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BBVA Research

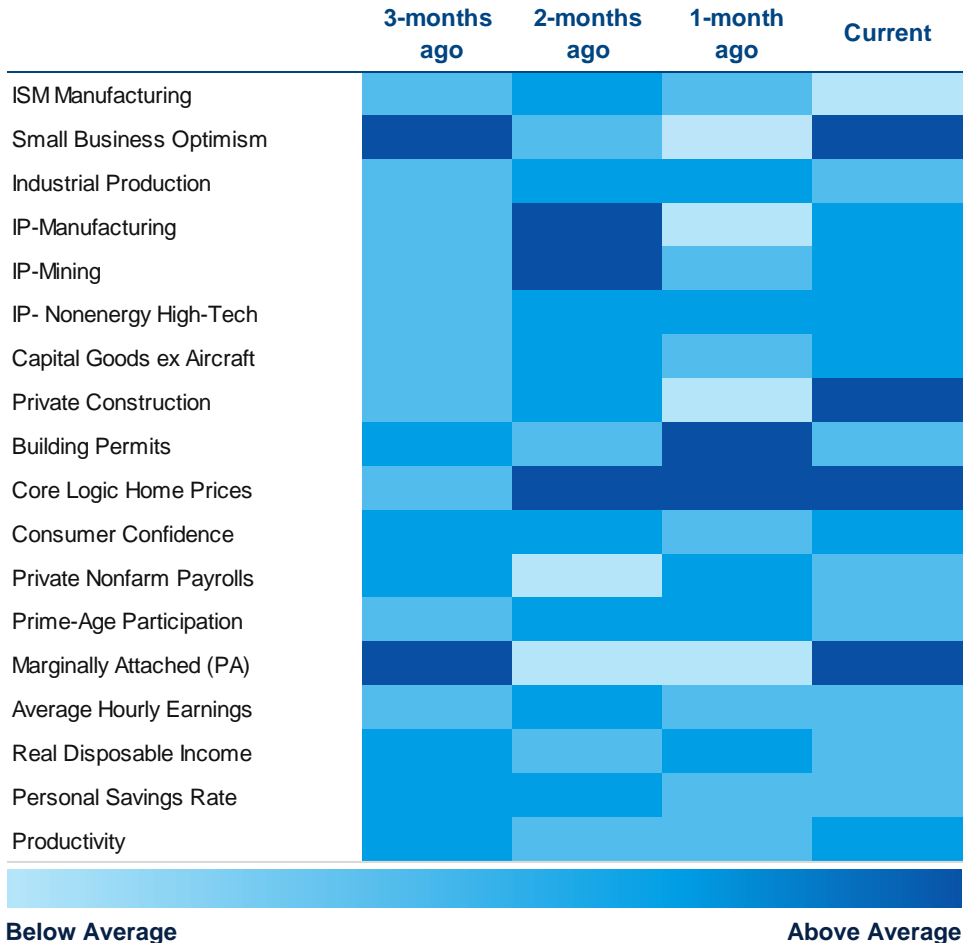
U.S. Economic Outlook

June 2018

Creating Opportunities

U.S. economic activity

Real-Time Economic Indicator Heat Map



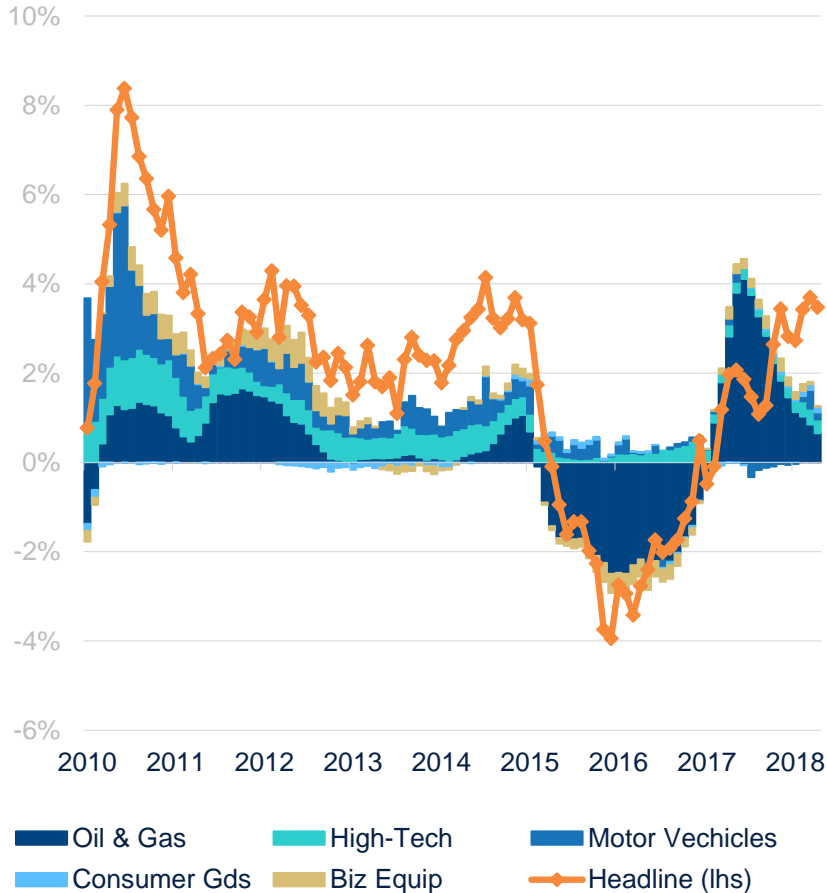
- Soft indicators continue to show strongest improvements
- Export growth remains strong due to dollar weakness and external growth
- Employment growth accelerating
- Nominal wages growing, but remain low by historical standards
- Savings rate being dragged down by rising personal interest expense

Economic Outlook

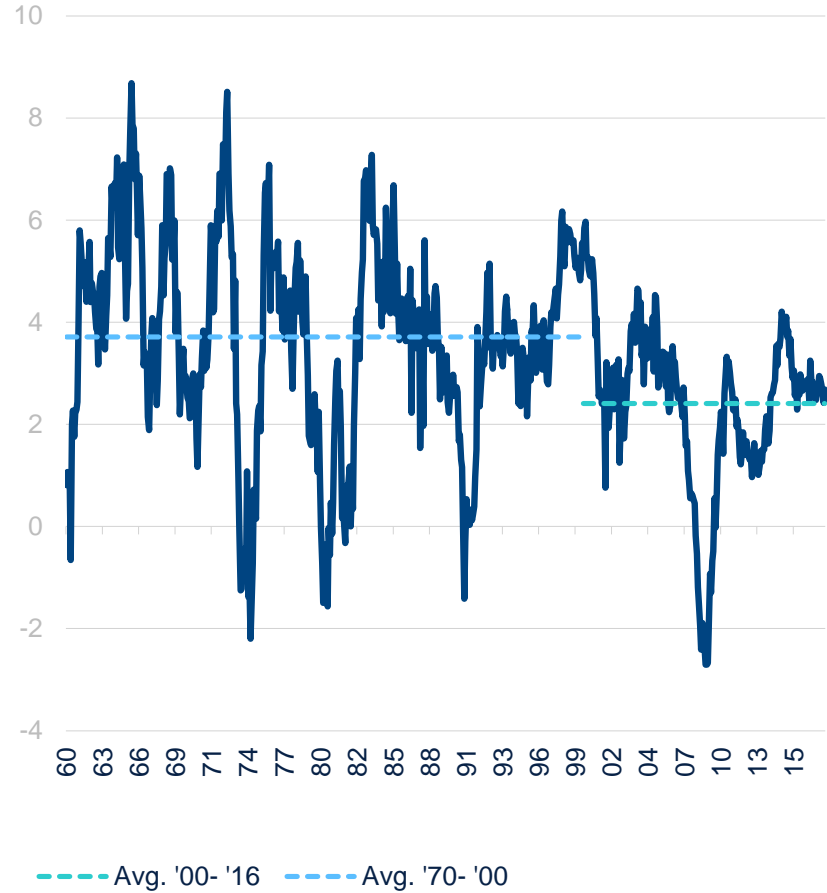
- Incoming data reaffirms our **baseline scenario of moderate to high GDP growth and higher inflation in 2018 & 2019**
- Federal Reserve poised to raise rates twice in the second half of the year and possibly **three times in 2019**
- We continue to expect above average growth in employment which will push the **unemployment rate to 3.6% by 2019**
- With the additional tailwinds from the expansionary fiscal policy, we expect **core PCE to rise to 2.3% in 2019 before returning to 2% in 2021**
- **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
- **Demand-side conditions sufficient enough to offset rising issuance**, which will continue to compress term-premium keeping long-term rates low; baseline continues to assume 10yr at **3.1% by year end**

Economic trends: Consumer and industrial activity remains strong

Industrial Production (Year-over-year %)



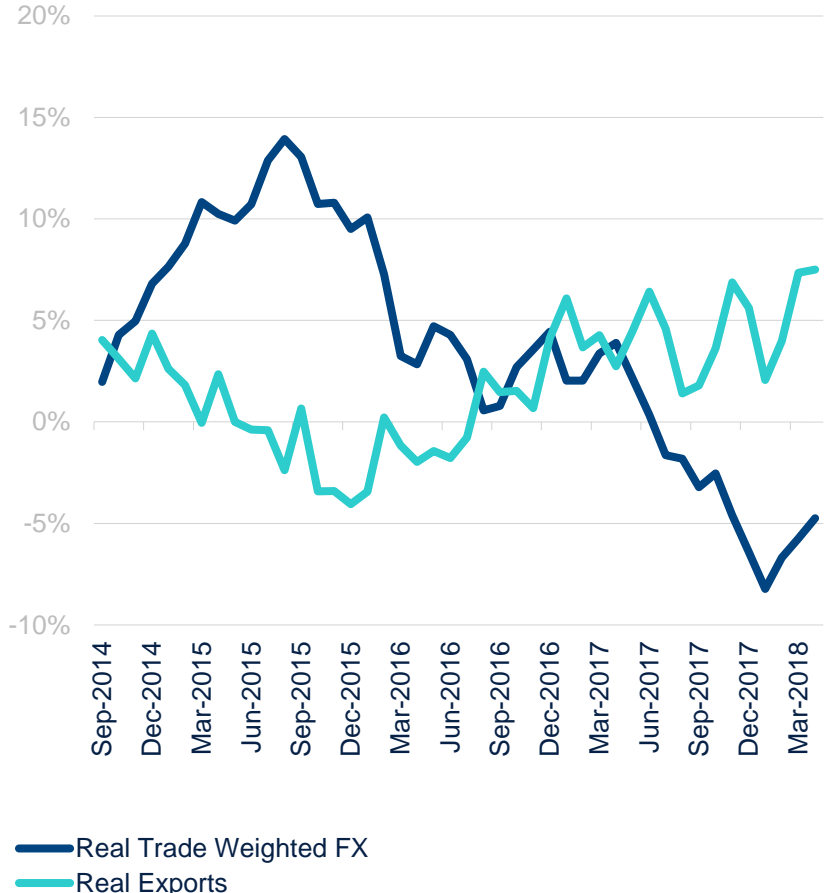
Real Personal Consumption (Year-over-year %)



