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BBVA Research

# U.S. Economic Outlook

July 2018

Creating Opportunities

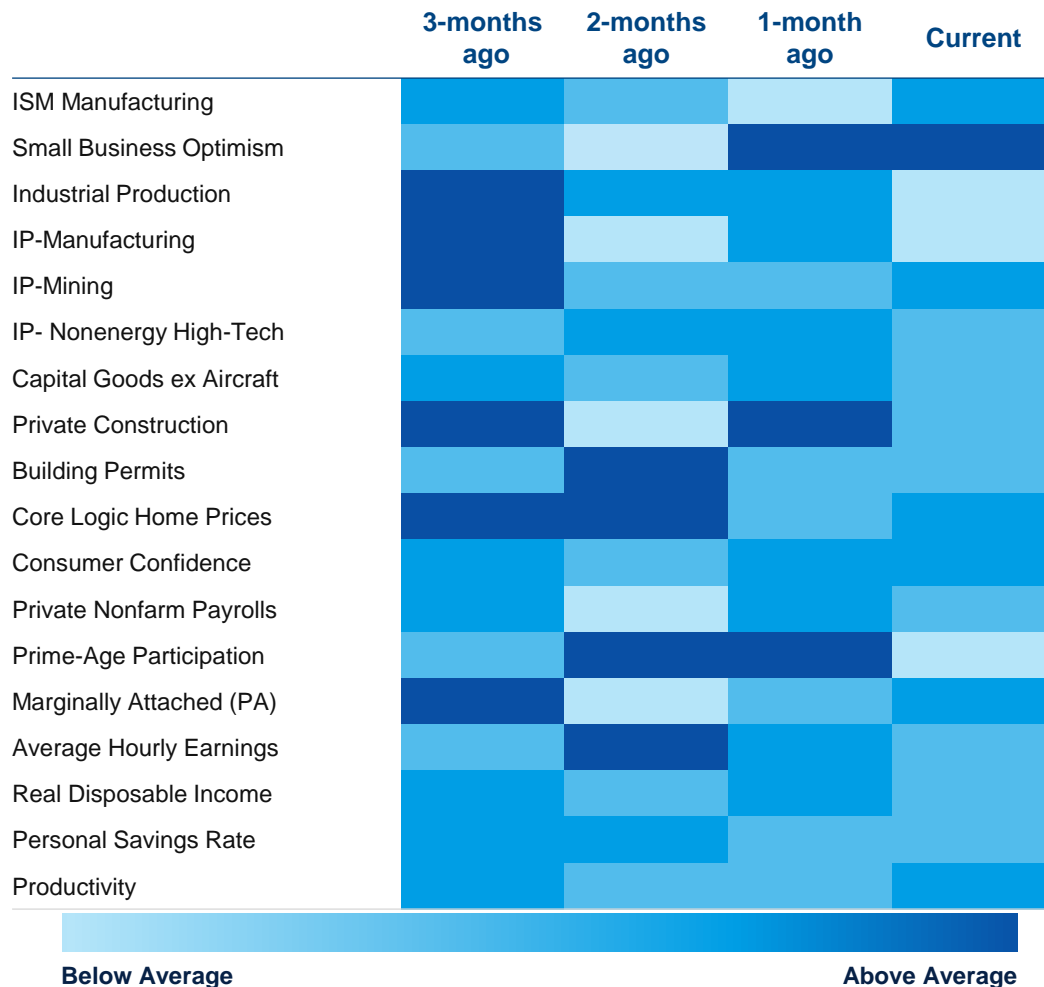
## Economic Outlook



- High growth and inflation will continue in 2018 & 2019
- We now anticipate that the Fed will raise rates **three times in 2019**; for 2018, we maintain our baseline scenario of **hikes in Sept. & Dec.**
- **Despite elevated volatility in the employment surveys** we maintain our outlook for ongoing tightening in the labor market; **unemployment rate to reach 3.7%**
- With the additional tailwinds from the expansionary fiscal policy, **we expect core PCE to rise above 2%**
- Economic fundamental continue to **support gradual rise in 10-year Treasury yields**
- The yield curve slope between the **10-year and 2-year Treasuries will flatten further, but remain positive**
- **Oil prices** to converge to **long-run equilibrium** despite short-term volatility

# Economic activity

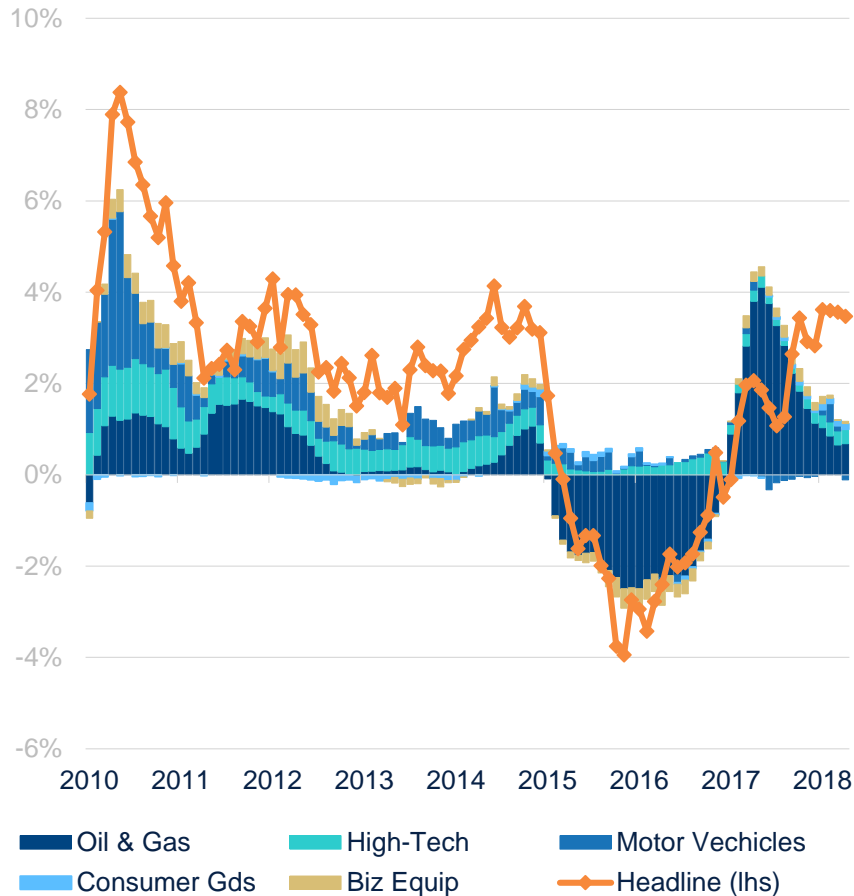
## Real-Time Economic Indicator Heat Map



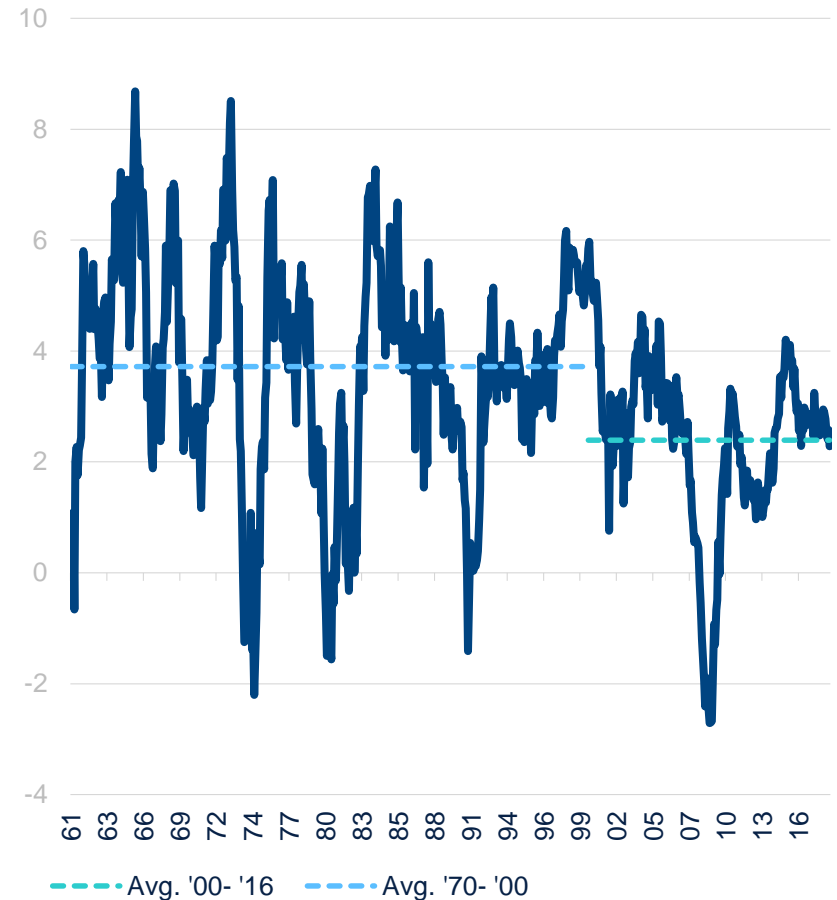
- Industrial activity remains strong, but is slowing
- Favorable oil prices supporting growth in mining strong, as excess capacity shrinks
- Durable goods orders excluding aircrafts slowing after torrid pace in 2Q
- Moderate rebound in labor productivity in 1Q
- Solid growth in disposable income
- Home prices growing on account of tight supply conditions

# Economic trends: Growth in mining sector stabilizing

## Industrial Production (Year-over-year %)



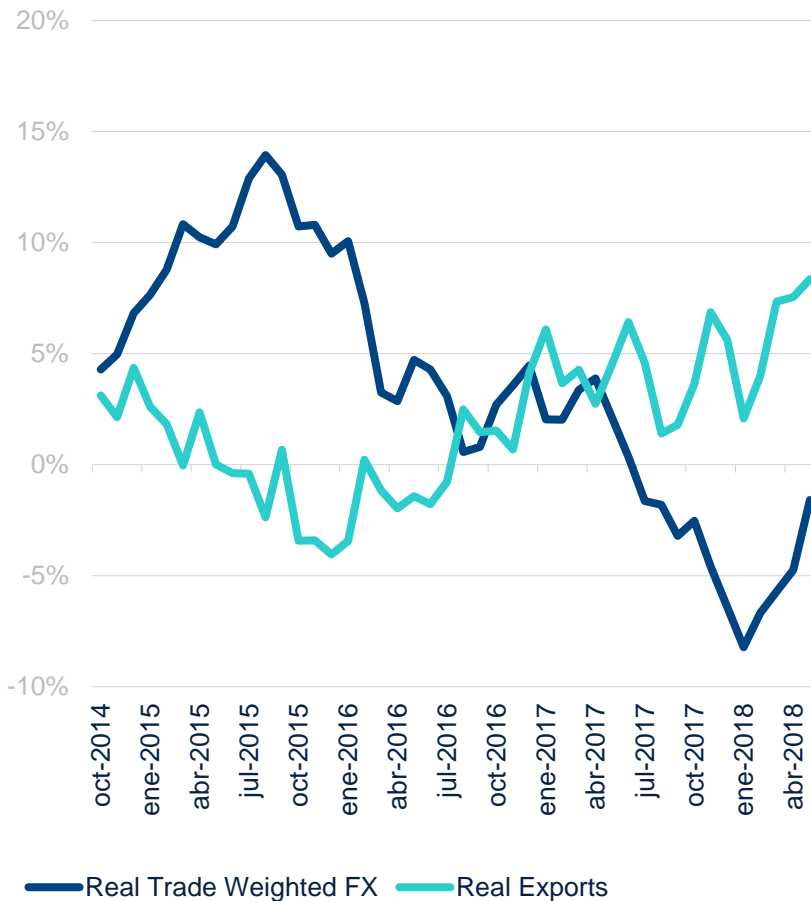
## Real Personal Consumption (Year-over-year %)



