BBVA Research

U.S. Economic Outlook

August 2018

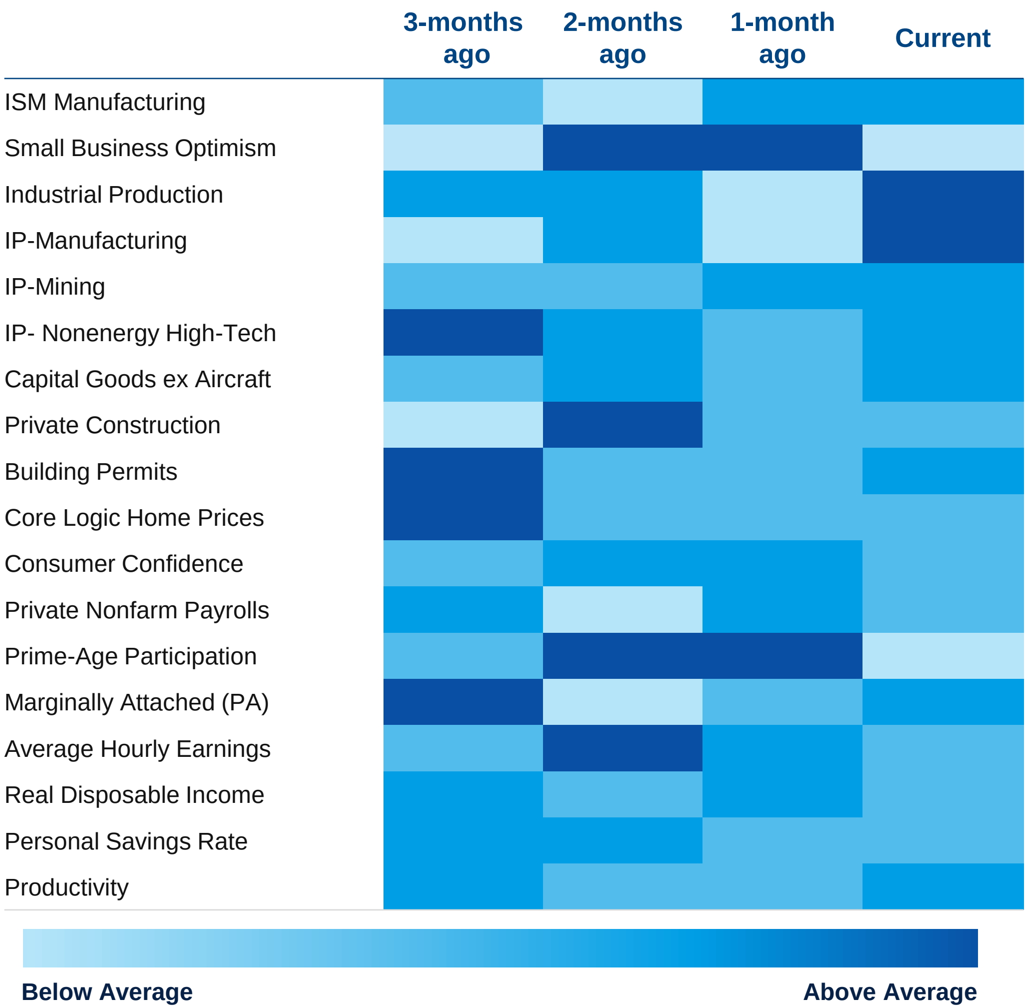
Creating Opportunities

Economic Outlook

- Incoming data consistent with baseline of high growth and inflation in 2018 & 2019
- There was no change to FOMC view on the level of accommodation, suggesting that they remain comfortable with further rates increases and additional balance sheet normalization
- Remaining labor market slack to be absorbed over the remainder of the year, as our baseline assumes average monthly job growth of around 200K
- We expect core PCE to rise meaningfully above 2% with added tailwinds from tariffs and rising nonlabor price pressures
- Economic outlook suggests gradual rise in 10-year Treasury yields
- The yield curve slope between the 10-year and 2-year Treasuries flattening on rising geopolitical frictions
- Oil prices to converge to long-run equilibrium despite short-term volatility

Economic activity

Real-Time Economic Indicator Heat Map

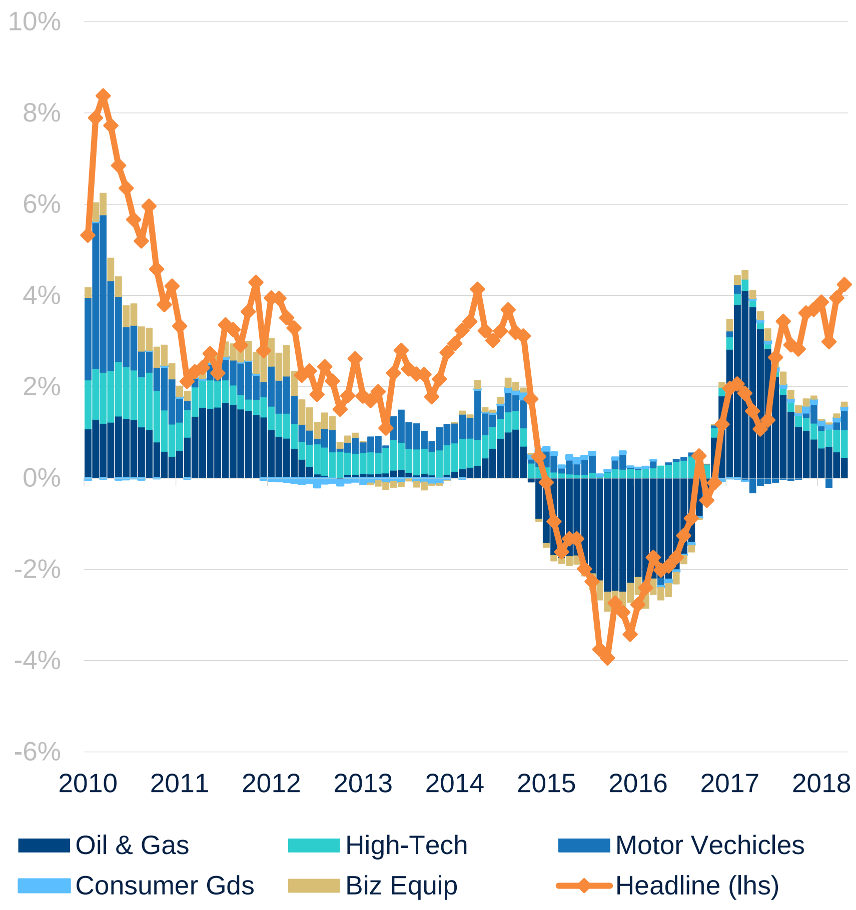


Source BBVA Research

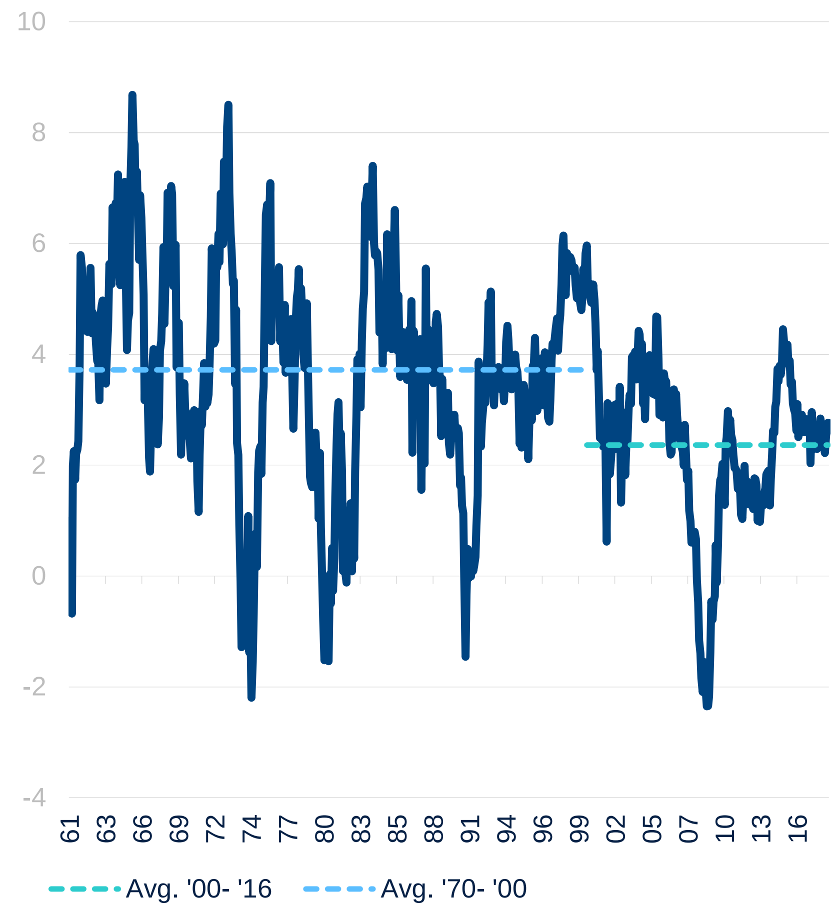
- Industrial activity strong in spite of headwinds
- Producers facing price pressures from rising import
- July retail sales data consistent with well above average consumption growth in 2Q18
- On average, labor market adding over 200K jobs per month
- Ongoing Residential construction activity supported by rising home prices

Economic trends: Manufacturing sector trends upward despite tariffs

Industrial Production
(Year-over-year %)



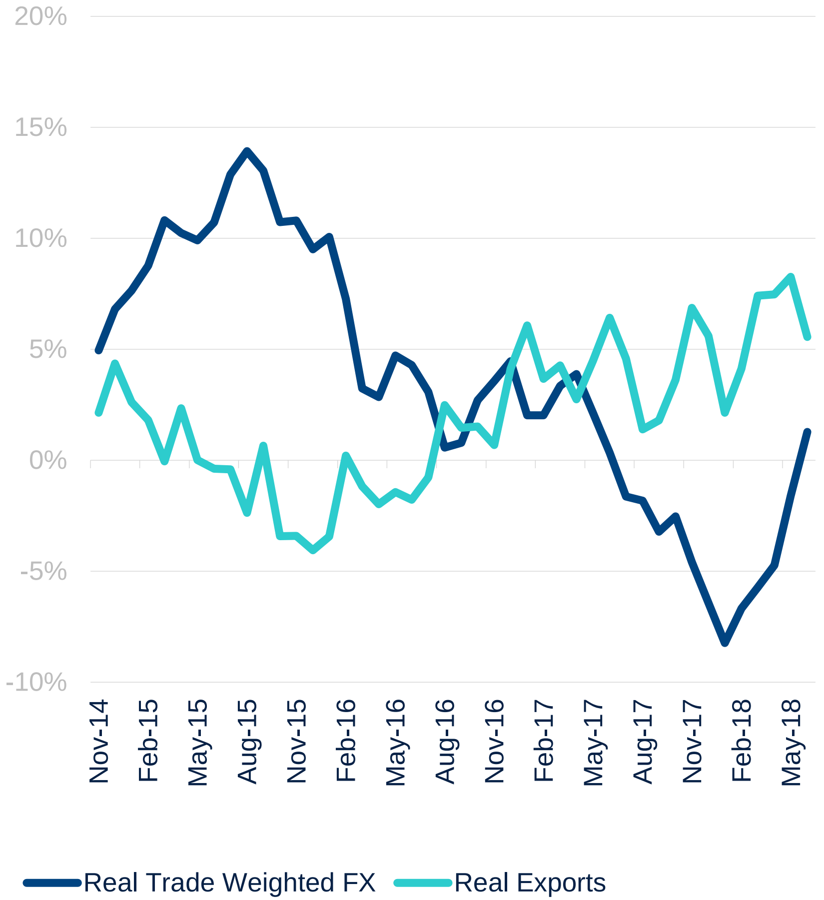
Real Personal Consumption Expenditures
(Year-over-year %)