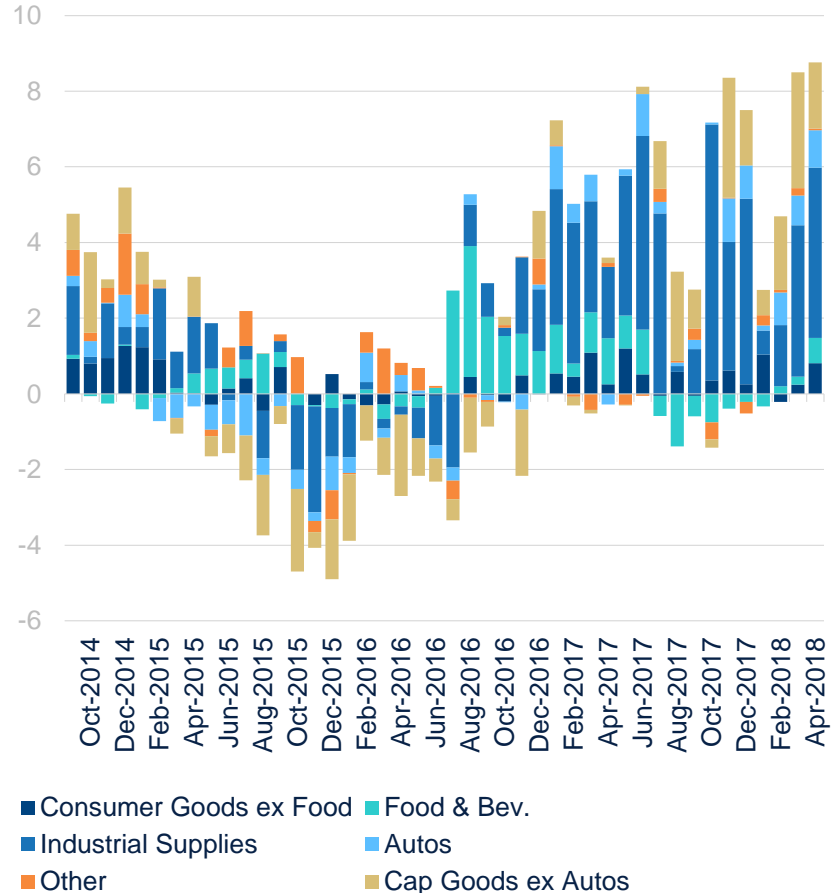
Source: BBVA Research, FRB & BEA

Economic trends: Despite rhetoric, trade momentum building

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



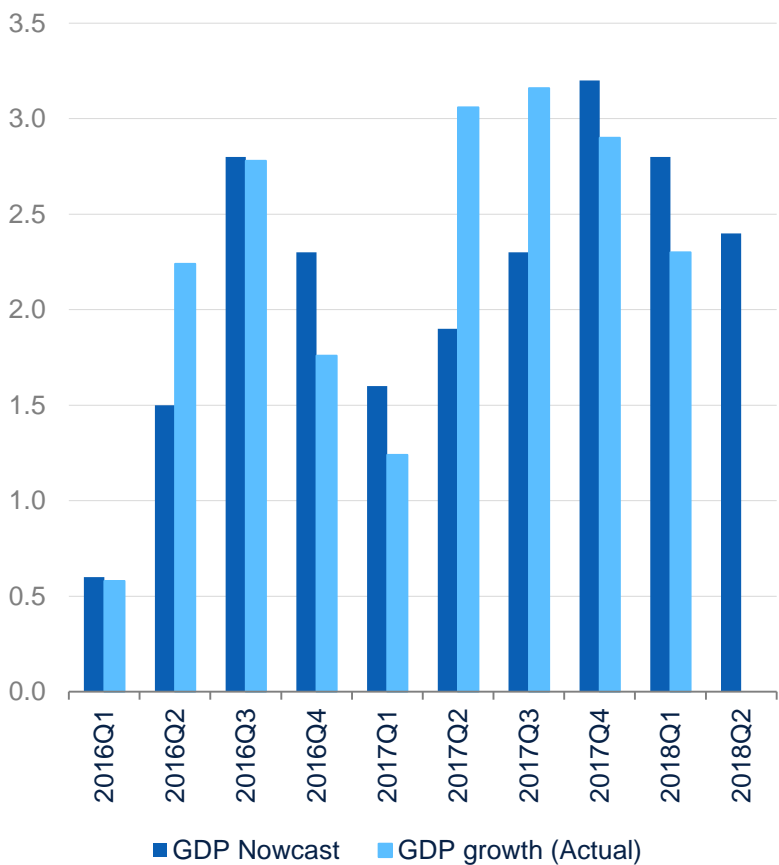
Real Exports (Contribution to year-over-year %)



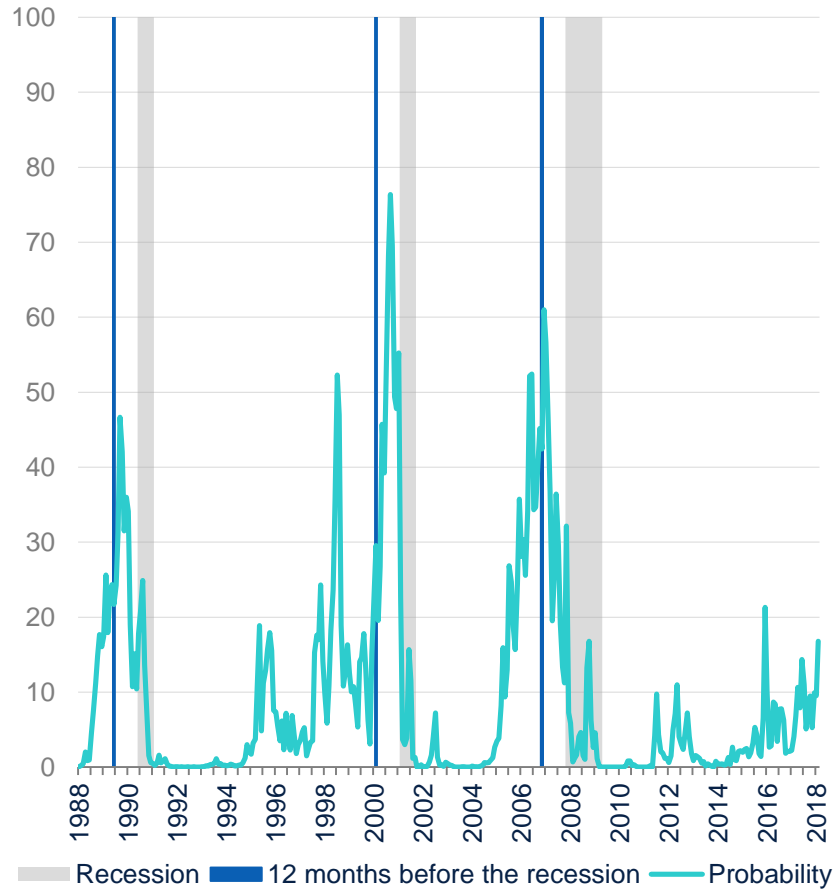
Source: BBVA Research, FRB & Census

Economic trends: Growth still on track, recession probability increased modestly

Real GDP (QoQ SAAR, %)



Probability of Recession in 12 Months (%)



