INTEREST RATE UPDATE

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

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Thomas Toerpe

POSITIONING FOR A SLOWER ECONOMY

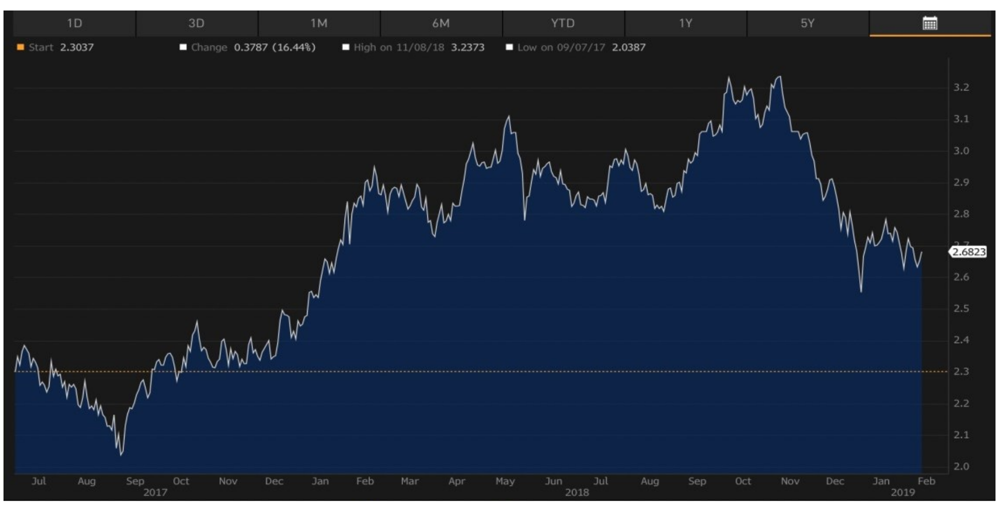
While the risk of a recession in the US remains low, business executives, investors and the Federal Reserve are all beginning to position themselves for a slowdown in the pace of economic growth. The downdraft in equity prices and interest rates at the end of 2018 signaled a shift in sentiment, and a more cautious tone has persisted into the first quarter even as stock indexes have partially rebounded:

- Federal Reserve Chair Jerome Powell sees limited likelihood of recession, but in recent comments, he and other Fed officials have positioned the Fed for a pause after nine rate hikes. Interest rate futures markets agree, pricing in an 83% probability of no Fed funds rate hikes this year, with the likelihood of a cut or hike equally balanced.

- Corporate earnings softened in the fourth quarter, and both stock analysts and company management teams are guiding expectations downward toward an outright decline in profit in the first quarter.

- Interest rate swap volume has jumped as borrowers fix their rates, taking advantage of the first meaningful drop in long term interest rates in 18 months. In the past 12 weeks, swap activity has more than doubled compared to the same period a year ago.

10 year US Treasury Yield



Source: Bloomberg, LP

Interest rates had been on a steady upward climb through late 2018, but a combination of factors boosted demand for the safety of U.S. Treasuries. Domestically, there was uncertainty over trade talks and the partial government shutdown. Internationally, a slowing Chinese economy, a drop in German industrial activity, recession in Italy and messy Brexit talks have weighed on the global economy. These factors also have led foreign central banks to keep monetary policy more accommodative than expected, improving the relative attractiveness of higher-yielding U.S. sovereign debt.

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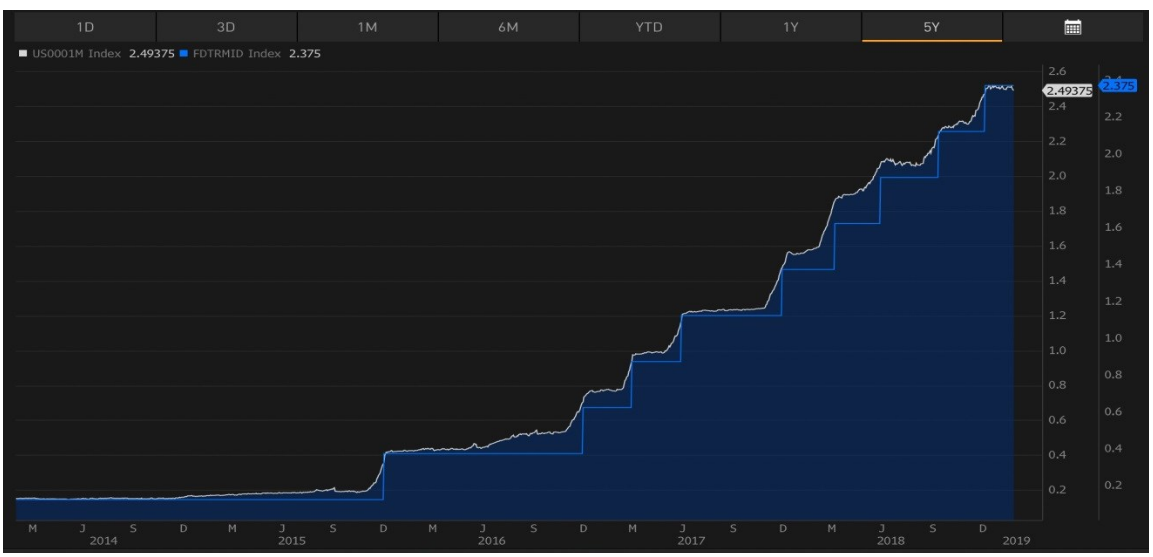
Key Statistics: Interest Rates, Unemployment and Inflation