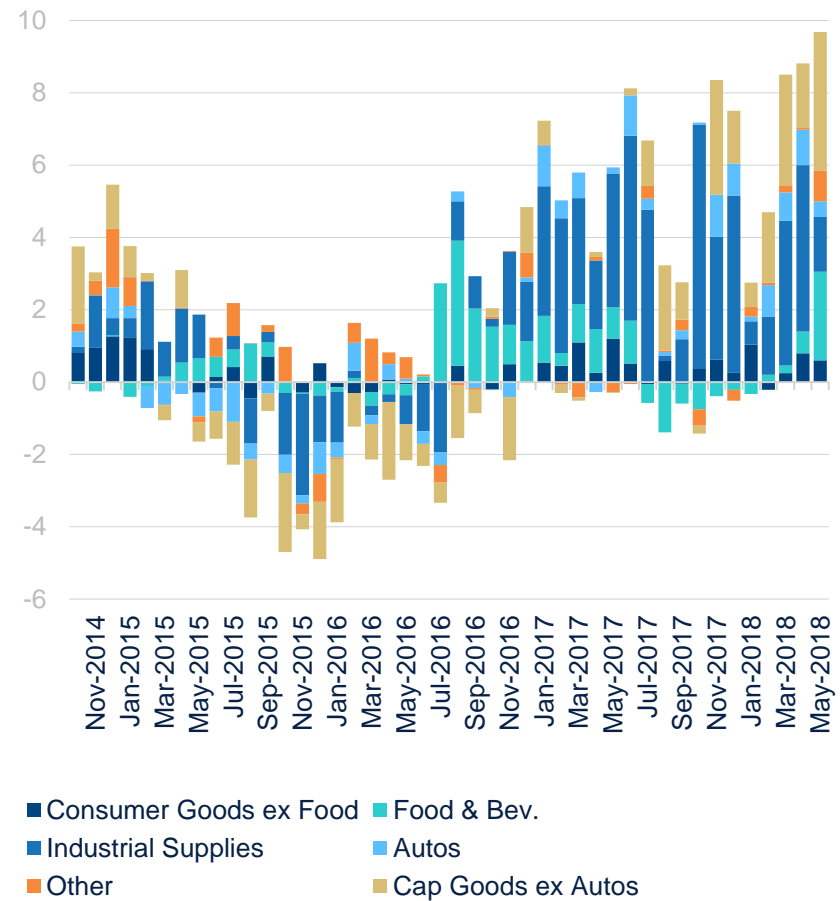
Source: BBVA Research, FRB & BEA

# Economic trends: Export activity strong despite trade-war build up

## Real Exchange Rates and Exports (Year-over-year %)



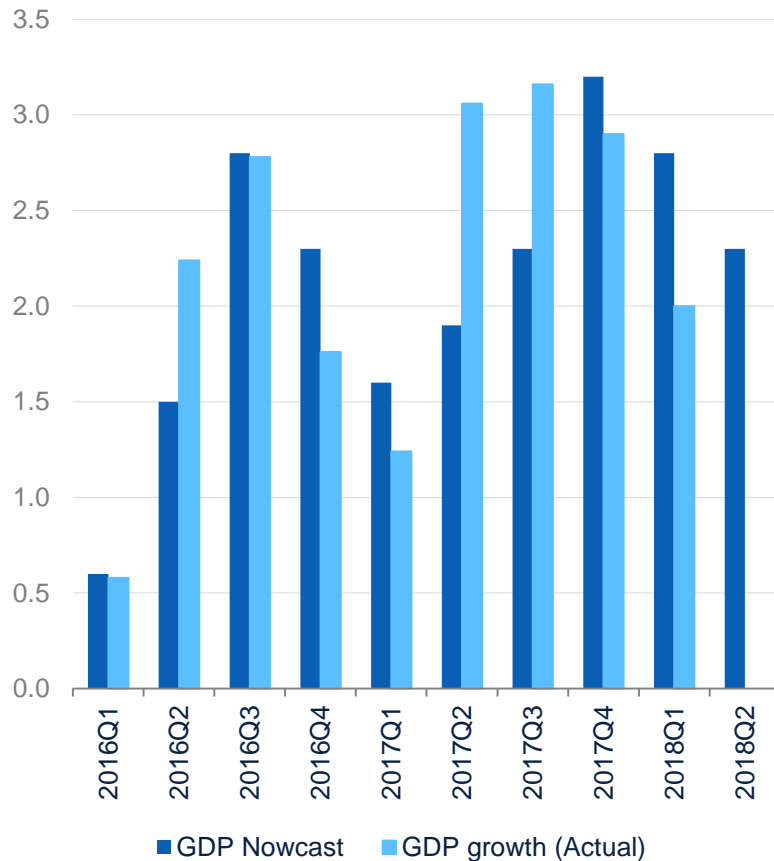
## Real Exports (Contribution to year-over-year %)



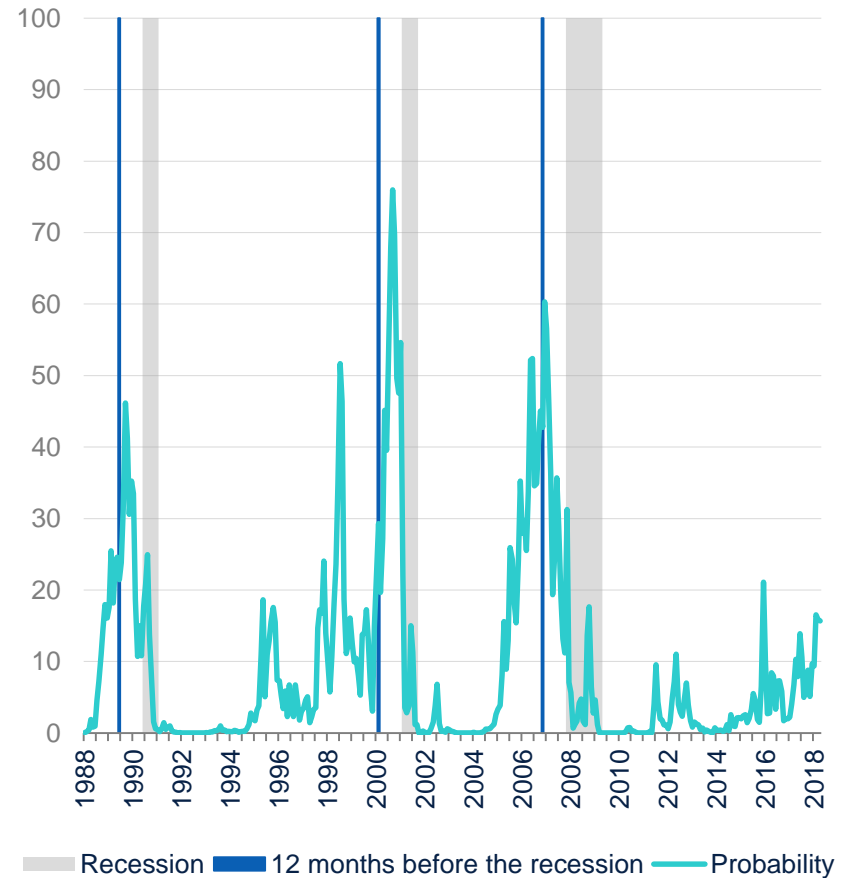
Source: BBVA Research, FRB & Census

# Economic trends: Strong GDP growth in 2Q with stable recession risk

**Real GDP**  
(QoQ SAAR, %)



**Probability of Recession in 12 Months**  
(%)



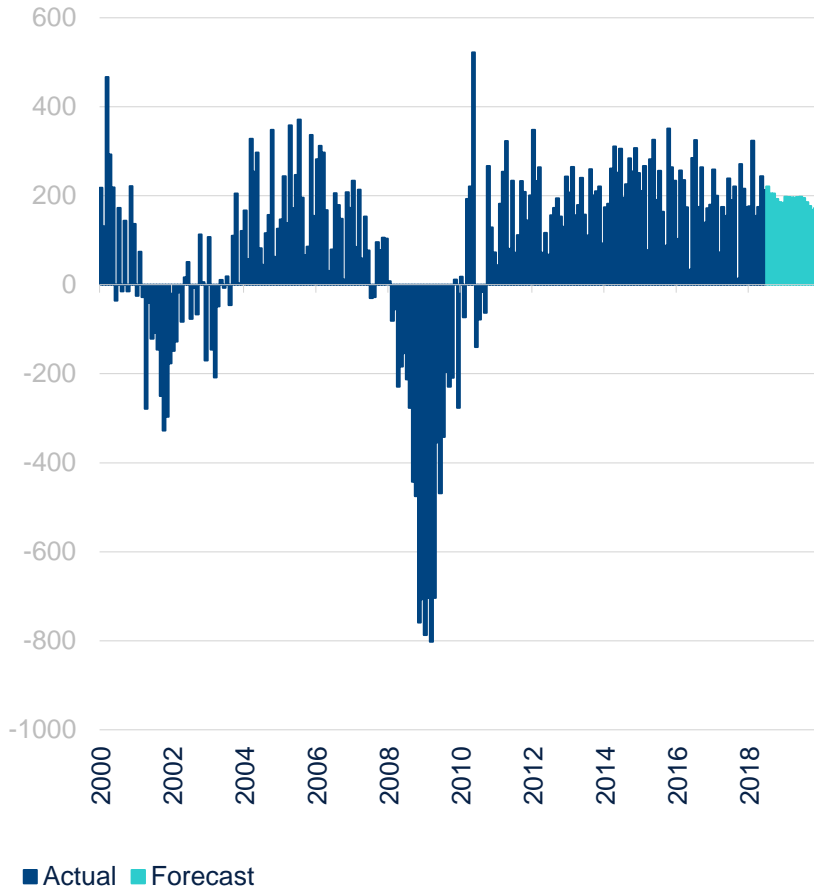
## Labor Market



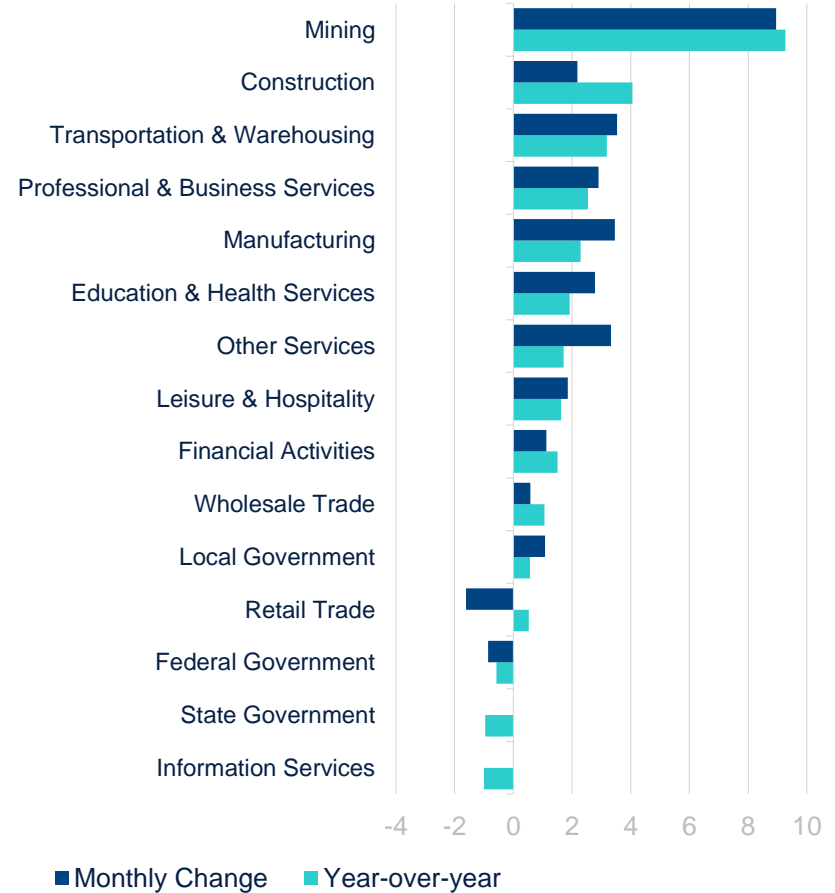
- In June, nonfarm payroll increased by 213,000, supported by professional and business services (50K), manufacturing (36K) and health care (25K)
- With 21.6K jobs lost over the second quarter, the retail sector continues to be a source of weakness
- The unemployment rate unexpectedly edged up to 4% from 3.8% on the back of a large increase (601K) in the labor force and soft gains in household employment
- Given the volatility inherent to the household survey we are not changing our outlook for the labor market in 2018; we continue to expect unemployment rate to reach 3.7% by mid-2019