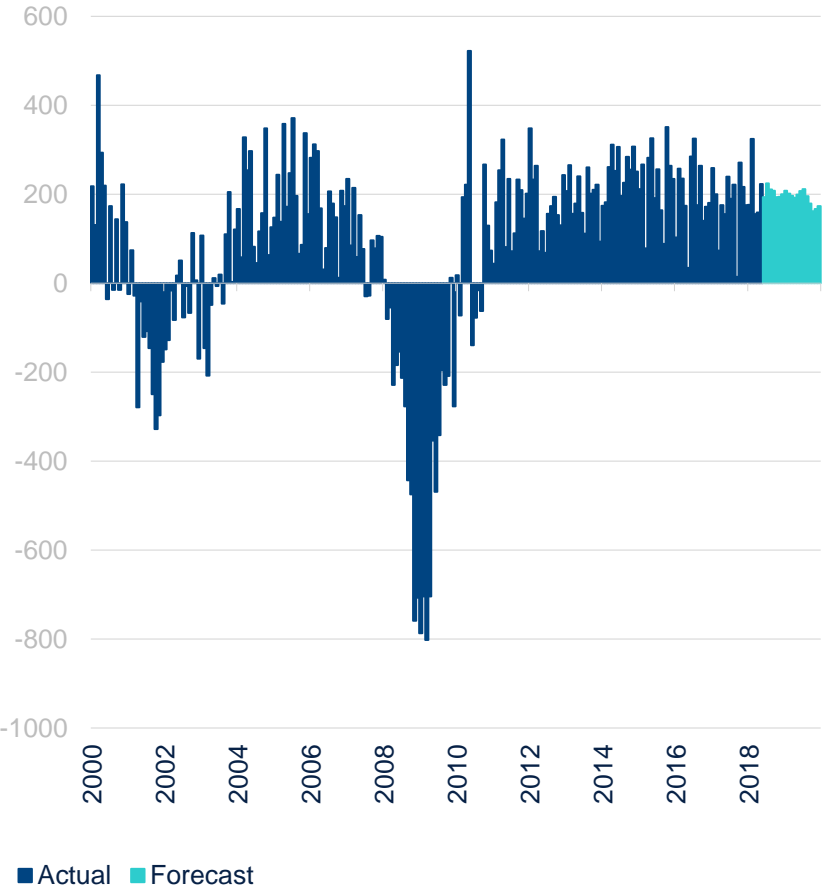
Source: BBVA Research

Labor Market

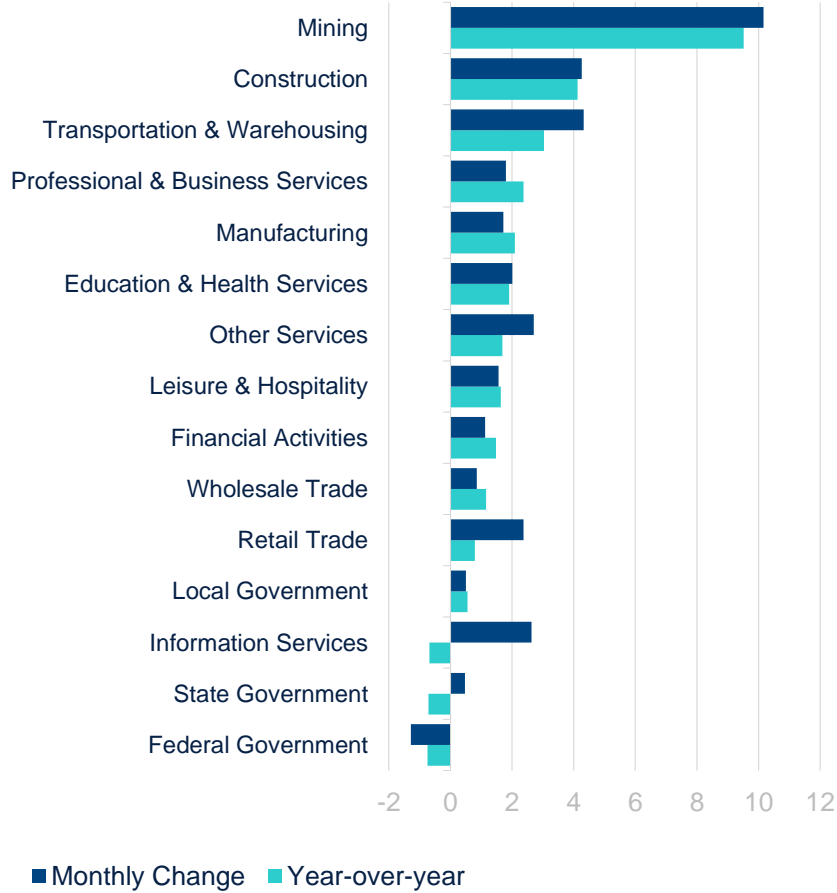
- In May, **nonfarm payroll increased by 223,000**, supported by solid gains in retail (31,000), manufacturing (24,000), health care (29,000), professional and technical services (23,000), and construction (25,000)
- **At 92 periods, this monthly gain in employment continues the longest streak** of consecutive gains in payroll employment since the start of the data in the 1930s
- **The unemployment rate edged down to 3.8%** tying the lowest rate in the last 58 years, due to a slight decline in labor force participation (62.7%)
- We continue to expect **above average growth in employment growth** which will push **the unemployment rate to 3.6% by 2019**

Labor market: Employment growth remains stronger than would be implied by slowing demographics

Nonfarm Payrolls (Monthly Change, K)



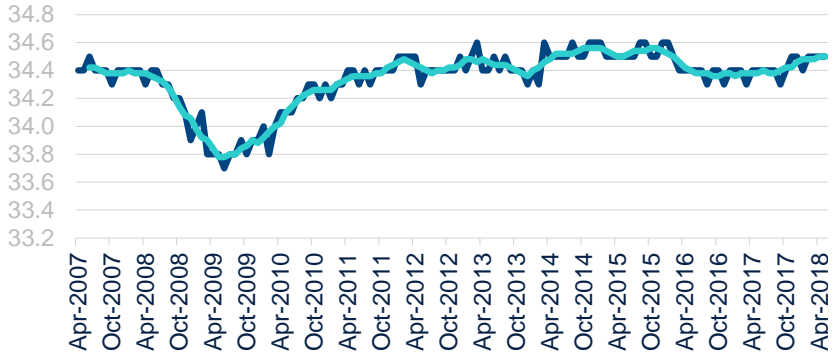
Industry Employment (Annualized % change)



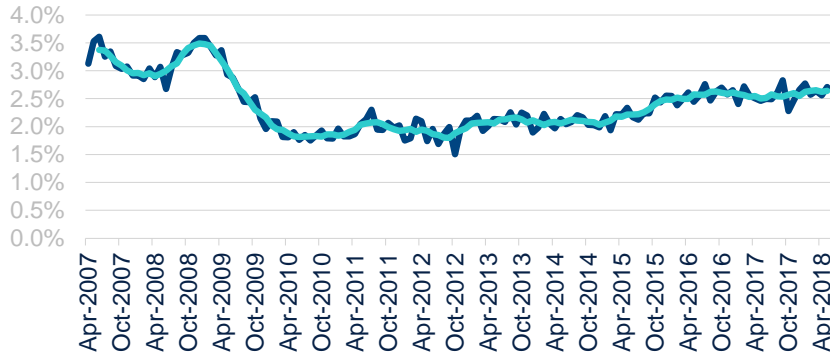
Source: BBVA Research & BLS

Labor market: Participation and wages trending upwards

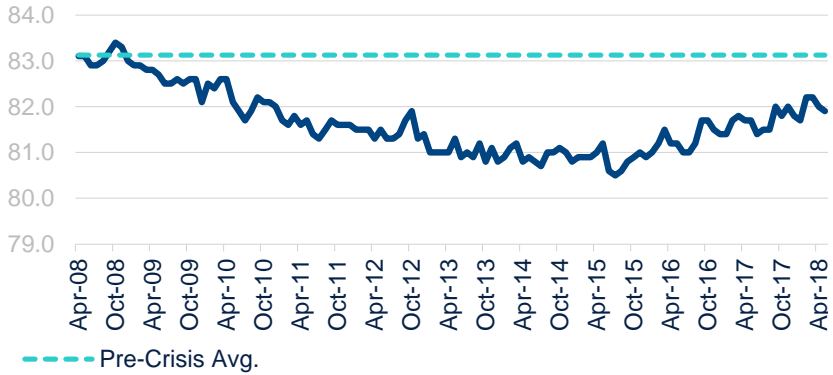
Average Weekly Hours (number & 5mcm)



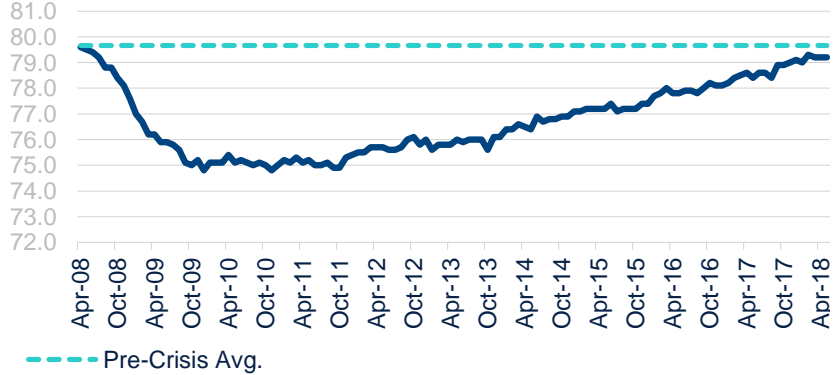
Average Hourly Earnings (YoY% & 5mcm)



Prime Age Labor Force Participation (%)



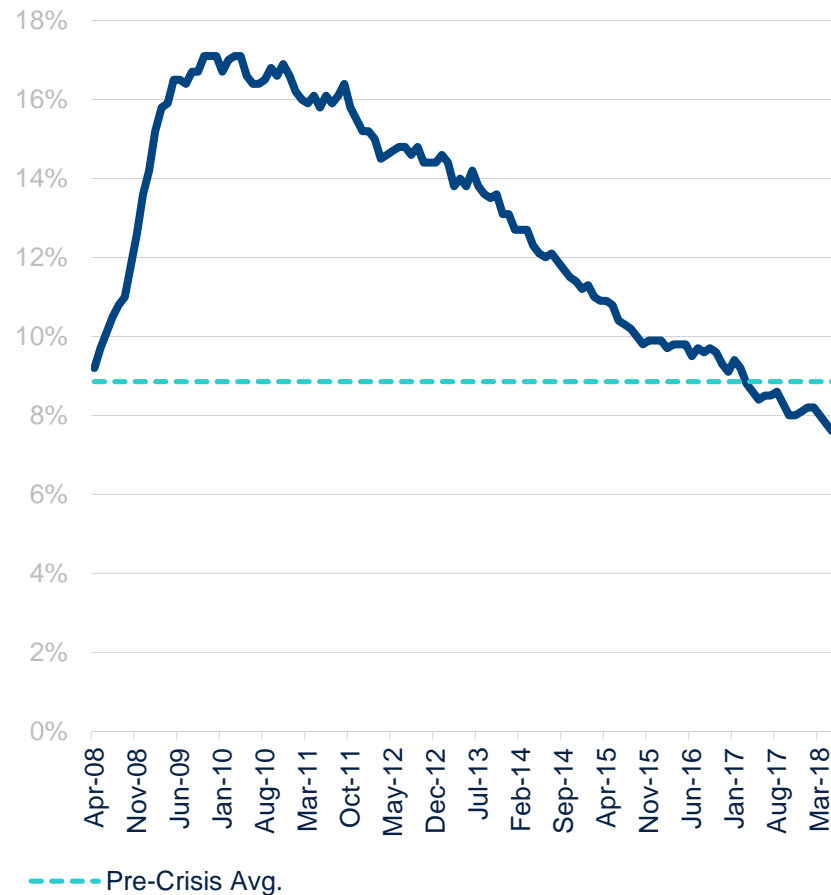
Prime Age Employment-to-Population (%)