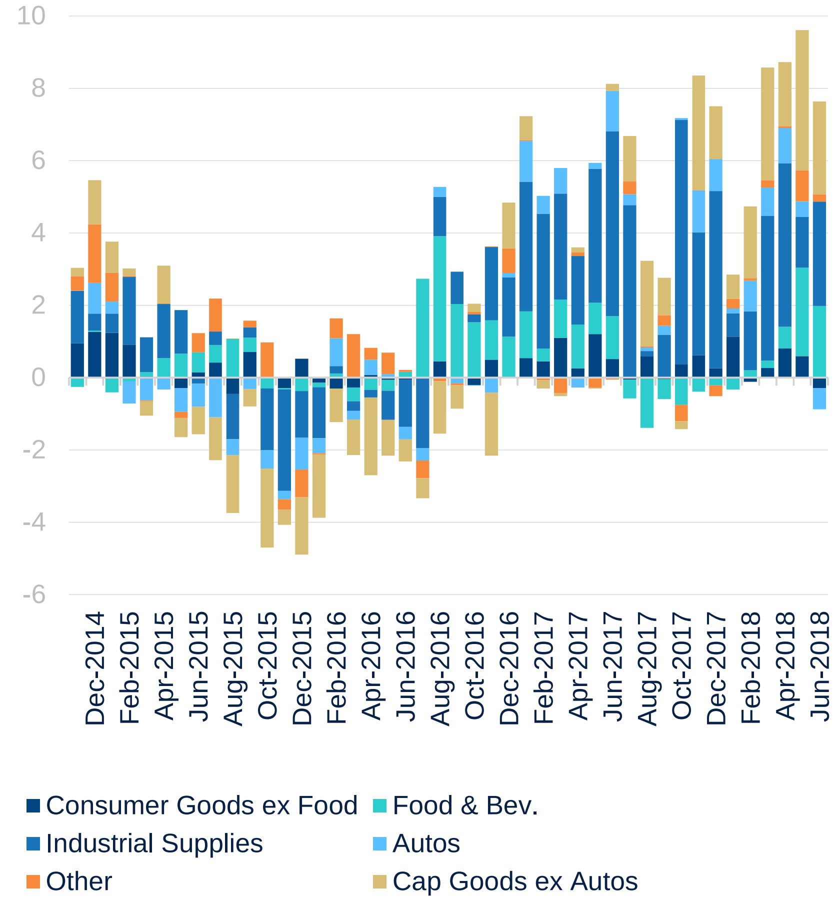
Source: BBVA Research, FRB & BEA

Economic trends: Export growth decelerates due to strengthening dollar

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



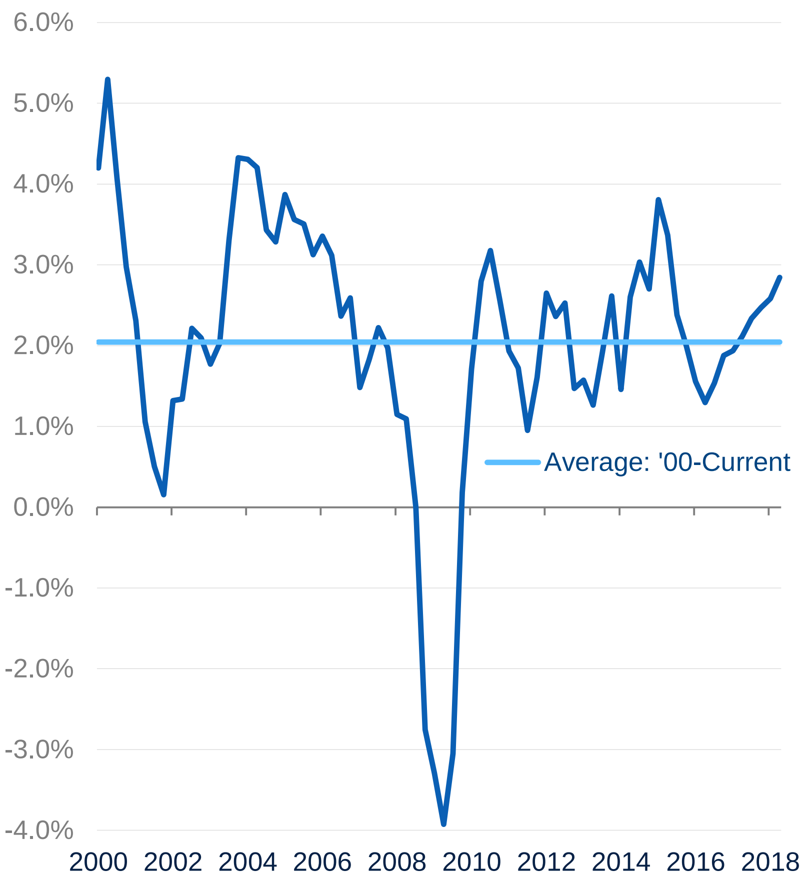
Real Exports
(Contribution to year-over-year %)



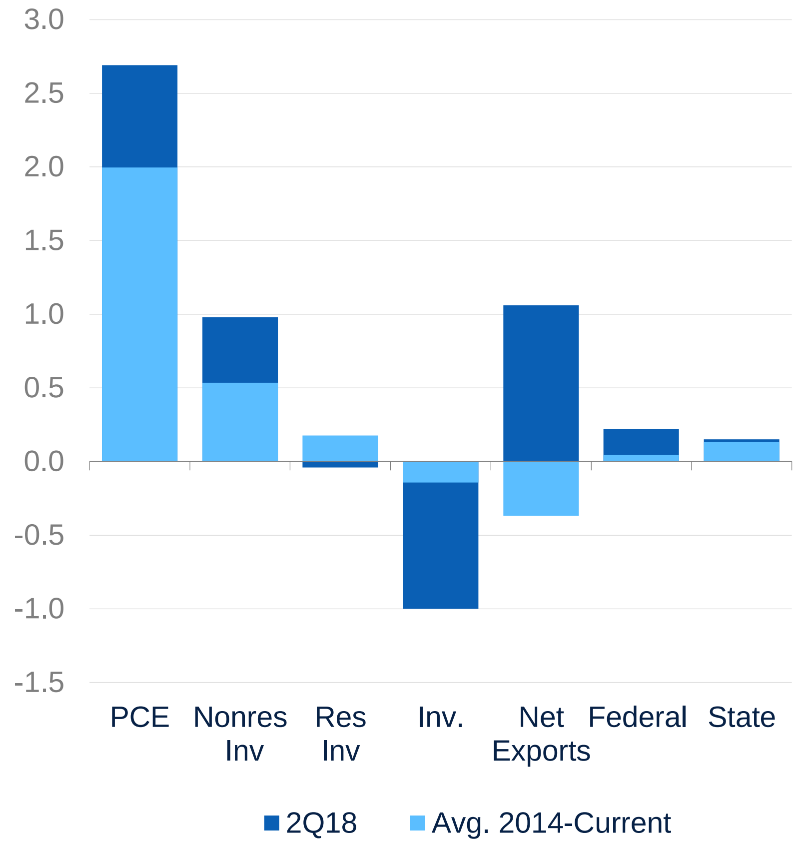
Source: BBVA Research, FRB & Census

Economic trends: Above average contributions from government and exports

Real GDP
(Year-over-year %)



GDP- Contribution to 2Q Growth
Annualized %

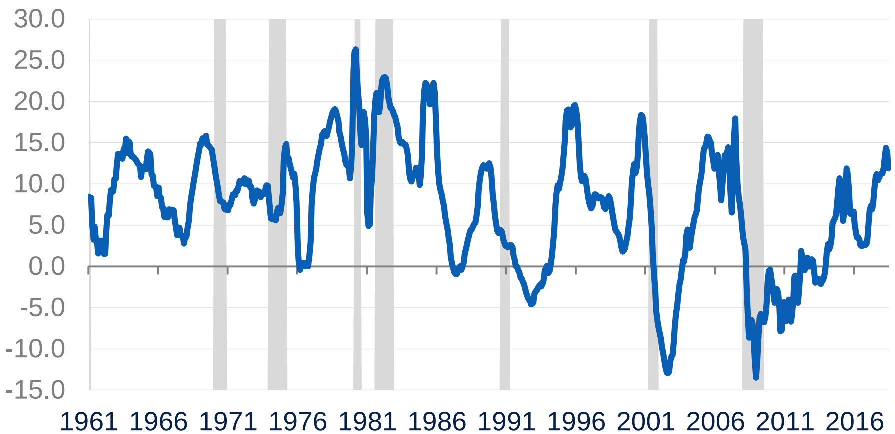


Source: BBVA Research & BEA

Consumer credit cycle: Leverage metrics edging up, but remain below previous peaks

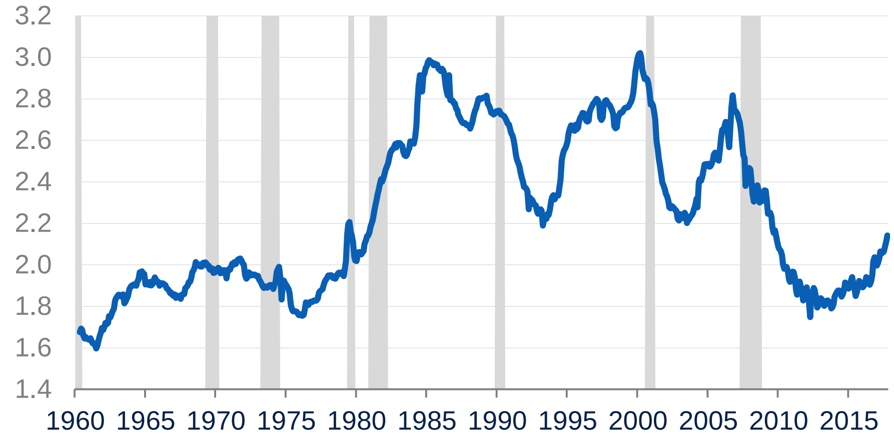
Personal Interest Expense

Year-over-year %



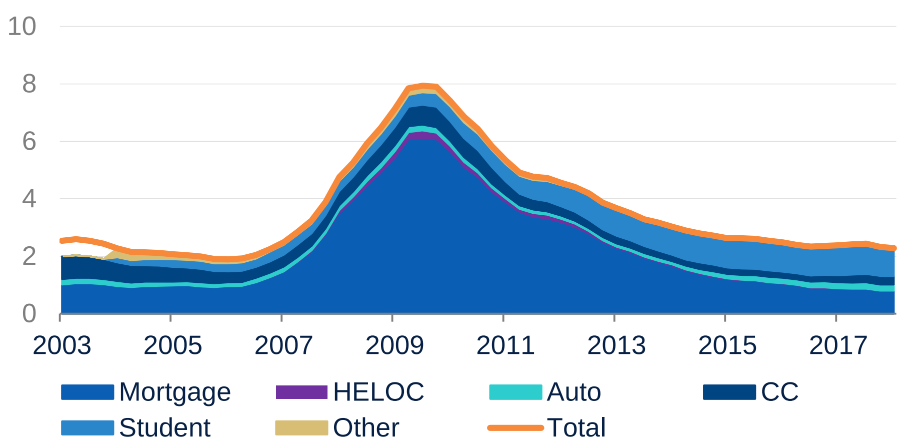
Personal Interest Expense to Disp. Income

