

PNC BANK CONTROLLING BORROWING COSTS IN A RISING RATE ENVIRONMENT

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Operator:

Let's go ahead and begin today's PNC Advisory Series event. It is my pleasure to turn today's call over to our moderator for today, who is Mr. Jim Bernier, Executive Vice President and head of the Derivative Products Group with PNC. Jim, with that, I'll turn it over to you.

Jim Bernier:

Great. Thanks very much, Aaron, and good afternoon, everyone, and welcome to our PNC Advisory Series webinar: "Controlling Borrowing Costs in a Rising Rate Environment". As Aaron mentioned, my name is Jim Bernier. I'm the head of PNC's Derivative Products Group. I'll be the moderator today. And just before we get started with our presentation, I wanted to highlight PNC's ongoing commitment to providing market insights, new ideas and best practices, like you're going to hear this afternoon. Our commitment is reflected in the types of conversations our bankers are having with companies like yours every day. Also reflected in our PNC Ideas on Leadership Series, which features a monthly e-newsletter, webinars and a dedicated website at pnc.com/ideas for brief videos, articles and economic reports, financial market commentary and webinar replays. We continue to choose topics and formulate our ideas based on the input that we get from you. So, at the end of today's session, please provide any feedback you may have so we can continue to focus on the right information for you and for your company.

Okay, let's get started with today's event. We are excited to have Bill Adams and Matt Gelles as our presenters today. Bill is a vice president and senior international economist at PNC, responsible for forecasting economic conditions and exchange rates, and covering Emerging Asia, the Eurozone, Canada and Latin America. Matt has more than 10 years' experience in capital markets and commercial banking, where he has advised, structured and executed interest rate strategies for hundreds of clients. Together, they will discuss current economic conditions, rate forecast and strategies for managing interest rate risk in this very dynamic market. Also as Aaron mentioned, we will also facilitate a question-and-answer session at the end of the presentation. You can submit questions at any time throughout the presentation using the question widget found in the lower portion of your screen. So, with all that, let me turn it over to the experts and they'll take us from here. And, again, thank you for joining us. Bill, I'll hand it over to you to begin.

Bill Adams:

Thanks, Jim, and good afternoon, everyone, and good morning to people dialing in from the West Coast. So, as Jim mentioned, I'm on the economics team, which produces PNC's forecasts for GDP growth, for inflation, and for interest rates for the United States. And the frame of interest rates, the way we think of that is through the Federal Reserve's mandate. By law they're supposed to target maximum employment and stable prices, so low in stable inflation. So, let me talk through what's going on in employment and inflation as a way to lead in to where we see interest rates headed in the United States in the next couple of quarters.

On employment, we've had pretty steady job growth both in the last three months — or, excuse me, the last four months, the opening months of 2017 — as well as through the period since the Great Recession. We've been adding about 180,000 jobs per month. We have the jobs reports for January through March already; we'll get the April report out tomorrow morning. We have a private sector estimate that says we added 177,000 jobs in the month of April. The official numbers come out tomorrow, but in any case it looks like we're on trend for about the amount of job growth that will keep the unemployment rate either steady where it is today — the unemployment rate is that orange line on the chart in front of you — or will actually make it fall even further. And the Federal Reserve believes that the policymakers who set U.S. interest rates believe that this level of the unemployment rate is more or less consistent with a labor market where most people who have the skills that employers are looking for are able to find a job over a reasonably short period of time. So, that's around how macroeconomists think of maximum employment.

The other line on this chart, the higher one, includes underemployment and workers who are discouraged. So, people who would like a job but haven't been actively seeking a job in recent weeks because they don't think one is available. And that underemployment rate is a little bit higher still than it was prior to the Great Recession, but it, too, has been trending downward and pointing to a tighter labor market. So, on the employment side of the Fed's dual mandate, the Fed believes that it has more or less met that part of the mandate. The labor market is no longer a reason for the Fed to maintain low interest rates, or the unemployment rate isn't a reason for them to keep interest rates low.

The other half of that dual mandate is inflation, and on inflation there are a couple of different ways of looking at it. Looking just at CPI, which is the most commonly followed measure of inflation, the trend in CPI, which we track by looking at CPI leaving out food costs, leaving out energy costs. Not because there are consumers out there and don't need to drive their cars and don't need to eat, but because those components of CPI are less volatile month-to-month than looking at other costs that are more influenced by global financial markets and the price of crude oil. And core CPI is pretty close to the Fed's mandate. And average hourly earnings, which is a measure of wages and income from the perspective of households, and from the perspective of businesses as a measure of labor costs going into production that has been gradually trending higher since 2015, as the unemployment rate has been falling. So, that's another measure of the labor market, showing that the labor market no longer has the slack that it had two years ago, which had been holding down wage growth.