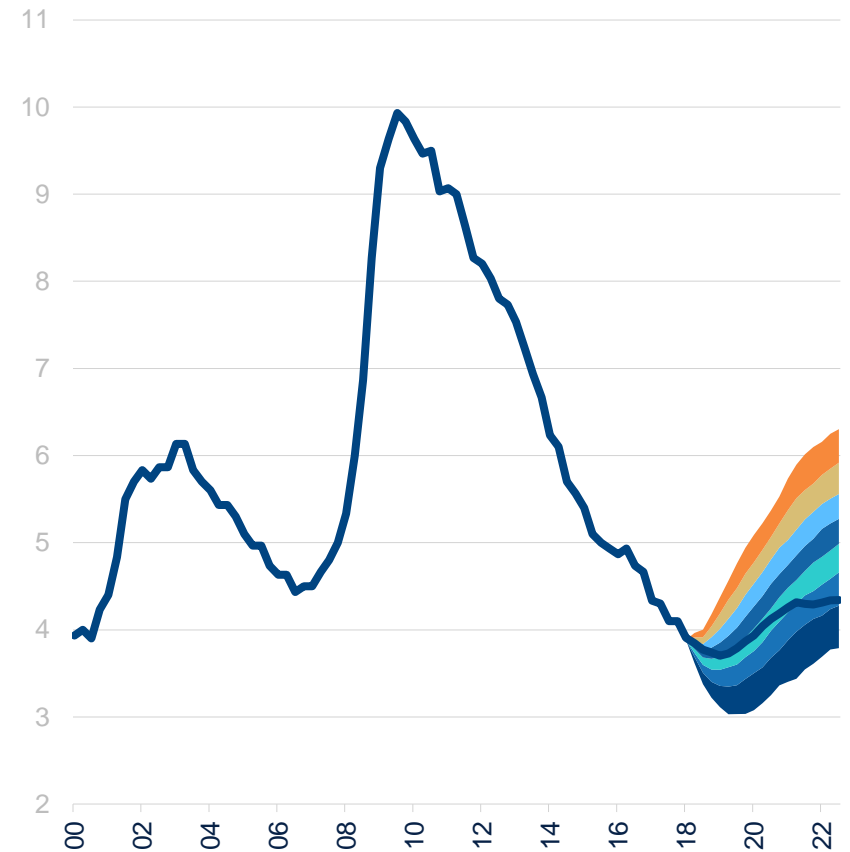
Source: BBVA Research & BLS

Labor market: Broader measures of unemployment suggest slack abating

U-6 (%)



Unemployment Rate (%)

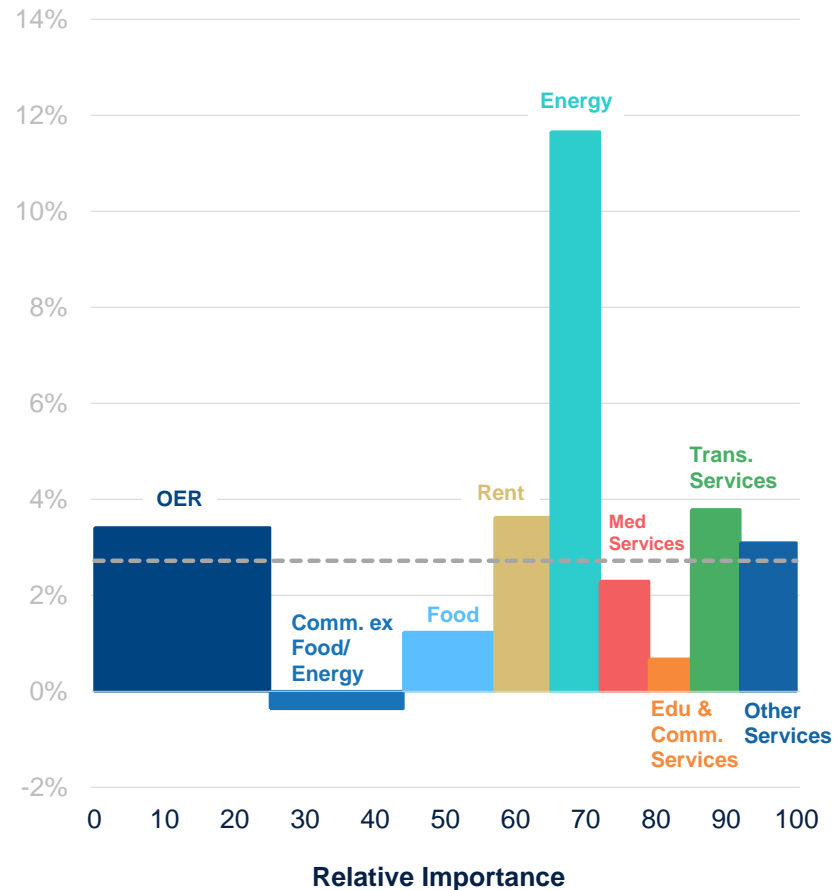


Inflation

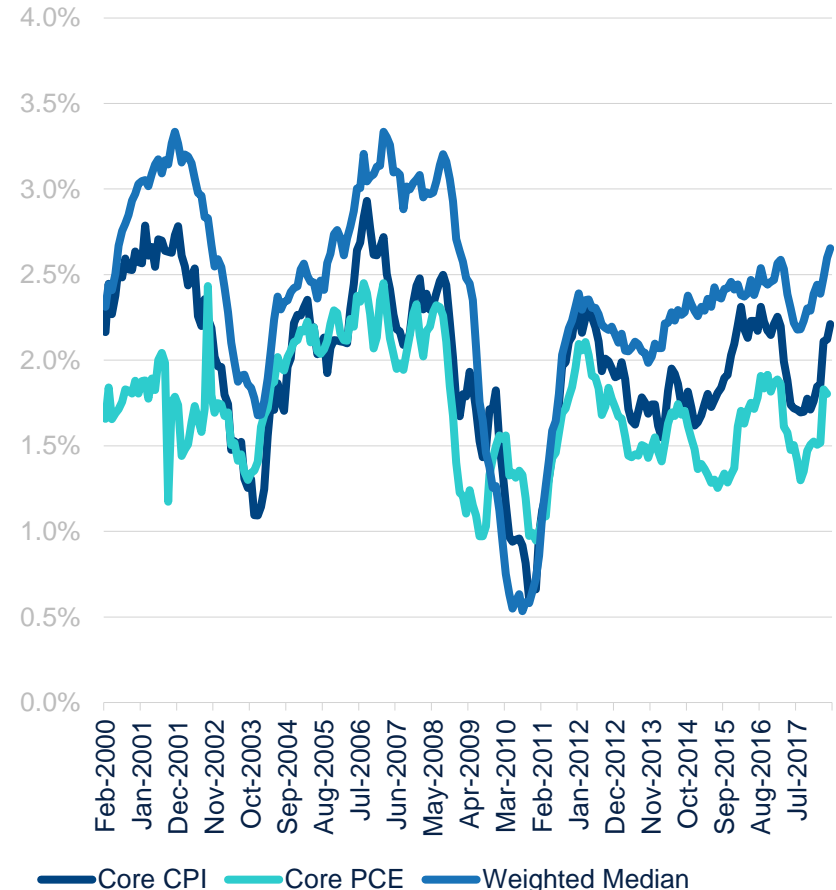
- April headline PCE accelerated to 2.0% year-over-year while core PCE surged to 1.8%; headline and core CPI increased 2.8% and 2.2% in May
- After trending upwards, inflation expectations have stabilized slightly above the 2% target; no major changes in survey-based expectations
- With the additional tailwinds from the expansionary fiscal policy, we expect Core PCE to rise to 2.3% in 2019 before returning to 2% in 2021

Inflation: Services driving core prices, headline increasing on higher energy prices

Consumer Price Inflation (12m change)



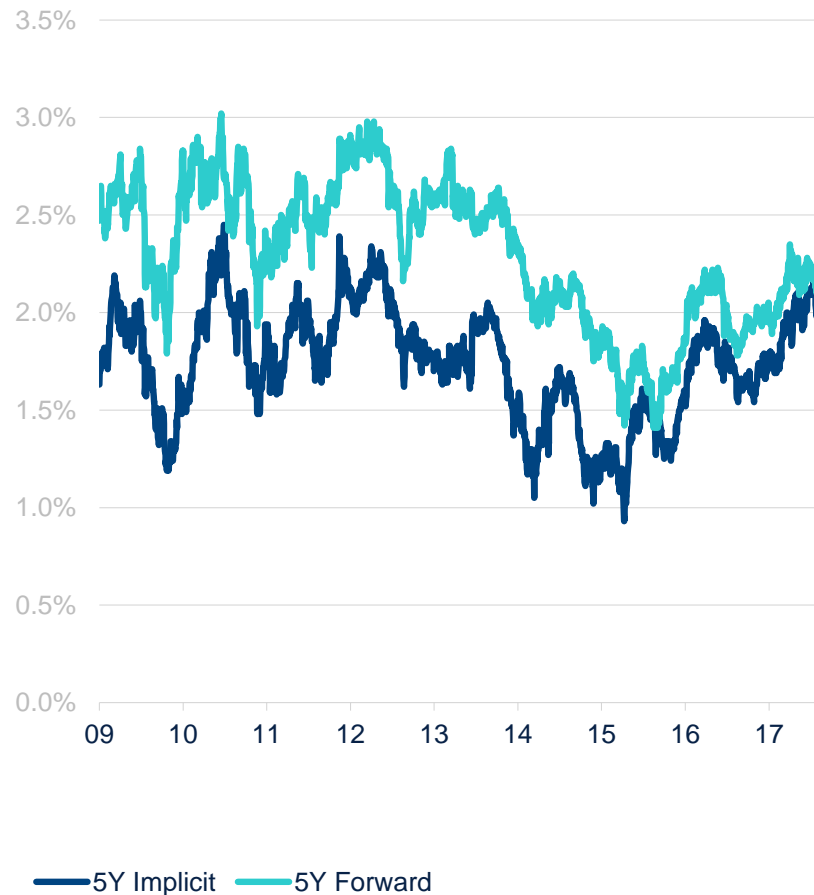
Core Inflation Measures (12m change)



