Associated Bank

INTEREST RATE UPDATE

Capital Markets Department
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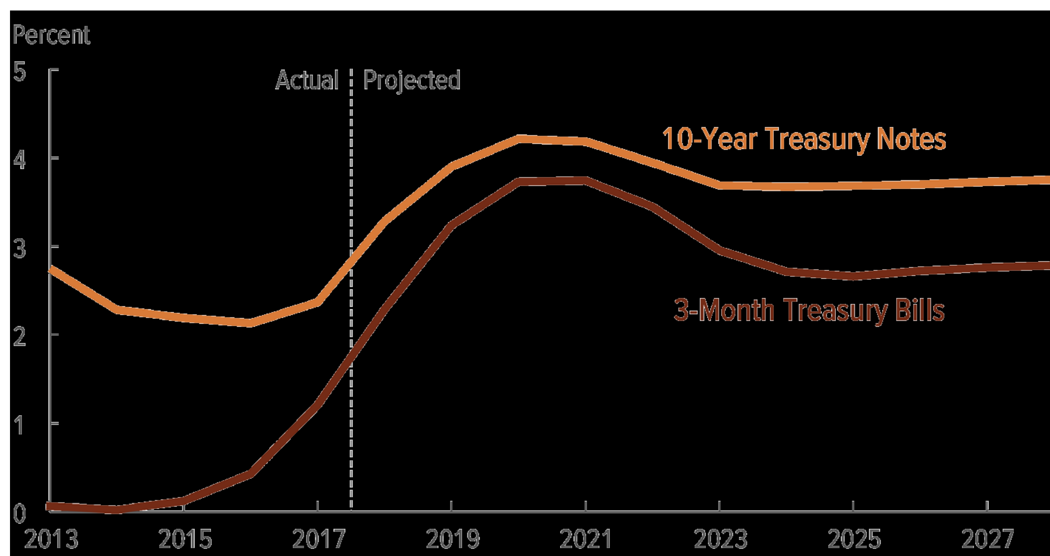
TRENDLINE GROWTH OR DISRUPTION?

The headlines this month have been all about discontinuity and disruption… Market volatility has spiked this year in response to a shifting series of concerns: a potential trade war with China; NAFTA negotiations; turnover in the White House and Congress; FBI investigations; the head of the world's largest social media platform under fire - and threats of military action in Syria. The VIX, which spent much of 2017 flirting with single digits, has doubled and the DJIA is down 1.5 percent year to date. Oil is at its highest since 2014. Investors clearly are on the watch for a catalyst that will indicate whether we will break toward faster growth or a recession.

…Yet the underlying economy looks almost placid. GDP is still growing at just under 3 percent, and corporate earnings, boosted by tax reform, are expected to be up by 17 percent this quarter, based on Bloomberg estimates. Despite month-to-month fluctuations, job growth continues at a 2.2 million annual pace, and the unemployment rate has been unchanged at 4.1 percent since October. Signs of an acceleration in wages are fleeting as inflation still hovers close to the Federal Reserve Bank's 2.0 percent target. The US central bank, looking through the market volatility, seems determined to maintain its planned pace of three to four rate hikes this year. And on the longer end of the rate curve, ten year US Treasury yields, which flirted with 3 percent in February, have fallen to 2.77 percent while the Treasury yield curve (the difference between two and ten year yields) has fallen to a cycle-low of 48 basis points.

Looking forward, the non-partisan Congressional Budget Office released its annual Budget and Economic Outlook this week (https://www.cbo.gov/publication/53651), forecasting 3.3 percent GDP growth in 2018 driven in part by a boost in capital spending. After that, the CBO anticipates 2.4 percent GDP growth in 2019, slowing to 1.7 percet annually through 2026. On the interest rate front, the CBO projects the Fed will lift the Fed funds rate above 4 percent by 2021 – higher than the Fed itself expects. Consistent with a slowing economy, the CBO anticipates further flattening of the yield curve over the next two years.



Source: Congressional Budget Office

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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%	2.78%
Two yr Treasury yield	0.66%	1.05%	1.19%	1.88%	2.28%
Spread	1.51%	1.22%	1.25%	0.53%	0.50%
1m LIBOR	0.17%	0.43%	0.77%	1.56%	1.90%
Five yr swap	1.82%	1.84%	2.11%	2.43%	2.84%
CPI (y/y change)	0.80%	0.50%	1.70%	2.20%	2.20%
Core PCE (monthly)	1.37%	1.33%	1.65%	1.50%	1.60%
TIPS (market breakeven)	1.21%	1.28%	1.87%	1.88%	2.05%
U-3 Unemployment	5.6%	5.0%	4.7%	4.1%	4.1%
U-6 Underemployment	11.4%	9.9%	9.2%	8.1%	8.0%
Annual change in NFP jobs	3,015,000	2.744,000	2,157,000	2,188,000	2,256,000

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US Treasury Yield Curve

Source: Bloomberg LP

The US Treasury yield curve has flattened across the curve. In the chart above, the green line (top) shows two year versus five year yields, the middle shows five year versus 10 year, and the yellow represents the spread between 10 year and 30 year Treasury yields.

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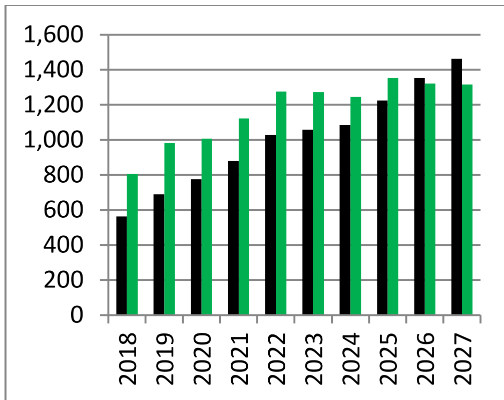
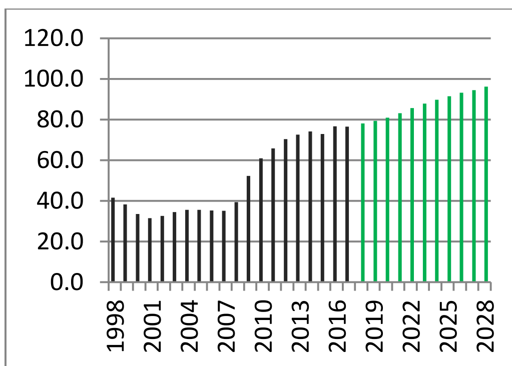


FEDERAL BUDGET DEFICIT: The CBO projects the Federal budget deficit will reach $1.0 trillion in 2020 (green bars) compared to their pre-tax reform estimate of $775 billion (black). Note that in the wake of tax reform, Federal deficits and debt will rise more quickly than previously anticipated.

The deficit had been declining for most of this economic cycle, reaching a recent low of $238 billion (2.4 percent of GDP) in 2015. The 50 year average is 2.9 percent of GDP.



DEBT TO GDP: As a result of rising deficits, US Treasury debt held by the public is projected to be $28 trillion by 2028, or just under 100 percent of GDP. While many observers worry that this is unsustainable, note that Japan has maintained significantly higher debt levels as a share of their economy for decades. The black bars at left are historical levels and green bars represent the current CBO forecast.

Interest rates and economic indicators are obtained from Bloomberg, LP . Employment and wage data from the Bureau of Labor Statistics, bls.gov. Congressional Budget Office forecasts are available at cbo.gov.

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