Ratio, %



New 30+ Day Consumer Delinquencies Rates

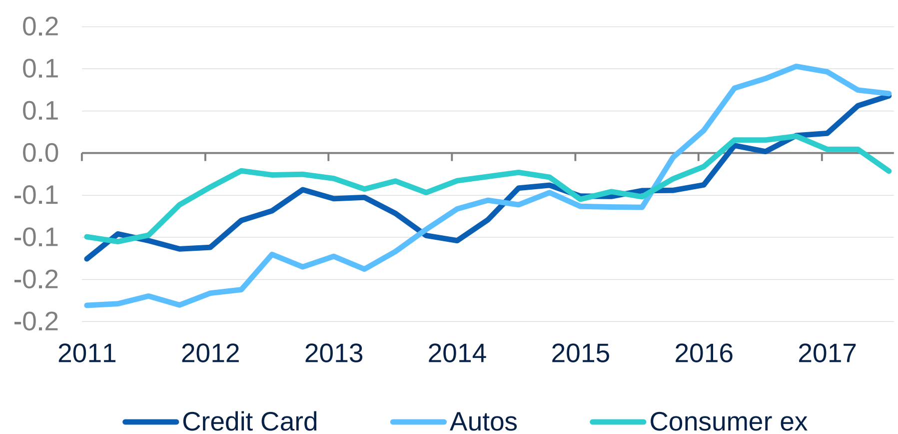
%



Source: BBVA Research, FRB, NY Fed & BEA

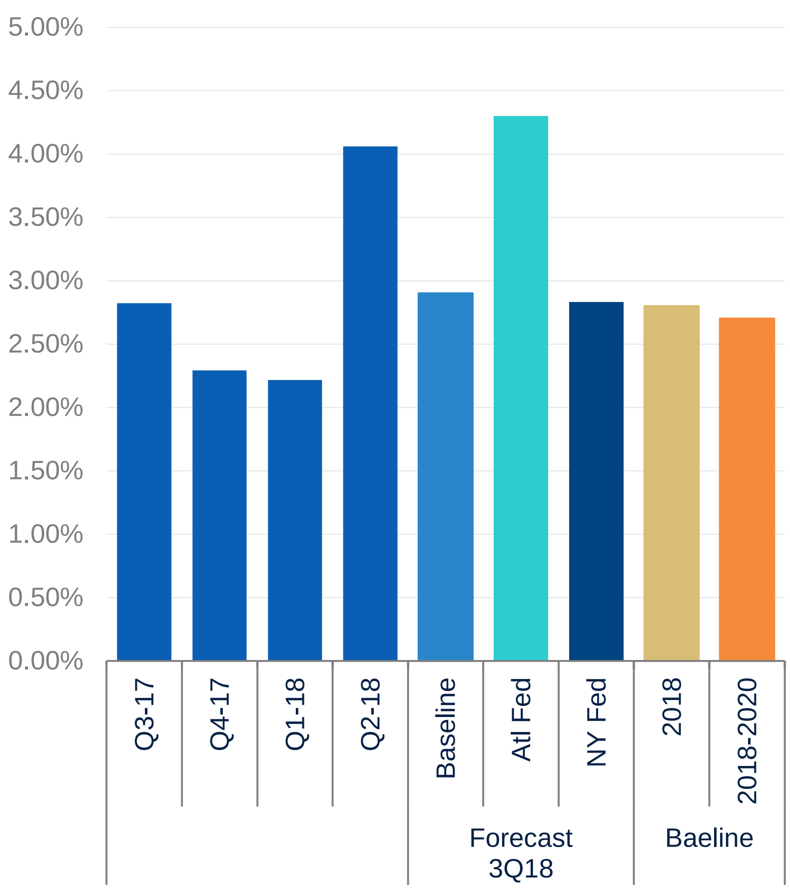
Senior Loan Officers Lending Standards

+ tightening / - loosening

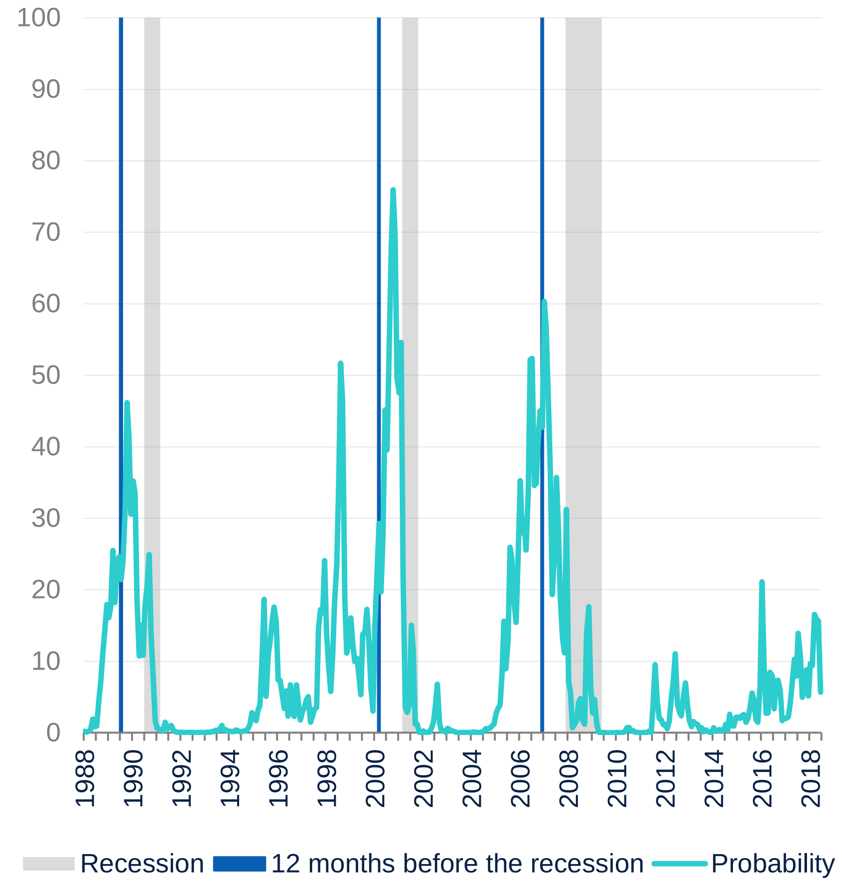


Economic trends: Recession probability drops on yield curve decompression

Real GDP
(QoQ SAAR, %)



Probability of Recession in 12 Months
(%)



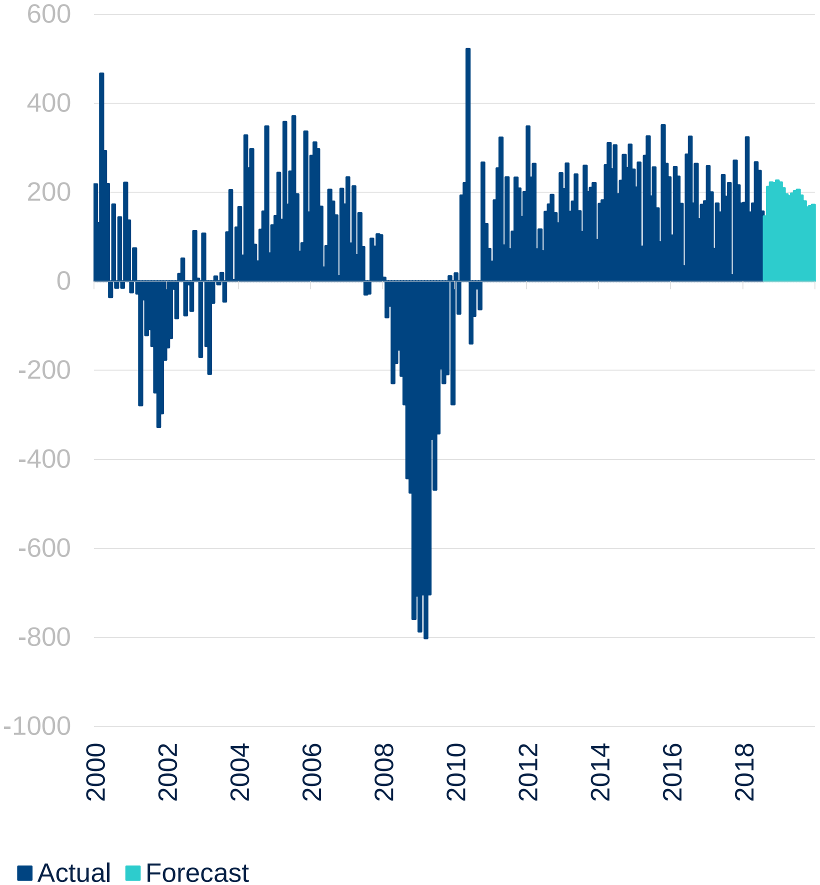
Source: BBVA Research, and ATL & NY Fed

Labor Market

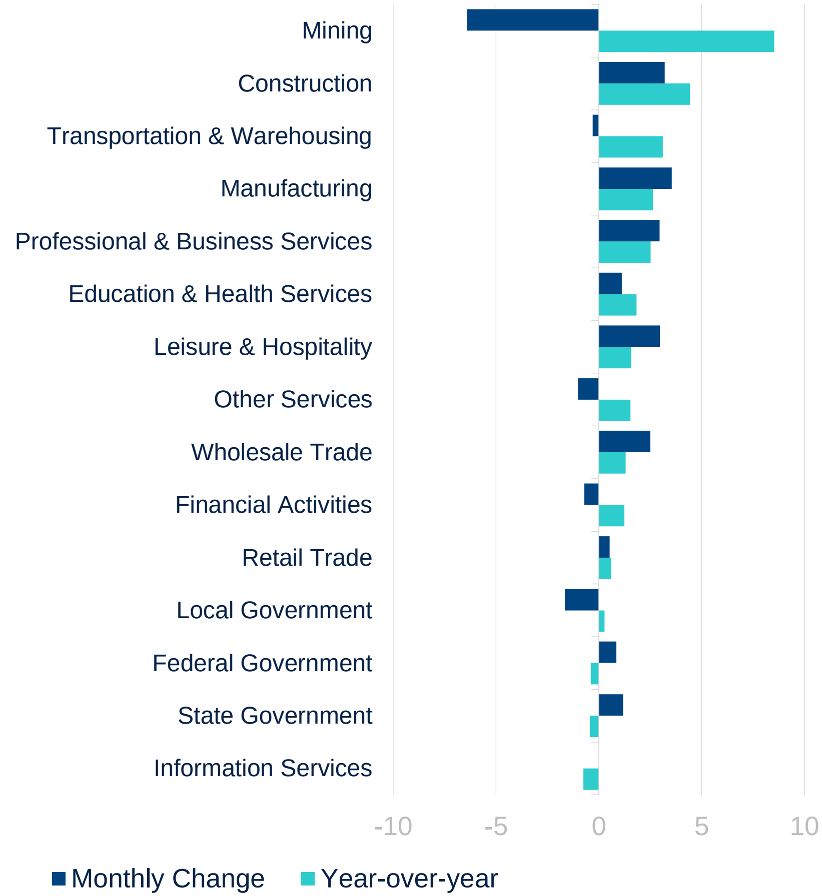
- In July, nonfarm payrolls increased by 157K, supported by solid gains in professional and business services (51K), manufacturing (37K), health care and social assistance (34K), and food services and drinking places (26K)
- Revisions to May and June resulted in a combined gain of 59K more jobs than originally reported
- The unemployment rate edged down once again to 3.9% from 4.0%, in part reflecting a 287K drop in reentrants to the labor force
- For people with less than high school diploma, the unemployment rate reached 5.1%, the lowest since 1992 when data began to be collected.
- We continue to expect any remaining labor market slack to be absorbed over the remainder of the year, as our baseline assumes average monthly job growth of around 200K

Labor market: Another month of solid employment growth ex mining sector

Nonfarm Payrolls
(Monthly Change, K)



