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BBVA Research

U.S. Economic Outlook

July 2018

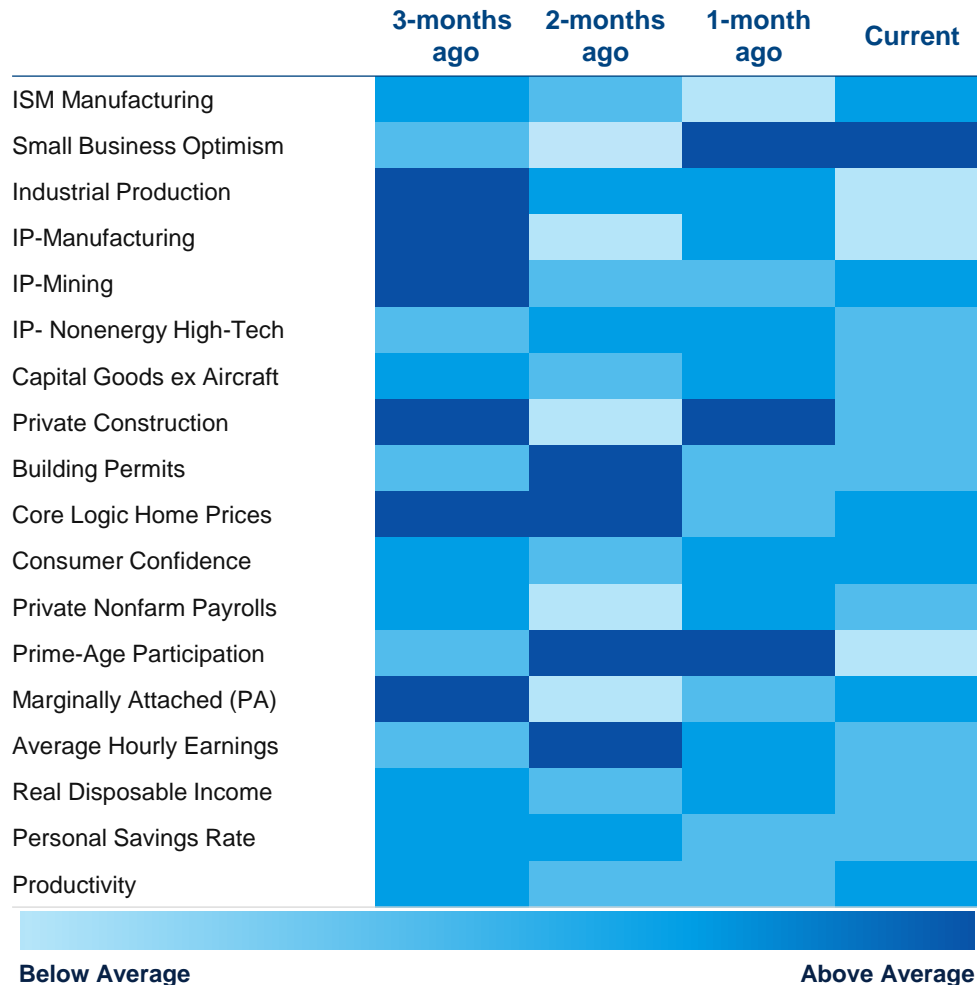
Creating Opportunities

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

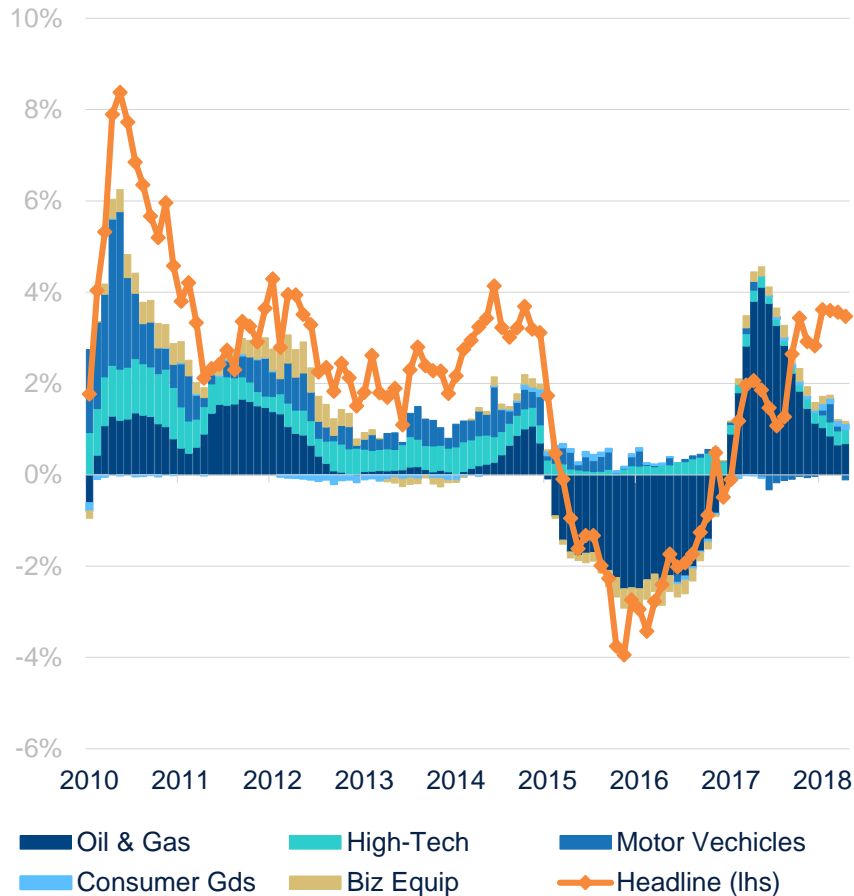
Real-Time Economic Indicator Heat Map



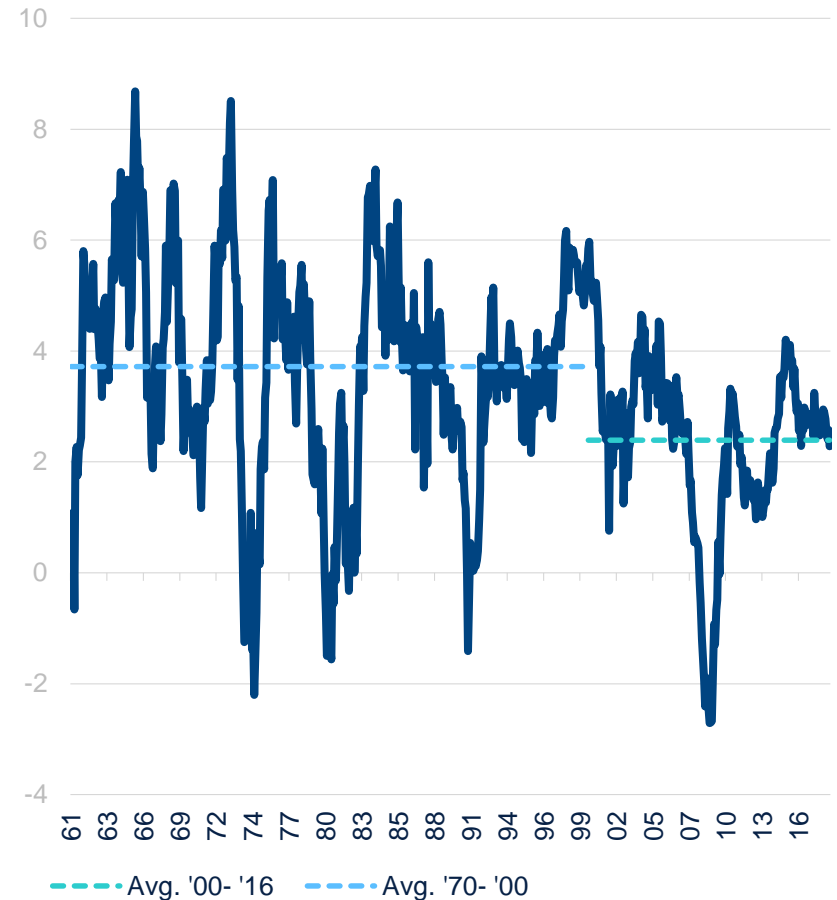
- Industrial activity remains strong, but is slowing
- Favorable oil prices supporting growth in mining strong, as excess capacity shrinks
- Durable goods orders excluding aircrafts slowing after torrid pace in 2Q
- Moderate rebound in labor productivity in 1Q
- Solid growth in disposable income
- Home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

Economic trends: Growth in mining sector stabilizing

Industrial Production (Year-over-year %)



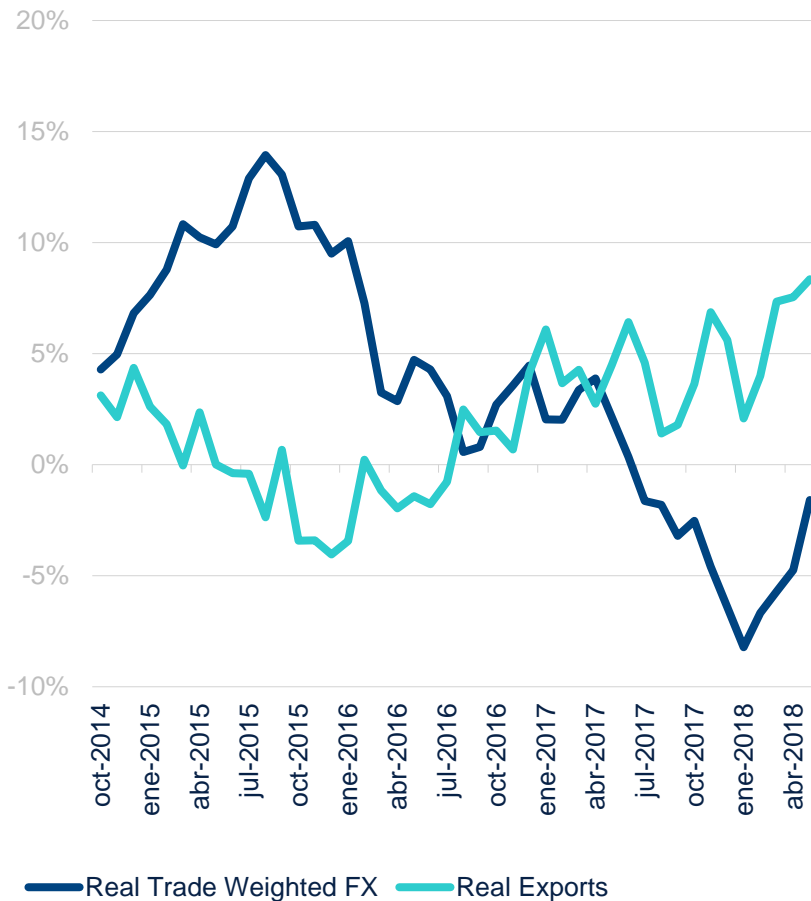
Real Personal Consumption (Year-over-year %)