# Labor market: Another month of strong employment growth ex retail and government

## Nonfarm Payrolls (Monthly Change, K)



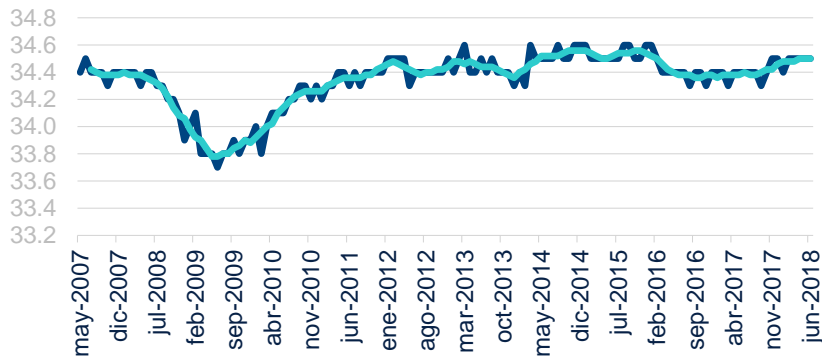
## Industry Employment (Annualized % change)



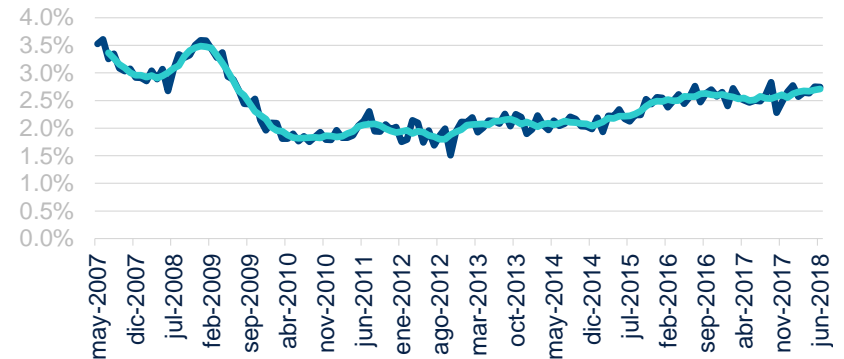


# Labor market: Hours worked continue to trend near post-crisis highs

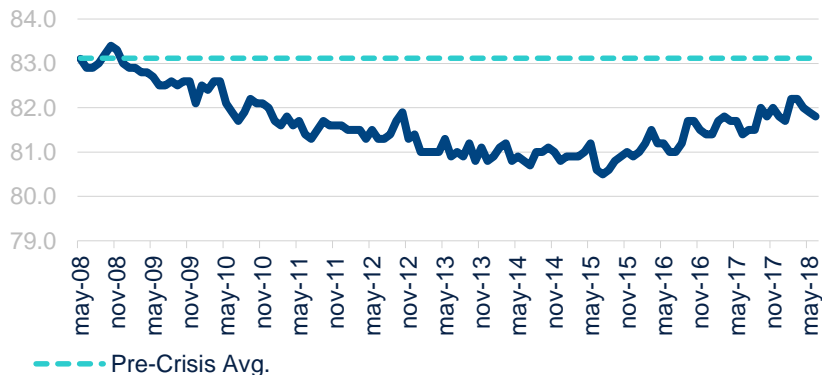
## Average Weekly Hours (number & 5mcm)



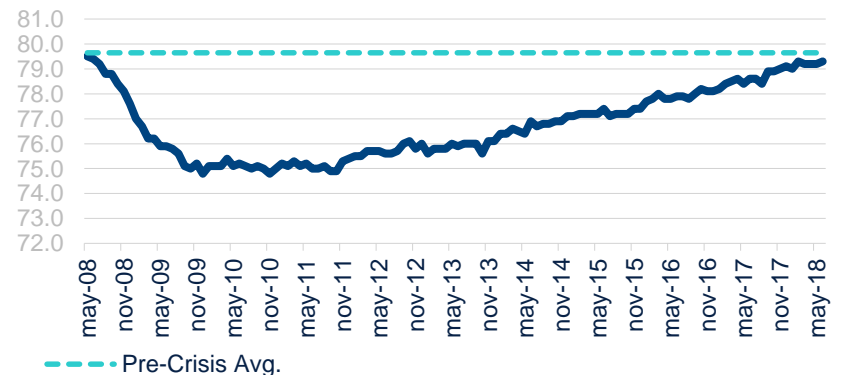
## Average Hourly Earnings (YoY% & 5mcm)



## Prime Age Labor Force Participation (%)

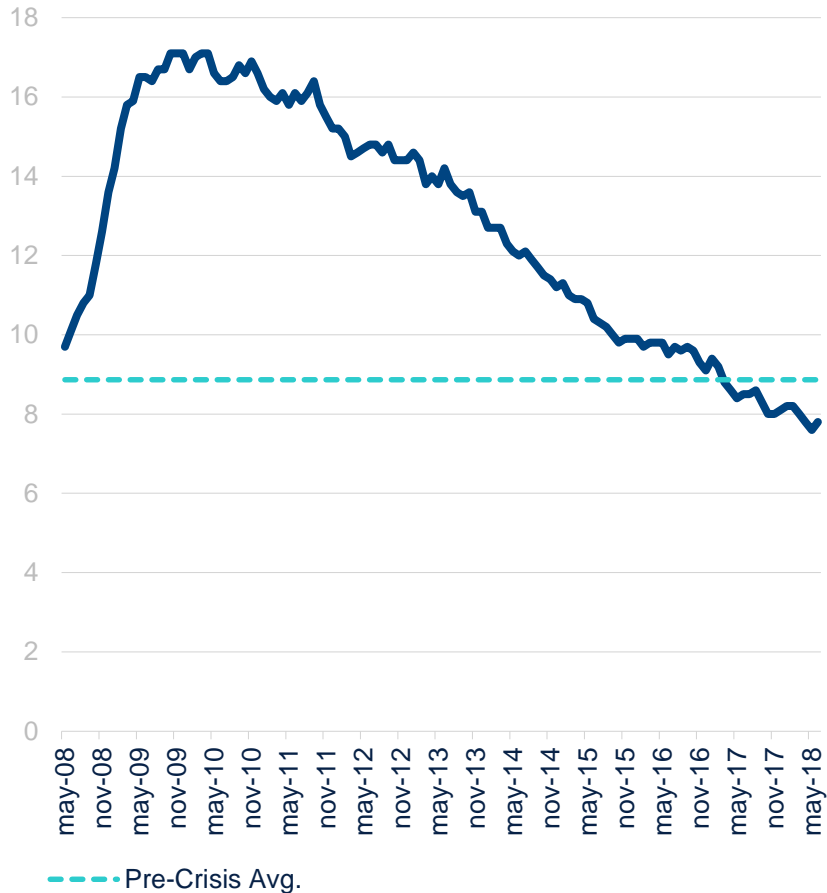


## Prime Age Employment-to-Population (%)

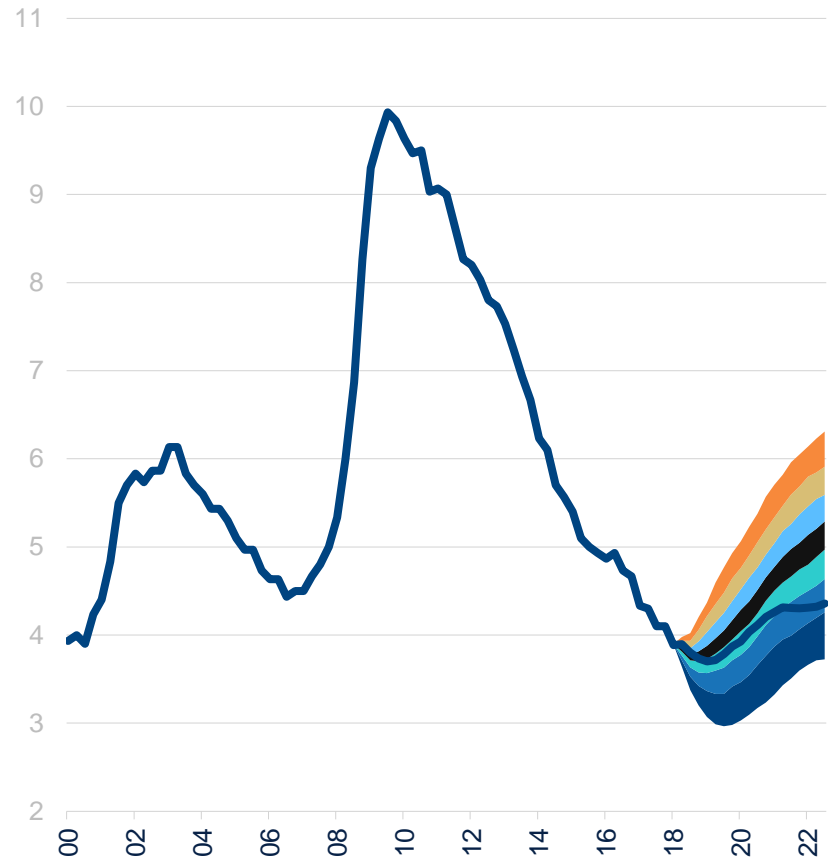


# Labor market: Slack to continue to abate, but downside risk to UR limited by inflows

**U-6**  
(%)



**Unemployment Rate**  
(%)



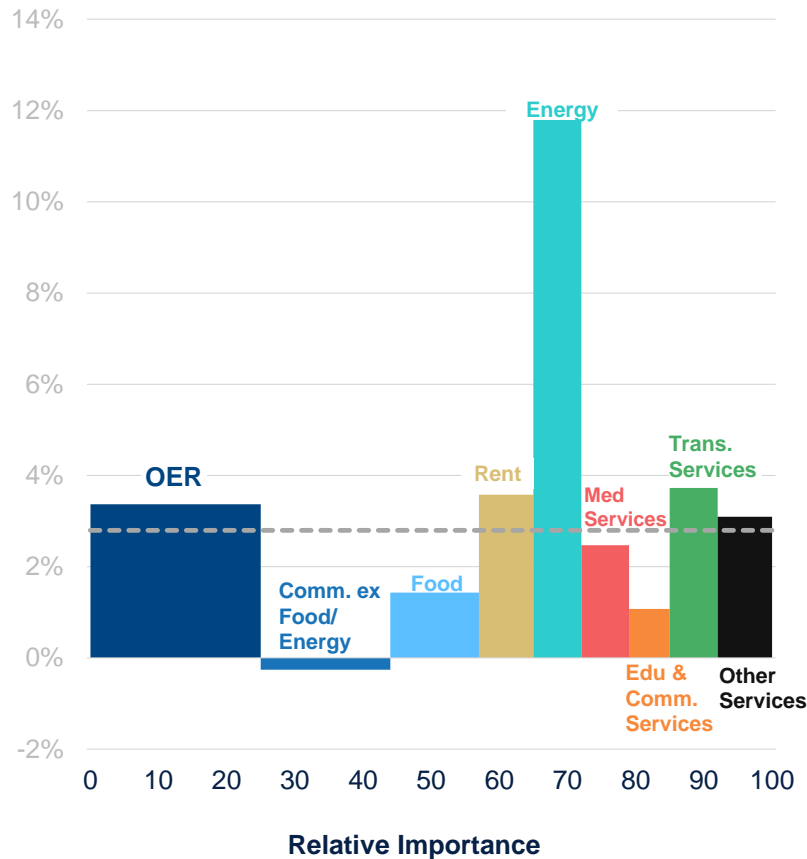
# Inflation



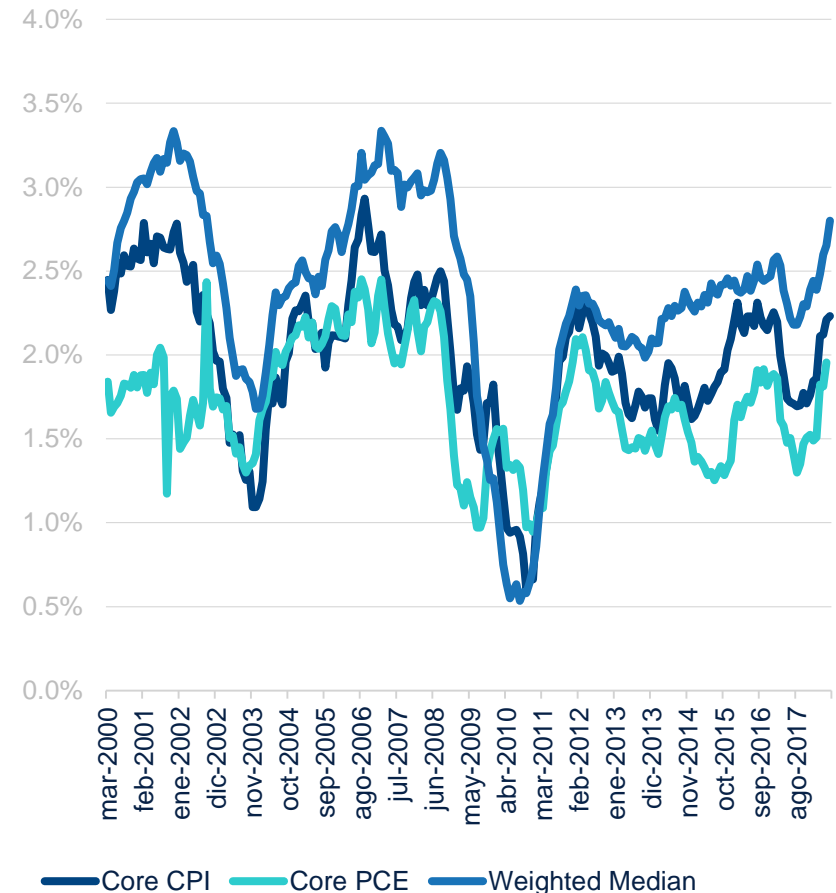
- Headline PCE in May accelerated to 2.3% year-over-year, the highest in six years, while core PCE surged to 2.0%
- Energy prices, services and housing costs largest contributors price increases in 2018; headline and core CPI increased 2.8% and 2.2% in May
- After trending upwards, inflation expectations have stabilized slightly above the 2% target; no major changes in survey-based expectations
- Fears of excessive inflation exaggerated as probability of entering high-inflation regime remains low
- With the additional tailwinds from the expansionary fiscal policy, we expect core PCE to rise to 2.2% in 2019 before returning to 2.1% in 2021