So, that faster wage growth, if it's not met — if businesses are having to raise wages to retain workers and attract new workers, and their output per worker is holding steady or only growing slowly — then that puts pressure on businesses to raise the prices of their products and pass on that cost increase to their customers. And when everyone does that — when all businesses are doing that — that's what creates inflation. So, that higher wage growth is a sign that the Fed looks to know where inflation is headed over the next couple of quarters. In the second half of this year into 2018, faster wage growth is a sign that, they think, inflation. Core inflation will also be higher in the next 12 months than it was in 2014 or 2015, when it was steadily below the Fed's target.

Now, one of the uncertainties about inflation, looking at total inflation and not just that core measure, is what will happen to energy prices. Energy prices plunged from 2014 into early 2016 on a global glut of crude oil that was caused by the OPEC, the cartel of petroleum exporting countries that decided that they wanted to flood the global oil market and slow down production that is here in North America. But oil prices have stabilized since early 2016, and are actually higher in year-over-year terms now than they were then, and this is the first year-over-year increase in energy prices that we've seen since 2014. So, that is contributing to higher, what we call headline inflation, so inflation including energy, including food prices, everything in the consumer basket. And it's another reason why the Fed is likely to continue to gradually raise interest rates over the near term.

We don't think that oil prices are necessarily going to double out of here, and one of the reasons for that is U.S. oil production, even with oil only back at around \$50 a barrel, give or take a few dollars, U.S. oil production has been growing since late 2016, which is a sign that the private companies in the U.S. oil industry believe that it's profitable to be producing more energy at these prices. And so that is adding to global supply. We don't think that there is going to be another supply bottleneck this year, the way the global economy saw in 2011, or in 2007, 2008, to cause oil prices to shoot well over \$100 a barrel. And so we don't expect a lot of upward pressure on inflation from oil prices, but neither do we expect oil prices to be holding down inflation in the near term.

So, a final factor that feeds into the outlook for inflation and for interest rates in the United States is the value of the dollar against the currencies of U.S. trading partners. This is our preferred way of thinking of the value of the dollar. This is an index put together also by the Federal Reserve, so it's another way of getting inside their heads following this number. And it's a weighted average of the value of the U.S. dollar against the currencies of U.S. trading partner economy. So, the euro was in this, the Chinese yuan is in this, the Canadian dollar, the Mexican peso, the British pound, they're all included in this index according to the share of U.S. imports and exports that go through those economies. And, as you can see, the dollar surged against foreign currencies in 2014 and 2015 into 2016, and as the dollar has strengthened, this has meant that products imported from Asia, or from Europe, or from Latin America have been much cheaper in U.S. dollar terms, and that has held down inflation in the United States. It has also meant that it's been a harder economy for U.S. manufacturers and for U.S. exporters, as well as for American businesses that compete against foreign imports over the last few years. And that has been a headwind to U.S. economic growth. It's the reason why our economy grew a little bit slower than it otherwise would have in 2015 and 2016.

We expect that over the next 18 to 24 months, the dollar will probably continue to strengthen on average against those trading partners' currencies, but not by nearly as much as we saw earlier in the Federal Reserve's move to begin raising U.S. interest rates. So, thinking back to the topic for today, what will the effect be on interest rates in the U.S.? The strength of the U.S. dollar against foreign currency is still a bit of a — it's a big of a restraint on how fast the Fed will raise U.S. interest rates, but we don't think it's going to prevent the Fed from raising rates again this year.

Now, specifically, for what we're expecting for the rest of 2017, the Fed concluded an open market committee meeting on Wednesday. They said that they think that with gradual additional rate hikes, the U.S. economy can continue to grow moderately, and they think that the economy's conditions will be consistent with getting their inflation target right seeing price stability over the medium term, meaning over sort of an 18- to 24-month to 36-month time horizon. And so, that is a sign to our minds that the Fed is quite likely to raise interest rates at its next meeting, in June, so next month. And we also think that if the U.S. economy continues to grow at a moderate pace — which is what's in our forecast — we have 2.3% real GDP growth in the outlook for 2017. We think that we'll get another rate hike in December of this year, or sometime in the second half of this year. And then probably three additional rate hikes in 2018.

This is a considerably faster pace of interest rate hikes than we saw earlier in the recovery, earlier in the normalization of U.S. interest rates. We had just one interest rate hike in 2015, just one interest rate hike in 2016. So, with a tighter labor market with less of a restraint on CPI inflation from falling commodity prices, falling prices of oil, of food commodities, there is more room for the Fed to be raising interest rates at closer to a normal pace. The Federal Reserve still describes this pace of rate hike as gradual, meaning that they're not expecting to raise interest rates at every meeting that they hold, and meaning that they're only raising interest rates by a quarter of a percentage point per hike, not half a percentage point, as they sometimes did in decades past. But nevertheless, the direction for interest rates is up on the short end of the yield curve on short-term interest rates.