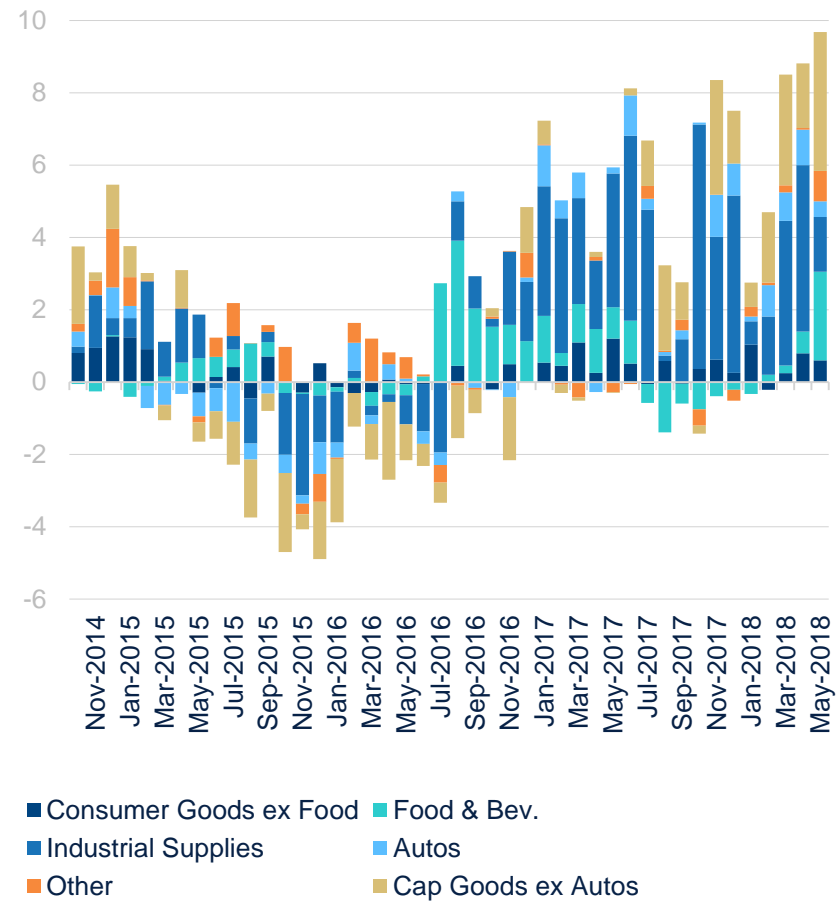
Source: BBVA Research, FRB & BEA

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

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



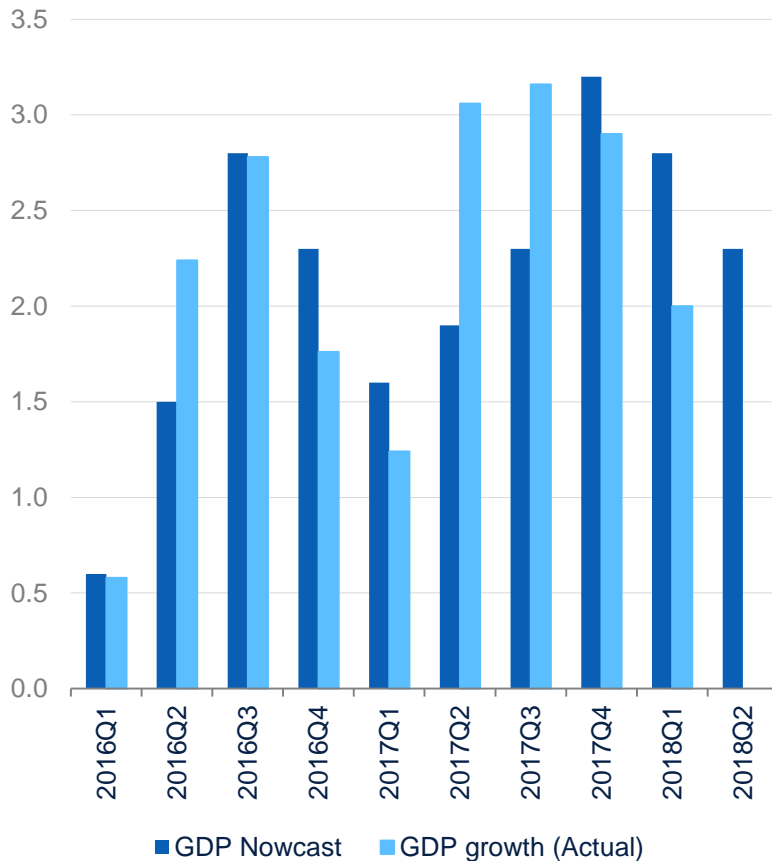
Real Exports (Contribution to year-over-year %)



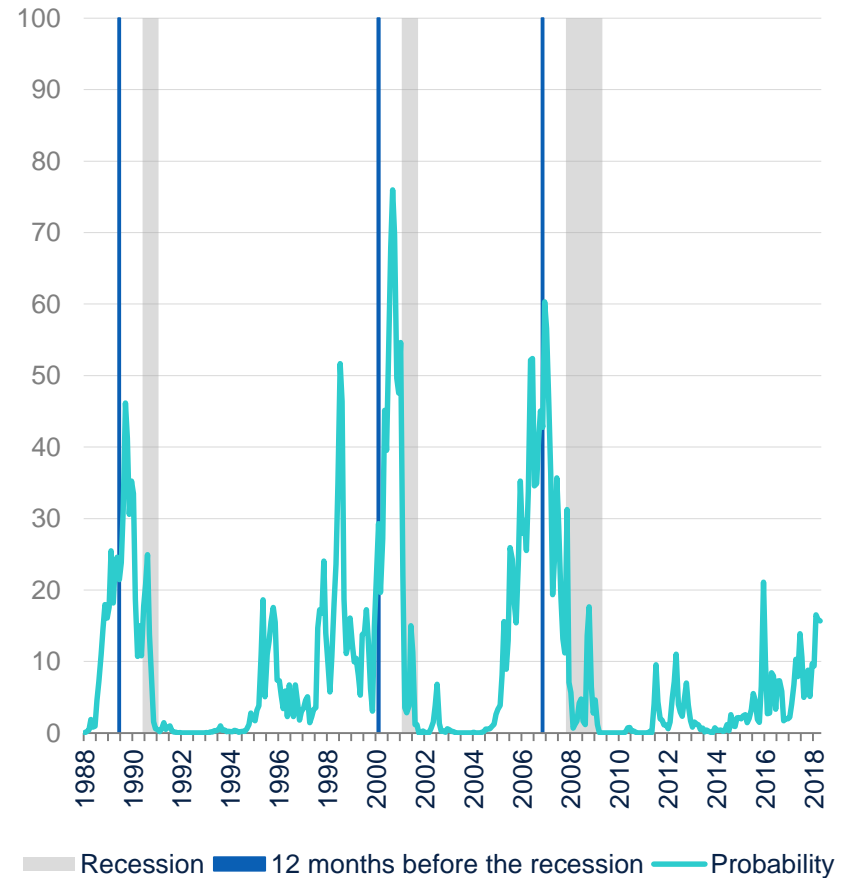
Source: BBVA Research, FRB & Census

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

Real GDP
(QoQ SAAR, %)



Probability of Recession in 12 Months
(%)



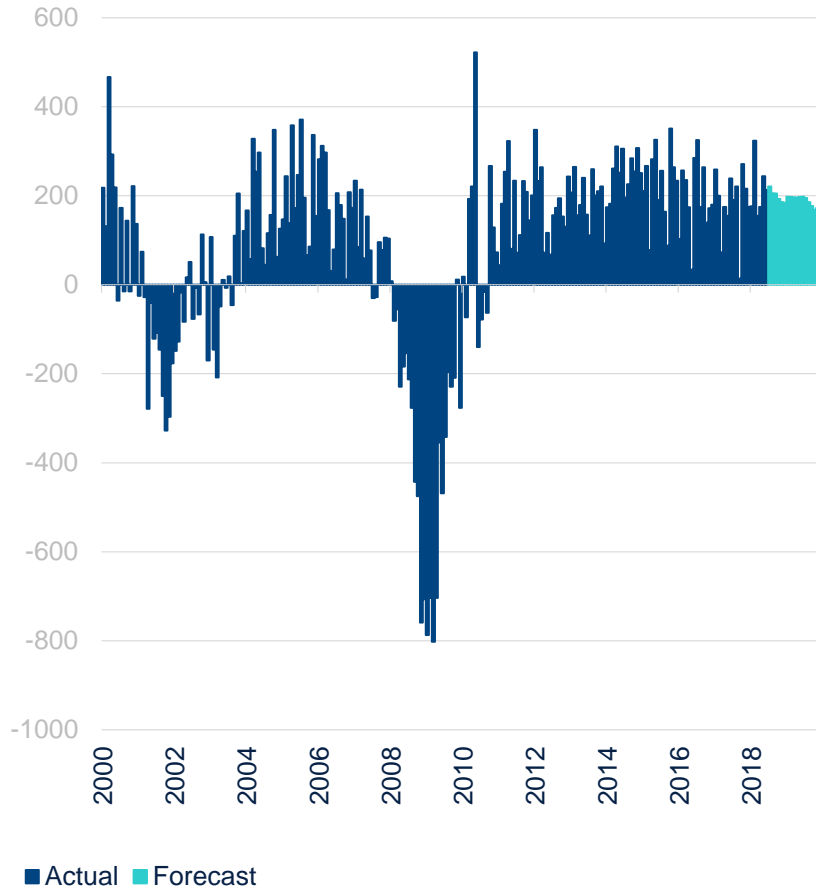
Labor Market



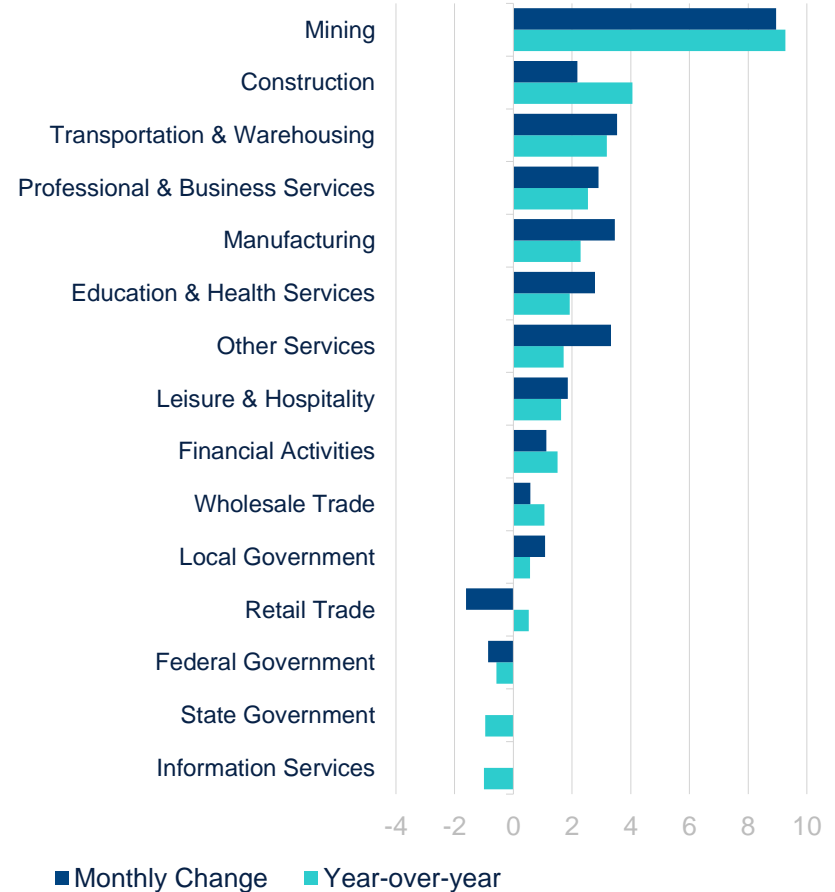
- In June, nonfarm payroll increased by 213,000, supported by professional and business services (50K), manufacturing (36K) and health care (25K)
- With 21.6K jobs lost over the second quarter, the retail sector continues to be a source of weakness
- The unemployment rate unexpectedly edged up to 4% 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)

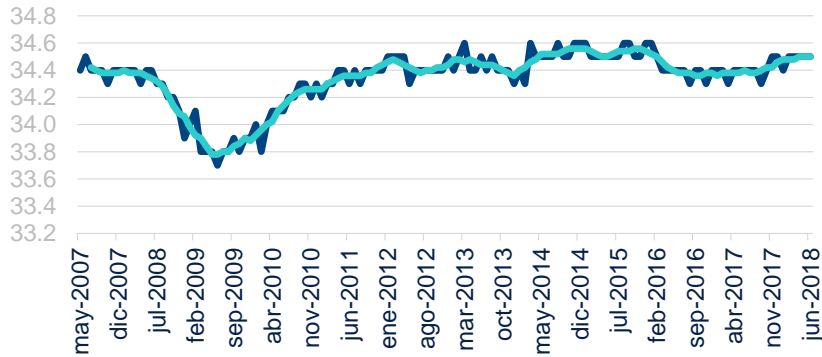


Industry Employment (Annualized % change)

