Associated Bank

INTEREST RATE UPDATE

Capital Markets Department
Chicago | Milwaukee | Green Bay
866-524-8836

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Thomas Toerpe

A “SYMMETRIC” INFLATION TARGET

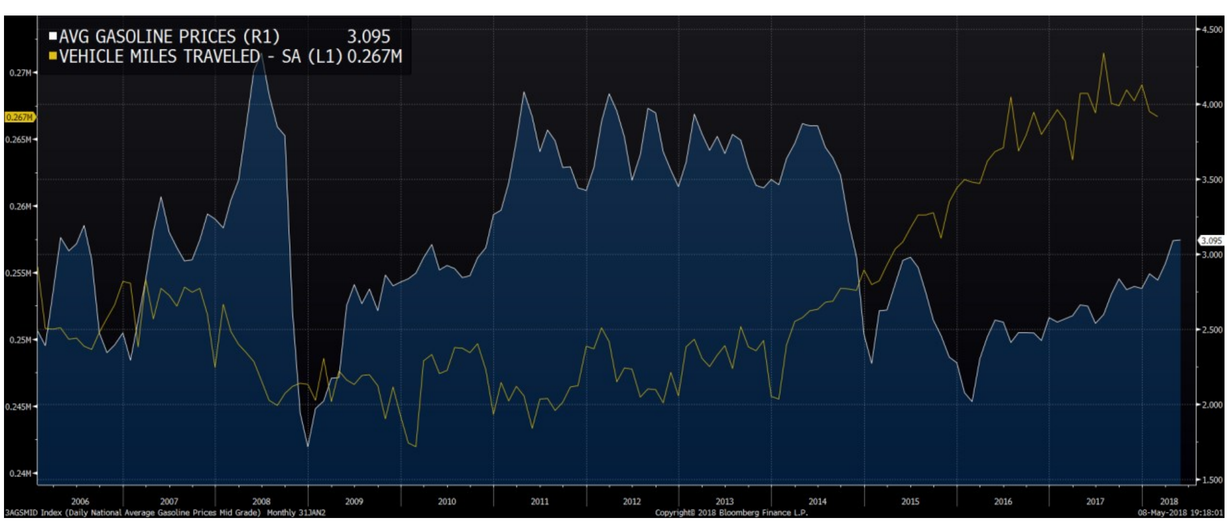
To nobody’s surprise, the Fed left interest rates unchanged last week, after a quarter-point rate hike in March. Currently, the Federal Open Market Committee (FOMC) is holding Fed funds in a target range between 1.50 and 1.75 percent. The markets responded with a big yawn as long term rates barely moved immediately after the announcement. Looking forward, the baseline market expectation is for three more quarter-point hikes in June, September and December, with the possibility of a fourth in August or November.

In its announcement, the FOMC made a point to highlight its “symmetric” inflation target. Throughout most of the current expansion, inflation has been running somewhat below the Fed’s 2 percent target. A number of Fed officials, including Chicago Fed President Charles Evans and former Chair Janet Yellen, have regularly suggested that it would be wise to let inflation run a little “hot” to make up for the years of shortfalls. Today, inflation is essentially at the Fed’s target. By reminding the market that 2 percent is not a ceiling but an average, Chair Jerome Powell is signaling a willingness to let inflation drift above target without accelerating the pace of rate hikes.

April unemployment came in at 3.9%, a strong signal that the Fed has effectively met its mandate to foster maximum sustainable employment. However, wage growth continues to be tepid, so the job market isn’t yet putting upward pressure on prices. This could change as long as job growth continues this year.

Oil prices, on the other hand, have been moving up sharply. While the Fed tends to look past temporary fluctuations in volatile energy prices, sustained changes – and the ability to pass cost increases to consumers – do signal an economy that is nearing peak. With the Fed’s “symmetric” inflation target, we don’t expect them to change the pace of monetary tightening this year, but the potential that the economy will overheat in 2019 may continue to push medium and long term rates higher in the coming months.