Now, on longer-term interest rates, it's a very different story. Longer term interest rates, and here we have the 10-year treasury bond yield, which is a benchmark that is closely tied to the cost of borrowing for private borrowers over longer time horizons, that had been trending down pretty steadily into late 2016. And then we saw a big jump in long-term borrowing costs both for the U.S. government, and that's the borrower who is borrowing this 10-year U.S. treasury bond, as well as for private borrowers, whose borrowing costs are indexed against, effectively, against the cost of borrowing for the government. And what that was was following the U.S. election, there's expectations for stimulus programs from the U.S. government and other policies that would tend to put upward pressure both on GDP growth and then possibly also on inflation over the near term, and let me talk about what some of those are.

So, the upside risk to interest rates over the next couple of quarters, first on this list is the proposal for fiscal stimulus from the government. From the macroeconomic perspective, if we cut taxes and if we increase spending on infrastructures program without having offsetting cuts to other types of government spending on a one-to-one basis, what that does is leave more money in the economy for more private demand and more economic growth. And when there is economic growth that is creating more demand for workers and more hiring at a time when there is not a pool of people looking for jobs like there was earlier in the recovery, when the unemployment rate was much higher, that tends to put upward pressure on inflation. Similarly, the proposals for changes to U.S. trade policies, tariffs on imports could tend to — would tend to raise the final cost of those imported goods for consumers in the United States. That goes into the CPI basket that puts upward pressure on inflation.

And, finally, changes to U.S. immigration policy, U.S. immigration enforcement. According to independent studies, there's approximately 8 million workers in the U.S. labor force who are, depending on the term you prefer, either undocumented or illegal immigrants, and if there were an 8-million-person decline in that labor force, that would amount to a very sudden tightening of the labor market, which would also tend to upward pressure on inflation. Similarly, on the downside risk to interest rates, if the changes to U.S. fiscal policy result in big spending cuts, just as stimulus that leaves more money and the economy tends to add the growth, if there are spending cuts without offsetting tax cuts or spending increases, that would tend to subtract from our economic growth.

Secondly, the border adjustment tax. This is the proposal to change the U.S. corporate tax system, funding more corporate taxes from taxes on imports rather than on corporate profits in the United States, and changing the structure of corporate profit taxes. Economic theorists will tell you that that would cause the U.S. dollar to appreciate, and a stronger U.S. dollar might actually mean that net-net at the end of this, foreign prices, even with the taxes included, are lower than they were prior to the change in fiscal policy. So, maybe that would be a downward pressure on inflation and cause interest rates to rise more slowly. And, similarly, there are a lot of tail risks to the global economy. The geopolitical tensions in the Middle East or with Russia, the rising U.S. oil production, which if it sort of continues to rise on an open-ended basis, could add to a global glut of oil and put downward pressure on oil prices and vulnerabilities in emerging markets, like China. China fueled a lot of global financial tensions in early 2016. The vulnerabilities in China that we were concerned about at that time are no longer a focus of global capital markets but could easily resurface.

So, there are a lot of uncertainties that we know about right now, but we can't really quantify how they're going to affect interest rates, because we're not sure if these seemingly unlikely events are going to happen and, if so, what the magnitude of their effect would be.

Now, finally, the last sort of "known unknown" about the outlook for U.S. interest rates is what the Federal Reserve will do with its balance sheet. The Fed over the process of quantitative easing over the course of the Great Recession and the recovery from it acquired this huge stock of government bonds as well as bonds issued by the mortgage finance, government-sponsored entities that finance mortgages in the United States. That's held down long-term interest rates, but the Fed has started talking about how it wants to begin to reduce its holdings of those bonds, and that would tend to put some upward pressure on long-term interest rates as that policy unfolds. They haven't really said how they're going to do it, the pace at which they're going to do it, how they will coordinate their changes to the size of their balance sheet with their changes to short-term interest rates. And so it seems like given what Fed policymakers are telling us, the beginning of reductions to the balance sheets are likely either late this year or perhaps early next year, but I think that's the most we can say with certainty right now. Or we can't even really say with certainty, we say that it's likely. And that is a big source of possible surprises to the outlook as the rest of this year unfolds and as we look to 2018.

So, with that, I've talked you through where we see U.S. interest rates and some of the areas of uncertainty around them, and I will turn it over to Matt to talk about what you and your companies can do to manage some of that uncertainty. Matt?

Matt Gelles:

Excellent. Thank you very much, Bill. Appreciate the very thorough overview there of the various inputs that the Fed will be looking at to adjust policy and how they may look to move rates moving forward. So, once again, good afternoon, to everybody on the line here. And just to reintroduce myself, as Jim kindly introduced me before, I'm Matt Gelles. I'm a member of the Derivative Products Group here at PNC. Our team's key role here within the bank is to work closely with you all, all of you on the line here, our clients, to make sure that you have a very thorough understanding of how movements in interest rates may affect your financial position. And along with that, we also assist and work very closely with you in tailoring customized solutions to hedge risk to interest rates.