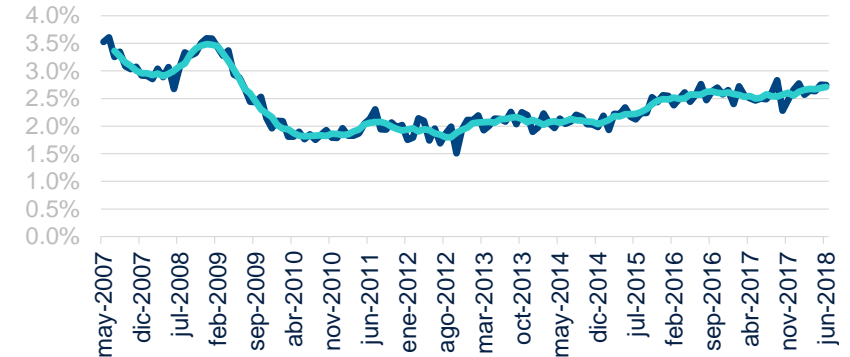


Labor market: Hours worked continue to trend near post-crisis highs

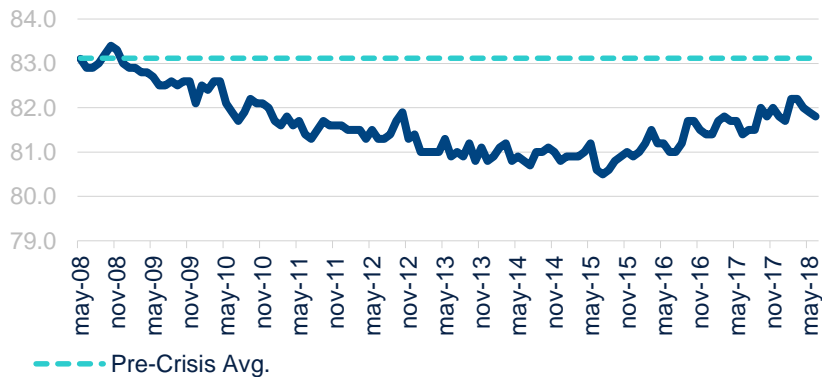
Average Weekly Hours (number & 5mcm)



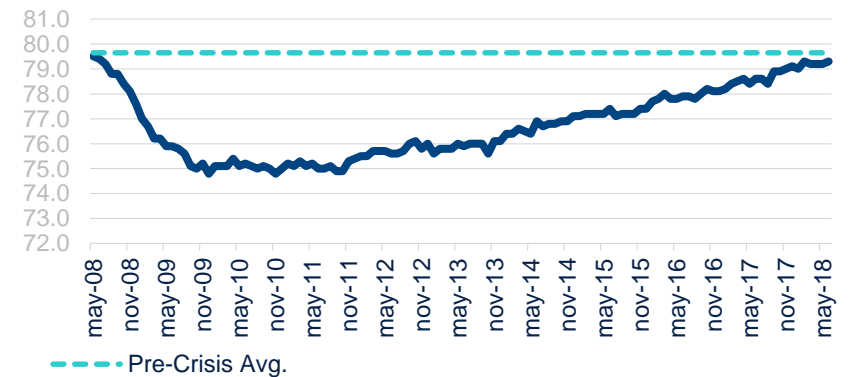
Average Hourly Earnings (YoY% & 5mcm)



Prime Age Labor Force Participation (%)

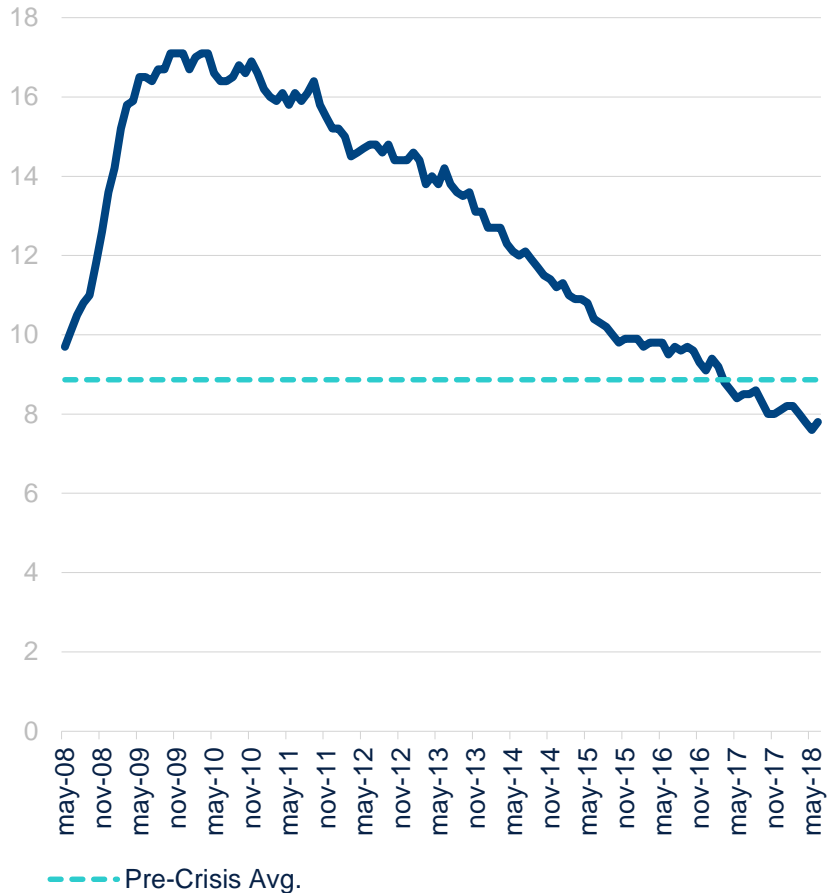


Prime Age Employment-to-Population (%)

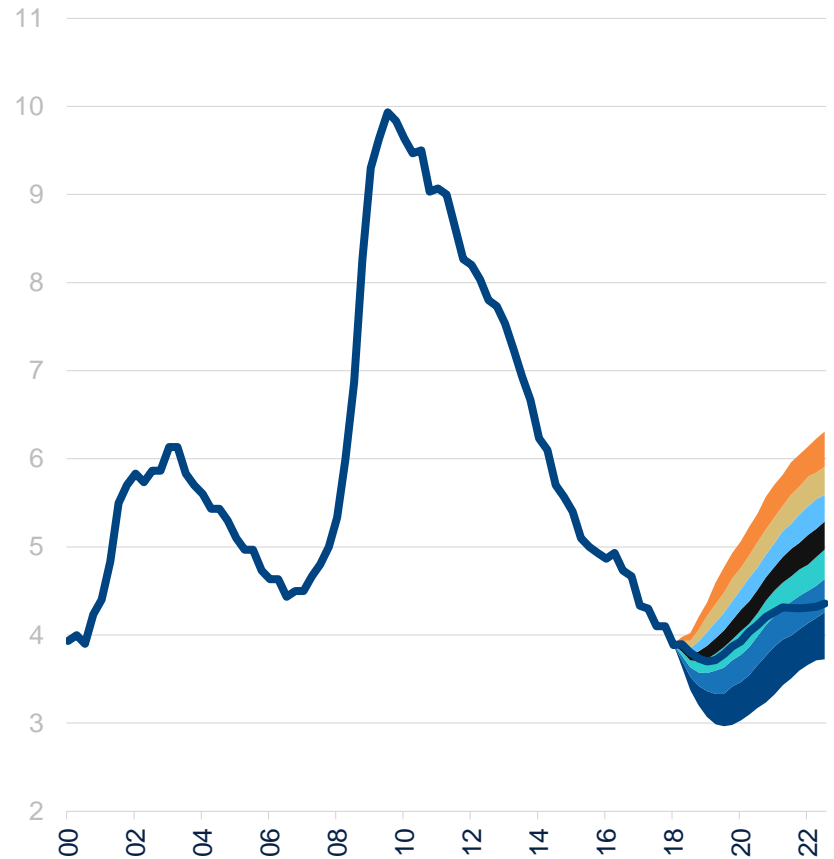


Labor market: Slack to continue to abate, but downside risk to UR limited by inflows

U-6
(%)



Unemployment Rate
(%)

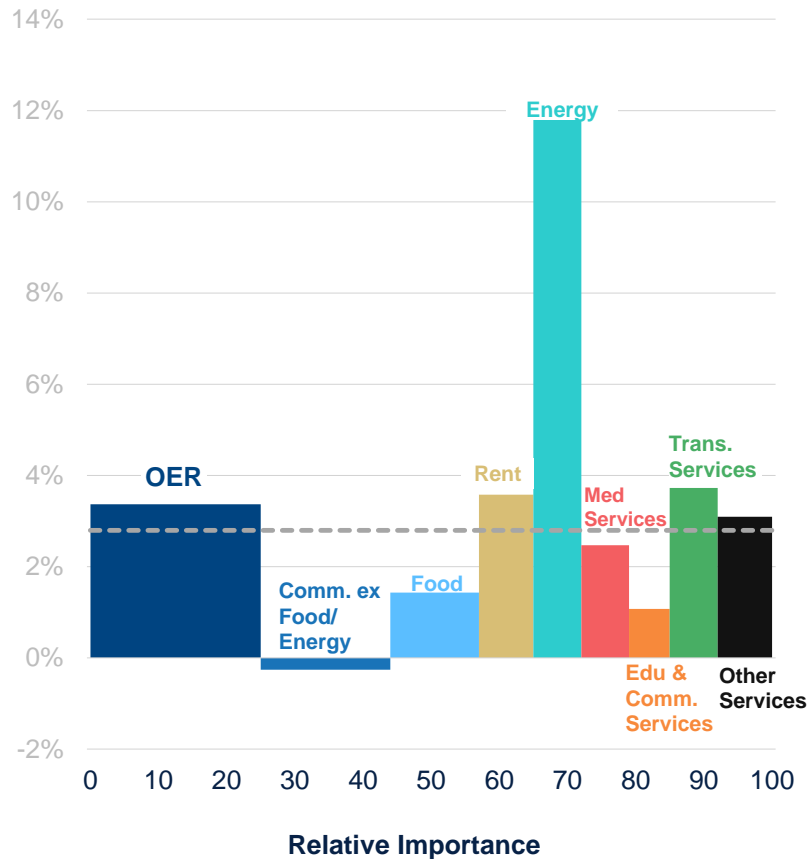


Inflation

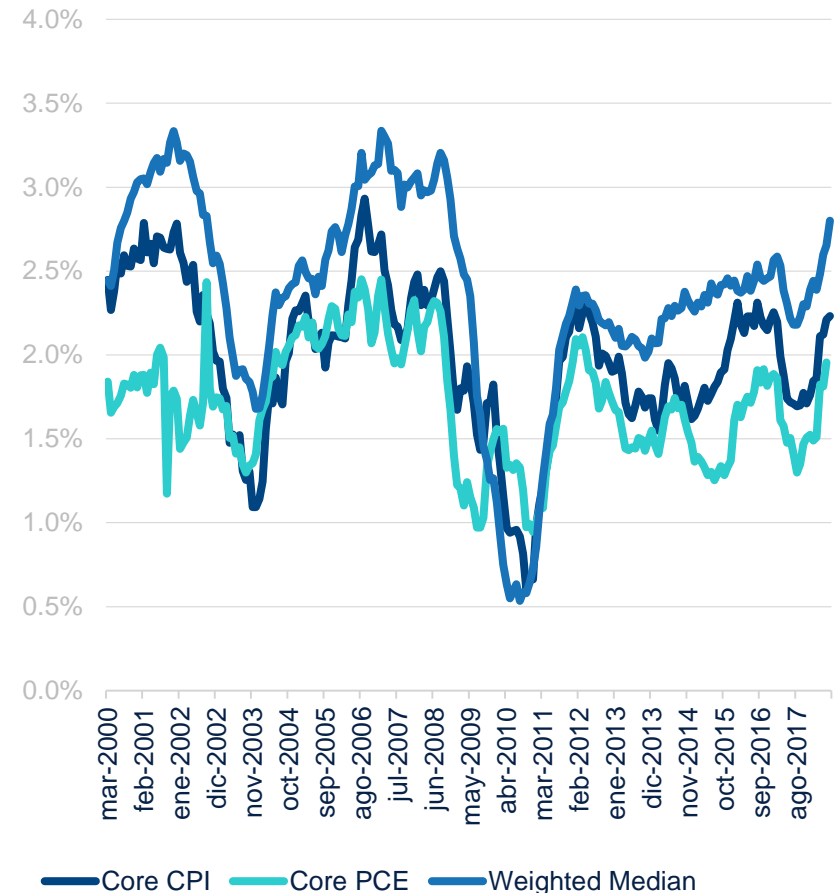
- Headline PCE in May accelerated to 2.3% year-over-year, the highest in six years, while core PCE surged to 2.0%
- Energy prices, services and housing costs largest contributors price increases in 2018; headline and core CPI increased 2.8% and 2.2% in May
- After trending upwards, inflation expectations 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)



