Associated Bank

INTEREST RATE UPDATE

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

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Thomas Toerpe

DO MIDTERMS MATTER FOR INTEREST RATES?

Interest rates jumped 17 basis points so far this month. The ten year US Treasury yield recently hit 3.24%, the highest level since February 2011. This sudden shift upward caught markets by surprise. As a result, market watchers struggled to identify the exact catalyst for the move. Among the proposed culprits:

- Bullish remarks by Federal Reserve Chairman Jay Powell. "There's really no reason," he said, "to think that this cycle can't continue for some time, *effectively indefinitely.*" [Emphasis mine.] He also added that interest rates are "a long way from neutral," suggesting continued rate hikes by the Fed in December and into next year.
- Acceleration of "Quantitative Tightening," the planned reduction of the Fed's balance sheet, as well as similar moves by the European Central Bank. The Fed will let $50 per month in their holdings of Treasury bonds run off.
- A rising supply of US Treasury bills and bonds as budget deficits continue to ramp up in the wake of tax cuts. We expect about $125 billion of new bill supply for the rest of 2018, putting upward pressure on shorter term rates. According to the Congressional Budget Office, the deficit for the first 11 months of the Federal fiscal year ending September 30 were $895 billion, and is expected to top $1 Trillion by 2020.
- Continued economic expansion. While September job growth came in light at 134,000, the unemployment rate hit 3.7% and wage gains were reasonable, providing a solid backdrop for the nine-year-old economic expansion to go into "extra innings". Can this go on "indefinitely" as Chair Powell suggests? That depends on how long the competing forces affecting the economy – fiscal stimulus vs. rising debt, job growth vs. labor supply, monetarily stimulus vs. inflation, capital spending vs. productivity – can be kept in balance.

How do the midterm elections factor into the equation? Current polling suggests Democrats are likely to take the House and pick up some governorship, with the Senate less likely to flip. Despite the claims of partisans, shifts in party control have not had a clear impact on the path of interest rates or the economy.

- In the past 30 years, there have been seven midterm elections. From September 30 prior to each midterm election through the end of the election year, the average increase in the ten year US Treasury yield was a mere seven basis points.
- There were four instances where the President's party lost at least one house of Congress. The average rate increase in the final quarter of those years was 19 basis points, ranging from a jump of 78 basis points in 2010 (when the GOP took the House) to a drop of 32 basis points in 2014 (when the GOP took the Senate).
- Overall, the partisan makeup of Congress had no consistent impact. Interest rate and equity market trends were more affected by major economic events – the dot com bubble, the housing bubble, and the global financial crisis – than by which party controlled the executive and legislative branch.

The bottom line: don't let your political preferences determine your views on the direction of interest rates. Instead, focus on Federal Reserve policy and economic fundamentals like inflation, employment, economic growth and productivity. Your forecasts – and stress level – will benefit from a cool-headed approach.

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Key Statistics: Interest Rates, Unemployment and Inflation

	Year-end 2014	Year-end 2015	Year-end 2016	Year-end 2017	CURRENT Oct-10-18
10 yr Treasury yield	2.17%	2.27%	2.44%	2.41%	3.16%
2 yr Treasury yield	0.66%	1.05%	1.19%	1.88%	2.89%
Spread	1.51%	1.22%	1.25%	0.53%	0.34%
Fed Funds Target (mid)	0.125%	0.375%	0.625%	1.375%	2.125%
1m LIBOR	0.17%	0.43%	0.77%	1.56%	2.28%
SOFR	NA	NA	NA	NA	2.15%
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%	2.00%
TIPS (market breakeven)	1.21%	1.28%	1.87%	1.88%	2.06%
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	2,537,000

US Treasury Yields since August 20

Source: Bloomberg LP

- Interest rates have been trending up all year, with Treasury yields decisively breaking out of their mid-2018 range this month. The ten year yield is now 82 basis points above its year-end level.
- The yield curve, which had been on a flattening trend since 2013, reversed course somewhat in recent weeks. Since August, the spread between two and ten year Treasuries has widened from a low of 19 basis points to 33 basis points.
- The Federal Reserve has raised short term rates by a quarter-point in each of the last four quarters, and seems poised to continue this pace at least through mid-2019.

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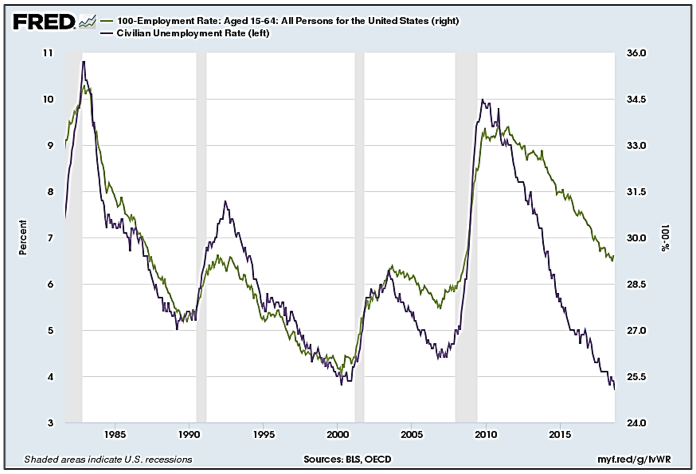
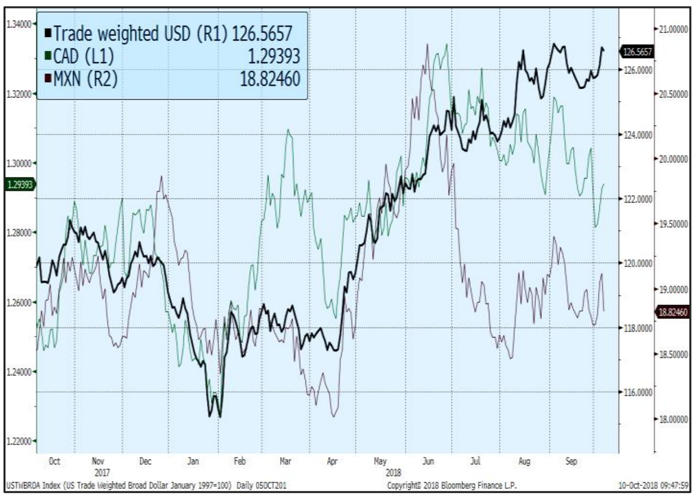


Headline unemployment (purple line at left) has dropped to 3.7% This is the lowest level since the 1960s. At the same time, wage increases continue to be modest, indicating the labor market is not overheating. The discrepancy between wage growth and unemployment is less puzzling when you look at broader measures of employment. For example, the green line at left shows the percentage of 15-64 year olds in the US who do not have jobs, either through circumstance or individual choice. The gap with headline unemployment is now at its widest since at least the 1970s.



Rising interest rates in the US have led to a strengthening dollar. The trade-weighted index is at its highest since January of 2017, driven by a combination of Fed tightening, economic weakness in emerging markets, concerns over Brexit, and the impacts of trade tension with China and India. The Canadian dollar and Mexican peso initially reacted positively to the completion of NAFTA negotiations, but eased off a bit more recently. Ultimately, the changes were seen as modest, and require Congressional approval before any new provisions can actually take effect.

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.

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