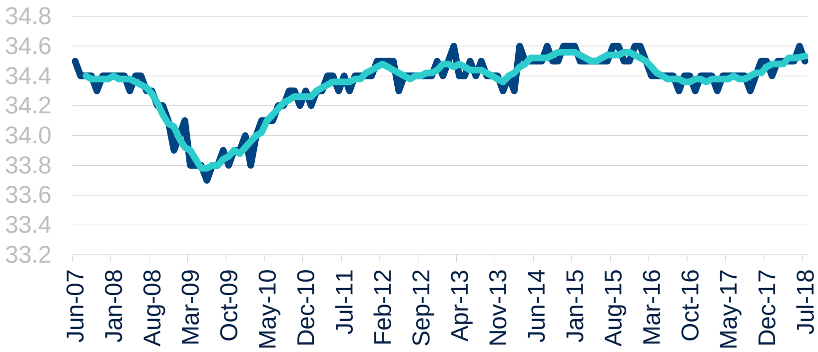
Industry Employment
(Annualized % change)



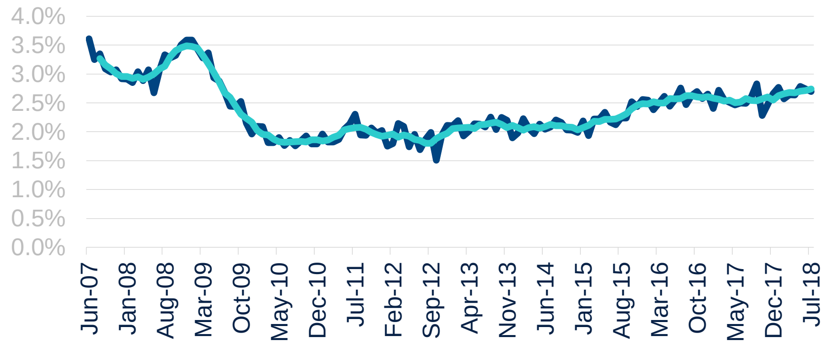
Source: BBVA Research & BLS

Labor market: Real wage growth flat with increasing price pressures

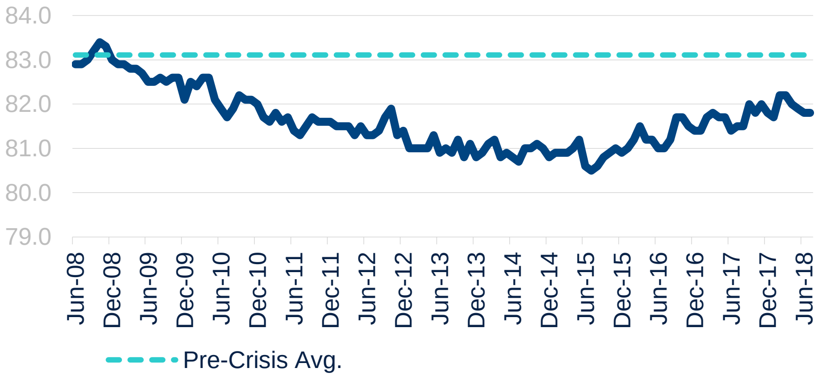
Average Weekly Hours
(number & 5mcma)



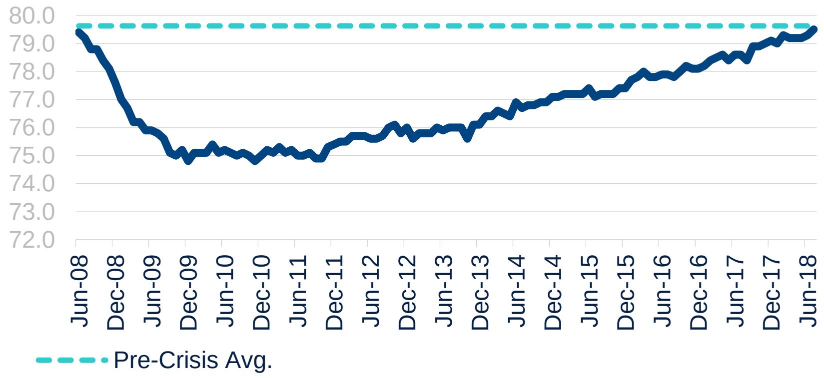
Average Hourly Earnings
(YoY% & 5mcma)



Prime Age Labor Force Participation
(%)



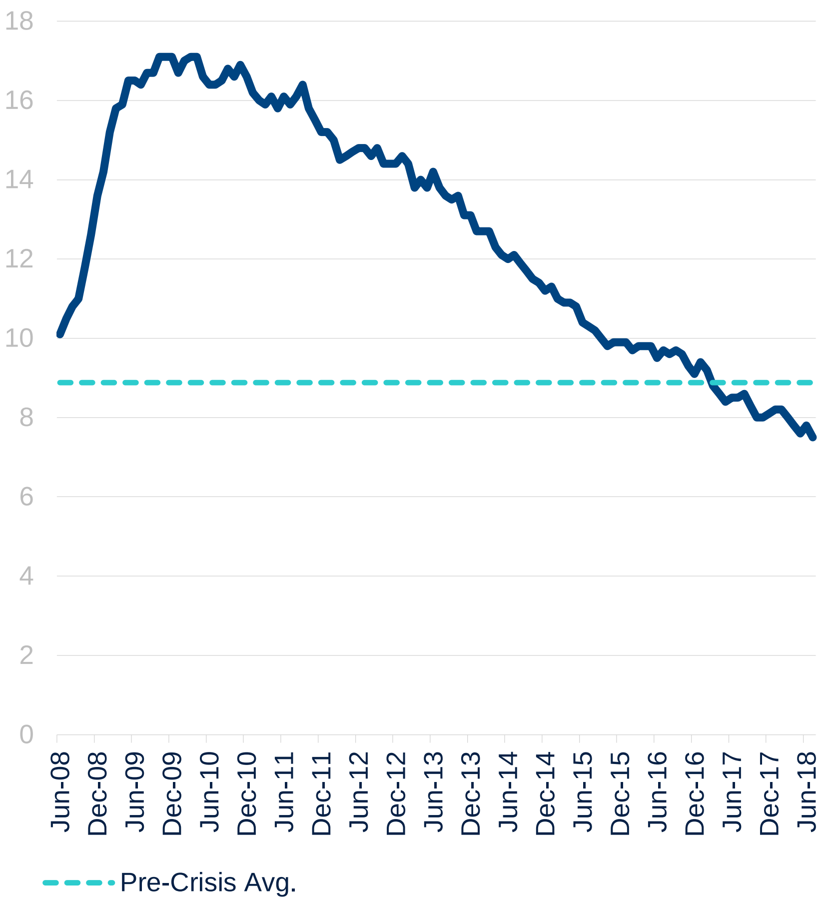
Prime Age Employment-to-Population
(%)



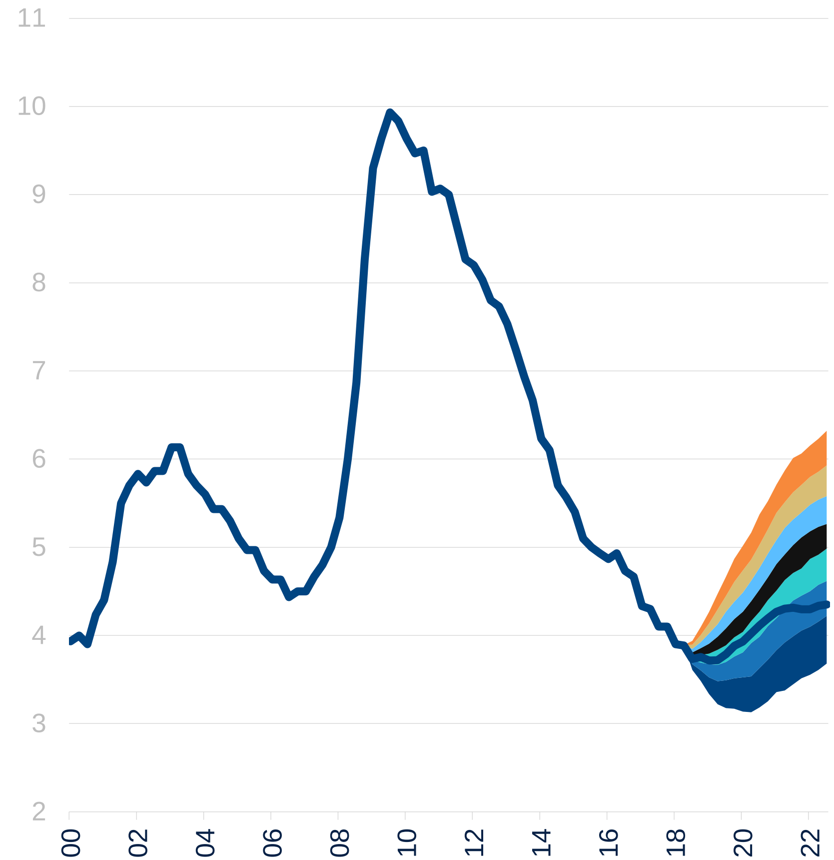
Source: BBVA Research & BLS

Labor market: UR to reach 3.7% by December

U-6
(%)



Unemployment Rate
(%)