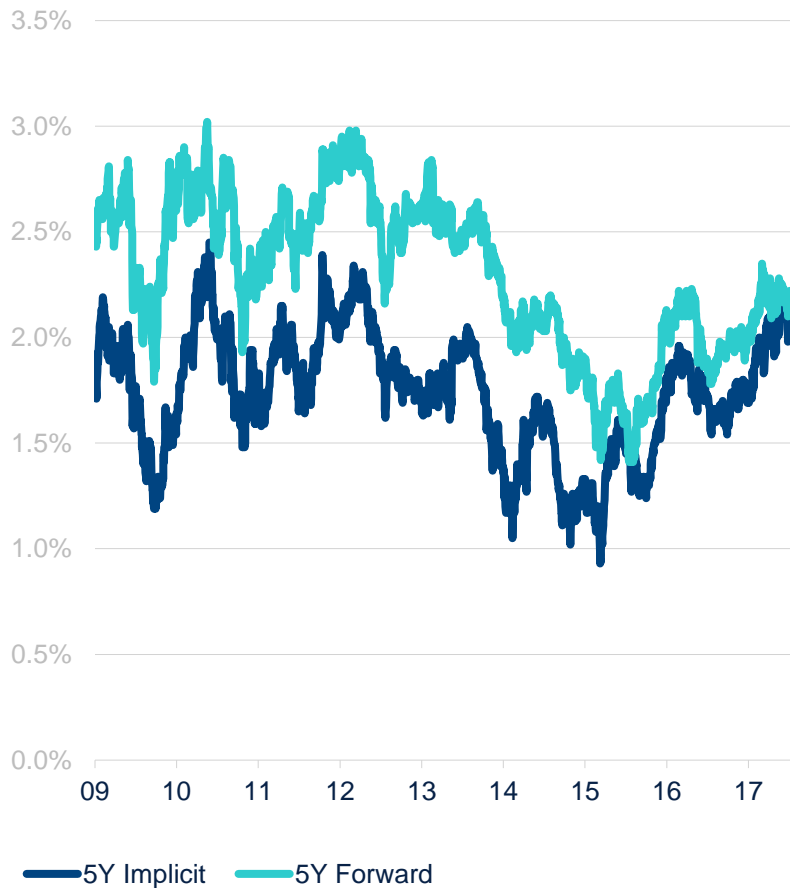
Core Inflation Measures (12m change)



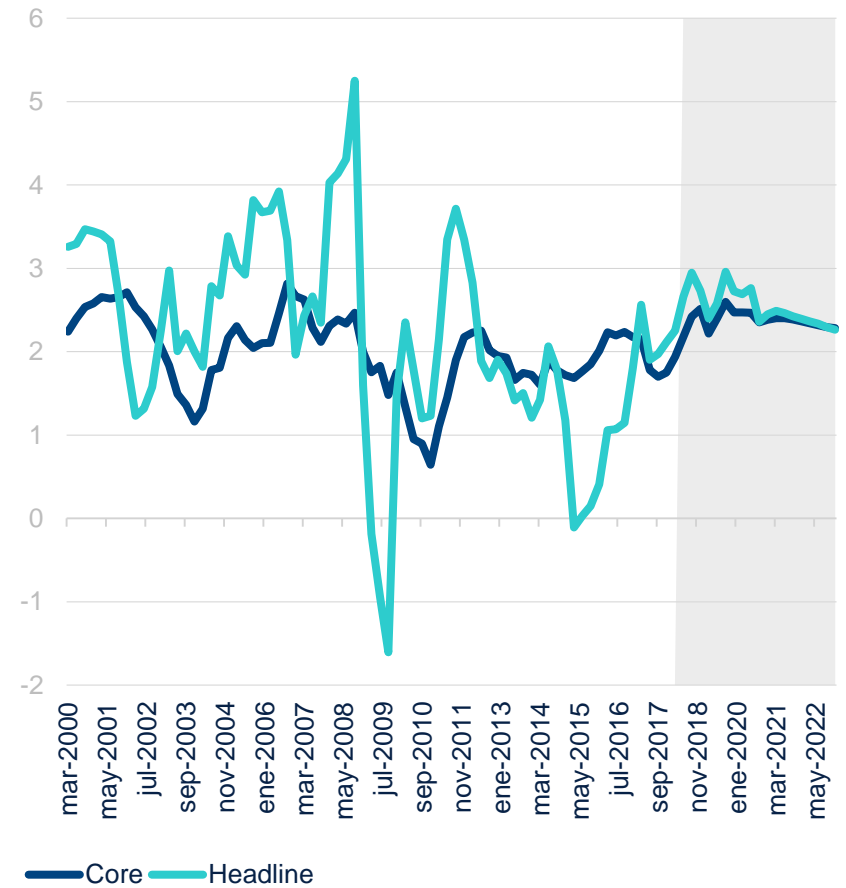
Source: BBVA Research, BLS & BEA

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

Inflation Expectations (%)

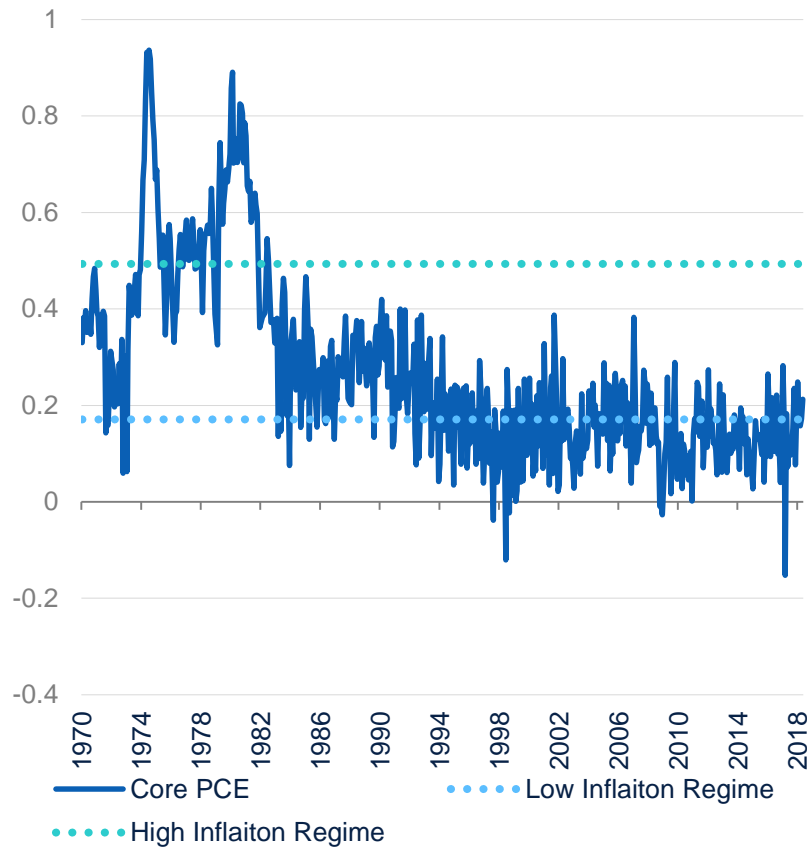


Headline & Core CPI (Year-over-year %)

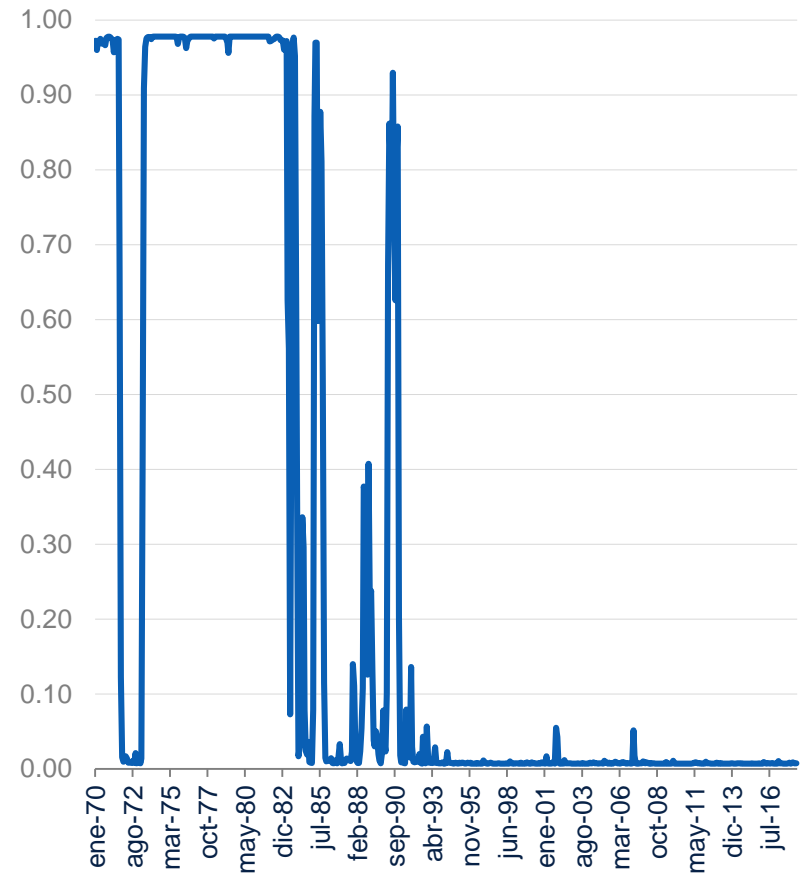


Inflation: Regime change probability remains low

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



Probability of Entering High Inflation Regime (%)