So, building on Bill's fantastic discussion of the economic environment and the interest rate environment, and our expectations for rates over the coming years, my key objective here for everyone on the line today will be to gain a more thorough understanding of interest rate risk management. In order to do this, we will begin with a bit of a bridge from the review of the economy and expectations for the Fed that Bill had provided for us, and how that directly affects the borrowing cost of your companies. Next, we'll complete a high-level overview of interest rate risk management, a few of the key angles that we find our clients take to approach the topic. Third, we'll take a look at a couple of sample situations so you can see some live examples of — in taking into account how increasing interest rates can impact some hypothetical companies that we have selected here, given their existing debt profile. And additionally to that, we'll take a look at how a company's risk to interest rates can shift if they're making a transformative transaction for their company. And, lastly here today, my goal for you is to discuss the key products that are utilized to manage interest rate risk and the way these strategies can once again, as I started here, be customized or tailored to meet your company's specific need.

So, we'll look here at slide 10 in the presentation, and you'll find here the economy and expectations for rate increases by the Fed and how they see through to impact the key borrowing rate in many bank credit facilities. And so you'll see here the reference to the LIBOR rate, or London Interbank Offer Rate, which is an interbank borrowing benchmark, which many bank credit facilities are priced from. And this LIBOR rate is a short-term variable rate of interest and can subject your company to volatility and increases in your interest expense.

With the Fed having increased rates, as Bill had mentioned, several times over the recent 18 months, back in December of 2015 and December of 2016, and then most recently, in March of this year, LIBOR has already moved higher in tandem, as you can see on the chart on the bottom right-hand side of this slide. And so with one-month LIBOR close to 1% today, it's actually up, believe it or not, over 80 basis points from its lows in May of 2014. And so what we did also in looking at the relationship between the Fed's key rate that we discussed here and that Bill had discussed in his section of the presentation today, the relationship between the Fed's key rate, the Fed fund's target rate and LIBOR shows that there is a very high correlation over the most recent 30 years, about 99% in fact. And you heard earlier, PNC's forecast for the Fed funds target rate, and the chart on the bottom left here displays the median expectation for the Fed's target rate from the Fed themselves.

And so what we're looking at here on the bottom left-hand side of this chart, the Fed provides us this forecast here through their summary of economic projections, or the SEP. And the SEP is one of the Fed's communication tools that they have to the market. And it is attempting to provide market participants, trying to provide us a guideline that if economic growth, real GDP here in the chart, if the labor market as described here as the unemployment rate, and how Bill had described it earlier in the presentation. And then, lastly, inflation. If those benchmarks perform as the Fed has forecasted here, that they anticipate that the Fed funds target rate should be at those levels that you see in the top of the chart there, at 1.375% at the end of this year, which gives us two more hikes in 2017, 2.125% at the end of 2018, and then 3% at the end of 2019. So, talking about, once again, two additional hikes this year and then three in 2018, and three more in 2019. So, given the correlation to LIBOR, as we described earlier, this would put a company's base borrowing cost before their credit spread from their loan facility at a fairly consistent level with the Fed's target rate that you're seeing here.

Now, we're talking a bit about how the interest rate market is shifting here and we're seeing upward pressure on interest rates, but certainly interest rate risk management is important in any market environment. So, I'm going to turn here to the following slide and we'll dive into the topic of interest rate risk management in a bit more detail.

So, interest rate risk management is the ongoing process of identifying and quantifying a company's financial risk related to interest rates. As mentioned before, when I introduced myself, our group is here to assist you in this process in quantifying and identifying your risks and, additionally, tailoring strategies to help you to mitigate this risk. So, we find out in the market, when we're working with our clients, we find that companies take a variety of approaches to managing risk. But most want to have at least a portion of that hedged or fixed, because this is going to offer more stability for your earning streams, and also may enable you to more effectively take educated risk with other variable costs inherent to your businesses, where you may already have a competitive advantage and be more comfortable with taking those risks.

And assisting our clients with a starting point in their thought process for managing their risk to interest rates, we do find a pretty consistent starting point in this process, a neutral position, if you'll have it, of about 50% fixed and 50% floating, as this gives you a starting point where you're agnostic to the future path of interest rates, up or down. Adjustments to this mix of fixed and floating rates in your debt portfolio take place from this starting point based on more company-specific elements, and these elements we've listed here on the page for you. The first includes the financial position of the company via your leverage profile, so how much financial risk you may have based on the amount of debt to your operating cash flow that you have. And then also your ability to cover your interest expense with those operating cash flows. Other key inputs to tuning that dial from that 50/50 starting point could include the type of industry or specific risk that your company may have, if you're a cyclical company, for instance. The other considerations that you may have are if you are able to pass along any movement in interest rates to your clients, whether that's positively or negatively affecting.