	Year-end 2015	Year-end 2016	Year-end 2017	Year-end 2018	CURRENT Feb 11, 2019
10 yr Treasury yield	2.27%	2.44%	2.41%	2.68%	2.69%
2 yr Treasury yield	1.05%	1.19%	1.88%	2.49%	2.51%
Spread	1.22%	1.25%	0.53%	0.19%	0.18%
Fed Funds Target (mid)	0.375%	0.625%	1.375%	2.375%	2.375%
1m LIBOR	0.43%	0.77%	1.565	2.50%	2.49%
SOFR	NA	NA	NA	3.00%	2.42%
CPI (y/y change)	0.50%	1.70%	2.20%	2.20%	1.90%
Core PCE (monthly)	1.33%	1.65%	1.50%	1.50%	1.88%
TIPS (market breakeven)	1.28%	1.87%	1.88%	1.49%	1.73%
U-3 Unemployment	5.0%	4.7%	4.1%	3.9%	4.0%
Avg weekly earnings (chg)	2.6%	2.1%	3.0%	3.2%	3.5%
Annual change in NFP jobs	2.744,000	2,157,000	2,188,00	2,513,000	2,807,000

Fed Funds Target vs 1m LIBOR



Source: Bloomberg LP

- The Fed has raised short term rates nine times since late 2015. In response to somewhat weaker economic data, the maturing labor market, and cautionary signals from the financial markets, U.S. central bank officials expect to take a pause after December's rate hike.
- The CME Group's Fedwatch tool https://www.cmegroup.com/trading/interest-rates/countdown-to-fomc.html shows a 98.7% probability that the Fed will remain on hold at the March 20th FOMC meeting and potentially hold steady for the next year.

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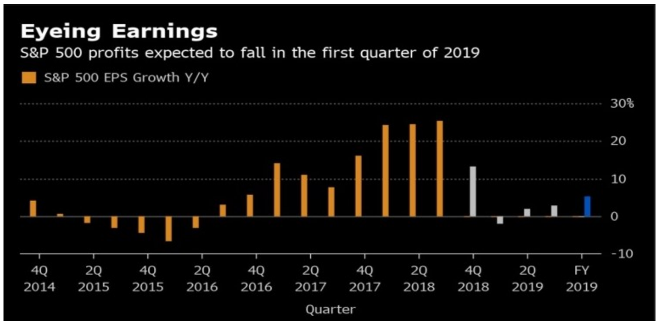
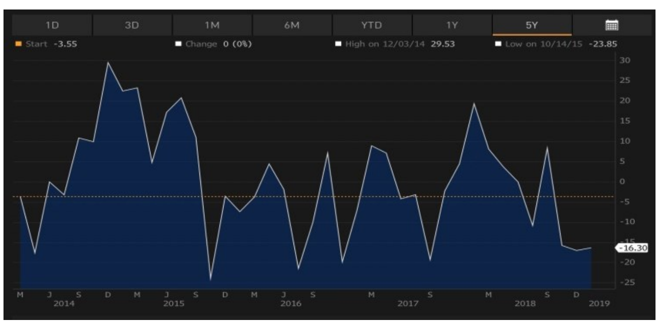


Corporate earnings are softening. With 66% of S&P 500 companies reporting, earnings expectations have been revised to 8% growth in 4Q18. And equity analysts now forecast a decline in earnings in the current quarter, and slow growth for the balance of 2019. This so-called "earnings recession" reflects wage pressures, higher rates, and weaker economies in overseas markets from Europe to China.

Low unemployment is finally translating into wage pressures. Over the past three months, average hourly earnings (white line at left) rose 3.4%. While this still is slower than the pace of growth seen at the peak of economic cycles, it's a welcome development. Labor markets, however, are a lagging cyclical indicator, and the recent upward move in unemployment back to 4.0% shows that job growth is likely to level off this year.



Capital spending by Midwest firms remains subpar compared to prior cycles. The Federal Reserve Bank of Chicago's survey of firms in the region continues to show that capital spending remains modest. This is surprising given the length of this recovery and the explicit goal of the 2017 tax cut to encourage more private investment in capital equipment.

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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