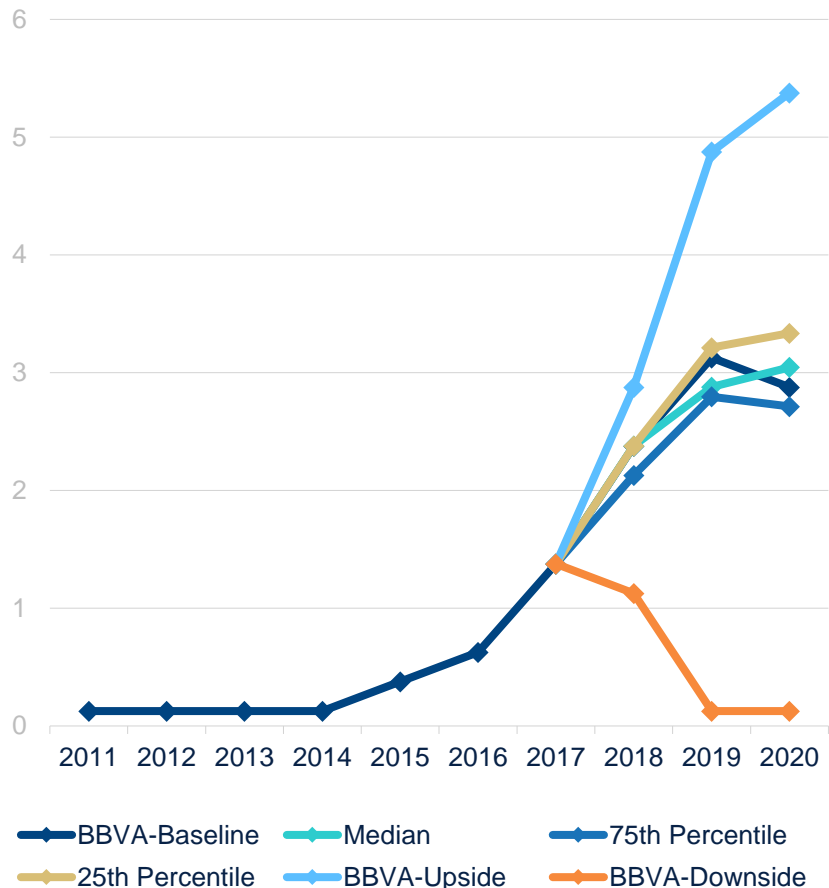


Monetary Policy: Federal Reserve

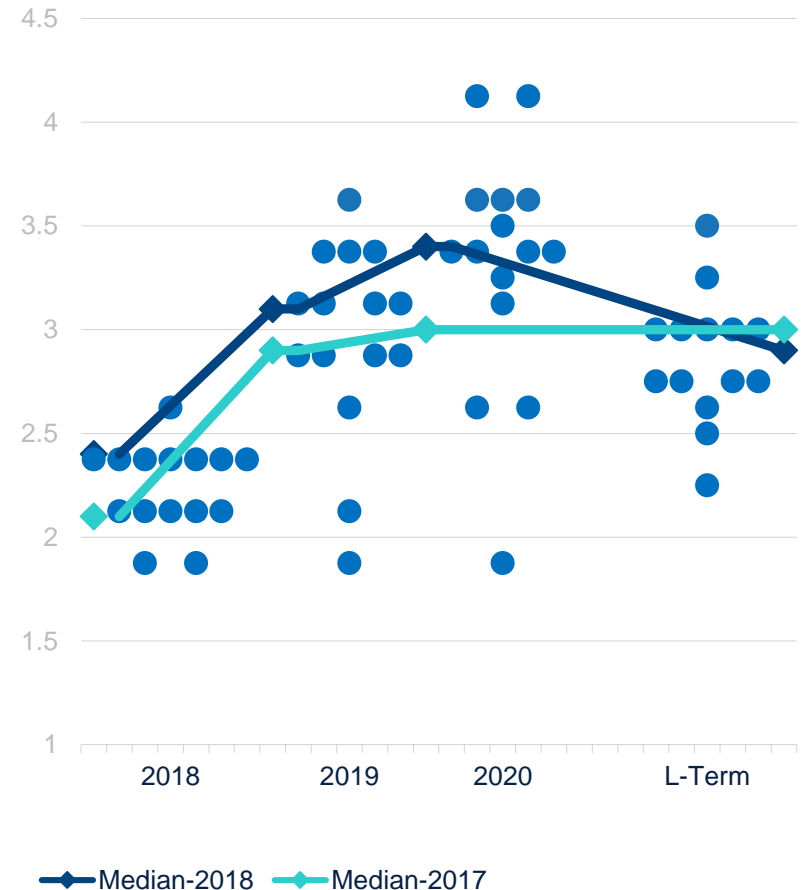
- June's FOMC statement, economic projections and press conference confirm our view that the Fed has fully transitioned to a new phase of monetary policy, leaving behind the post-crisis era
- Fed to continue actively managing interest rate corridor, suggesting possible future adjustments in interest 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)



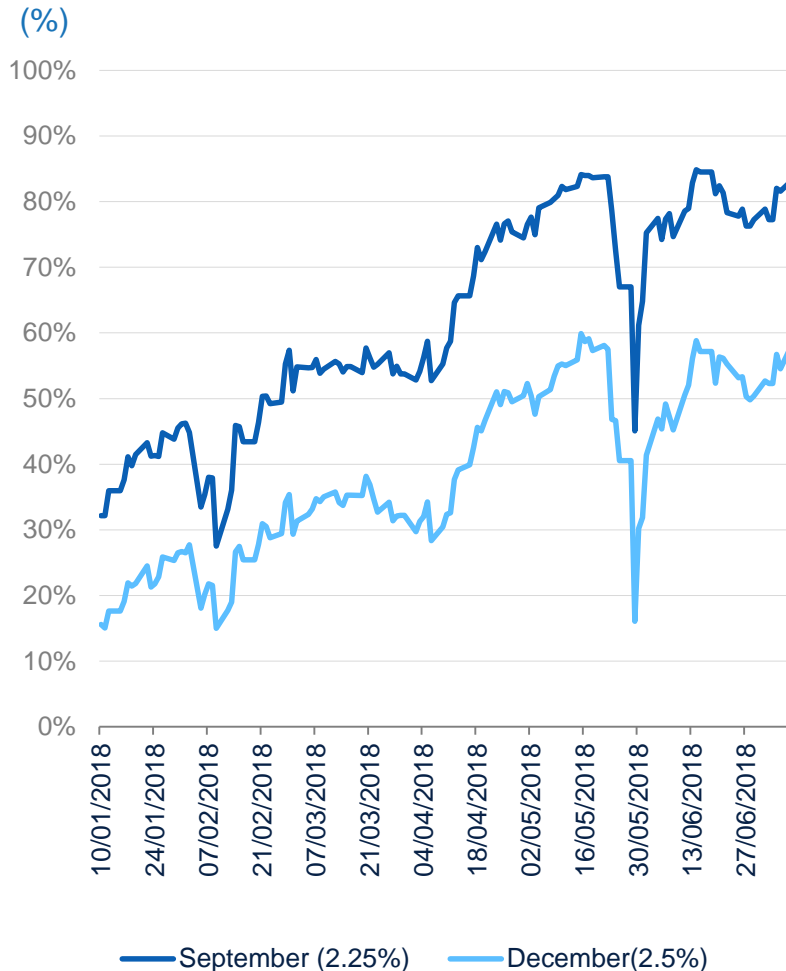
FOMC Projections of Fed Funds (Year-over-year %, Mid-point)



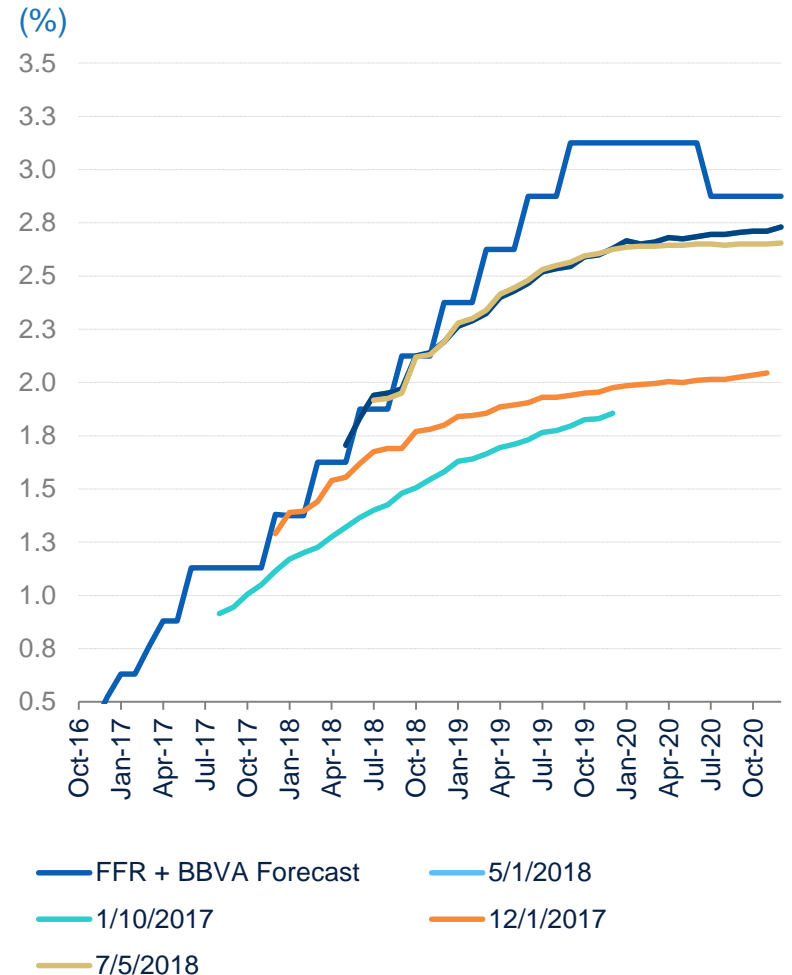
Source: BBVA Research & FRB

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

Fed Funds Implied Probability (%)

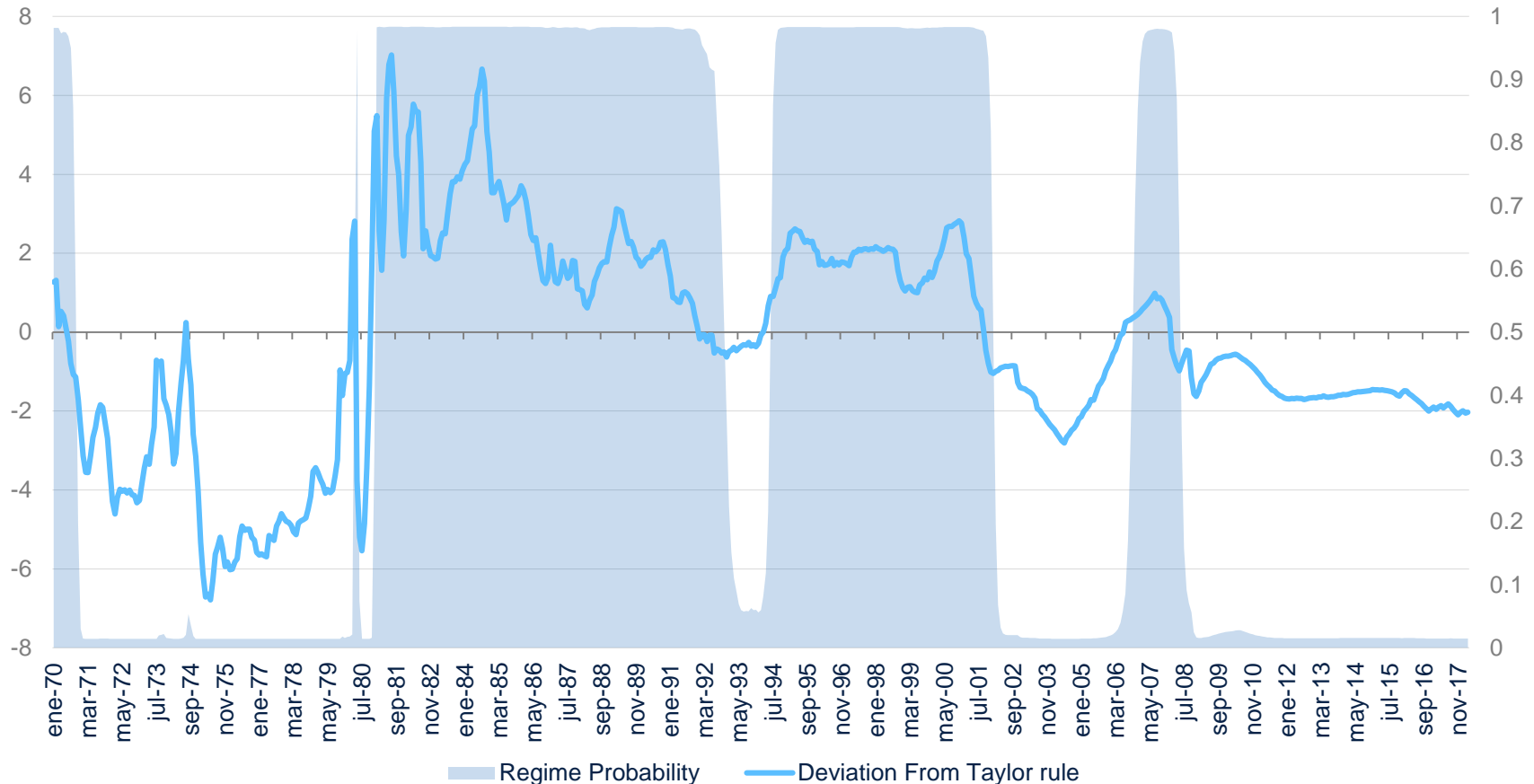


Fed Funds Futures & BBVA Baseline (%)