The other key factors to look at as you're projecting out over the next couple of years what your anticipated future debt levels may look like. Could that add additional financial risk to your profile, where interest rates may be a further risk to you, so you may turn the dial in a higher direction of fixed rate debt.

And, lastly, what we commonly find with our companies that are private companies and not in the public company space, management themselves will often have a particular approach to how conservative or not conservative they may want to be with their approach to managing interest rate risk, which will once again turn that dial in on direction or the other from that 50/50 starting point that I described.

So, to demonstrate what you may look at with respect to a current interest rate risk position, take a look at the following slide here. And what we're taking a look at, we're assessing a hypothetical company that has in their debt profile on the right-hand side of the page, this company has an existing revolving credit line, a term loan, and a mortgage that are all currently based on the LIBOR rate that we described earlier which, once again, is a floating rate of interest. The company in its debt capitalization has exposure to some fixed rates via the capital leases that the company has. And so you can see that only one-fifth of the company's total debt is currently fixed or hedged via the fixed rate capital leases described. And so in the interest rate market environment that Bill described in his part of the discussion today and the bridge that I had earlier and that effect on LIBOR rates, should we follow that path, the company is exposed on 80% of its debt to their borrowing cost increasing. And so just that 80% effect is one of the main factors on a spot basis here, looking at the company's position as of this period end date. But there is also other ways you may want to dig into your current debt profile to see if there is any other risk to interest rates that may be inherent into it.

So, one of the big factors that is often overlooked is under the revolving credit line, if there is some seasonality there, where there could be higher balances throughout the course of the year because of how your business cycle may work over the course of the calendar. So, with those higher balances as interest rates would rise, that would certainly expose the company to more risk to interest rates.

The other factors here, as you're looking at the particular pieces of debt, it's very important to understand the maturity profile of the credit facility that you have. Even if the described term loan here and mortgage, if they were actually fixed or hedged with some of the products that we'll describe later; if this debt were coming to a maturity over the next year or years and had a balloon associated with it at its maturity date that you'd be looking to refinance with some debt, it would further expose the company as rates would move higher, or as they move from now until the point of refinance. So, you have that as a potential risk to interest rates as well. That's an important consideration when you're evaluating your current debt profile.

We have other key questions here, that when you're looking at your current debt profile that you would want to answer and that play into, from the previous slide, on how you may want to look at that mix of fixed and floating rate debt that you have, and what level of risk that you're comfortable with.

That's looking at a company's current profile and where there could be current risk to interest rates. Another very common situation that we find is, when we're working with a company on a financing for a potential, very transformative type of transaction. And on the next slide here we see a company that is looking at taking on some additional debt capital in order to finance an acquisition in this case, utilizing a bank loan, which has, of course, a floating rate profile to fund it. And so the company that we're taking a look at here previously managed to a level of just over 50% fixed to total debt, so they had a policy that they wanted to have a nice diversified profile for their debt out there. So, with the overlay of adding in the new debt to the transaction here, you can see how that would materially change their profile here going from that over 50% fixed to total debt more down to being underweight fixed rate debt versus their total debt profile.

And so this company not only has that particular risk where it's no longer meeting what its policy was, what its hedging objectives were, it's also taking on additional risks pertaining to the transformative transaction that they're putting in place. So, this could also call for asking the question internally, when I'm making this very material transaction to our business, do I even want to go a step further and reassess what my policy is? Do I want to mitigate further risk to variable interest rates and shift my previous, about 50% fixed profile, to perhaps a level that may be 75% or greater given the risks that are common with an acquisition, including having a bit tighter cash flow at the onset as the companies integrate with each other. And, of course, taking on that integration risk that is related to the transaction.

So, given the risks that can be inherent in a company's current position to interest rates and, of course, with how the interest rate profile can change materially due to an important transaction for the company, we'll now take a look at some of the key products that are utilized to manage risk, to mitigate risk in the rising interest rates.

The most common in key products that we work with clients to structure, to manage their risk to interest rates are displayed here. The first one is the interest rate swap, and really out of the two, the most commonly used. The swap in profile here, the swap is used to utilize to fix — which is the key here — to fix the cost of capital related to current or even anticipated future floating rate debt. This fixed rate profile will provide a given company with a mitigant of course to increases in short-term floating rates. And then provide that certainty around budgeting with fixed cash outflows related to the debt that they have in place.

The other key product on this slide here, you'll see, is the interest cap, and the cap is also an effective tool to manage risk, but it doesn't actually achieve a fixed rate profile for you. So, what the objective of the cap is, of course, not to fix the rate on the credit facility but to provide a maximum rate of interest while still keeping a variable rate profile. And this maximum rate is put into effect under the cap in exchange for a one-time cash premium that is paid to the bank at the onset of the transaction. And I alluded to before and I'll mention again, the swap product is definitely the most commonly used that we see in practice, and it's the case there, because quite often companies that we're working with prefer to have the comfort of knowing that their cost of capital is fixed versus having that variable profile with a cap.