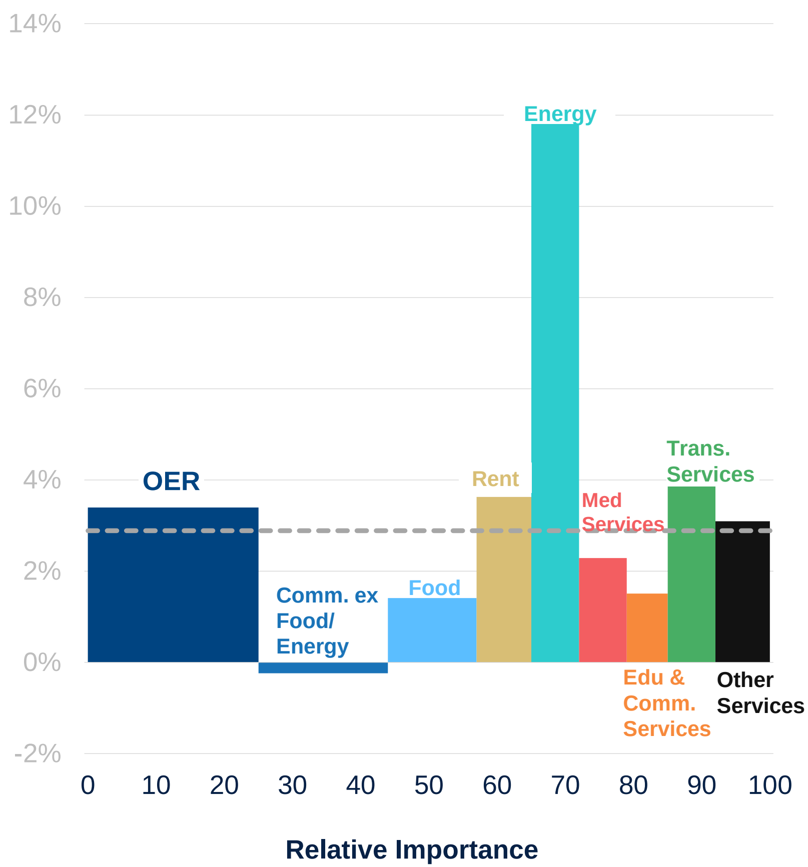
Source: BBVA Research & BLS

Inflation

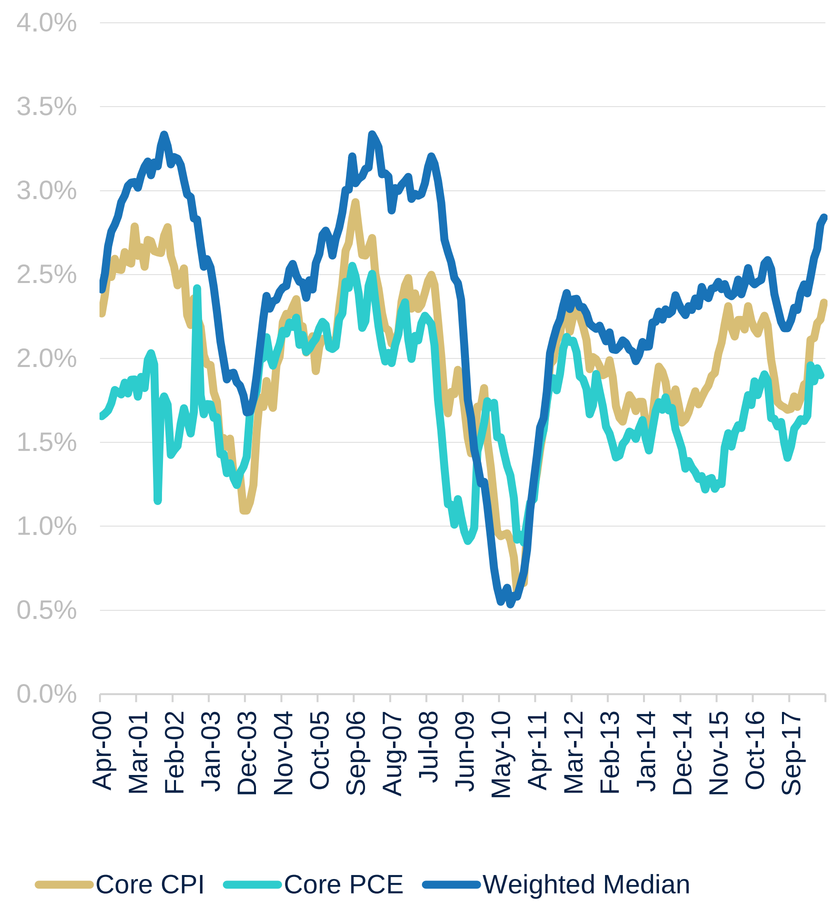
- Headline CPI accelerated to 2.9% year-over-year, the highest in six years, while core CPI surged to 2.3%
- Core prices reached their highest level since prior to 2008 financial crisis.
- Home price appreciation supporting growth in OER and rents, which were up 3.4% and 3.5% year-over-year, respectively
- Nonlabor cost pressures rising on the back of high resource utilization and increasing tariffs
- Probability of entering high-inflation regime is less than 1%
- With the additional tailwinds from the expansionary fiscal policy and rising tit-for-tat tariffs, we expect core PCE to rise to 2.2% by 2019

Inflation: Consumer prices continuing to trend upwards

Consumer Price Inflation
(12m change)



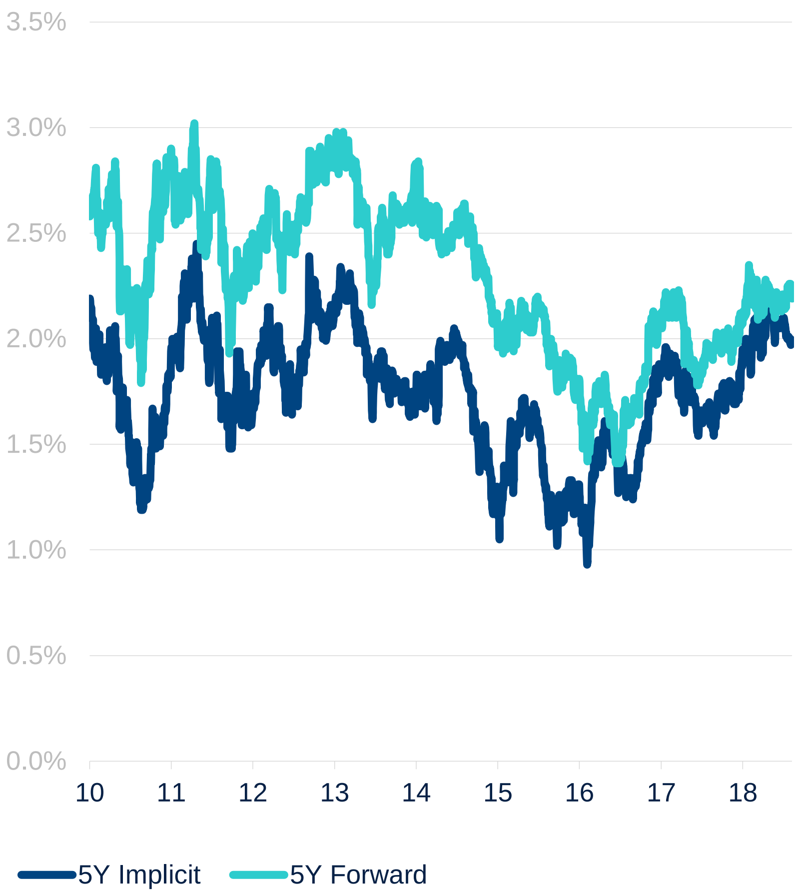
Core Inflation Measures
(12m change)



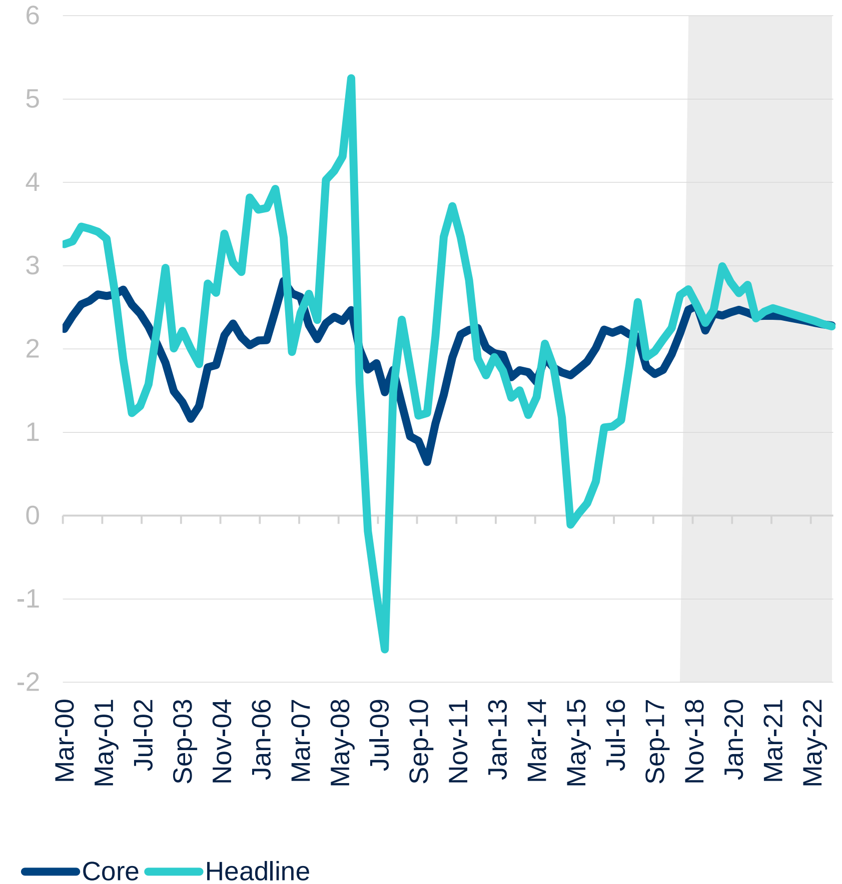
Source: BBVA Research, BLS & BEA

Inflation: Building inflation pressures pushing up inflation expectations, outlook remains rooted around 2%

Inflation Expectations
(%)



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



Source: BBVA Research & Haver Analytics

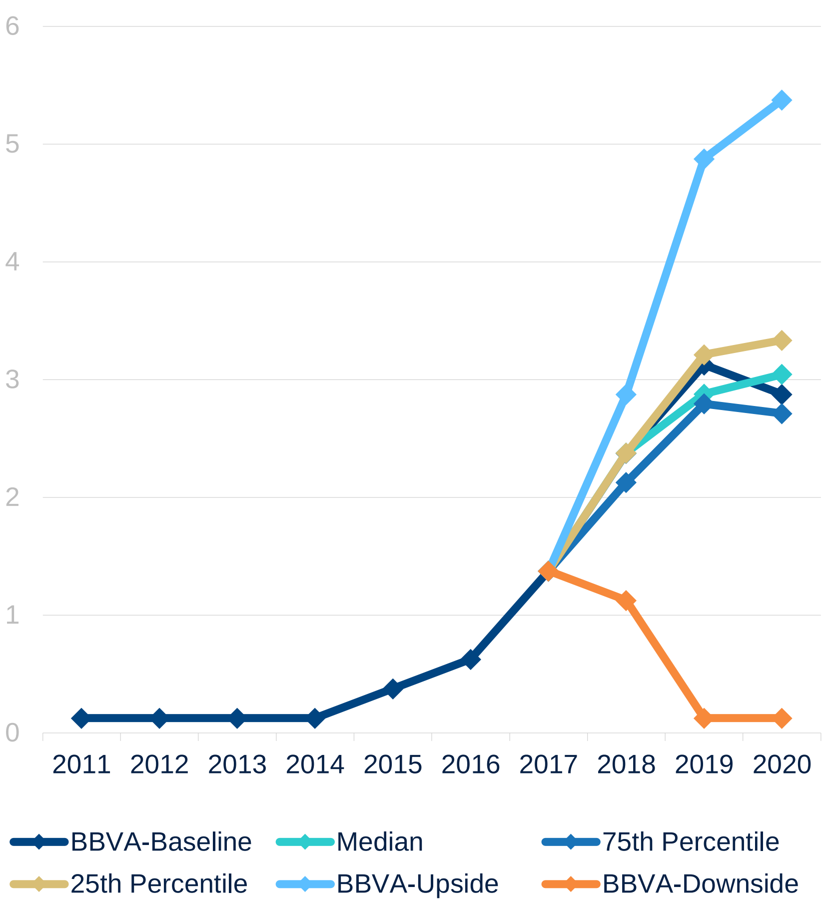
Monetary Policy: Federal Reserve

- The FOMC maintained the target range for the federal funds at 1.75% to 2.0% at their July meeting
- The statement strengthened the language surrounding their outlook to “strong” from “solid”, which is no surprise given that quarterly GDP growth in the 2Q18 was 4.1% SAAR, the unemployment rate is at 4.0% and inflation is effectively at the Fed’s 2% target
- In terms of the outlook, there was no change to their view on the level of accommodation, suggesting that they remain comfortable with further rates increases and additional balance sheet normalization
- For the FOMC, there remain a set of key issues that will present risks to their outlook, including the ongoing trade disputes and building political headwinds
- We continue to expect that the committee will raise rates 25bp in September and again in December, and three more times in 2019

Fed: No change to outlook, two rate increases this year and 3 rate increases next