# Inflation: Core prices reach Fed 2% target

## Consumer Price Inflation (12m change)



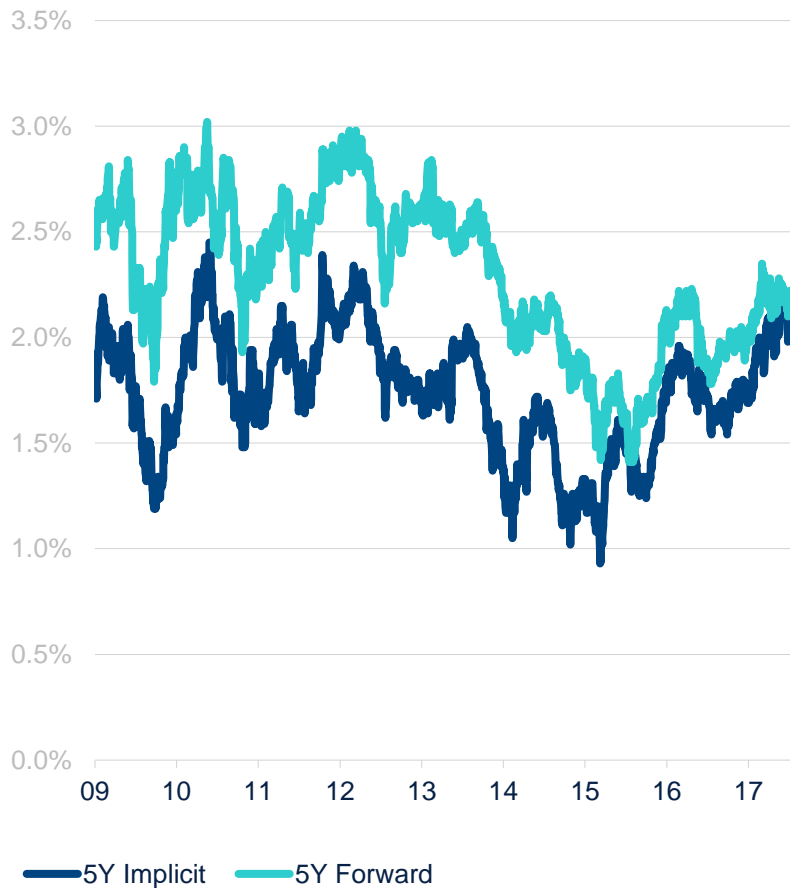
## Core Inflation Measures (12m change)