So, both of these strategies also further set themselves aside due to their ability to be customized. That's one of the most important parts here. In addition to the profile that you're getting with each of the products is the ability to fully customize these products to meet whatever your objective is. So, not only with utilizing your underlying debt here that you're using to fund important projects or acquisitions at the company level, or your revolver for ongoing working capital purposes. So, not only are you able to source your most efficient source of capital with these products here, but you're also — you're separately using the swap in the cap and tailoring specifically to meet the company's objectives.

So, there's a couple ways that you're able to customize these products to meet what your objectives are. And the first is how much of a particular debt facility that you may hedge. And so, for example, if you're looking at a \$5 million financing, you could use either of these products to customize the hedge only a portion of that total. So, if you wanted it to be 50%, that would be \$2.5 million of that \$5 million financing that you're looking at. So, that's the first way that you're able to customize these products to meet your risk management objectives.

The second key way that you can use these products and customize them is you can actually decide when the hedge begins. So, that can be now. You could enter into these contracts and have the effective date of the contract be today, or you can actually choose a future date when the company is forecast to be subject to interest rate risk.

The last way that you can customize these contracts here is you can choose how long the hedge is in place for independent of the term of the debt. So, this could be a shorter term than the term of the debt, it could be the same, or in some unique cases you can actually structure these contracts if you are expecting debt to be outstanding beyond the term of your bank commitment. In some of these unique cases you can actually structure your hedge to exceed the term of the loan that's in place. So, a lot of flexibility, a lot of ways that you can customize these products to really meet what your individual situation is.

What we've done on the following slide here is just further outline various ways that you can customize the products, and we broke down a couple of those as described here. But what we've done here as well, just to further dig into how you can utilize the swap product, we first here have the forward-starting interest rate swap, which I discussed how you can customize the products on the prior page, the hedge debt that could be effective at a future date, where you could be subject to interest rate risk. And so this is a very common structure that we find utilized, the forward-starting swap. This is a common structure that is utilized, the hedge, a future term loan, or a mortgage that finances out the draws under a credit line for progress payments on equipment line or perhaps construction borrowings related to a mortgage. So, what this forward-starting strategy enables you to do is, you're able to lock in your rate in today's market environment without having to wait until the end of, say, construction or when all the equipment pertaining to a particular capital project is delivered to lock in your interest rate. So, you're able to identify and lock in what your cost of capital is going to be over the longer term of the financing without having to wait until the effective completion of the construction project or for that equipment to be delivered. That's the first, more customized approach.

The second here describes, once again, is the partial hedge, and this particular strategy may be utilized, and we find it utilized for two unique purposes. Firstly, a company may want to, as we have been discussing here and looking at your interest rate risk, the company may want to have diversification of the interest rate profile related to either a particular loan or, as we described before, a portfolio of debt. So, that way, if interest rates rise, you're protected on a portion of that debt, and if rates fall, there is some benefit there as well, having a mix of fixed and floating rate debt related to either a particular instrument or several instruments in your portfolio.

The other reason why we find companies utilizing the partial hedge, and once again this is customizing your hedge, if you want to have certainty in your rate profile on a portion of the debt that you're taking out. But you may also have in mind that you would like to freely prepay a portion of that loan prior to when it's contractually scheduled for you to do so under your loan agreement. Having that piece of debt that is floating and the other portion of it fixed, you are able to prepay that piece that is floating really without having any concerns with early termination risk. So, that's another important way — in digging into these customized strategies in more detail — which we find our customers utilize.

And last but not least here, the last customized strategy reviewing here is the callable or cancellable swap. And oftentimes we find that clients do want to have fixed rate protection on their credit facilities, but there is that ongoing concern about having to perhaps make a termination payment to the bank should they pay off the debt early. This early termination risk is a feature that certainly consists amongst many fixed rate contracts including swaps that we're describing here today. And what this strategy provides is that fixed rate that you may be seeking, but it also has the related impact of embedding into the structure the ability to pay off the debt early, terminate the swap on predetermined dates, and eliminating or mitigating that risk of having an early termination payment. That could be due to the bank. Note that in this structure in putting this together, there is typically a slight premium to a traditional fixed rate, to have that flexibility, but it's an important detail that you can add — a very flexible detail that you can add to the swap to further customize it to what your need is.