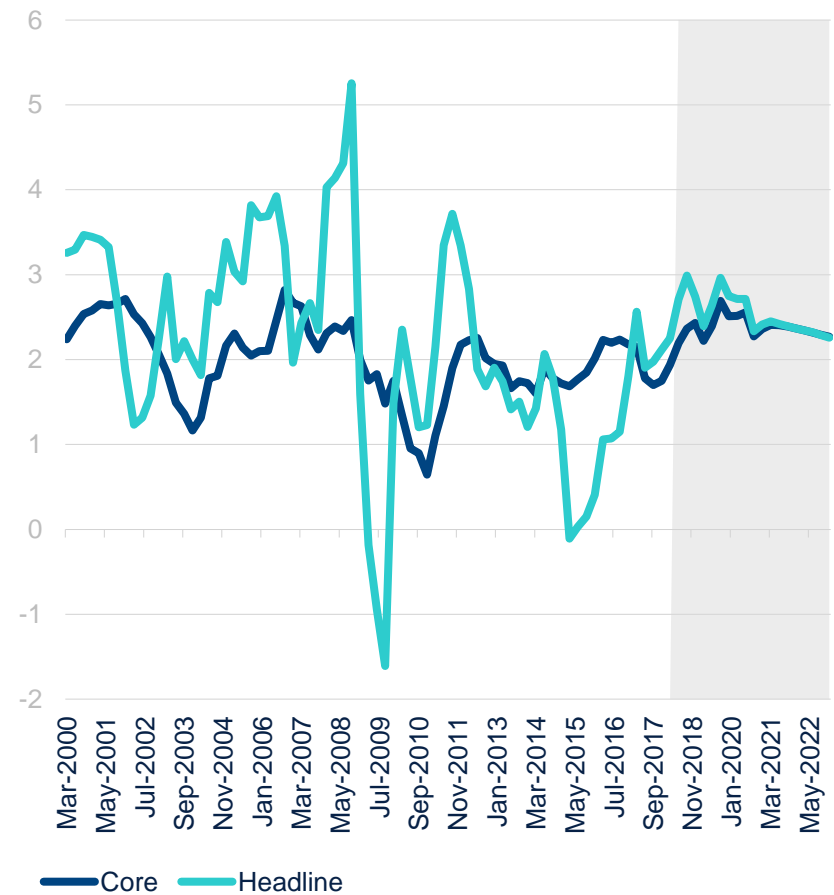
Source: BBVA Research, BLS & BEA

Inflation: Headline and core prices to overshoot target in the short-run

Inflation Expectations (%)



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

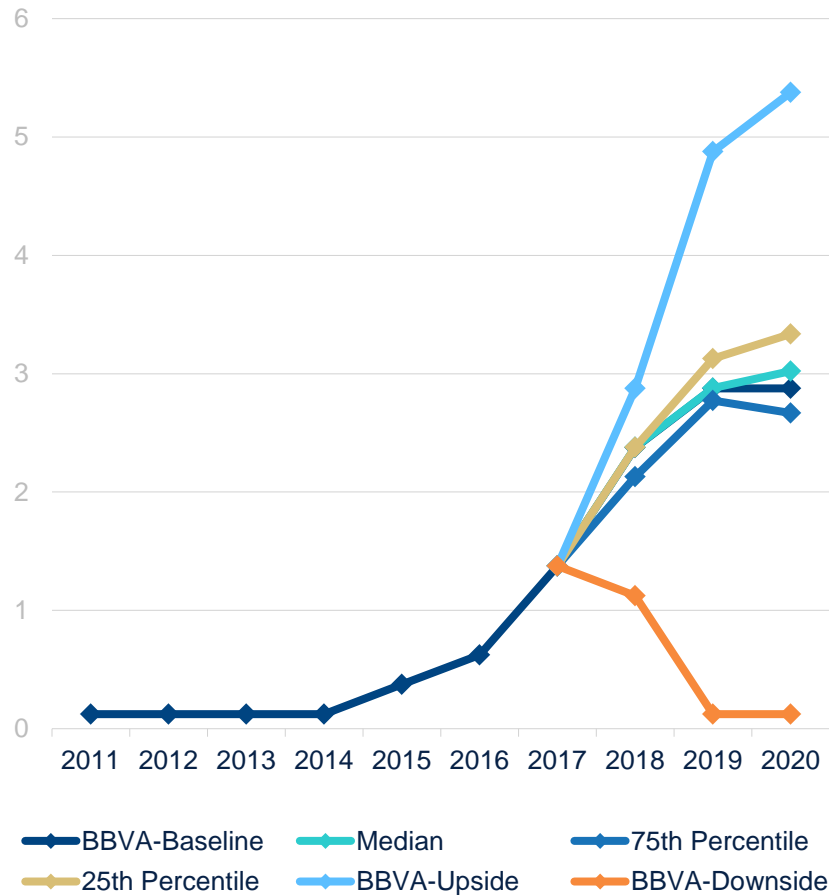


Monetary Policy: Federal Reserve

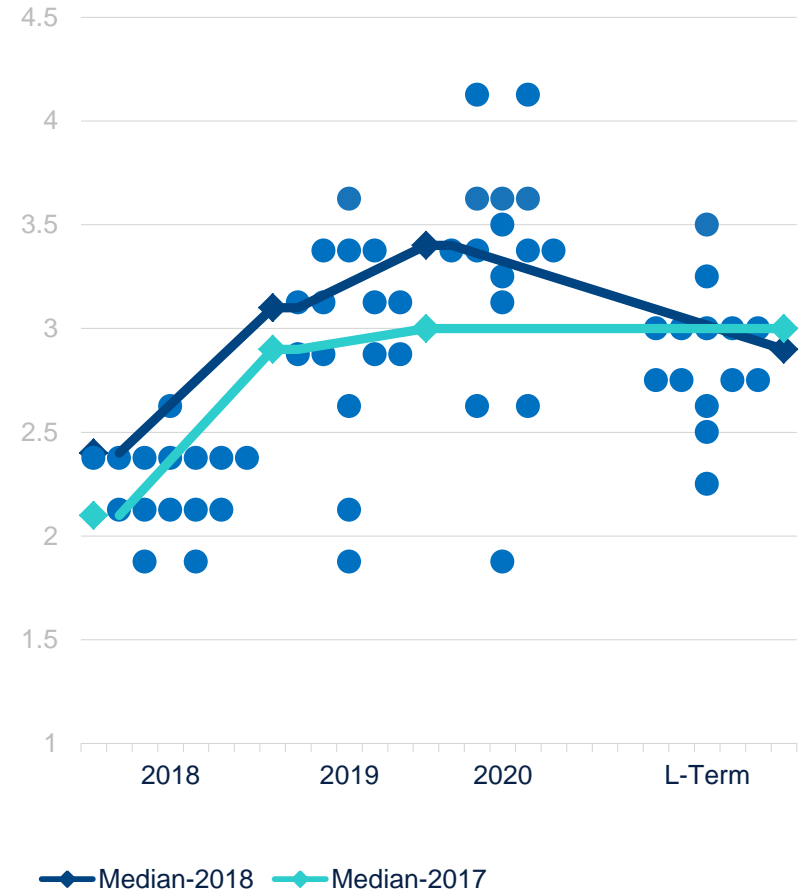
- As expected, the FOMC raised the Fed funds rate target range to 1.75%-2.00% at its June meeting
- June's statement, economic projections and press conference marks the end of the post-crisis era and the beginning of a new phase of monetary policy
- The FOMC dropped the forward guidance language from the statement while simplifying the wording.
- Starting in January, the Chairman will hold press conferences following every meeting
- The Fed adjusted the interest paid on excess reserves to 5 basis points
- The risk of three rate increases in 2019 continues tilting to the upside; for 2018, we maintain our baseline scenario of two additional rate increases

Fed: Poised for two more hikes in 2H18, after raising twice in 1H18

BBVA & Dealers Projections of Fed Funds (%)

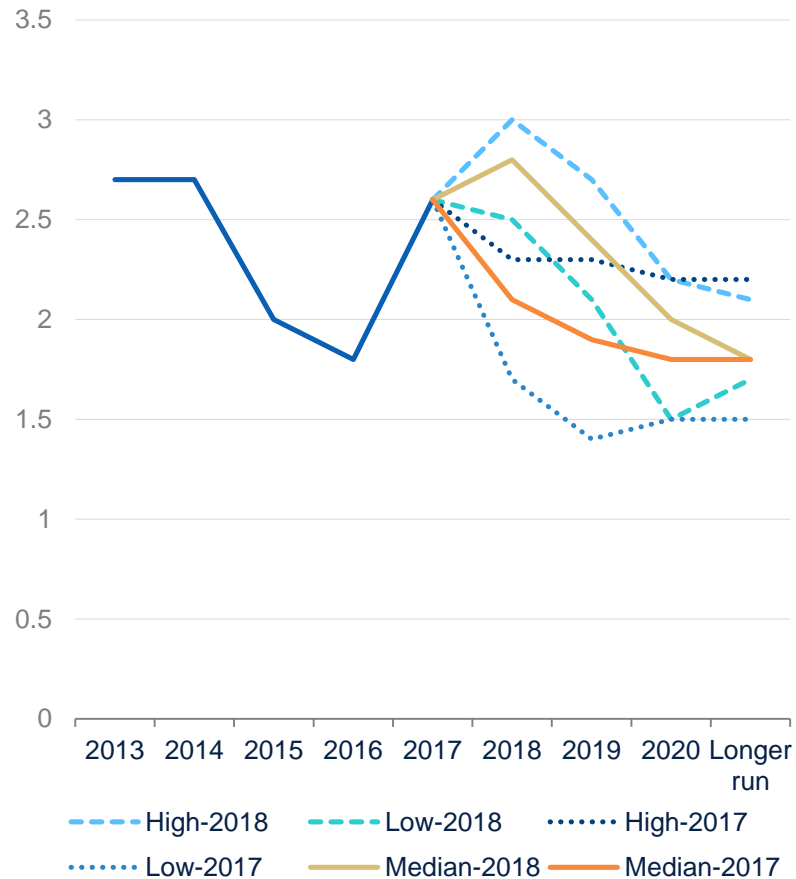


FOMC Projections of Fed Funds (Year-over-year %)