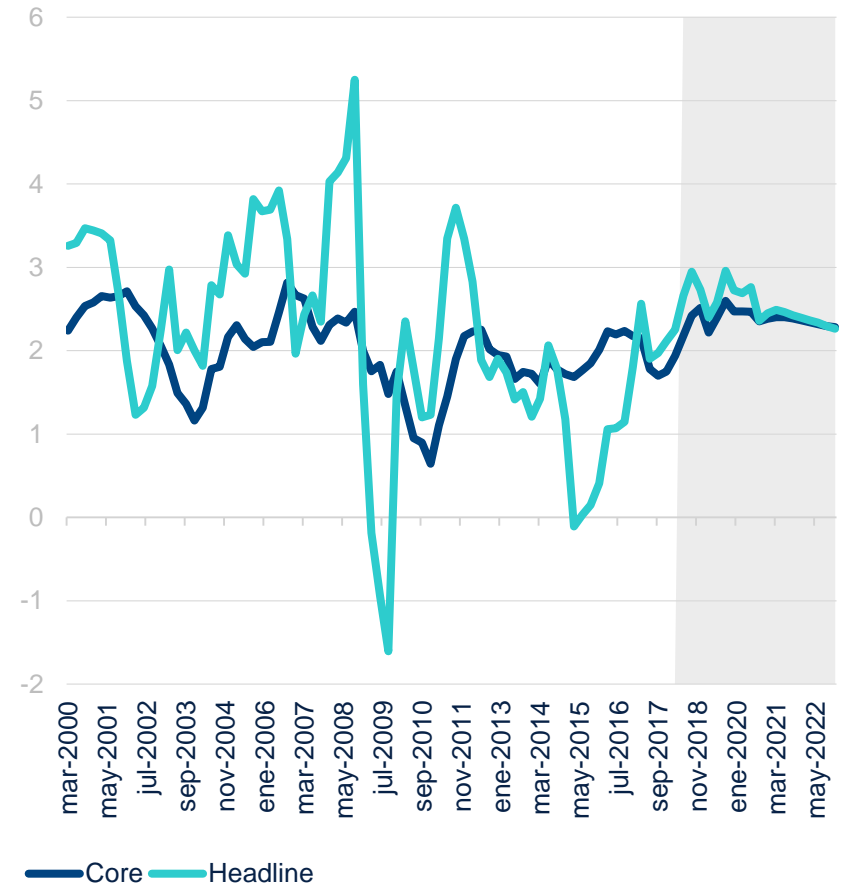
Source: BBVA Research, BLS & BEA

# Inflation: Expectations remain anchored reinforcing our baseline for only short-term overshooting

## Inflation Expectations (%)

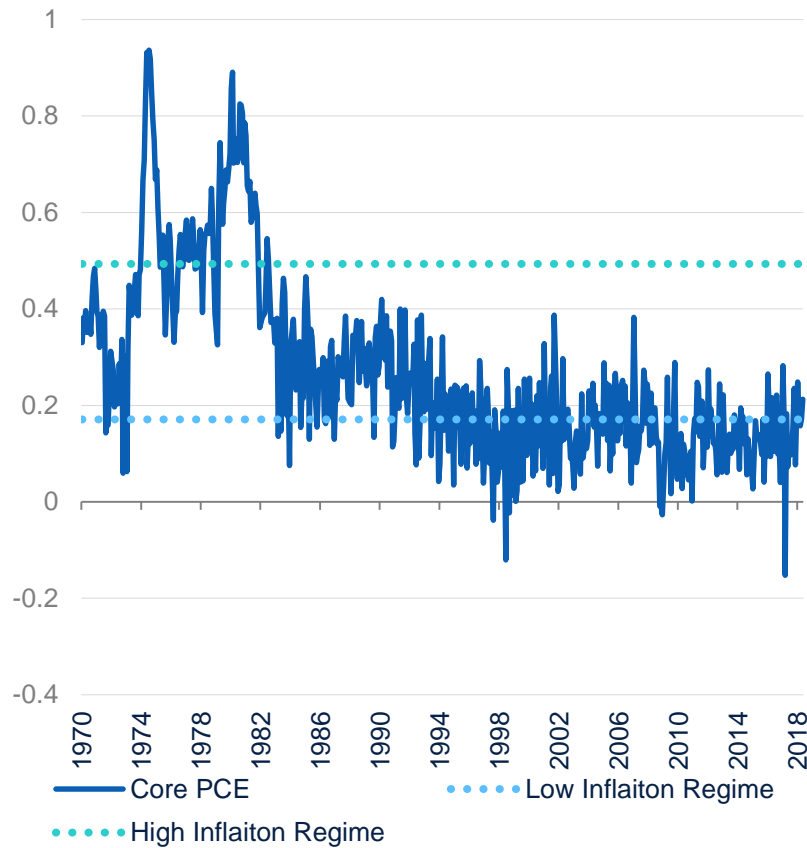


## Headline & Core CPI (Year-over-year %)

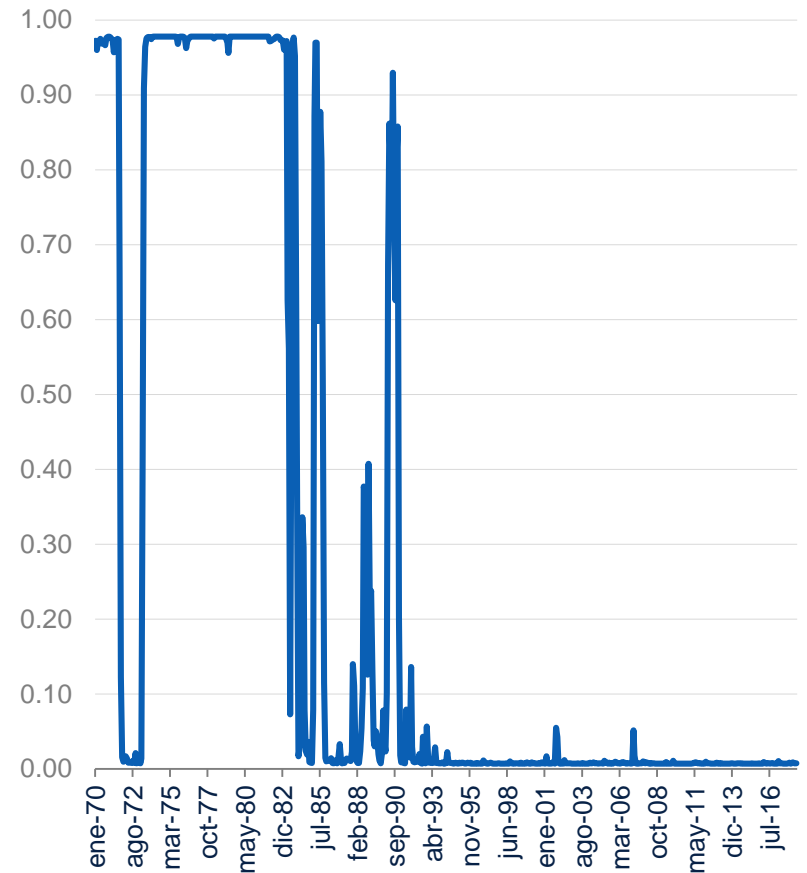


# Inflation: Regime change probability remains low

## Core PCE and Inflation Regimes (Quarter-over-quarter %)



## Probability of Entering High Inflation Regime (%)



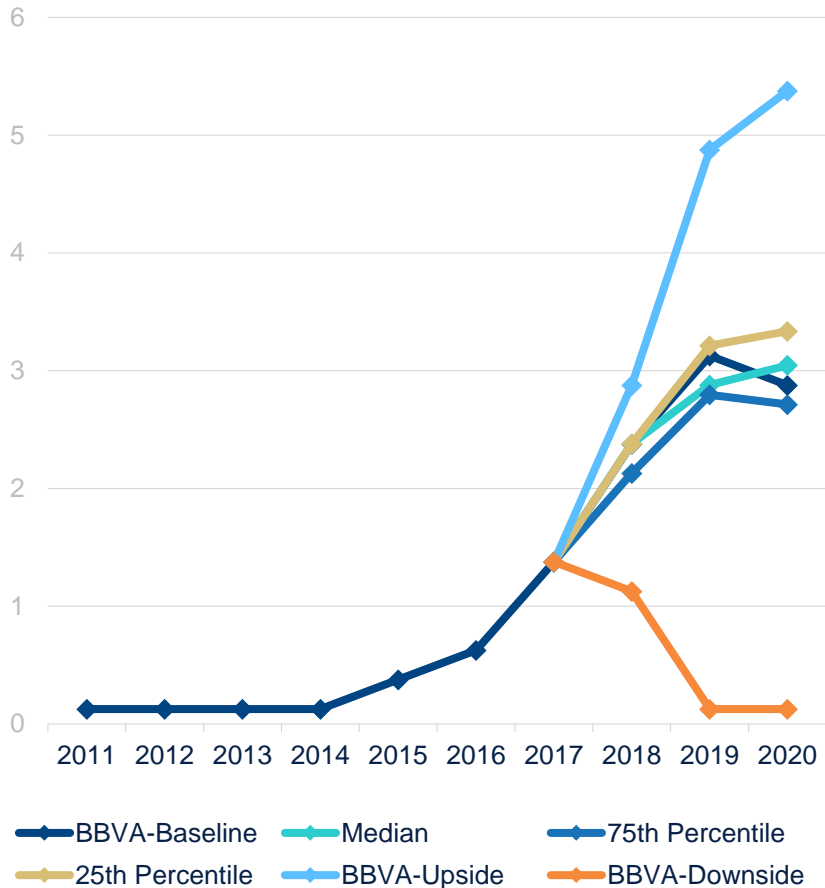
# Monetary Policy: Federal Reserve



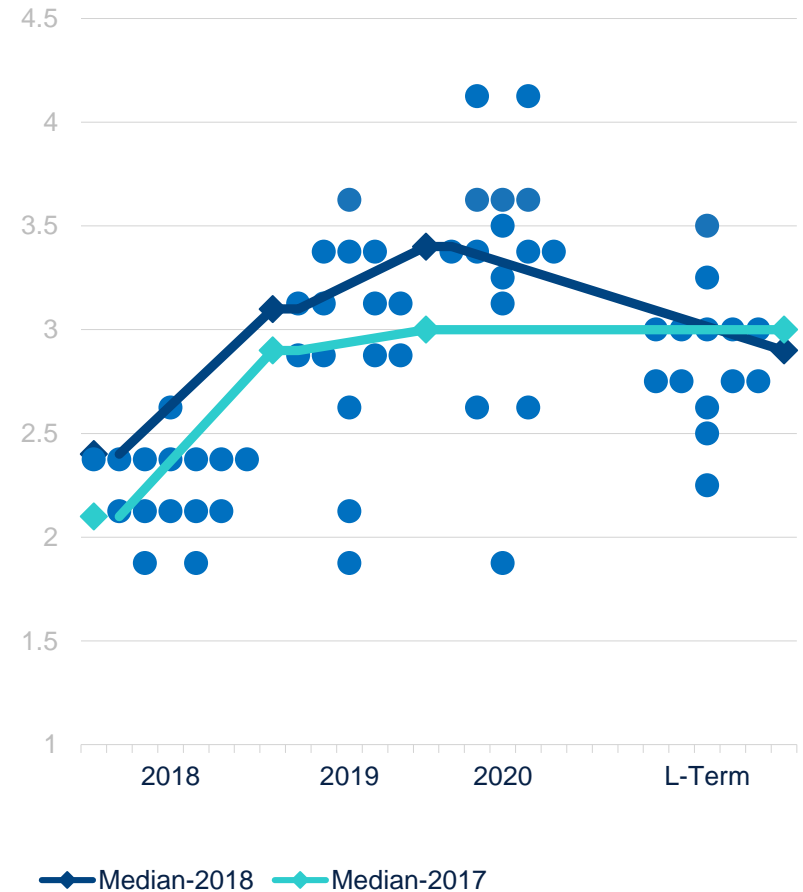
- June's FOMC statement, economic projections and press conference confirm our view that the Fed has fully transitioned to a new phase of monetary policy, leaving behind the post-crisis era
- Fed to continue actively managing interest rate corridor, suggesting possible future adjustments in interest paid on excess reserves
- Although doubts remain about the prescience of the yield curve, the minutes confirmed that members are concerned about an inversion and its signaling power
- Although many district surveys have shown anecdotal effects from the trade war, the committee stills views trade disputes as a potential risk to their outlook
- Our baseline now assumes three rate increases in 2019; for 2018, we maintain our baseline scenario of two additional rate increases (Sept. & Dec.)

