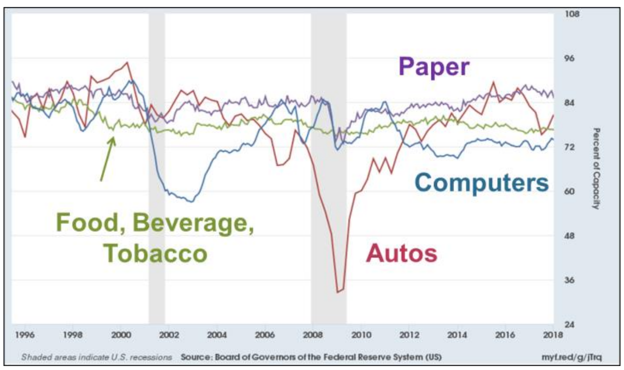


Capacity utilization has rebounded solidly from Great Recession lows, but the long term trajectory has been downward. With utilization currently at 78%, the need for capital spending has been muted, going primarily toward technology upgrades and cost/efficiency improvements. This is one reason why producers have been able to absorb rising demand without inflation flaring up.



At an industry level, capacity utilization has varied by economic sector. Auto manufacturers, who suffered during the financial crisis as lending dried up, peaked at over 90 percent. Utilization has since softened, but remains in the mid 80 percent range. Meanwhile, sectors tied to consumer staples and the global economy has been less volatile.

Interest rates, economic indicators and survey information is obtained from Bloomberg, LP . Employment and wage data from the Bureau of Labor Statistics, bls.gov.

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