For the audience's benefit, we did have on the following two slides, just to dig into further scenarios in utilizing the forward-starting swap that was described, and then once again an example of the callable swap for your takeaway here. And certainly if there are any questions on these particular scenarios, we can certainly respond to you in due time there. And overall, what we strive to do today here is educate you on the current market environment and some of the common approaches to both your thought process and strategies around interest rate risk management. Given the expectation for higher interest rates over the coming years, certainly work closely with PNC's Derivative Products Group to understand your particular situation, create a plan of action, and put in place the key relationship and regulatory documents that will enable you to act in a very flexible fashion to put your hedging strategies in place in the future. I'll now turn it back over to our moderator, Jim Bernier, to conclude today's webinar.

Jim Bernier:

That's great. Thanks, Matt, and thanks, Bill, also. Really great overview and some really great material. We would now like to open it up to questions. As a reminder, you can ask questions using the Q&A window located on your screen. If you do not see the Q&A window, please click on the Q&A widget found in the lower center portion of your screen. Okay, let's take a look at our first question. I think this would be for Bill. Bill, how will the Fed react if financial markets and interest rates become more volatile as the Fed's balance sheet shrinks?

Bill Adams:

Thanks, Jim. I think that — the very short version of the answer to that question, I think, is — I don't know. I think in general, the Fed tries to make policy to target employment and to target inflation, not to target a level of stock prices or of interest rates specifically. But when there is significant volatility in the stock market or in other capital markets, the Fed does take notice of that, and it has stayed the Fed's hand or slowed the pace at which the Fed has been raising interest rates earlier in the recovery.

One of the reasons why we're forecasting three rate hikes in 2018 rather than four rate hikes in 2018, is because the Fed is signaling that they're going to begin this reduction in the size of their balance sheet later this year into early next year. And there seems to be a good chance that either there will be some financial market reaction to that or, at the very least, the Fed will want to wait and see after it starts changing the size of the balance sheet and see what the reaction of private capital markets is before it goes ahead and continues to move with short-term interest rates. But I think the most direct answer we can give to this question is the Fed has never done it before. This is the first time they've ever had this \$4.5 trillion balance sheet. Quantitative easing was largely successful in lowering long-term interest rates, boosting the housing market in the recovery, but they've never had to exit from this policy before. So, the plans they have so far sound like good plans, but don't have a track record in actual practice yet.

Jim Bernier:

Great. Thanks, Bill. Definitely uncharted territory. I think we'll direct the next question to Matt. When our company has borrowed from banks in the past, it has just been structured as a fixed rate loan. What benefits are there to utilizing an interest rate risk management product to achieve a fixed rate profile compared to how we had previously operated?

Matt Gelles:

Very fair question there, and we certainly get this question all the time as our clients transition over to utilizing interest rate risk management products, such as the swap that we've described in the presentation here today. So, we certainly acknowledge that the fixed rate loan that you may have utilized in the past, it does, of course, create that fixed rate profile for your borrowings, but that's really where the comparisons to taking the interest rate risk management approach that we talked about today and the related products ends. So, firstly, when utilizing an interest rate risk management approach, you are separately identifying your most efficient or cheapest source of funding, and then distinctly formulating an approach to how that source of that may be subject to interest rates and affect your financial position. So, once again, you're identifying and quantifying that risk and then coming up with a solution to meet your particular objectives. So, historically, by just using the fixed rate loan, as I said before, you may have achieved that fixed interest rate, but you may have passed on finding perhaps a better funding source and then customizing your fixed rate solution to more appropriately to how your corporate objectives and your interest rate objectives may be, which could have been a better combination of costs and risk. And so we outline some of these more customizable features to how you could utilize the products to more meet what your risk management and cost objectives are in the presentation. And those included the partial hedge that we described, certainly, the forward hedges, of course, and the callable or cancellable structure.

Secondly, when comparing using the interest rate swap in particular, and interest rate risk management product, we discussed a bit early in the presentation we were talking about the callable or cancellable swap. We described a bit in that part of the presentation early termination risk surrounding a swap. So, interest rate swaps do present the risk of having to potentially pay the bank a payment if terminated prior to the scheduled maturity, which at a very high level is consistent with what a prepayment penalty would have been under a traditional fixed rate loan that you may have had in the past. However, with the swap, it also provides the opportunity for users of this product to actually receive a payment if you're terminating the swap prior to its scheduled maturity in the case that comparable interest rates at the time that you are terminating it are higher than the rate that was originally locked in with the swap. So, a very huge benefit versus the traditional fixed rate loan, which, when interest rates are higher, the bank gets its capital paid back to them and is then able to reinvest it at a higher rate. With a swap, you are able to get passed back some of the benefit of interest rates being higher at that time that you may be paying the bank back and terminating the swap.

And then, lastly, we mentioned the customizable aspects, of course, but going to some of the more flexible ways that the swap — some of the more flexible features the swap has versus a fixed rate loan. Swaps are actually, because they are independent from your loan, they're actually transferrable between debt instruments. So, for example, if you have a swap on a term loan and you want to pay that off, and you have revolver balances that have a variable rate associated, you can actually transfer that swap from hedging the term loan over to that revolver.