# Fed: Our baseline assumes two rate increases in 2018 and three in 2019

## BBVA & Dealers Projections of Fed Funds (%, Effective)



## FOMC Projections of Fed Funds (Year-over-year %, Mid-point)

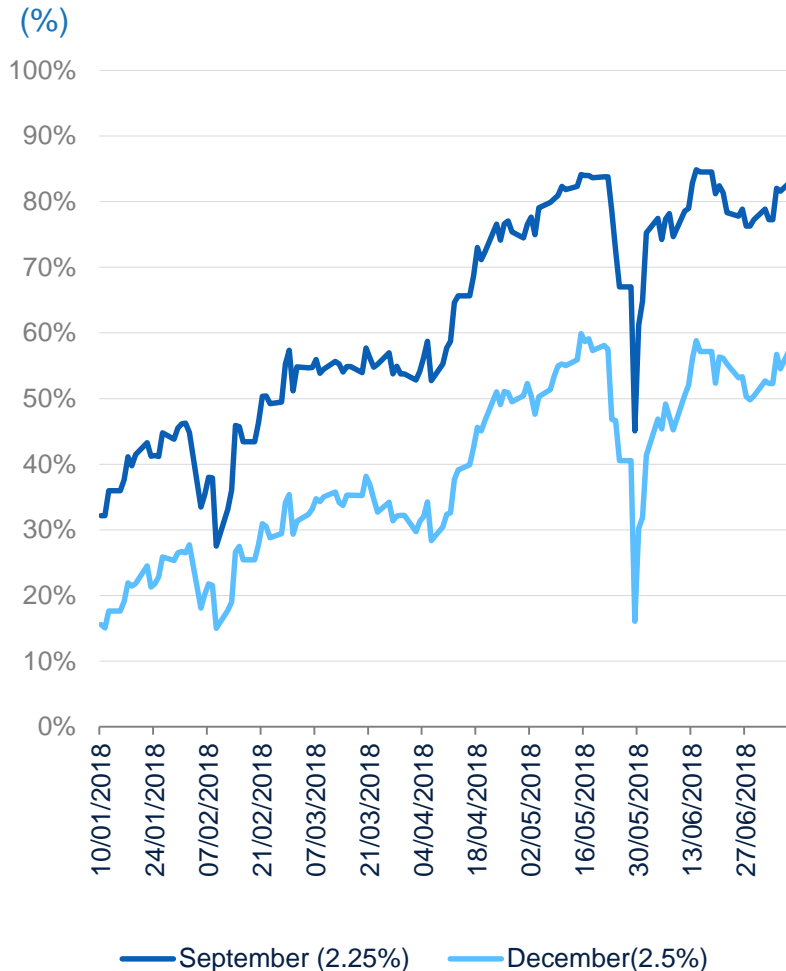


Source: BBVA Research & FRB

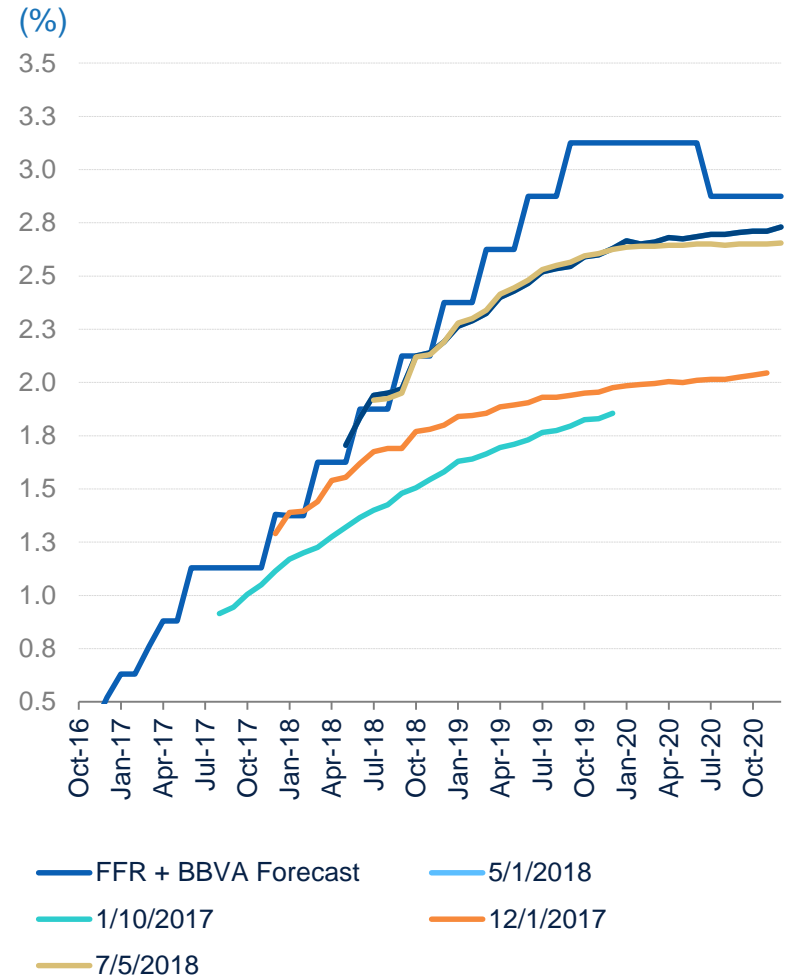


# Monetary policy: Fed futures edging up with anticipation of strong growth and higher inflation

## Fed Funds Implied Probability (%)

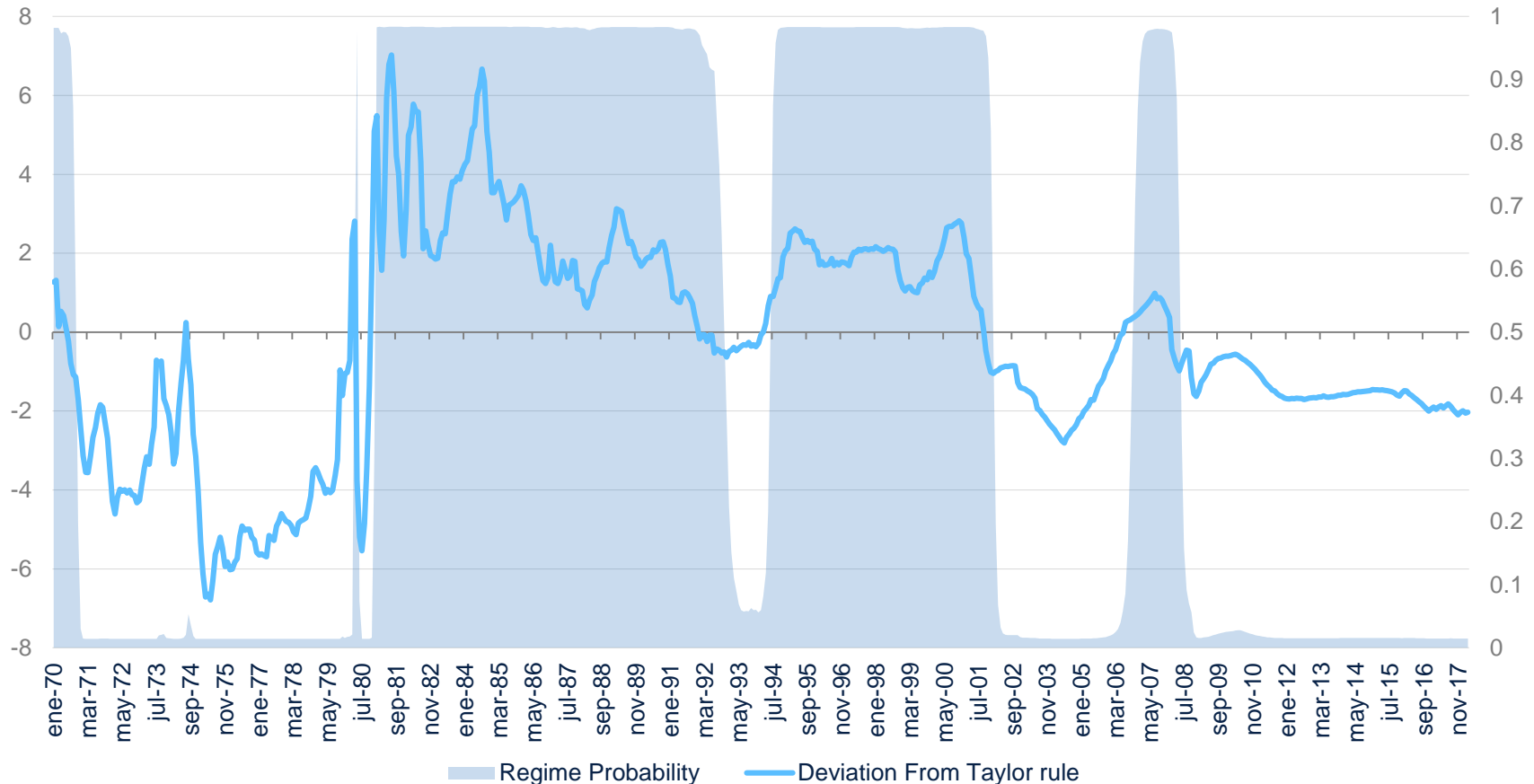


## Fed Funds Futures & BBVA Baseline (%)



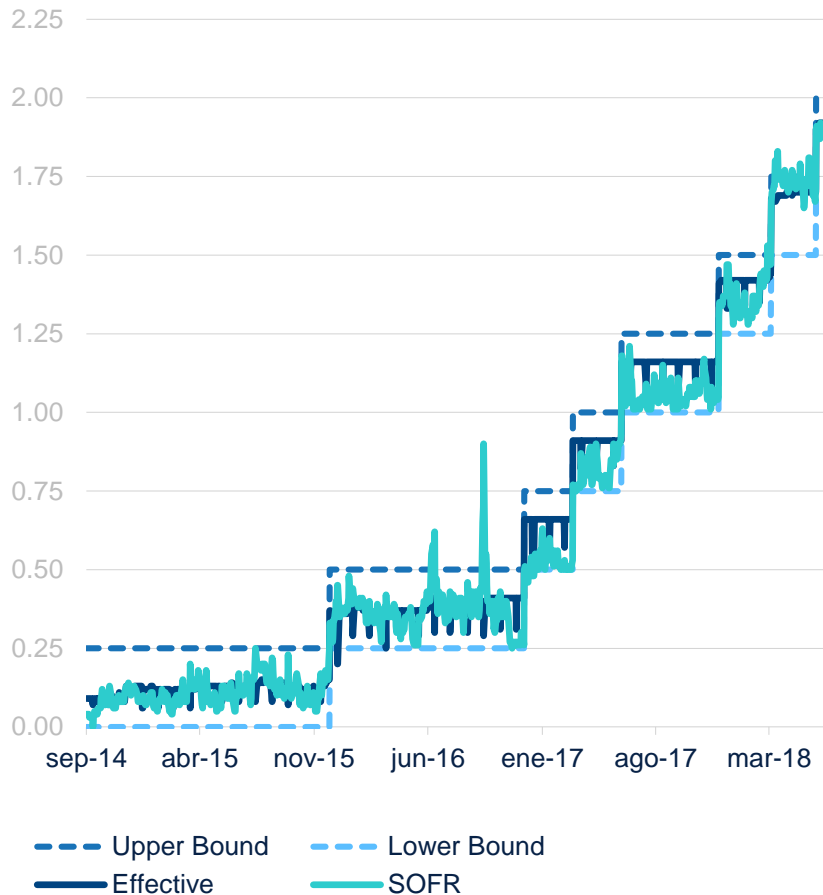
# Fed: Current deviation from Taylor-rule and inflation conditions suggest low probability of shift in monetary policy regime

Fed Deviation from Taylor Rule and Probability of Monetary Policy Regime Change (%)

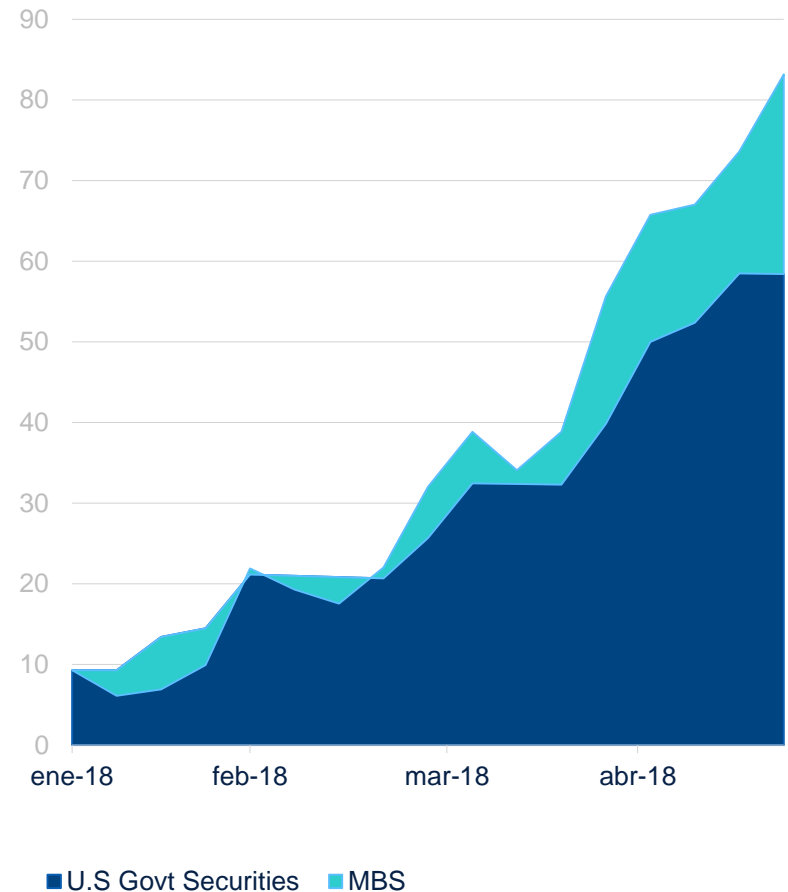


# Interest rates: Interest rate corridor remains a source of concerns for FOMC

## Fed Funds & Repo Rates (%)



## Balance Sheet Attrition (US\$bn, Cumulative)



# Interest Rates

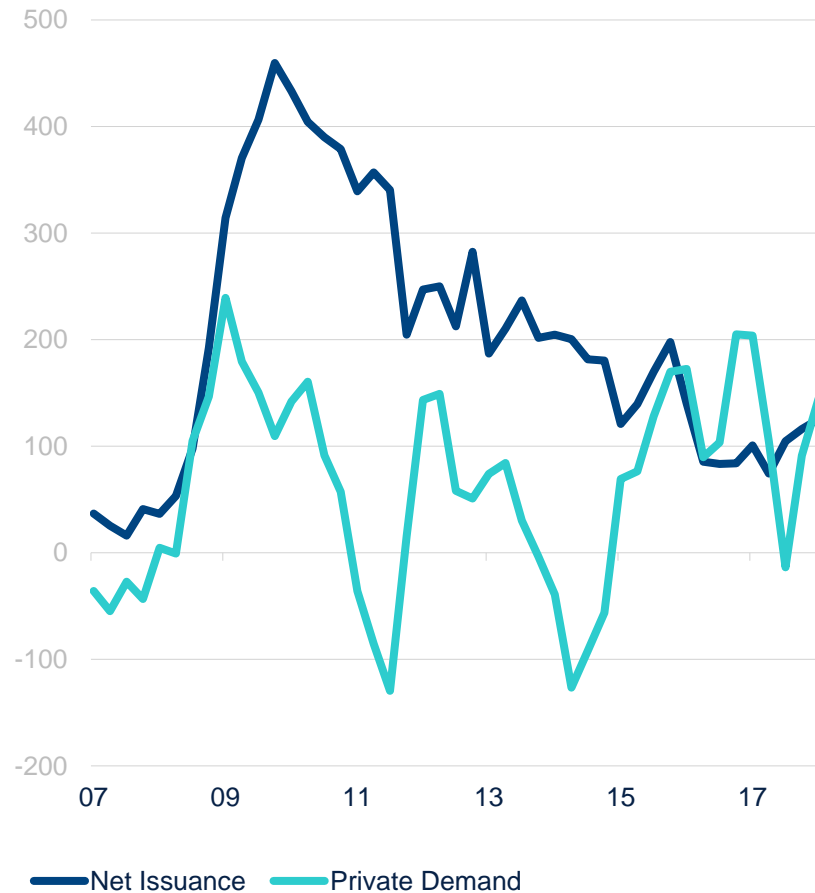


- Despite some idiosyncratic issues with short-term rates and the fed funds target range, we continue to expect a gradual rise in short-term rates
- Global uncertainty, monetary policy and domestic policy uncertainty continue compressing term-premium
- Long-term rates have lost some momentum as inflation expectations –major driving force behind increases- stabilize around 2.0%
- Baseline continues to assume 10-year Treasury yield at 3.1% by year-end 2018 and 3.6% by year-end 2019
- The yield curve slope between the 10-year and 2-year Treasuries to flatten further, but remain positive

# Interest rates: Demand-side conditions remain stable

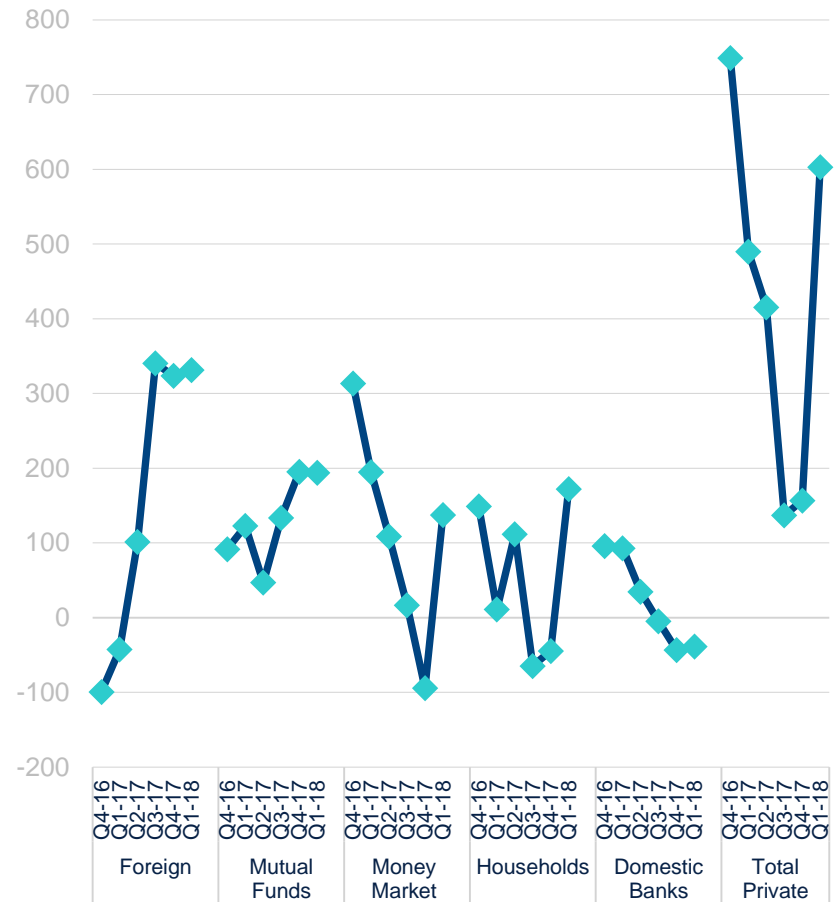
## Net Treasury Supply & Change in Private Domestic Demand

(US\$bn & 3qcm)