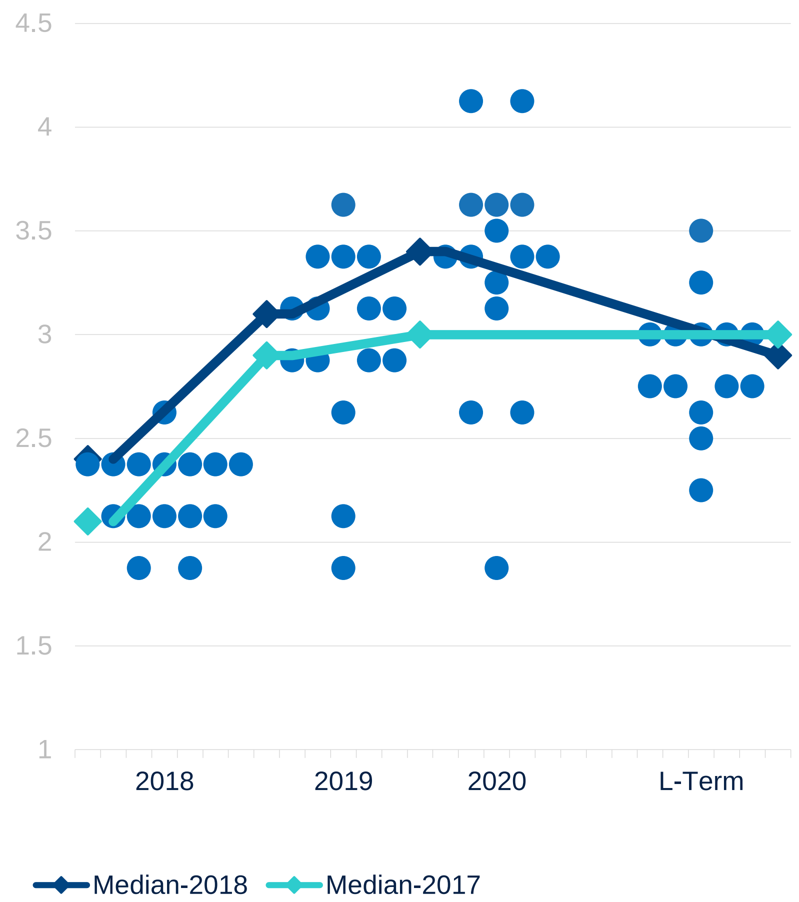
BBVA & Dealers Projections of Fed Funds

(%, Effective)



FOMC Projections of Fed Funds

(Year-over-year %, Mid-point)

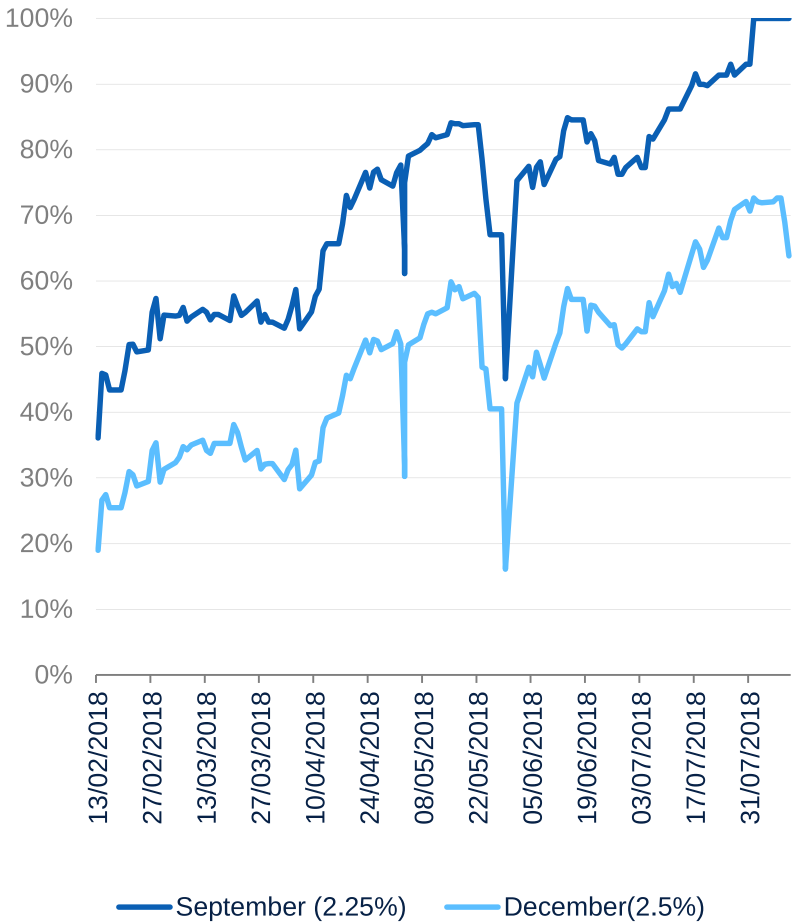


Source: BBVA Research & FRB

Monetary policy: Global financial tightening dampening market expectations

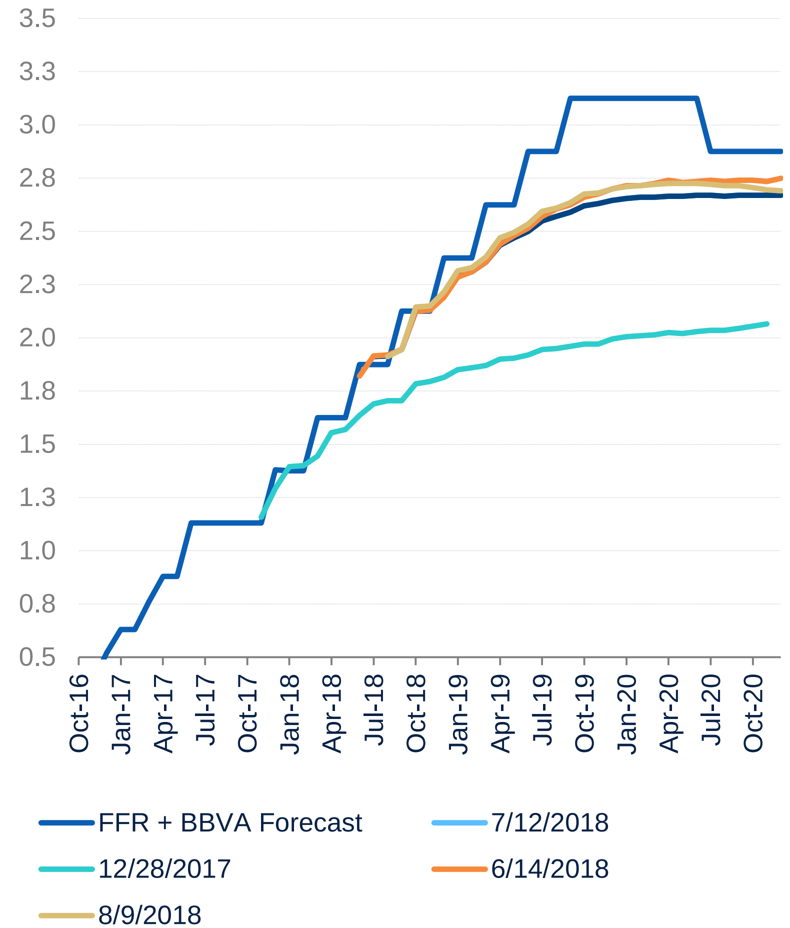
Fed Funds Implied Probability

(%)



Fed Funds Futures & BBVA Baseline

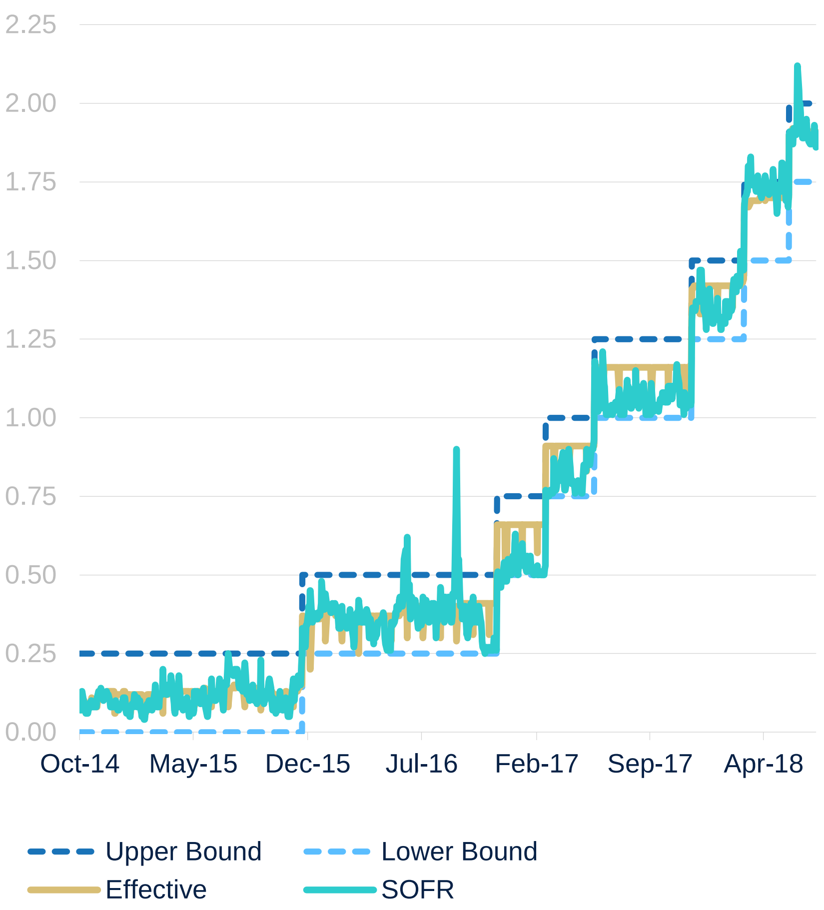
(%)



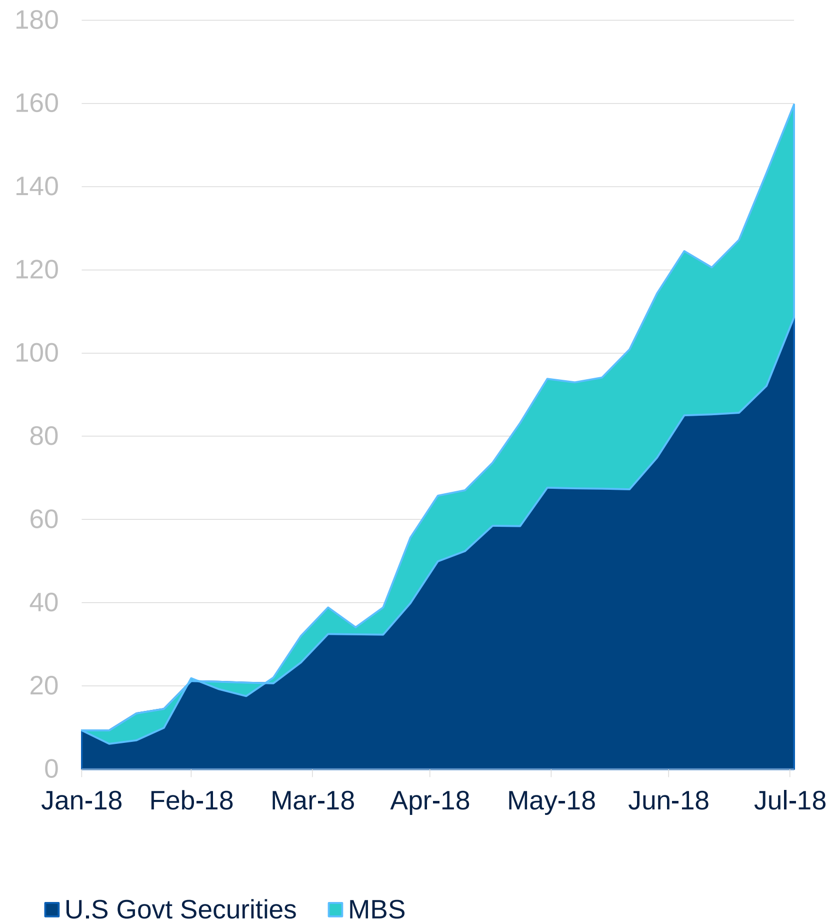
Source: BBVA Research & Bloomberg

Interest rates: Fed sensitivity to rate corridor and balance sheet wind down increasing

Fed Funds & Repo Rates
(%)



Balance Sheet Attrition
(US$bn, Cumulative)



Source: BBVA Research & FRB

Interest Rates

- Short-term rates continue to upward trend despite headwinds from global financial volatility and geopolitical uncertainty
- Global uncertainty and nontraditional monetary policy continue to compress term-premium
- Concerns of growing instability in emerging markets and spillovers to the developed world containing long-term rates
- 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: Inflation expectations and term premium holding ten-year below 2018 peak