And then, additionally, you can actually transfer swaps between financial institutions as well. And so we've worked with clients where PNC has been refinancing out the banking relationship for our customer from a previous banking relationship, and we're able to in many cases transfer the swap that they had with the prior institution over to us, so that would mitigate a cash event that they may have to owe that former financial institution a payment when they were coming over to PNC. So, a variety of ways and benefits of using the swap product as a fixed rate mechanism versus the more traditional fixed rate loan structure that many companies may have seen in the past.

Jim Bernier:

Great. Thanks, Matt, a lot more flexibility and some more potential benefit there. This would be a good follow-on question to that, Matt. If I enter into an interest rate swap and I still prepay my loan, what happens to the rate risk contract?

Matt Gelles:

That's actually a perfect transition there, given the response to the prior question and some of the additional benefits of the swap over the fixed rate loan. So, if you do have a situation where the best utilization of your company's cash is to prepay the loan balance, you are able to prepay your loan freely, if that is the best use of your cash. But it's also important, if the swap is in place, that you're taking a holistic look at your positions between the loan and the swap. So, working closely with the relationship team and our team here, we can analyze your desire and your use of that cash to prepay the loan. And then the termination cost or benefit, as I just described, pertaining to a swap that may be in place, and see if that remains to be your best use of cash at that time. So, having the swap in place does not preclude you from prepaying a loan. If that's the best use of your cash, you are able to do that. I would just caveat that with saying that we take a more holistic look and see if there is any benefit or consideration related to the swap in conjunction with that early payoff.

And then I also alluded to the further flexibility of the swap in that situation. If you have two separate loans in place that are variable rate in nature, that you did want to prepay to the term loan but had revolver balances out there, you could move the swap over to hedge that alternative debt instrument and be able to use your cash to prepay one of those facilities.

Jim Bernier:

Perfect. Thanks, Matt. Let's jump back to Bill for a minute. Bill, crude oil prices hit a five-month low today. What does that mean for your forecast?

Bill Adams:

Well, I think — which crude oil prices? The level right now is somewhere, last I looked, we were around \$45 a barrel. And that, I think, is pretty close to where PNC economics has oil prices averaging over the course of 2017. We have, I think, a modest increase in oil prices in our forecast for 2018. So, I think with oil prices at this level, I don't really think that changes the forecast. I think if oil goes back to \$25 a barrel, if oil were to go to \$15 a barrel, and I don't think that's going to happen, but I didn't think that a couple of years ago the oil would be at \$45 today, either. I think if we see a continued further sharp decline in oil prices, that could create the same sorts of concerns about the outlook for the energy industry and industries that do business with it, and U.S. manufacturers who sell into energy, that slowed the U.S. economy in 2016, and I think the Fed could react to that. That could put some downward pressure on interest rates because of expectations of slower growth of the energy side of the economy. The Fed doesn't, probably doesn't take a huge interest in short-term oil price fluctuations as they affect inflation, because of all of that tends to wash out of the CPI index over the course of 12 months or so. They're more looking at a little bit longer of a time horizon for making interest rate decisions. But I think, net-net it's probably a reason for interest rates to be a bit lower, or to rise a little bit more slowly. And that's if we get a bigger move lowering oil prices than we've seen so far.

Jim Bernier:

Great. Thanks, Bill, and I'm looking at the time, I think we're just about out. Let's just do one more quick question. Bill, again, doesn't the unemployment rate understate the true level of unemployment in the U.S.?

Bill Adams:

Great question. So, the unemployment rate is, it's asked a very specific question about have you — do you want a job and have you searched for a job in, I think it's the most recent three weeks or six weeks, and there are lots of people who have a job but it's part-time and they want to be working full-time. Or they want a job but they don't think that one is available. Or they've dropped out of the workforce and have taken long-term disability or early retirement, but think that they could have a job if they were looking. So, we're not capturing those measures in the unemployment rate. But whichever measure of the labor market you're looking at, whether it's wage group or claims for unemployment insurance, or the unemployment rate or the broader unemployment rate, they all point to a labor market that has improved dramatically from the depths of the Great Recession to today.

Jim Bernier:

Perfect. Thanks, Bill. And I think we're going to be out of time for questions. I know we did have a couple of other questions out there. We'll try to follow up with everybody with email. Again, would like to very much thank Bill and Matt today for really great presentations, and you both provided some really great insight and perspective. And, of course, we also want to thank all of you for attending. A PDF of today's presentation as well as a CTP certification credit and a recent investment outlook update is now available for you to download in the green resource list file folder widget. It's in the lower center portion of your screen. You will also see a link to a short survey on your screen. Again, your feedback is important to us, and we really greatly appreciate your thoughts of today's session and presenters. Again, that helps us more tailor next presentations to the types of things that you're most interested in hearing. With that, this concludes our presentation today and thank you again very much for joining us.

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