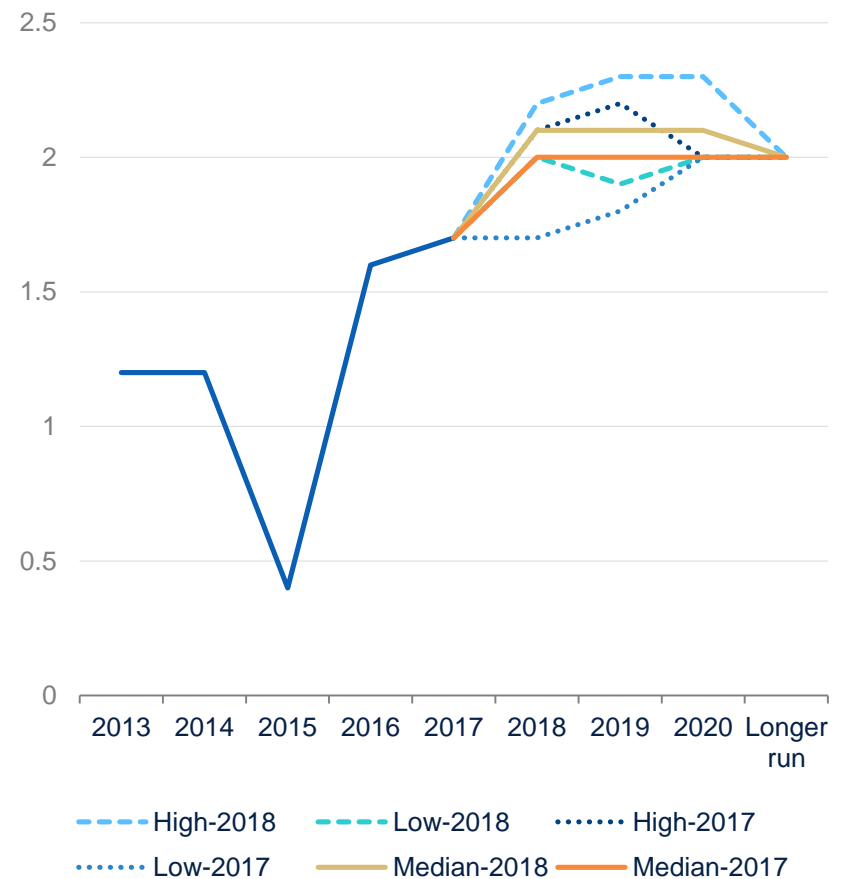


Monetary policy: FOMC projections

FOMC Real GDP Projections (Q4/Q4, %)

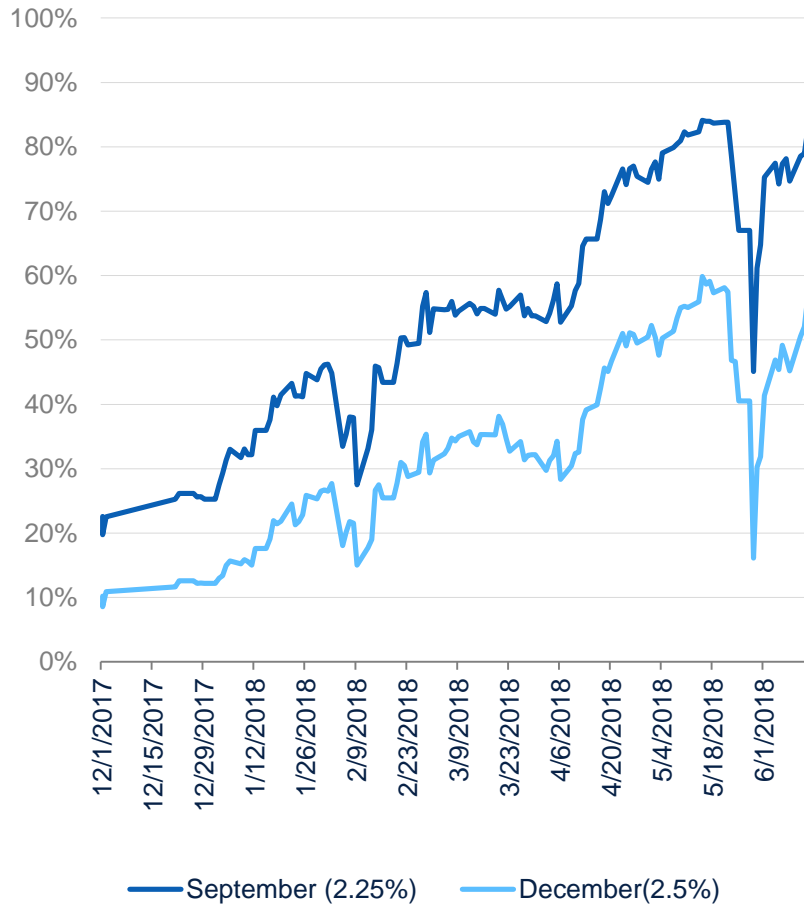


FOMC Headline PCE Projections (Q4/Q4, %)

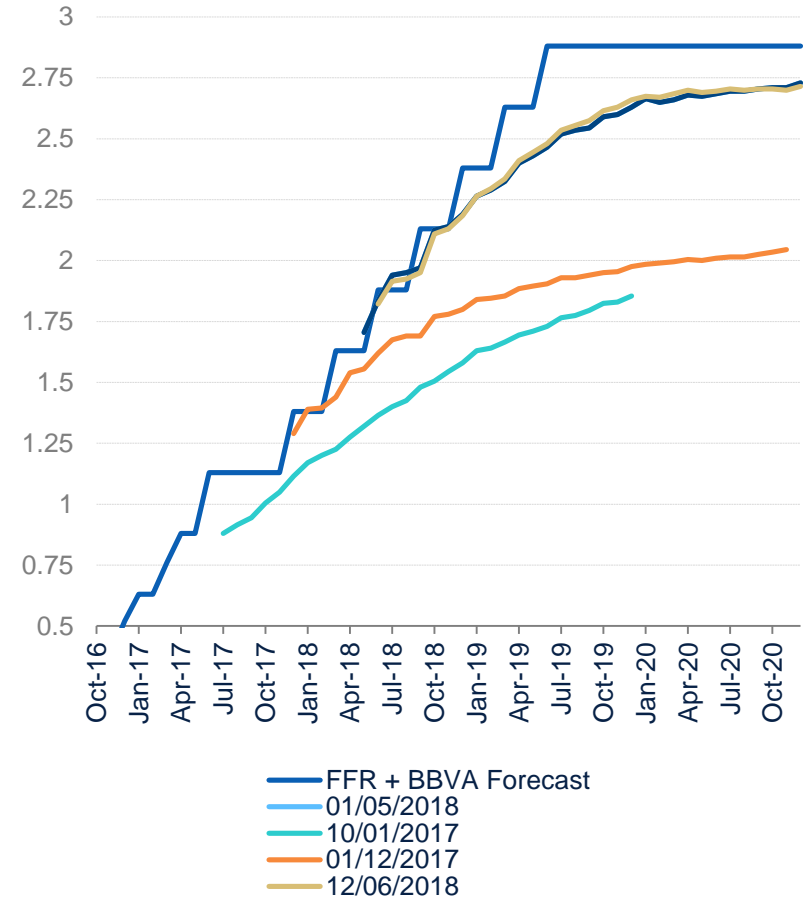


Monetary policy: Fed futures markets

Fed Funds Implied Probability (%)

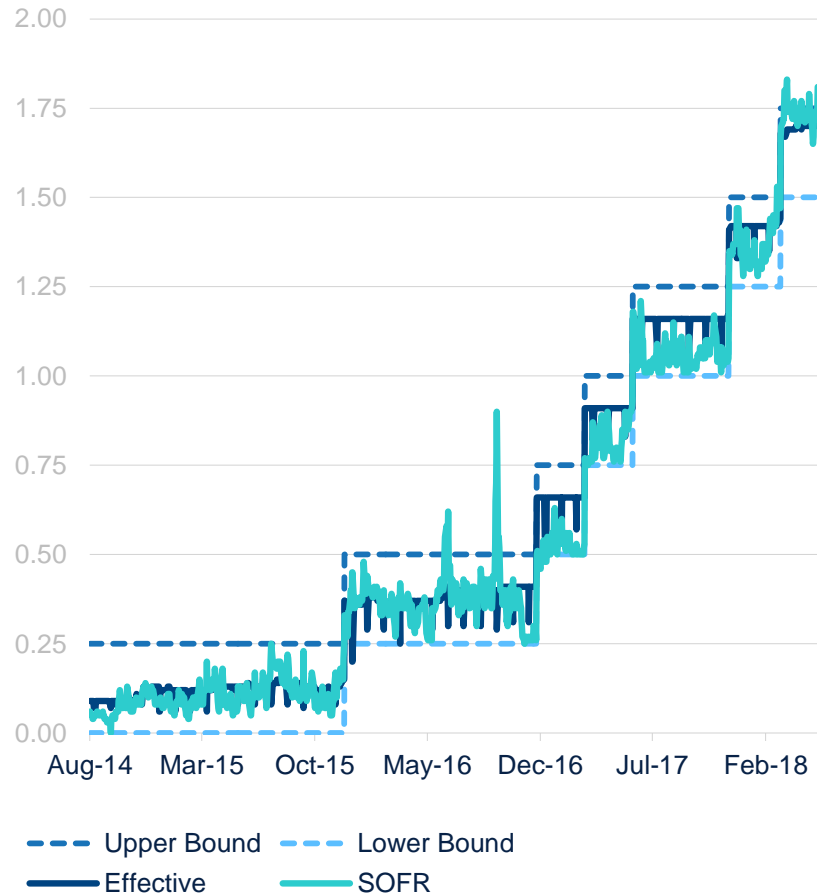


Fed Funds Futures & BBVA Baseline (%)

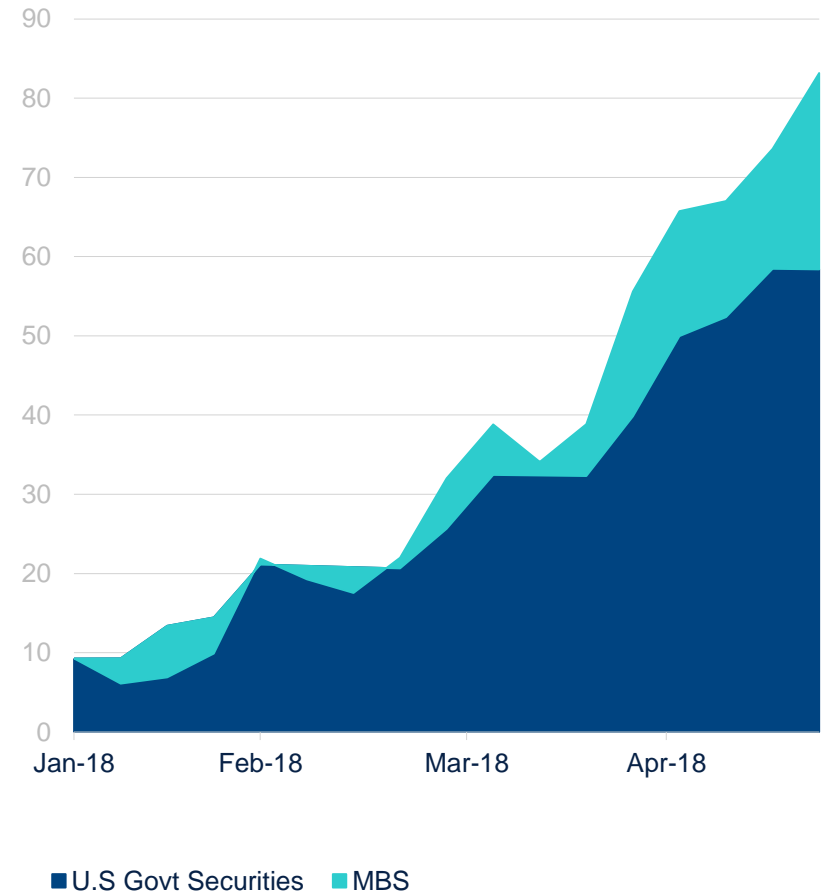


Interest rates: Impacts of policy normalization

Fed Funds & Repo Rates (%)