## Private Demand for Treasuries

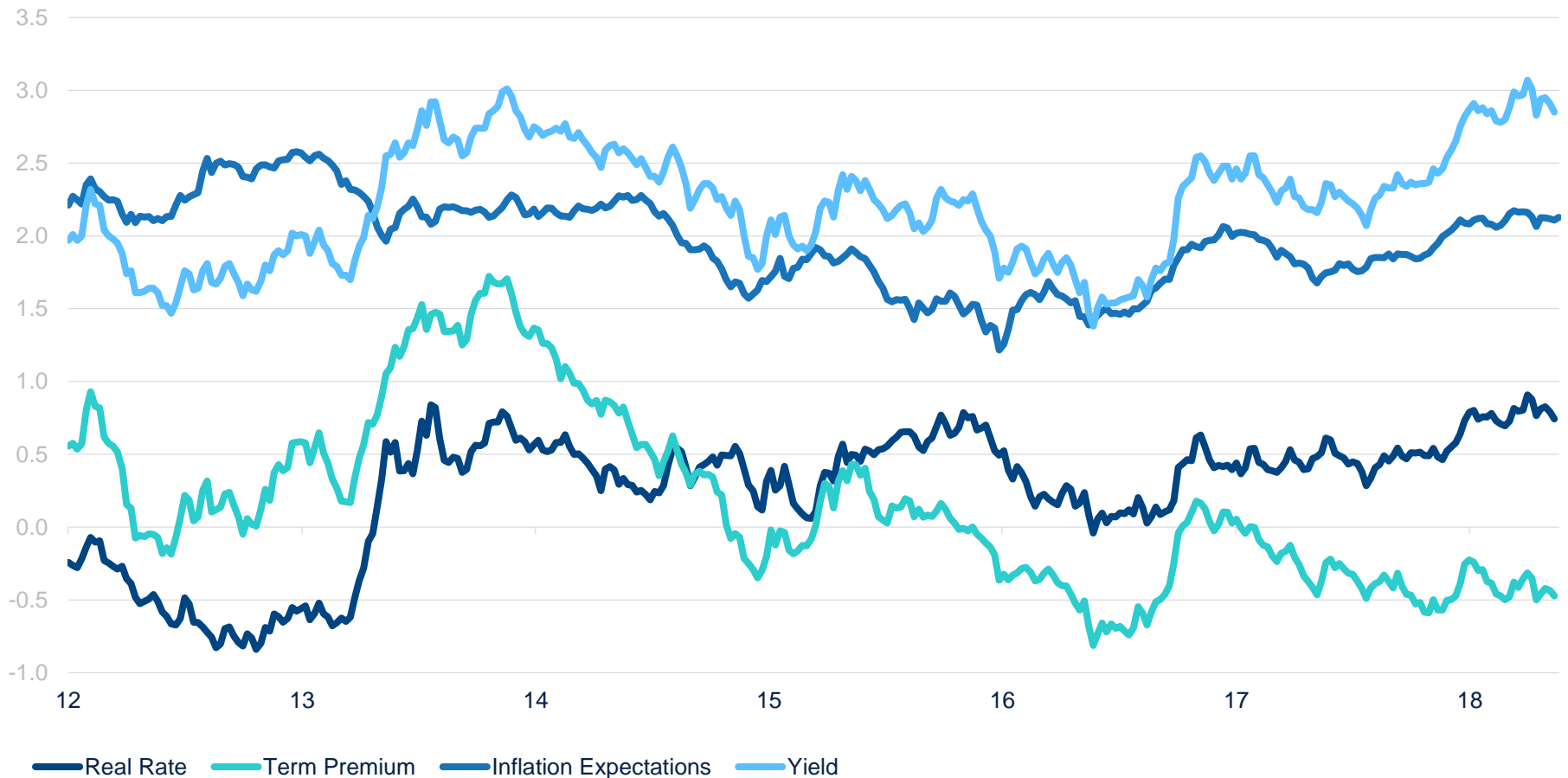
(US\$bn, 4qma)



Source: BBVA Research & U.S. Treasury

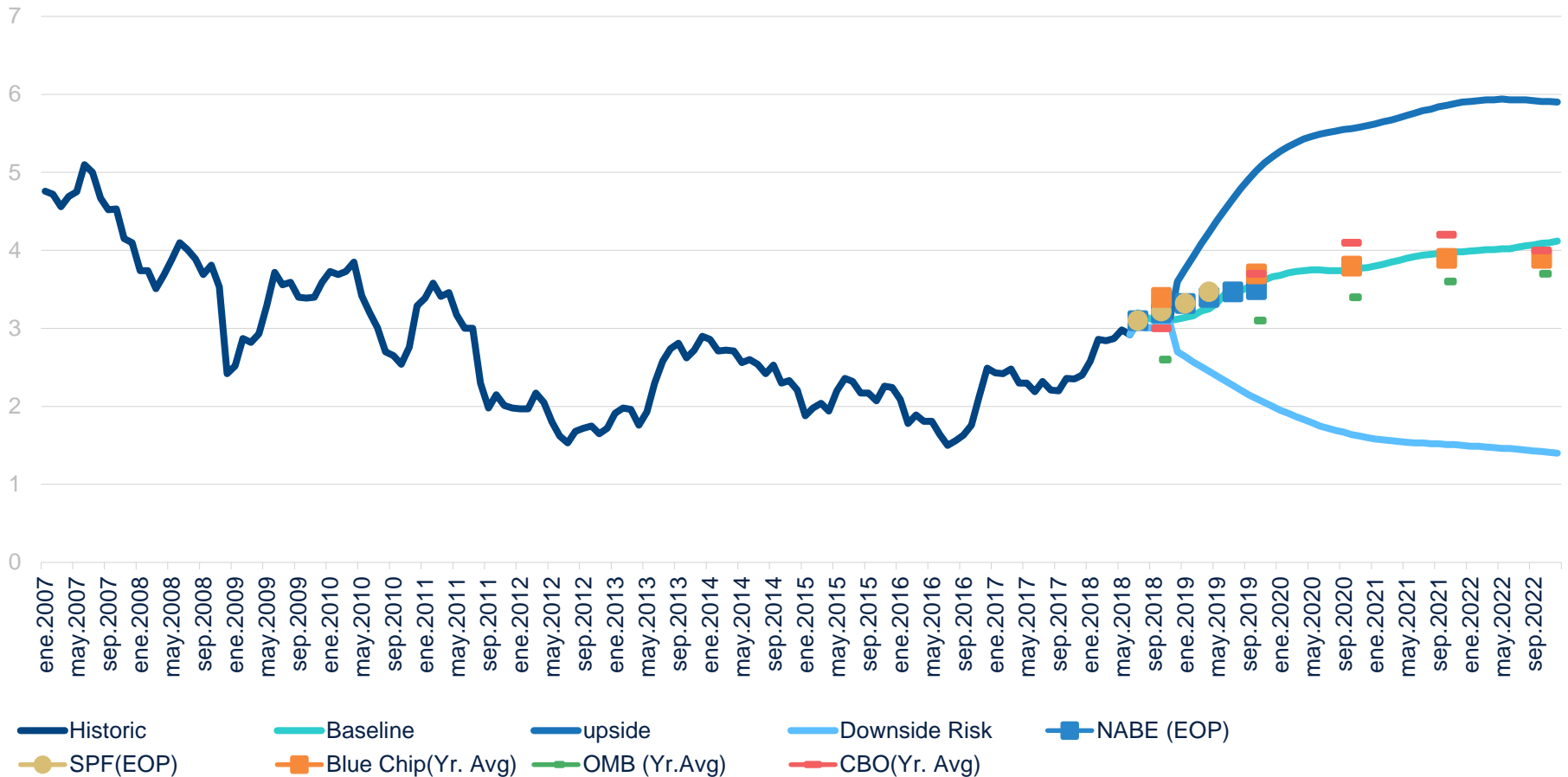
# Interest rates: Term premium compressed, inflation expectations close to Fed target

## 10-Year Treasury Yield Decomposition (%)



# Interest rates: 10-year treasury yield to reach 3.1% by year-end 2018 and 3.6% in 2019

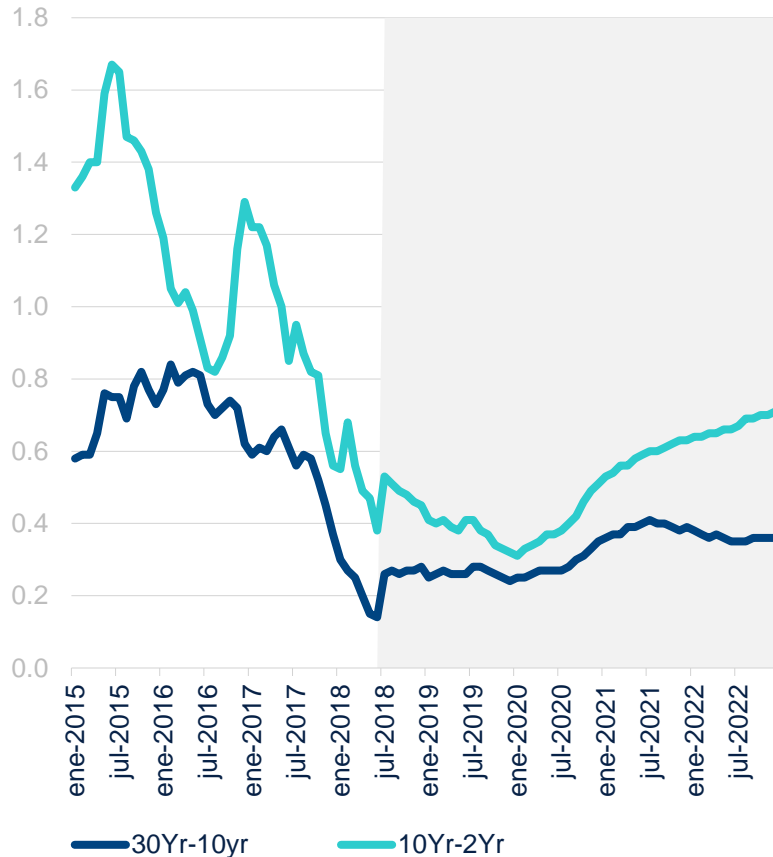
## 10-Year Treasury Yield (%)



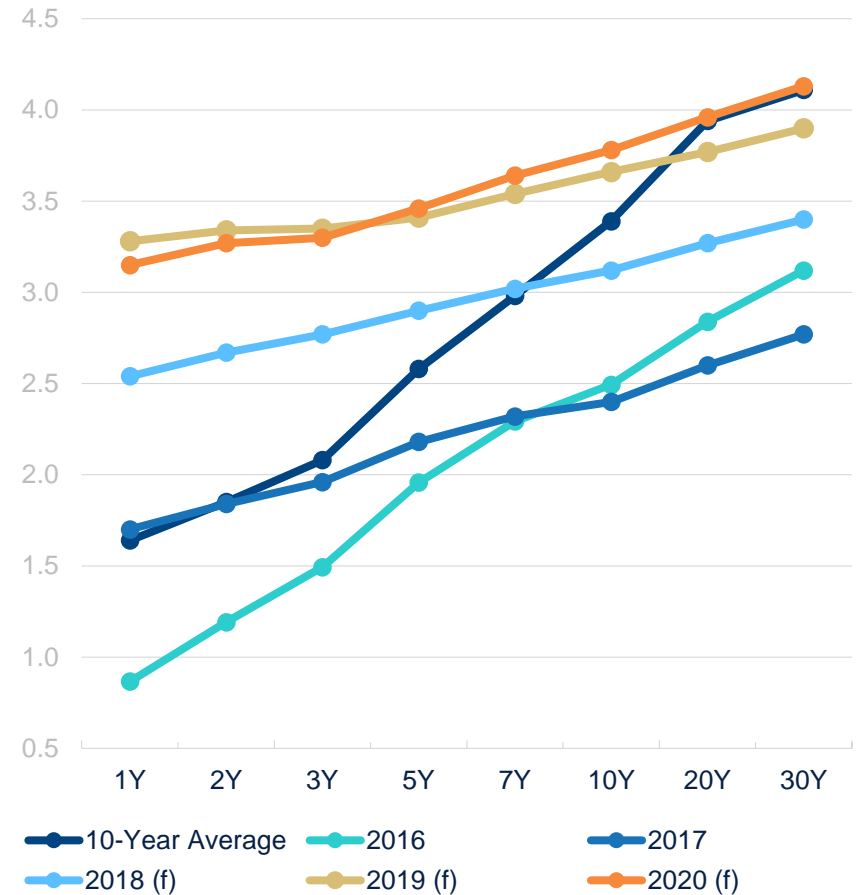
Source: BBVA Research, ACM & Haver Analytics