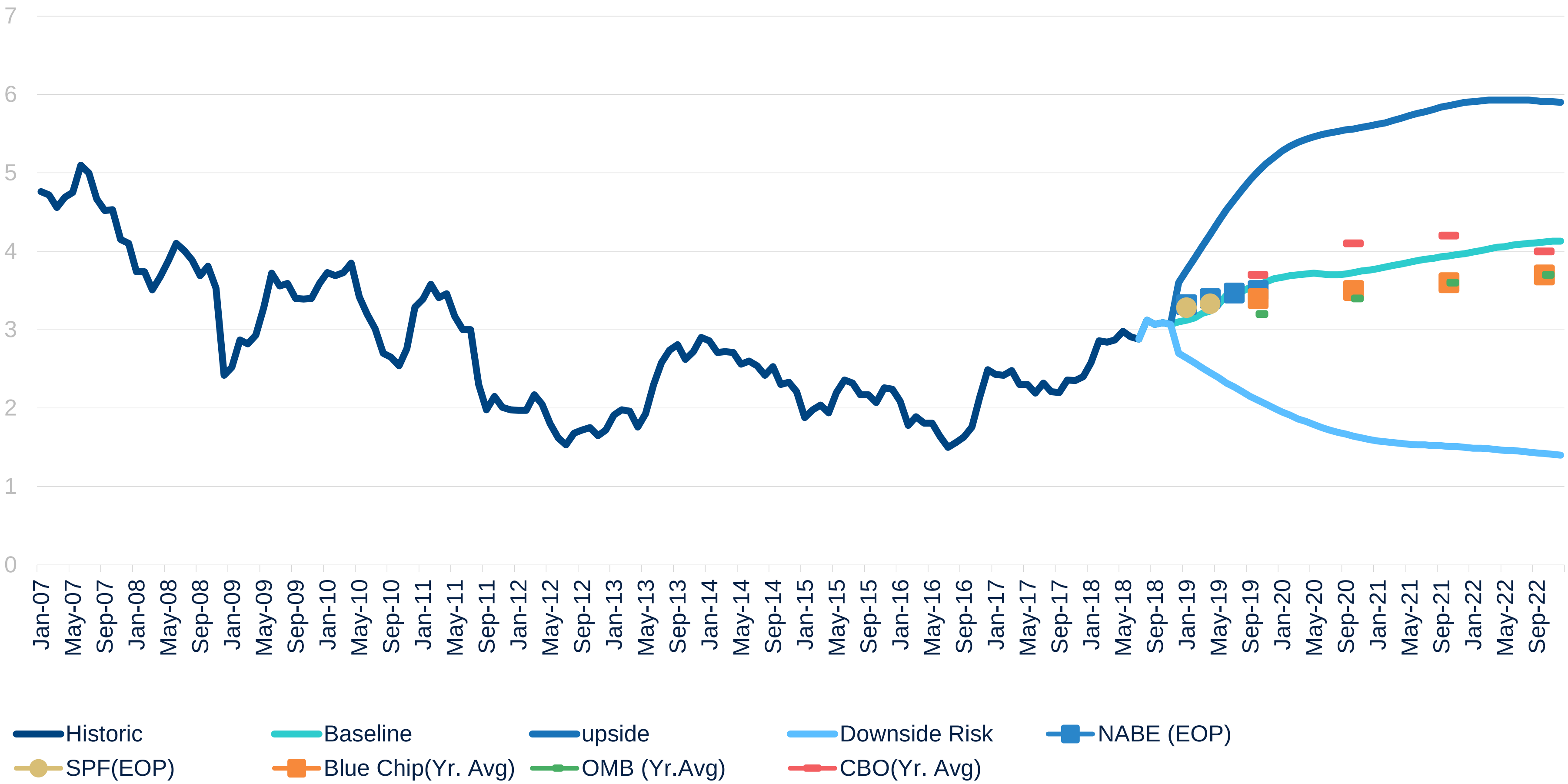
10-Year Treasury Yield Decomposition
(%)

Source: BBVA Research, ACM & Haver Analytics

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

10-Year Treasury Yield

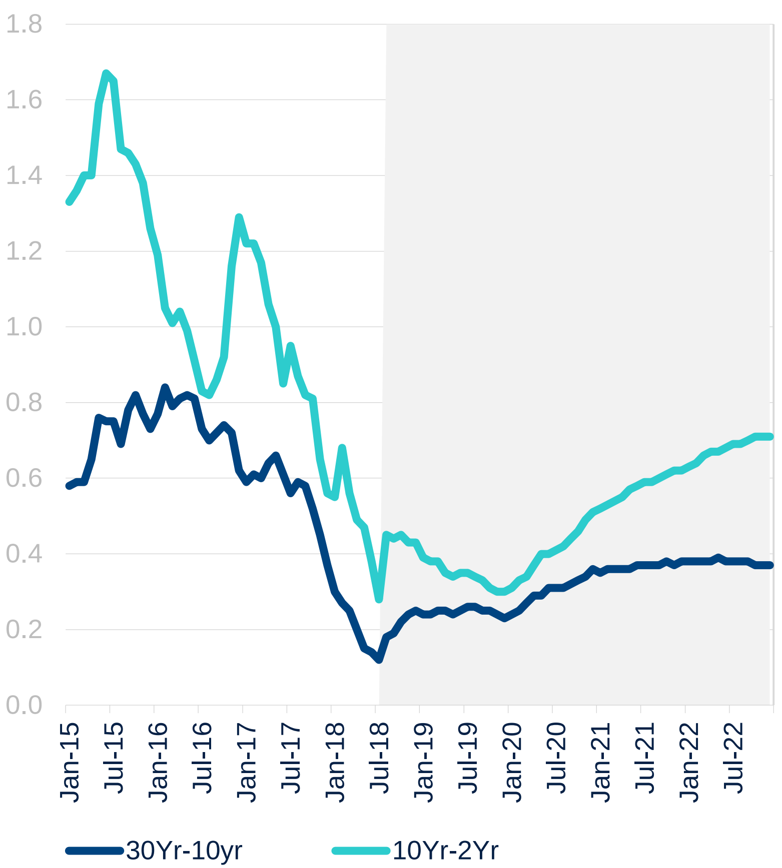
(%)



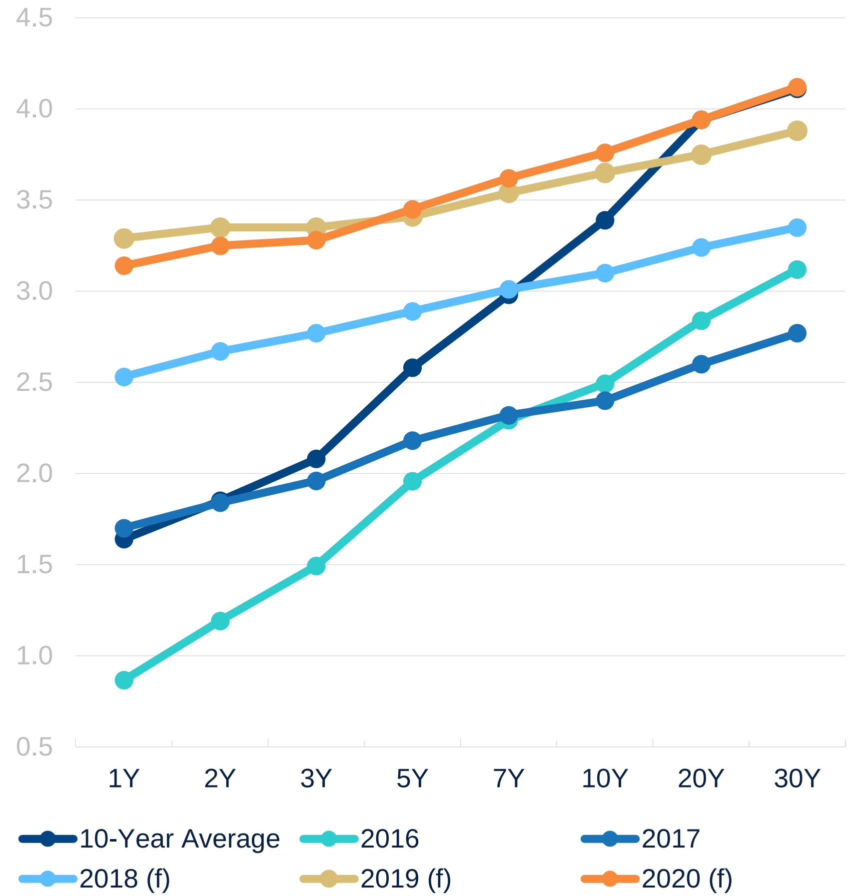
Source: BBVA Research, ACM & Haver Analytics

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

Yield Curve Slope
(Bp)



Yield Curve
(%, eop)



Source: BBVA Research

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	1.8	2.5	2.9	1.6	2.2	**2.8**	**2.8**	**2.5**	**2.3**	**2.1**
Upside	1.8	2.7	2.7	1.1	2.5	**3.7**	**3.8**	**3.4**	**3.1**	**3.0**
Downside	1.8	2.7	2.7	1.1	2.5	**2.4**	**-1.7**	**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	**3.9**	**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	**2.5**	**2.6**	**2.6**	**2.4**	**2.3**
Upside	1.5	1.6	0.1	1.3	2.1	**2.7**	**3.2**	**3.3**	**3.4**	**3.7**
Downside	1.5	1.6	0.1	1.3	2.1	**2.4**	**1.4**	**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	**3.1**	**3.65**	**3.76**	**3.97**	**4.13**
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**

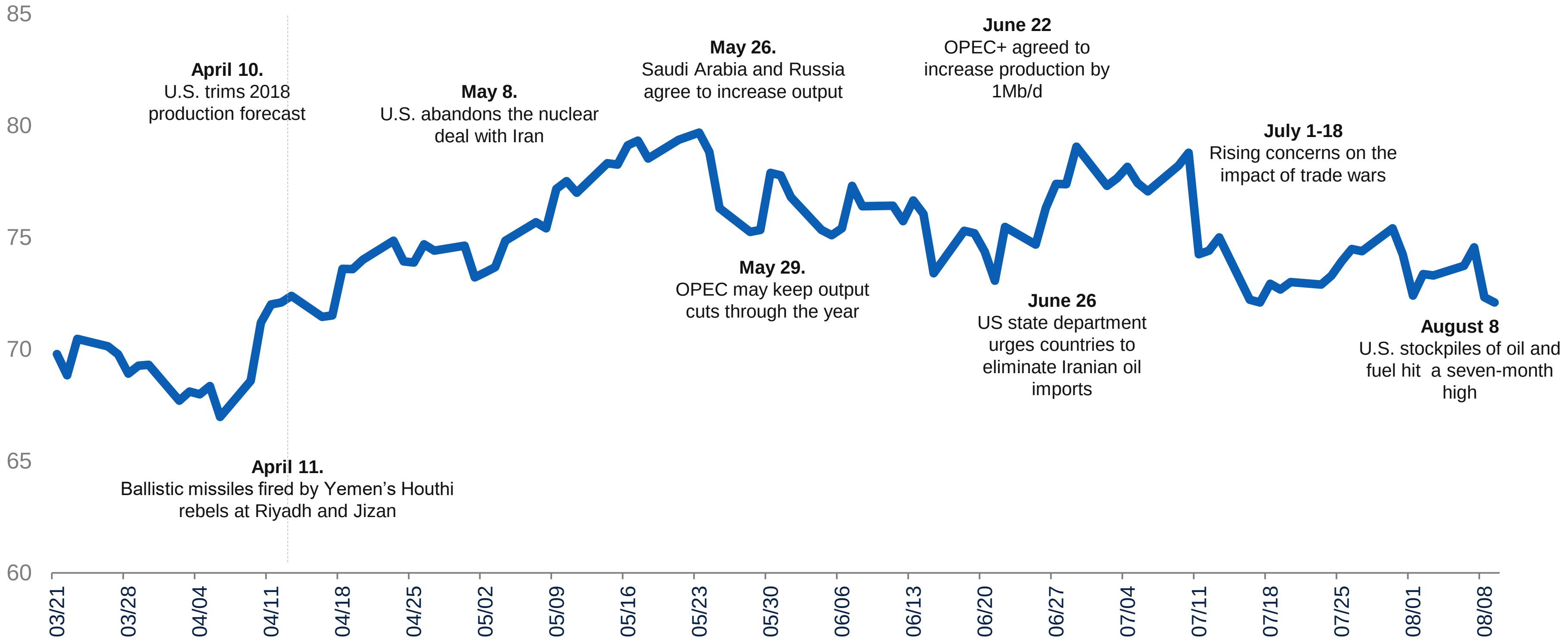
Subject to revision without notice

Energy Prices

- Geopolitics, concerns on OPEC spare capacity and the potential impact of trade wars will continue to add volatility
- Prices will remain supported by robust demand from China, India and the U.S.
- We continue to expect convergence to long-term equilibrium as demand returns to its historical trend and U.S. export capacity increases
- The main uncertainty to oil prices arises from the effect of subpar CAPEX on supply