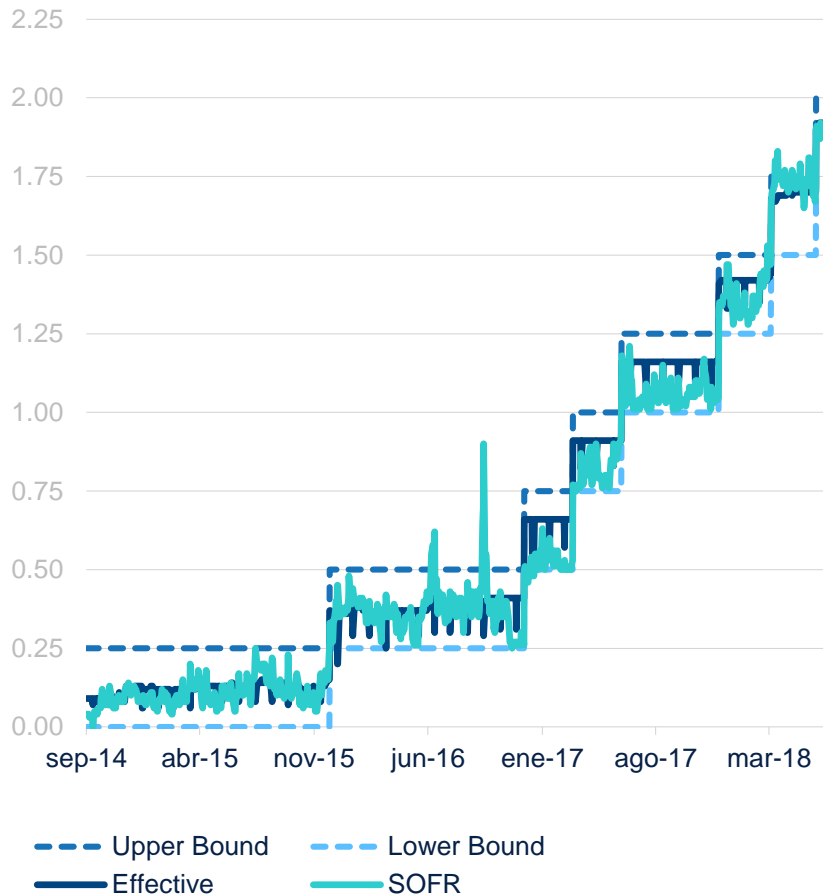
Fed: Current deviation from Taylor-rule and inflation conditions suggest low probability of shift in monetary policy regime

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

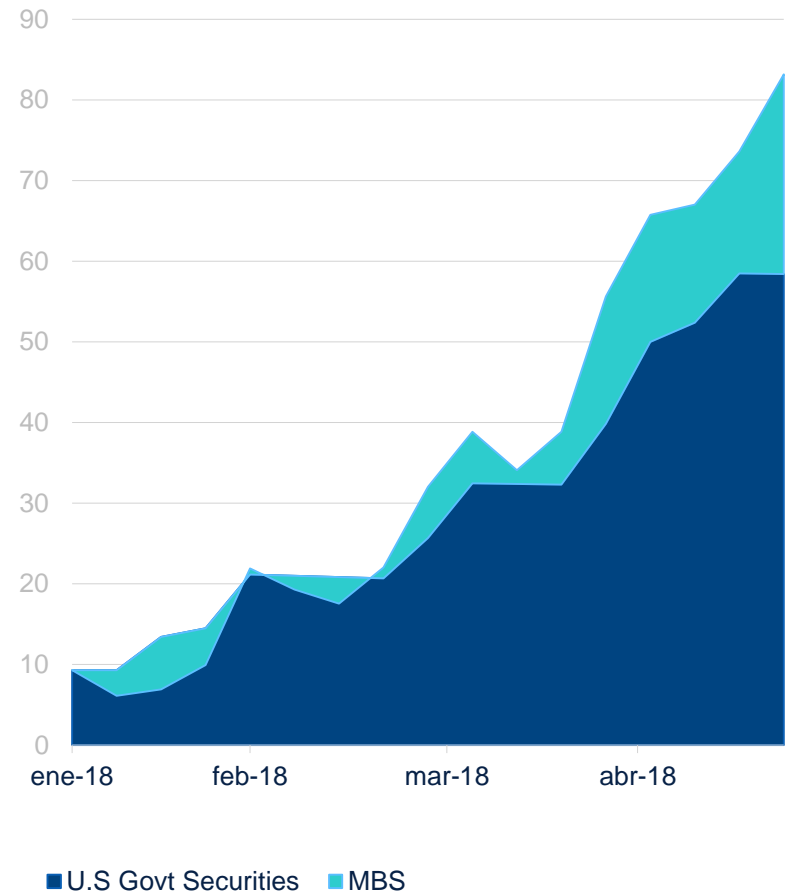


Interest rates: Interest rate corridor remains a source of concerns for FOMC

Fed Funds & Repo Rates (%)



Balance Sheet Attrition (US\$bn, Cumulative)



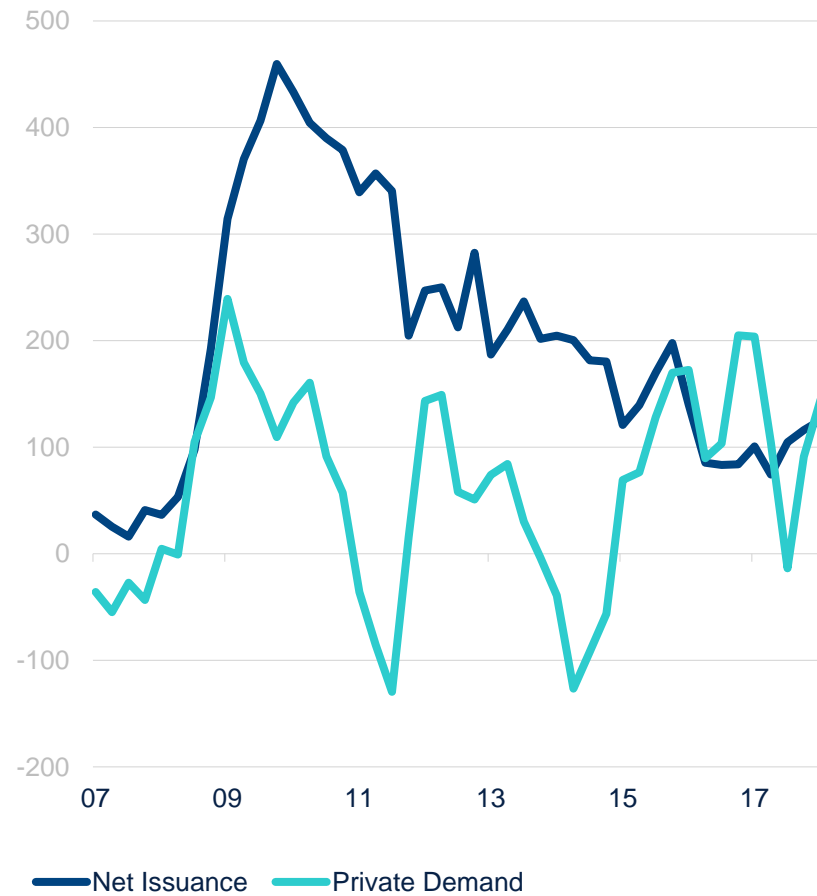
Interest Rates

- 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

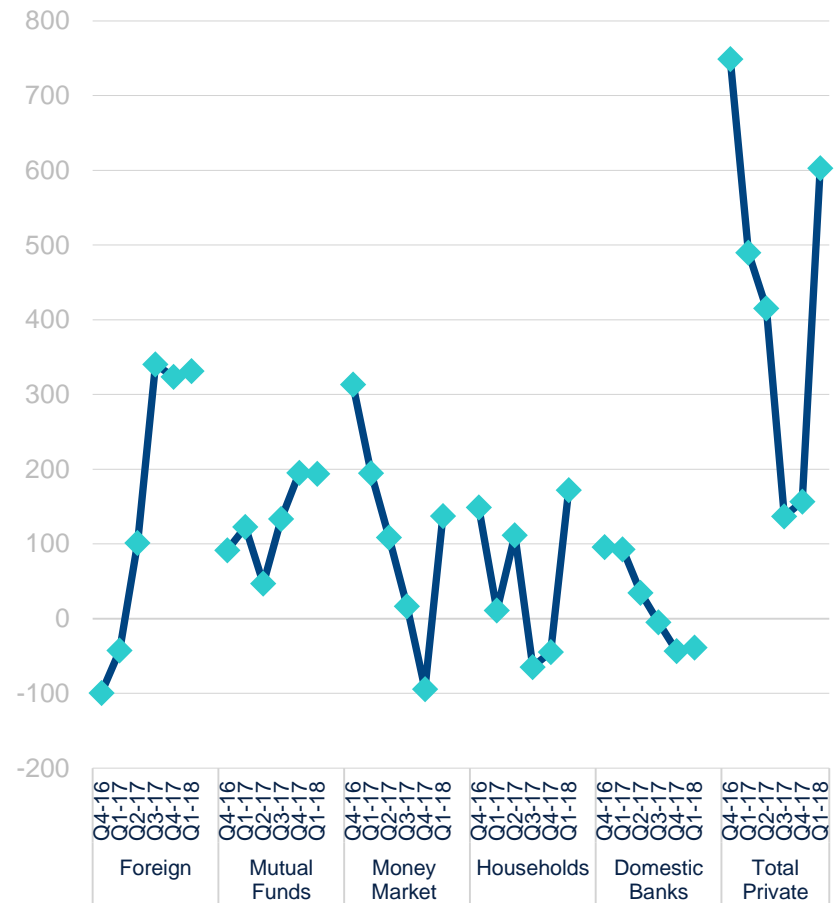
Net Treasury Supply & Change in Private Domestic Demand

(US\$bn & 3qcm)