Balance Sheet Attrition (US\$bn)



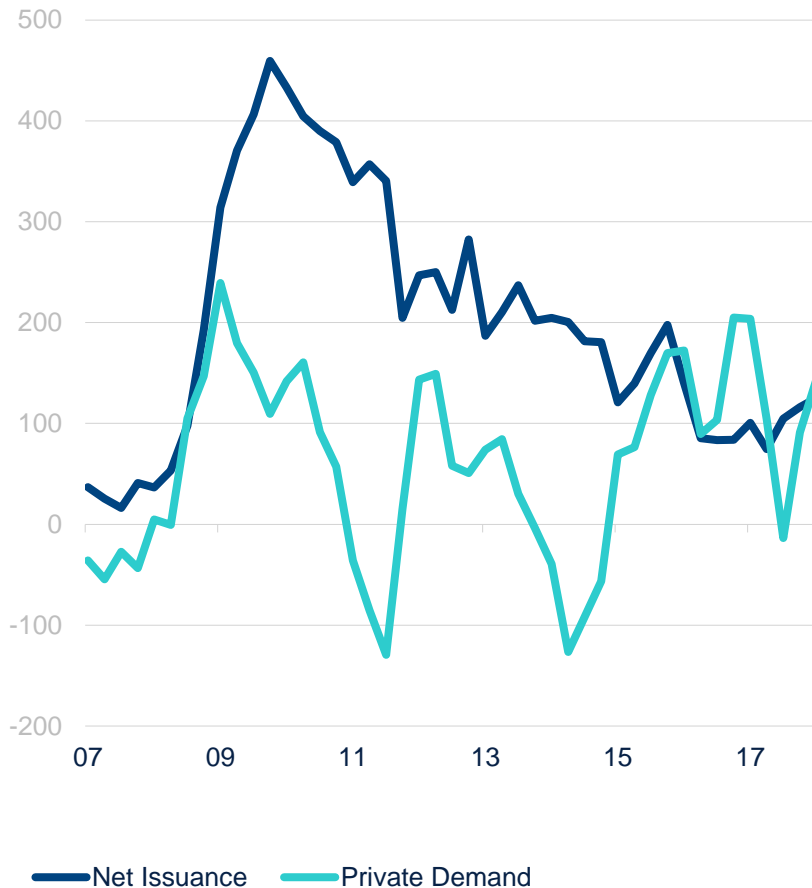
Interest Rates

- 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
- Demand-side conditions sufficient enough to offset rising issuance, which will continue compress term-premium keeping long-term rates low
- Inflation expectations will remain the major driving force behind increases in long-term rates in short-to-medium run
- The yield curve slope between the 10-year and 2-year Treasuries to flatten further
- Baseline continues to assume 10-year at 3.1% by year-end 2018

Interest rates: Private demand absorbing uptick in issuance

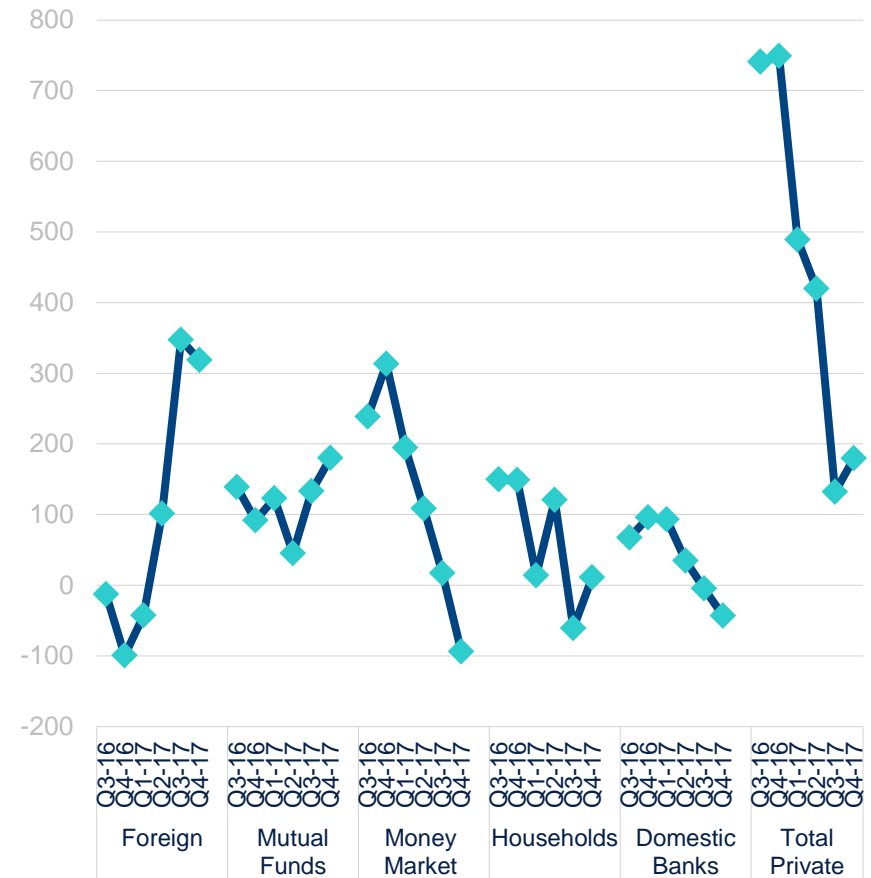
Net Treasury Supply & Change in Private Domestic Demand

(US\$bn & 3qcm)



Private Demand for Treasuries

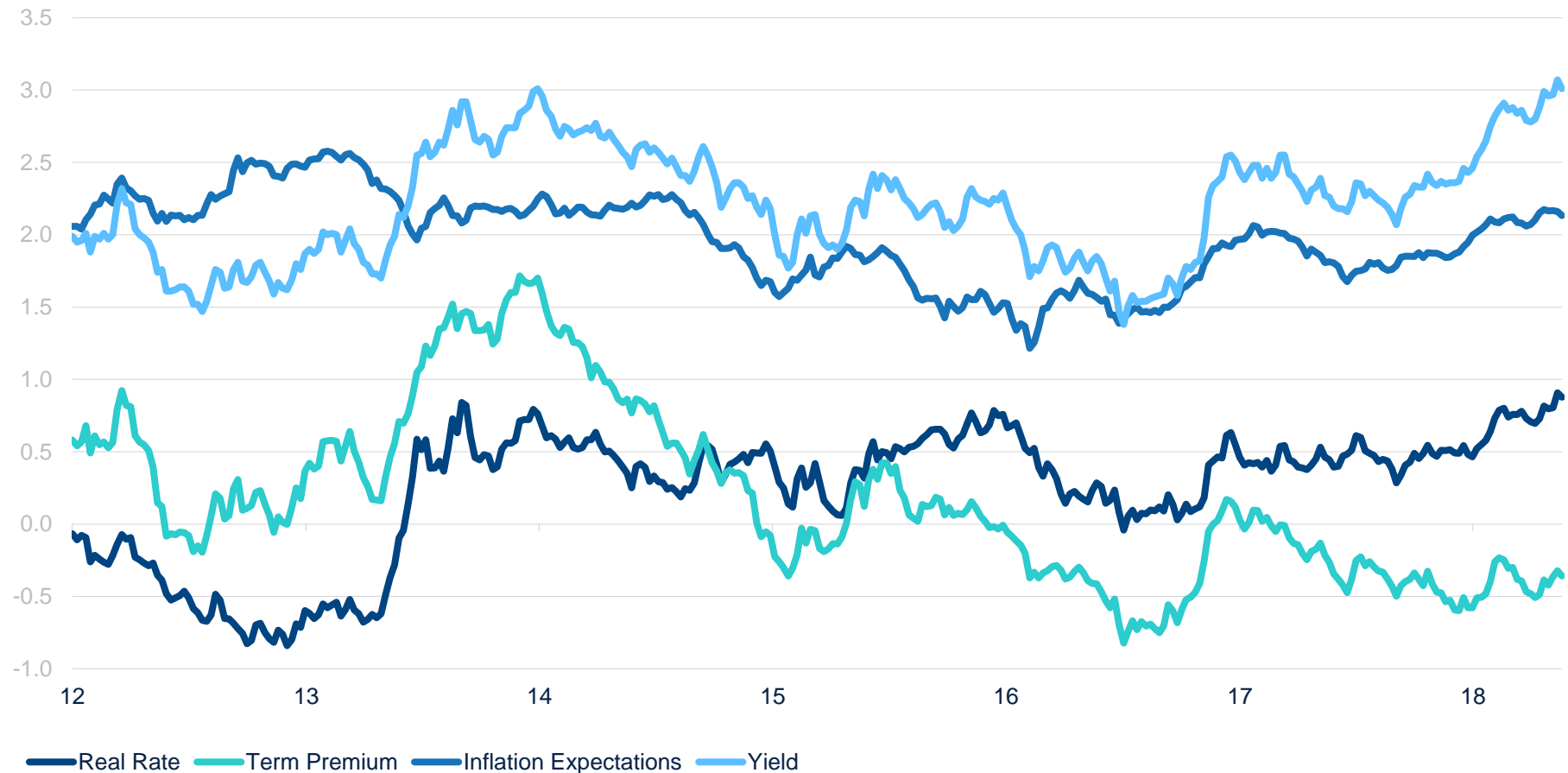
(US\$bn, 4qma)