Oil prices under pressure due to ample supply and concerns on the potential impact of trade wars on demand

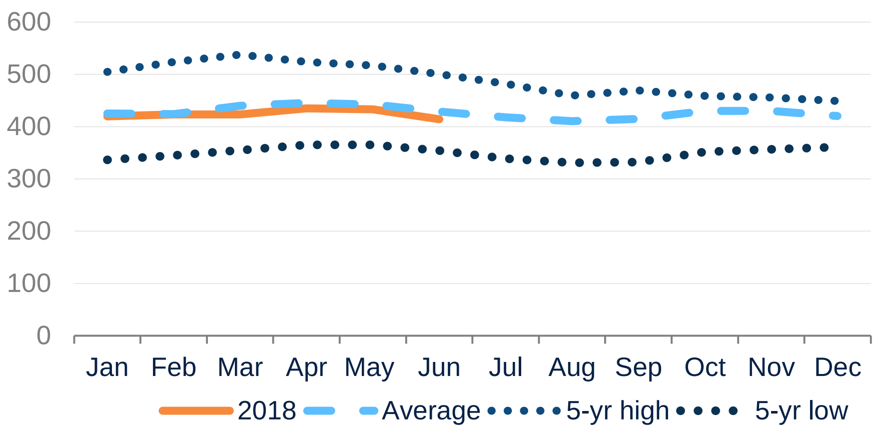
Brent crude oil prices
($ per barrel)



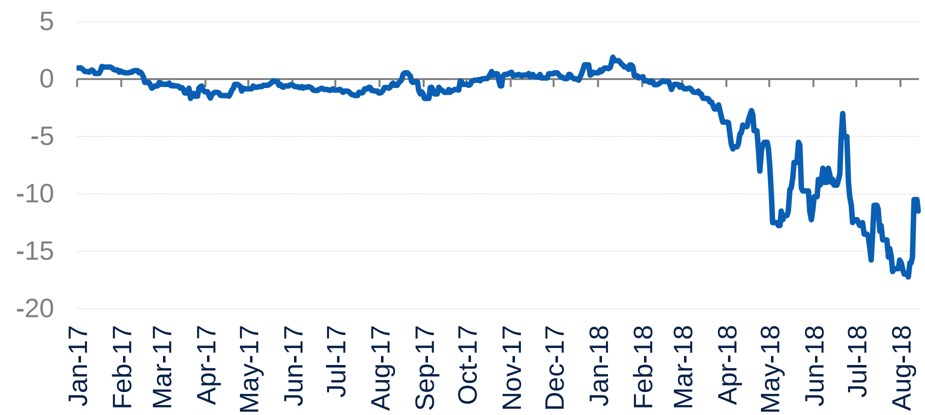
Source: BBVA Research and Haver Analytics`

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

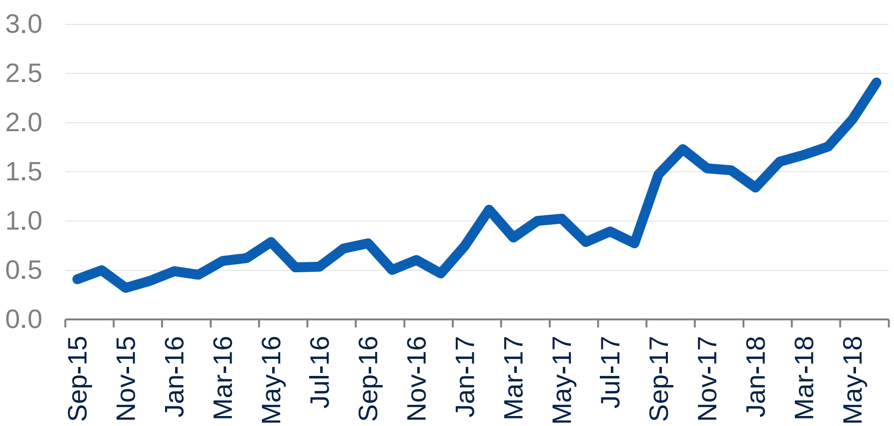
U.S. Crude oil inventories
(Excluding SPR, million barrels)



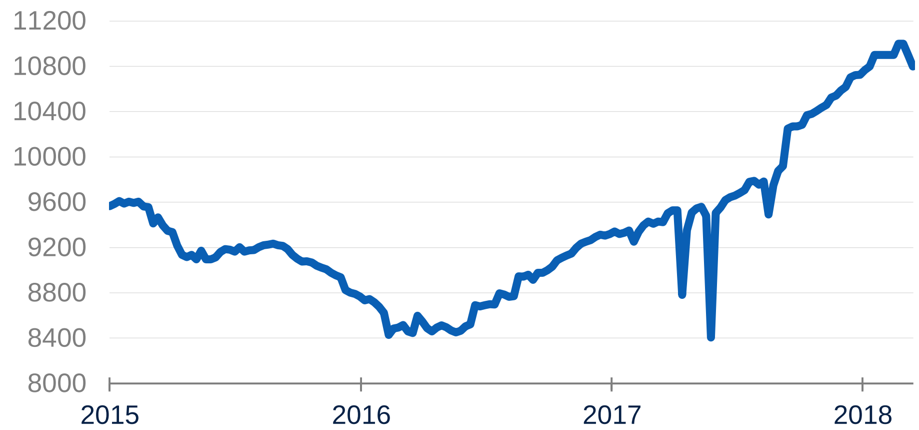
WTI Midland-Cushing differential
($/b)



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



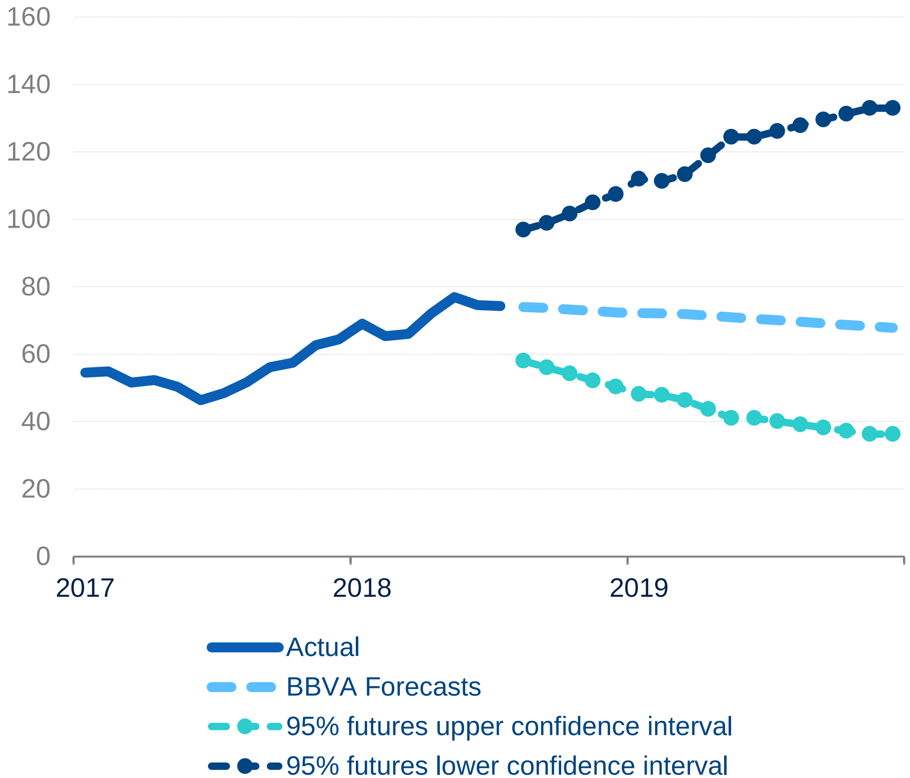
U.S. Estimated crude oil production
(Thousand barrels/day)



Source: BBVA Research and Haver Analytics

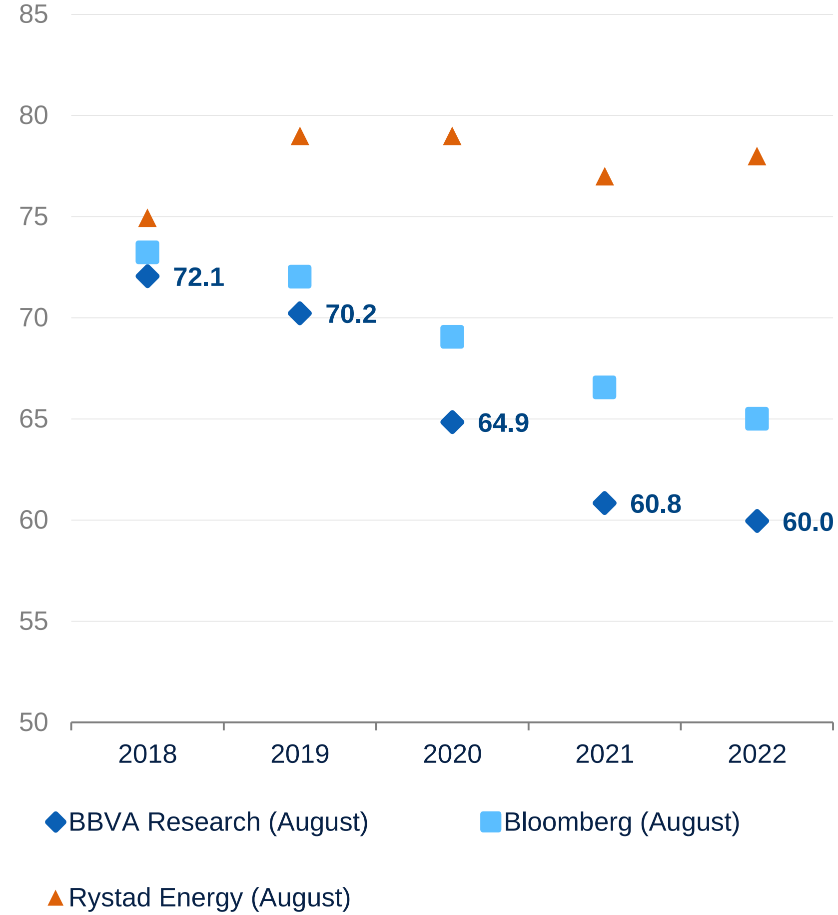
Forecasts

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



Source: BBVA Research, Bloomberg and EIA

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



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