Private Demand for Treasuries

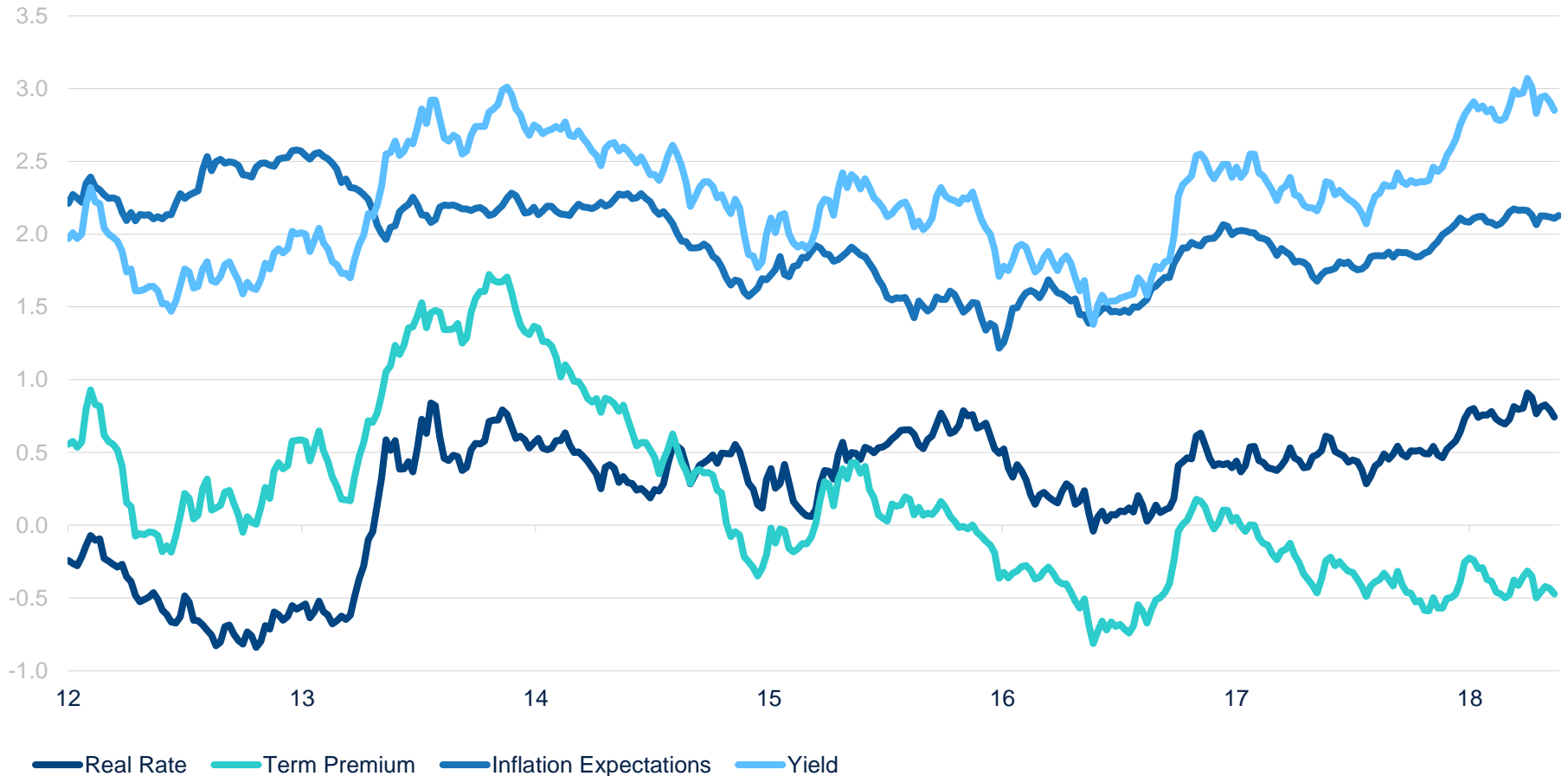
(US\$bn, 4qma)



Source: BBVA Research & U.S. Treasury

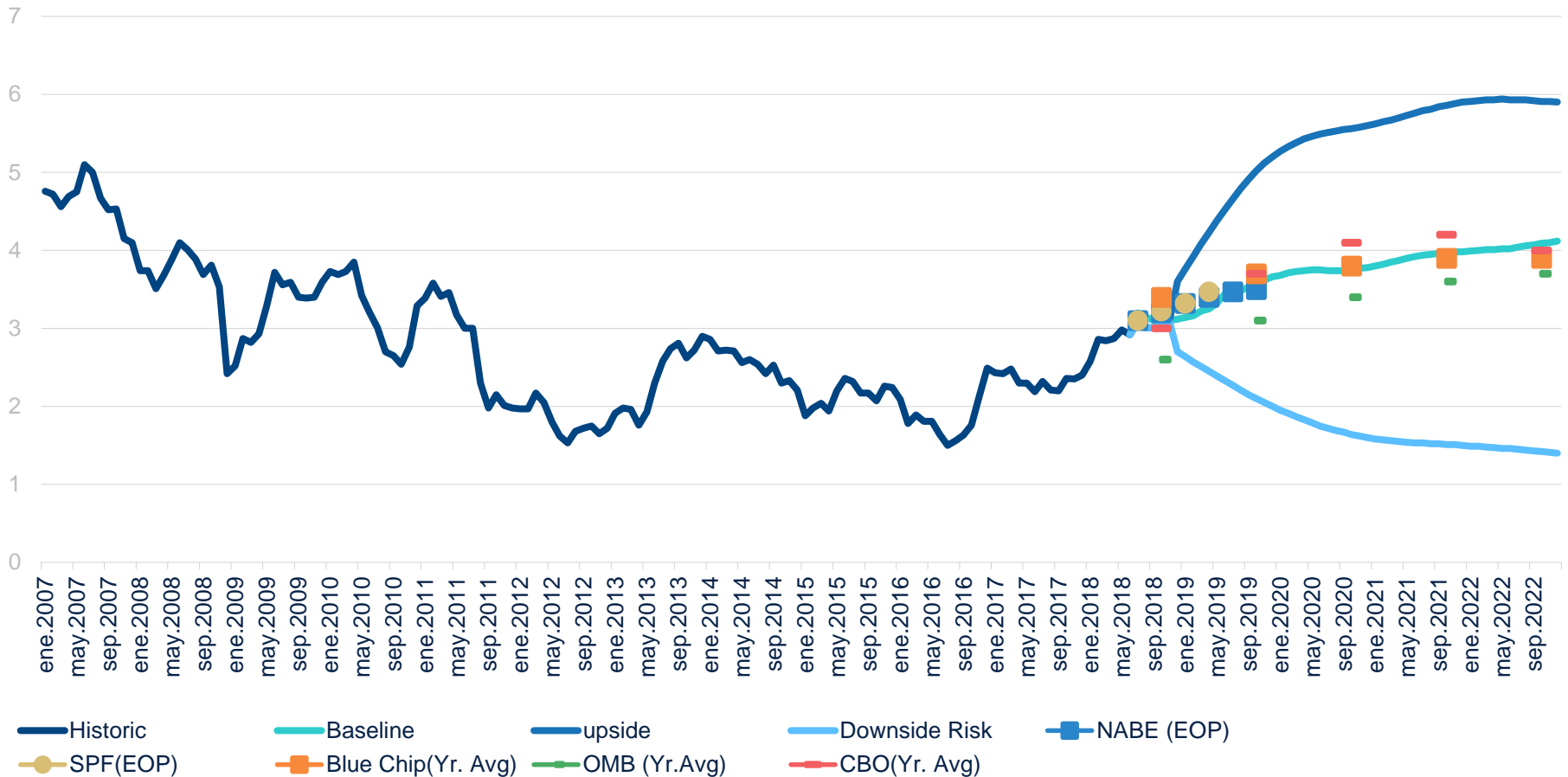
Interest rates: Term premium compressed, inflation expectations close to Fed target

10-Year Treasury Yield Decomposition (%)



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

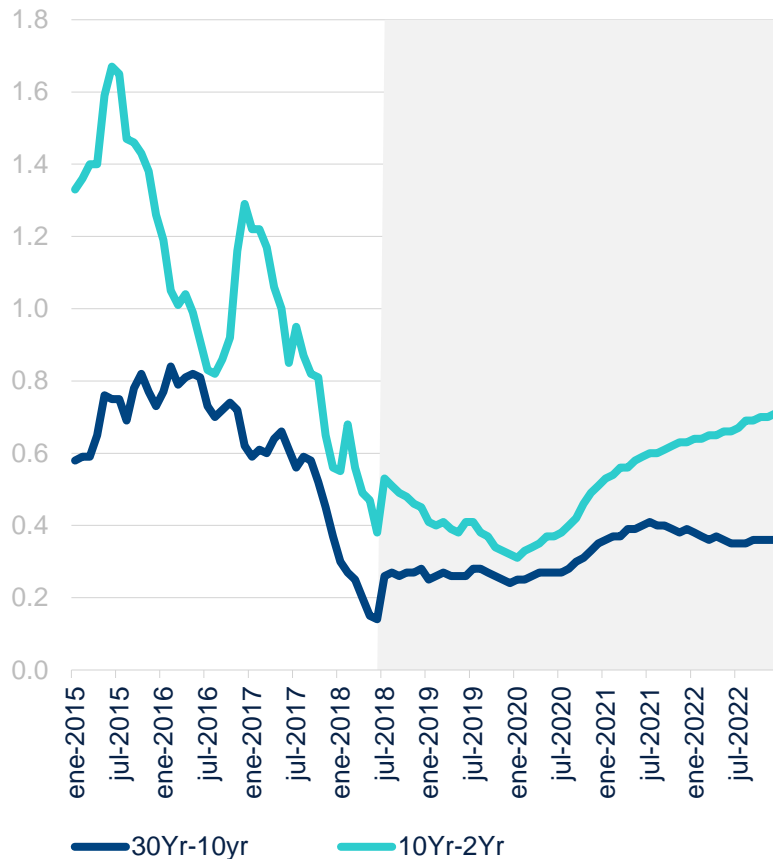
10-Year Treasury Yield (%)



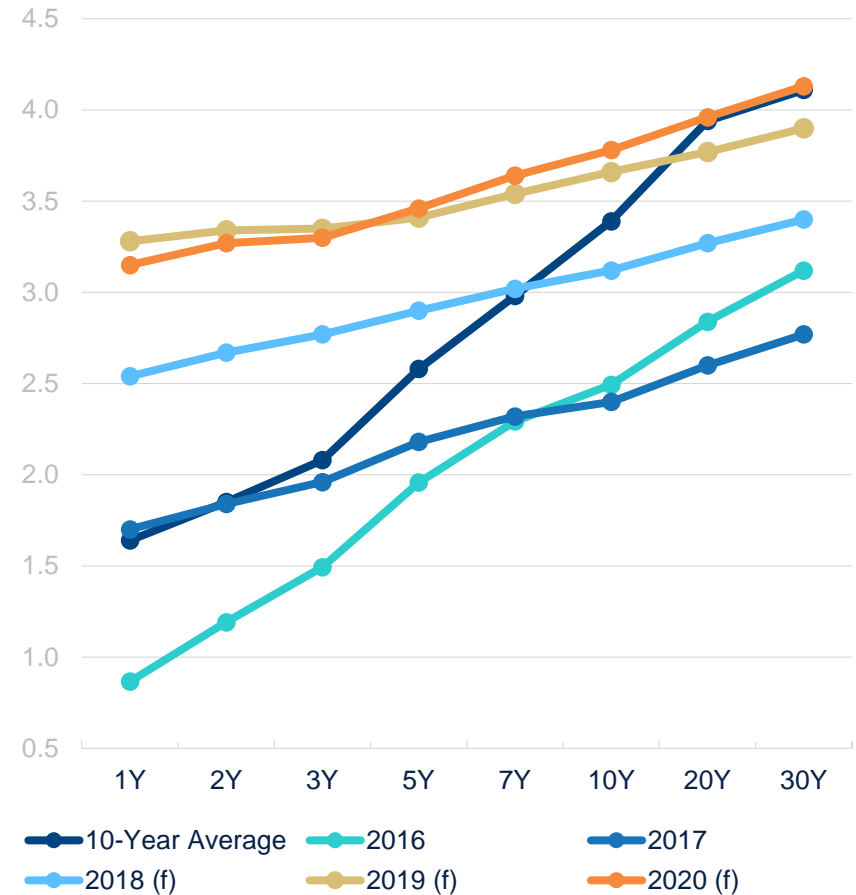
Source: BBVA Research, ACM & Haver Analytics