# Interest rates: Baseline scenario continues to assume no yield curve inversion

## Yield Curve Slope (Bp)



## Yield Curve (% eop)





# Economic Scenarios

Probability (%)	Current	Previous
Upside	10	10
Baseline	65	65
Downside	25	25

## Macro Scenarios

	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
<b>GDP</b>	1.7	2.6	2.9	1.5	2.3	2.8	2.8	2.5	2.3	2.0
<b>Upside</b>	1.7	2.6	2.9	1.5	2.3	3.2	3.8	3.4	3.1	3.0
<b>Downside</b>	1.7	2.6	2.9	1.5	2.3	2.0	-1.8	0.4	1.2	1.4
<b>UR</b>	7.4	6.2	5.3	4.9	4.4	3.9	3.7	4.0	4.3	4.3
<b>Upside</b>	7.4	6.2	5.3	4.9	4.4	3.8	3.1	2.8	3.0	3.0
<b>Downside</b>	7.4	6.2	5.3	4.9	4.4	4.0	4.6	6.6	7.0	5.7
<b>CPI</b>	1.5	1.6	0.1	1.3	2.1	2.6	2.7	2.6	2.4	2.3
<b>Upside</b>	1.5	1.6	0.1	1.3	2.1	2.8	3.3	3.3	3.4	3.7
<b>Downside</b>	1.5	1.6	0.1	1.3	2.1	2.4	1.3	1.0	0.7	0.6
<b>Fed [eop]</b>	0.25	0.25	0.50	0.75	1.50	2.50	3.25	3.00	3.00	3.00
<b>Upside</b>	0.25	0.25	0.50	0.75	1.50	3.00	5.00	5.50	5.50	5.50
<b>Downside</b>	0.25	0.25	0.50	0.75	1.50	1.25	0.25	0.25	0.25	0.25
<b>10-Yr [eop]</b>	2.9	2.21	2.24	2.49	2.4	3.12	3.66	3.78	3.98	4.12
<b>Upside</b>	2.90	2.21	2.24	2.49	2.40	3.60	5.20	5.60	5.90	5.90
<b>Downside</b>	2.90	2.21	2.24	2.49	2.40	2.70	2.00	1.60	1.50	1.40

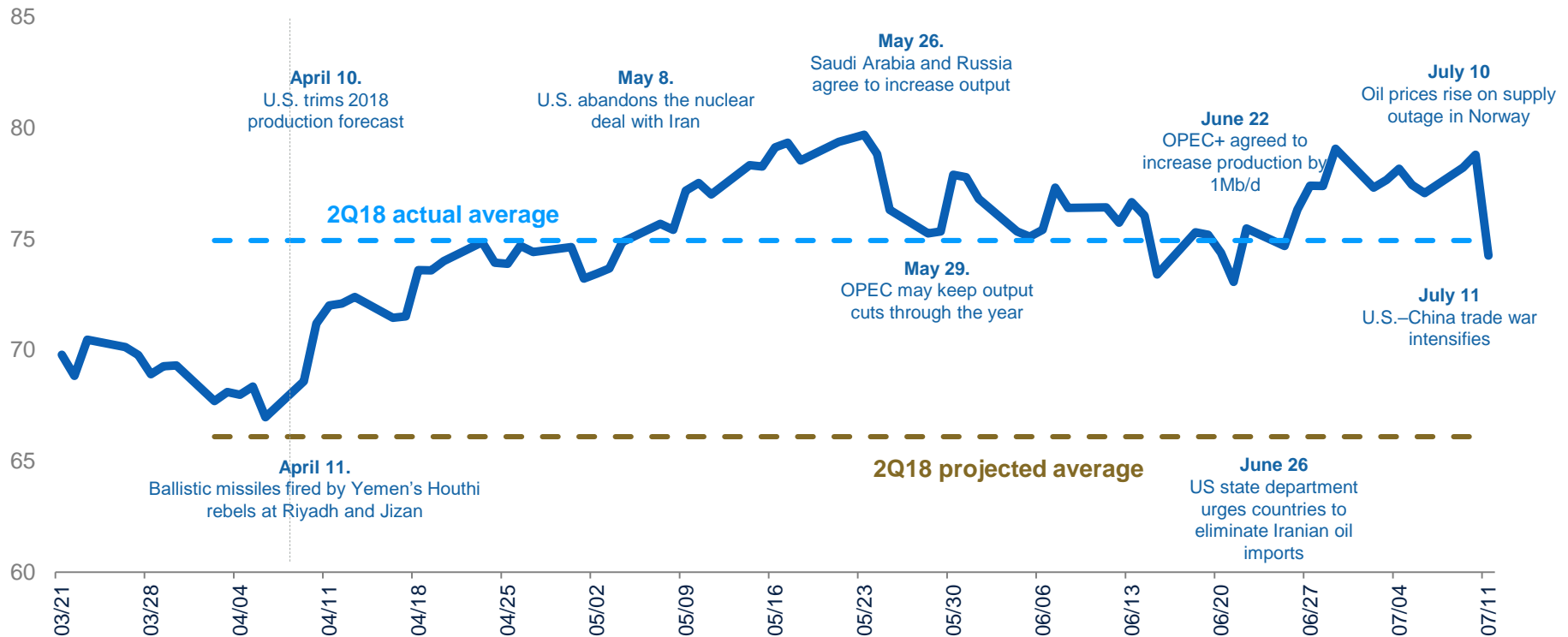
# Energy Prices



- OPEC+ agreed to boost production to compensate the shortfall left by Iran and Venezuela
- Geopolitics, the US-China trade war, and concerns on OPEC spare capacity will continue to add short-term volatility
- Prices will remain supported by robust demand from China, India and the U.S.
- We continue to expect prices to converge with long-term equilibrium, as demand growth returns to historical trend and U.S. export capacity increases
- In the long-run, unexpected price increases could arise from insufficient E&P CAPEX
- We expect domestic natural gas prices to trade around \$2.6-\$3.1 per MMBTU, which is low enough to support domestic growth and exports

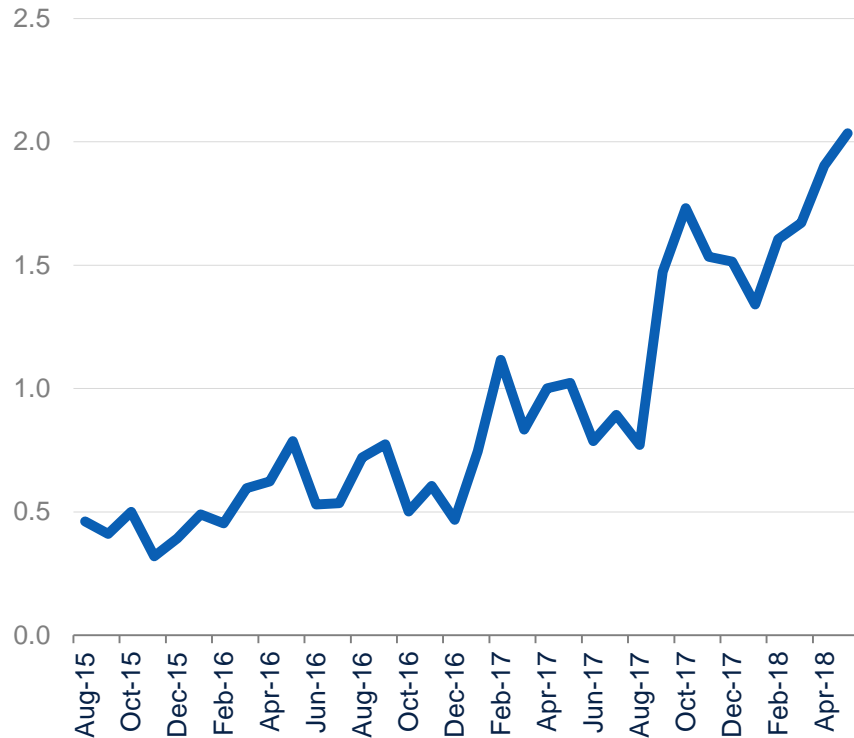
# Oil prices: Geopolitics and concerns on OPEC spare capacity are driving oil prices

**Crude oil prices**  
(\$ per barrel)



# Oil prices: In the U.S., transportation bottlenecks limit impact on international prices

**U.S. Crude oil exports**  
(Million barrels/day)



**WTI Midland-Cushing differential**  
(\$/b)



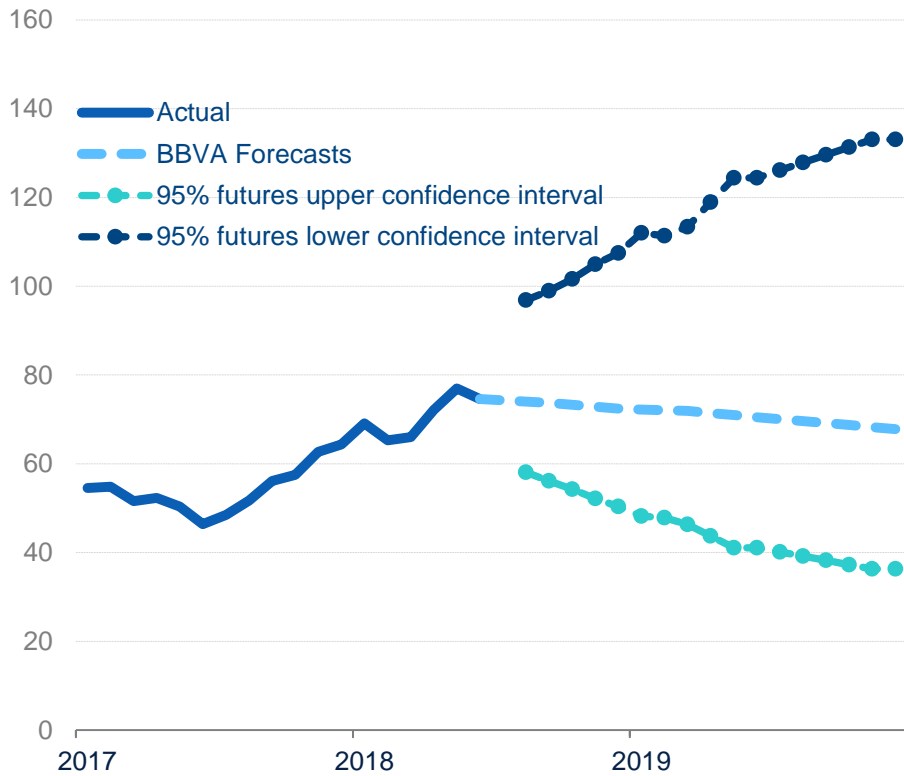
**U.S. Estimated crude oil production**  
(Thousand barrels/day)



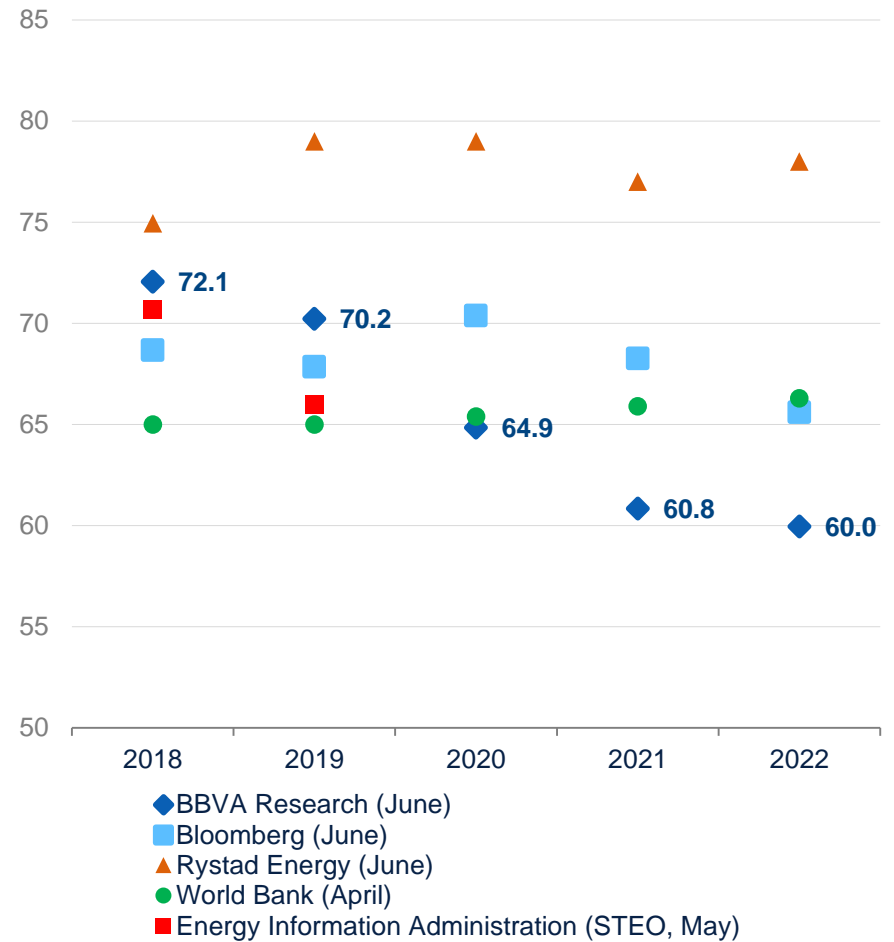
Source: BBVA Research, Haver Analytics & Bloomberg

# Oil prices: Forecasts

## Short-term oil prices forecast (Brent, \$/b)



## Oil prices forecast (Brent, \$/b)



Source: BBVA Research, Bloomberg & EIA

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