Source: BBVA Research & U.S. Treasury

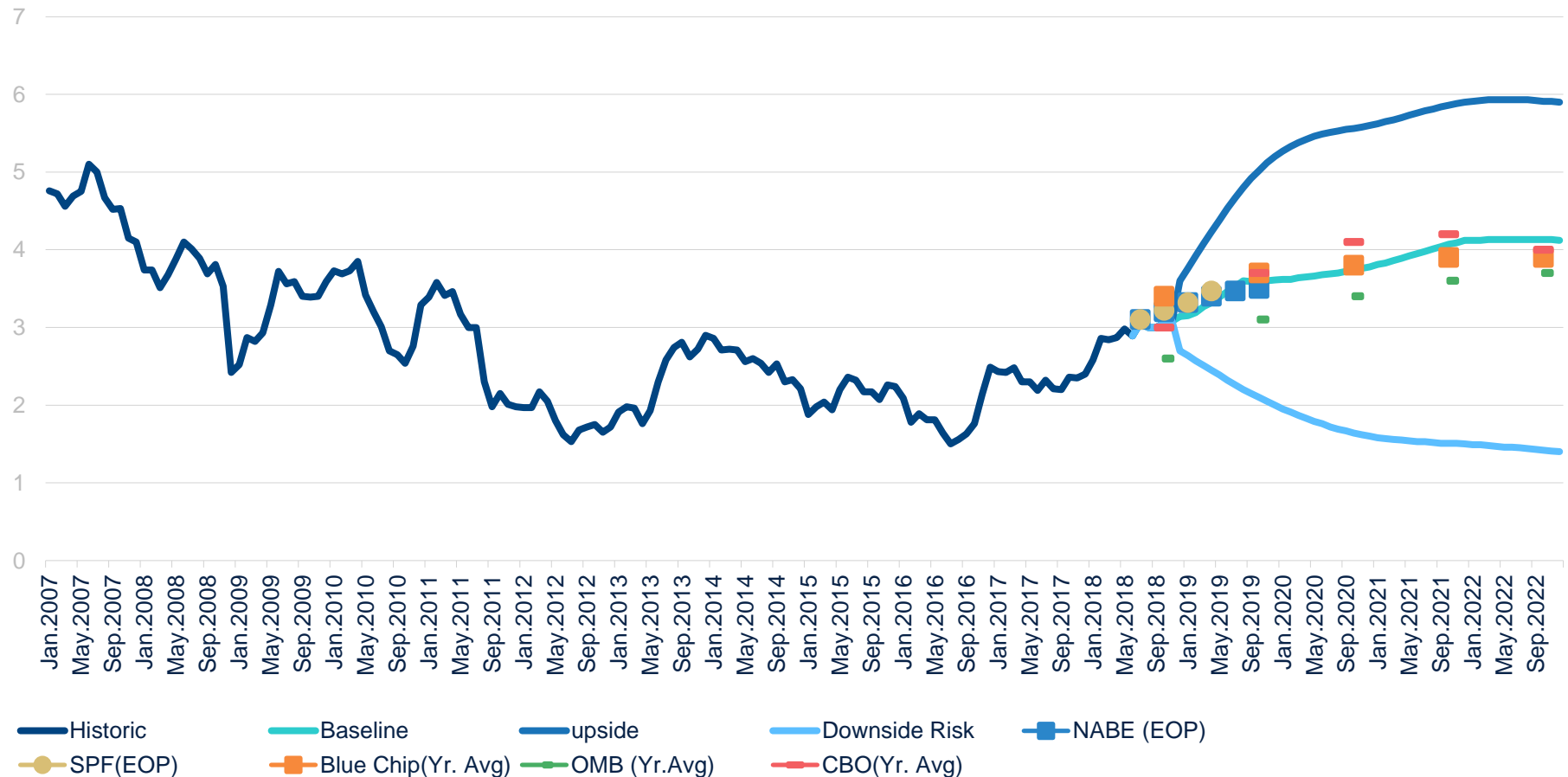
Interest rates: Term premium negative, inflation expectations rising

10-Year Treasury Yield Decomposition (%)



Interest rates: 10-year treasury yield forecasts

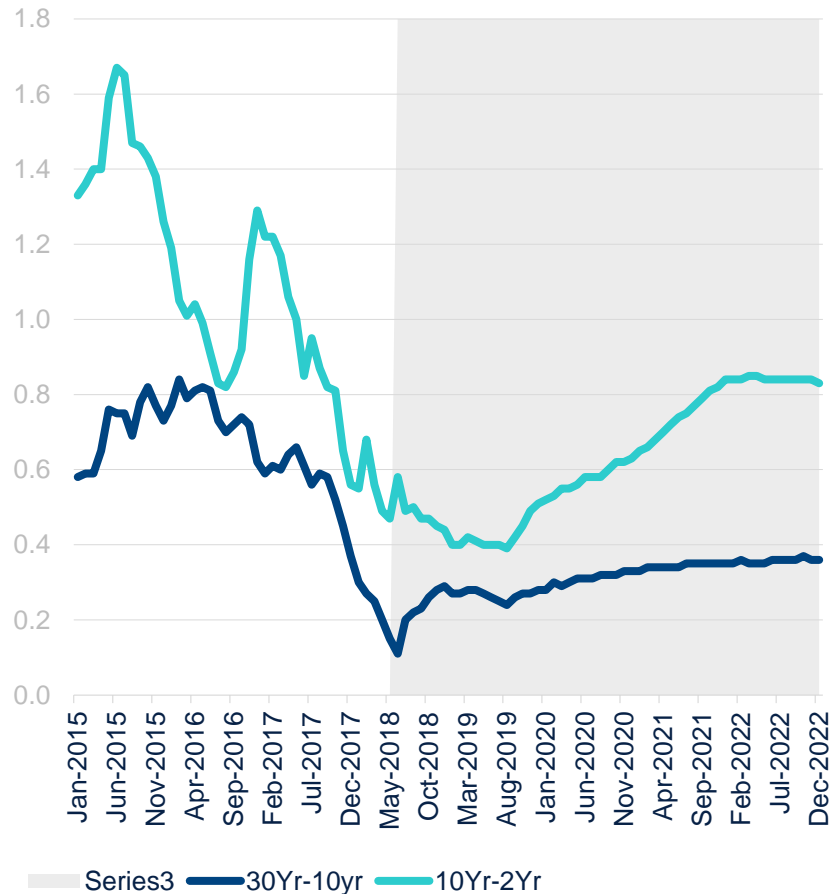
10-Year Treasury Yield (%)



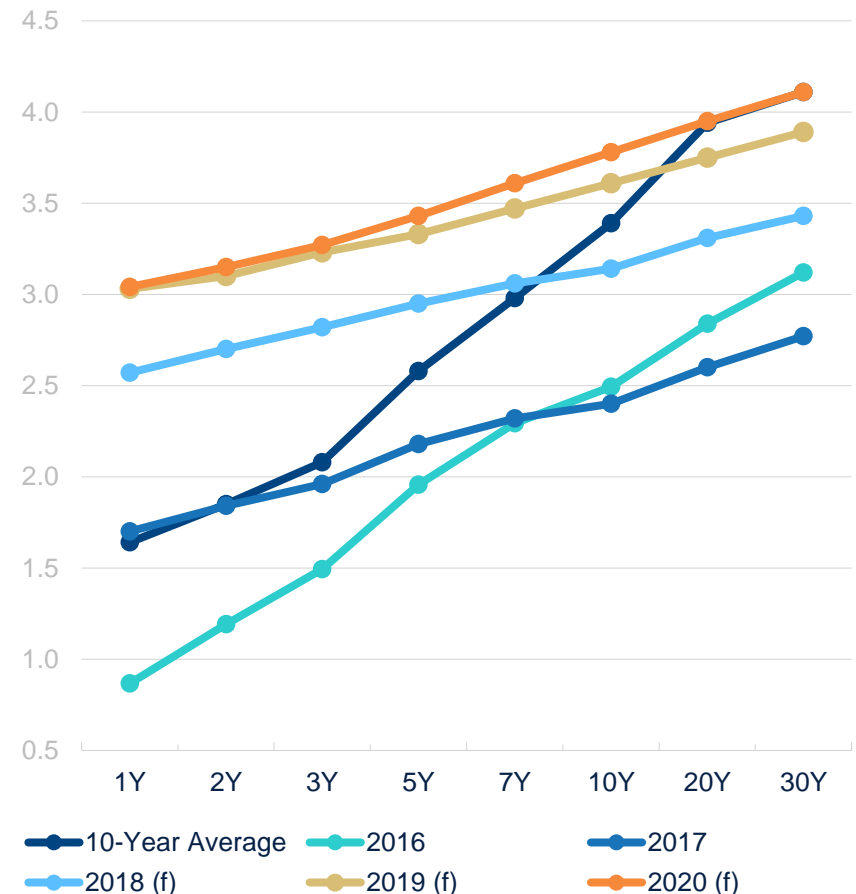
Source: BBVA Research, ACM & Haver Analytics

Interest rates: Yield curve slopes will continue to compress in short-term

Yield Curve Slope (Bp)



Yield Curve (% eop)



Economic Scenarios

Probability (%)	Current	Previous
Upside	10	10
Baseline	65	70
Downside	25	20

Macro Scenarios

	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
GDP	1.7	2.6	2.9	1.5	2.3	2.8	2.8	2.5	2.3	2.0
Upside	1.7	2.6	2.9	1.5	2.3	3.8	3.6	3.4	3.2	3.1
Downside	1.7	2.6	2.9	1.5	2.3	2.0	-1.8	0.4	1.2	1.4
UR	7.4	6.2	5.3	4.9	4.4	3.9	3.7	4.0	4.3	4.3
Upside	7.4	6.2	5.3	4.9	4.4	3.8	3.1	2.8	3.0	3.0
Downside	7.4	6.2	5.3	4.9	4.4	4.0	4.6	6.6	7.0	5.7
CPI	1.5	1.6	0.1	1.3	2.1	2.7	2.7	2.5	2.4	2.3
Upside	1.5	1.6	0.1	1.3	2.1	2.8	3.3	3.2	3.4	3.6
Downside	1.5	1.6	0.1	1.3	2.1	2.3	1.3	0.9	0.7	0.6
Fed [eop]	0.25	0.25	0.50	0.75	1.50	2.50	3.00	3.00	3.00	3.00
Upside	0.25	0.25	0.50	0.75	1.50	3.00	5.00	5.50	5.50	5.50
Downside	0.25	0.25	0.50	0.75	1.50	1.25	0.25	0.25	0.25	0.25
10-Yr [eop]	2.9	2.21	2.24	2.49	2.4	3.14	3.61	3.78	4.12	4.12
Upside	2.90	2.21	2.24	2.49	2.40	3.60	5.20	5.60	5.90	5.90
Downside	2.90	2.21	2.24	2.49	2.40	2.70	2.00	1.60	1.50	1.40

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