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

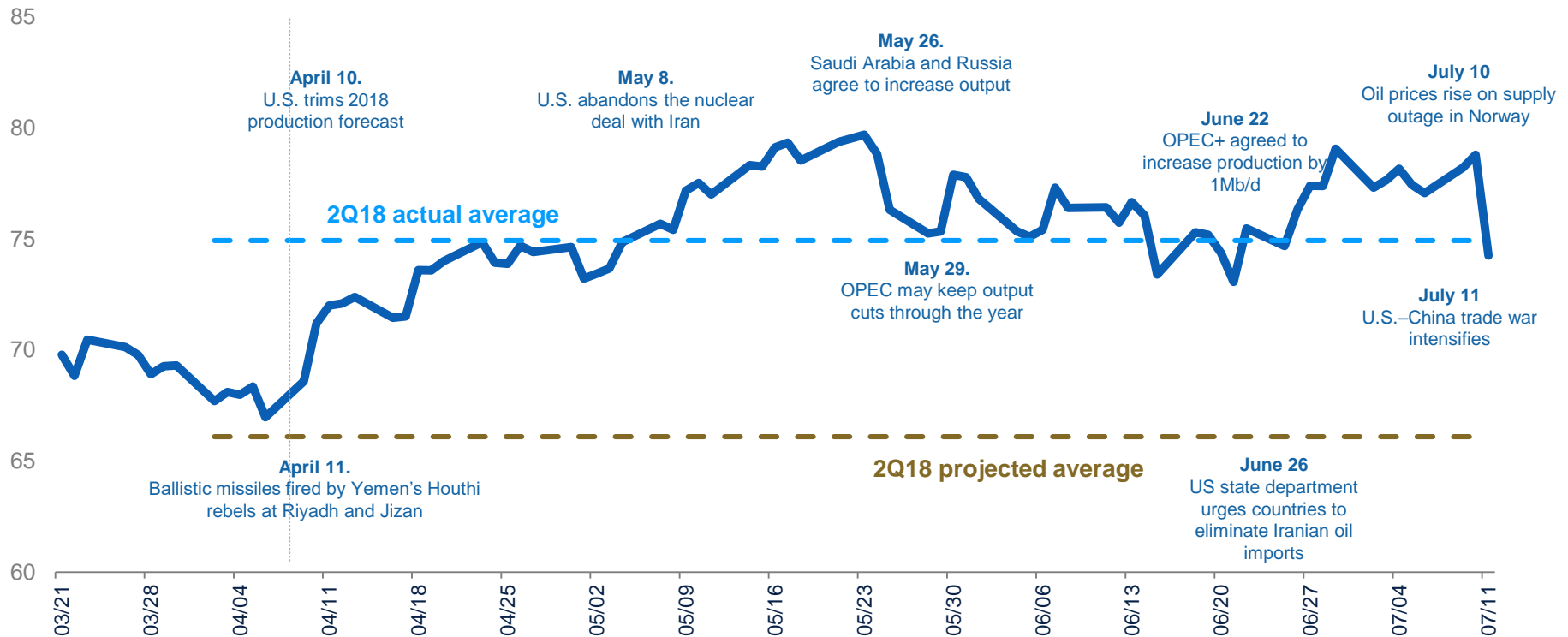
	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
GDP	1.7	2.6	2.9	1.5	2.3	2.8	2.8	2.5	2.3	2.0
Upside	1.7	2.6	2.9	1.5	2.3	3.2	3.8	3.4	3.1	3.0
Downside	1.7	2.6	2.9	1.5	2.3	2.0	-1.8	0.4	1.2	1.4
UR	7.4	6.2	5.3	4.9	4.4	3.9	3.7	4.0	4.3	4.3
Upside	7.4	6.2	5.3	4.9	4.4	3.8	3.1	2.8	3.0	3.0
Downside	7.4	6.2	5.3	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	2.6	2.7	2.6	2.4	2.3
Upside	1.5	1.6	0.1	1.3	2.1	2.8	3.3	3.3	3.4	3.7
Downside	1.5	1.6	0.1	1.3	2.1	2.4	1.3	1.0	0.7	0.6
Fed [eop]	0.25	0.25	0.50	0.75	1.50	2.50	3.25	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	3.12	3.66	3.78	3.98	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

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

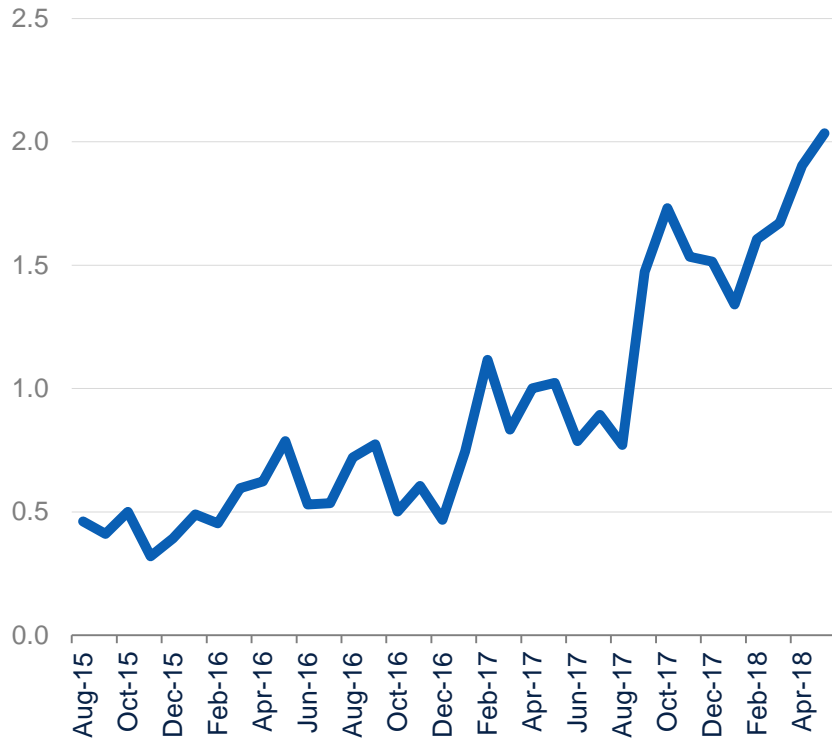
Oil prices: Geopolitics and concerns on OPEC spare capacity are driving oil prices

Crude oil prices
(\$ per barrel)

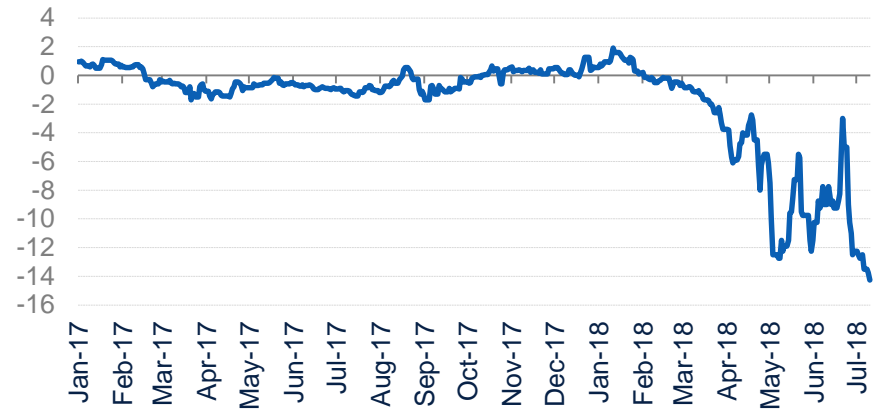


Oil prices: In the U.S., transportation bottlenecks limit impact on international prices

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



WTI Midland-Cushing differential
(\$/b)



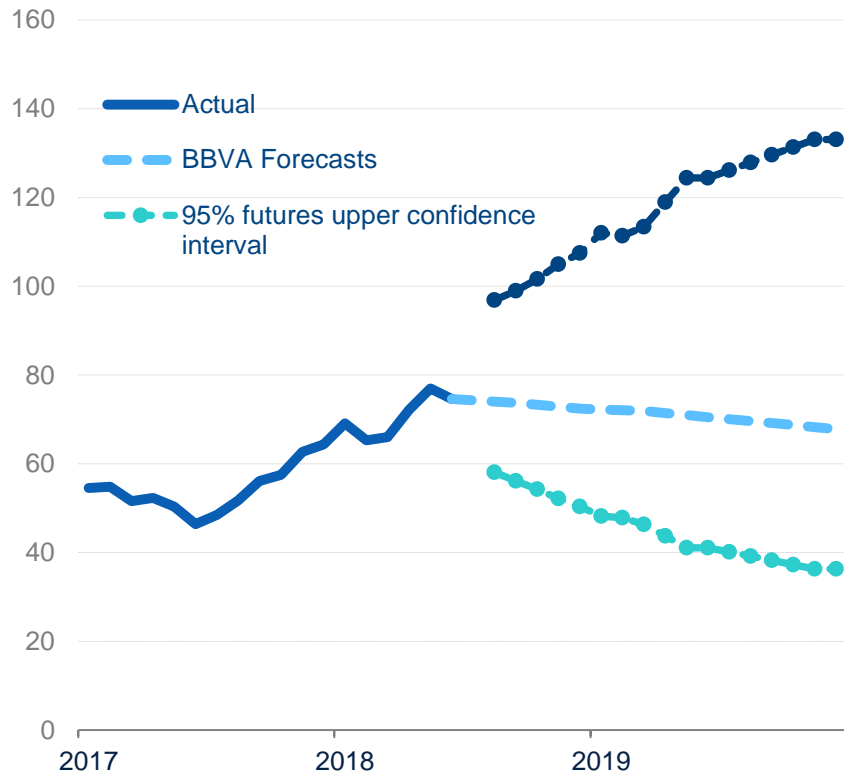
U.S. Estimated crude oil production
(Thousand barrels/day)



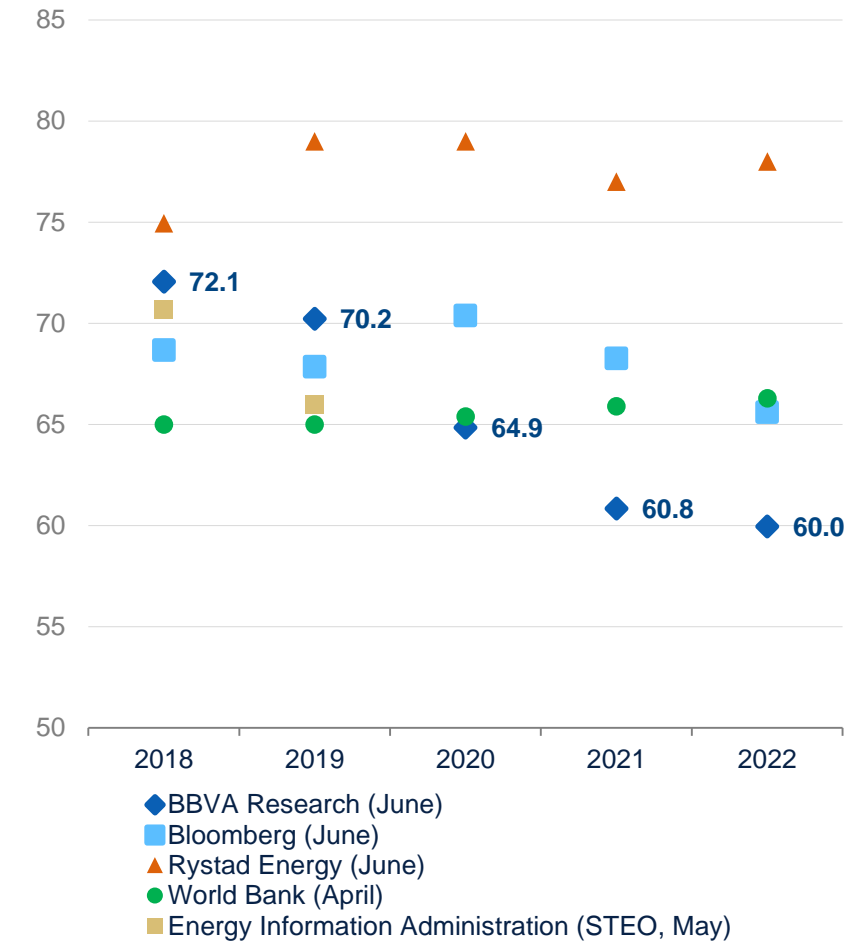
Source: BBVA Research, Haver Analytics & Bloomberg

Oil prices: Forecasts

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



Oil prices forecast (Brent, \$/b)



Source: BBVA Research, Bloomberg & EIA

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