Rising Gasoline Prices Slow Travel



Source: Bloomberg LP

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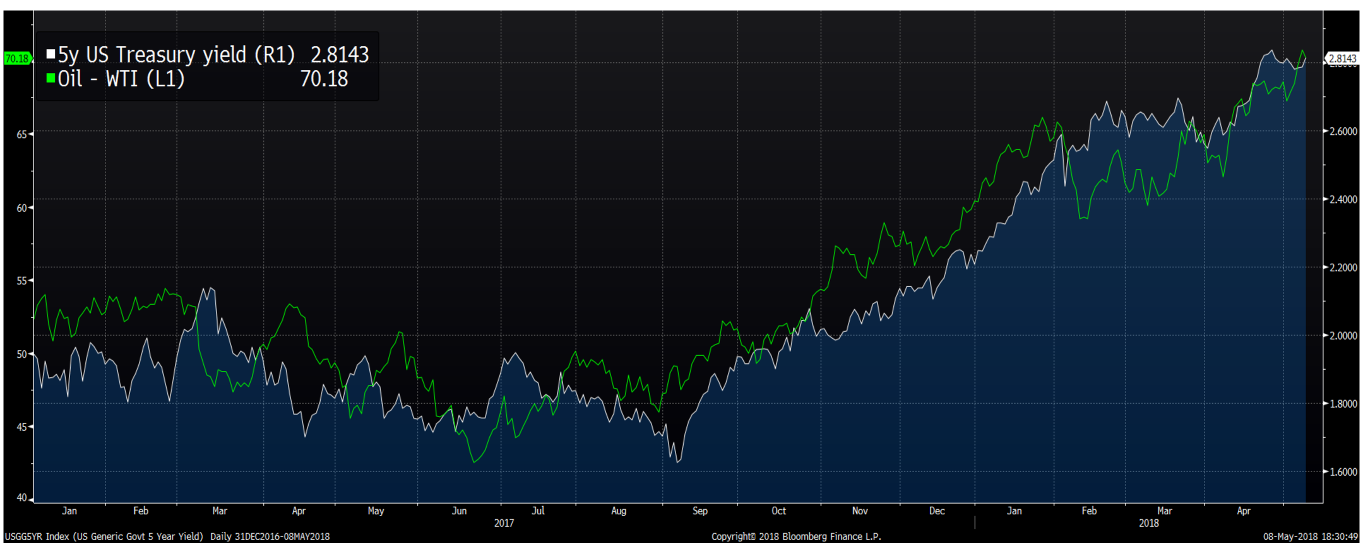
Key Statistics: Interest Rates, Unemployment and Inflation

	Year-end 2014	Year-end 2015	Year-end 2016	Year-end 2017	CURRENT Apr-10-18
10 yr Treasury yield	2.17%	2.27%	2.44%	2.41%	2.98%
2 yr Treasury yield	0.66%	1.05%	1.19%	1.88%	2.51%
Spread	1.51%	1.22%	1.25%	0.53%	0.47%
1m LIBOR	0.17%	0.43%	0.77%	1.56%	1.93%
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%	2.40%
Core PCE (monthly)	1.37%	1.33%	1.65%	1.50%	1.90%
TIPS (market breakeven)	1.21%	1.28%	1.87%	1.88%	2.12%
U-3 Unemployment	5.6%	5.0%	4.7%	4.1%	3.9%
U-6 Underemployment	11.4%	9.9%	9.2%	8.1%	7.8%
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 have been closely correlated with oil prices since late 2016. This reflects the impact of energy costs on measured inflation, and on the inflation expectations that are embedded in US Treasury yields. While the Fed tends to look past temporary fluctuations in volatile energy prices, the rise in WTI appears to be steady and sustainable, especially in an environment where consumers are nearly fully employed and the labor market is poised to tighten.

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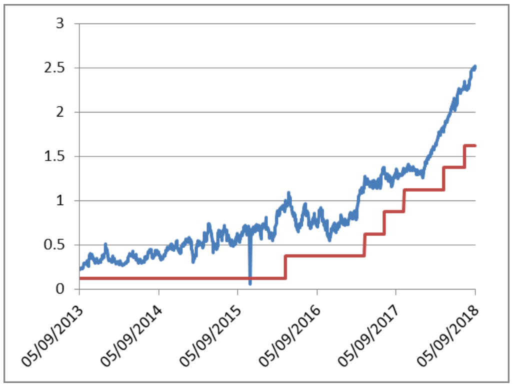
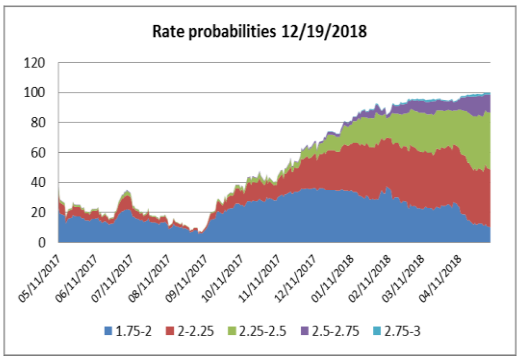


The FOMC has raised their Fed funds target six times this cycle (red line) bringing short term rates up by 150 basis points. Two year Treasury yields (blue line) are generally quite sensitive to monetary policy expectations, so the fact that this benchmark has topped 2.5 percent shows that the market anticipates continued tightening by the US central bank in 2019.



Futures markets also indicate continued Fed tightening. Traders in this market are pricing in an increasing probability of three or more rate hikes by year end. The graph at the left shows a decline in the likelihood of only one increase by December (blue area), even as traders see a rising chance of four hikes (purple).

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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