BBVA Research

U.S. Economic Outlook

December 2018

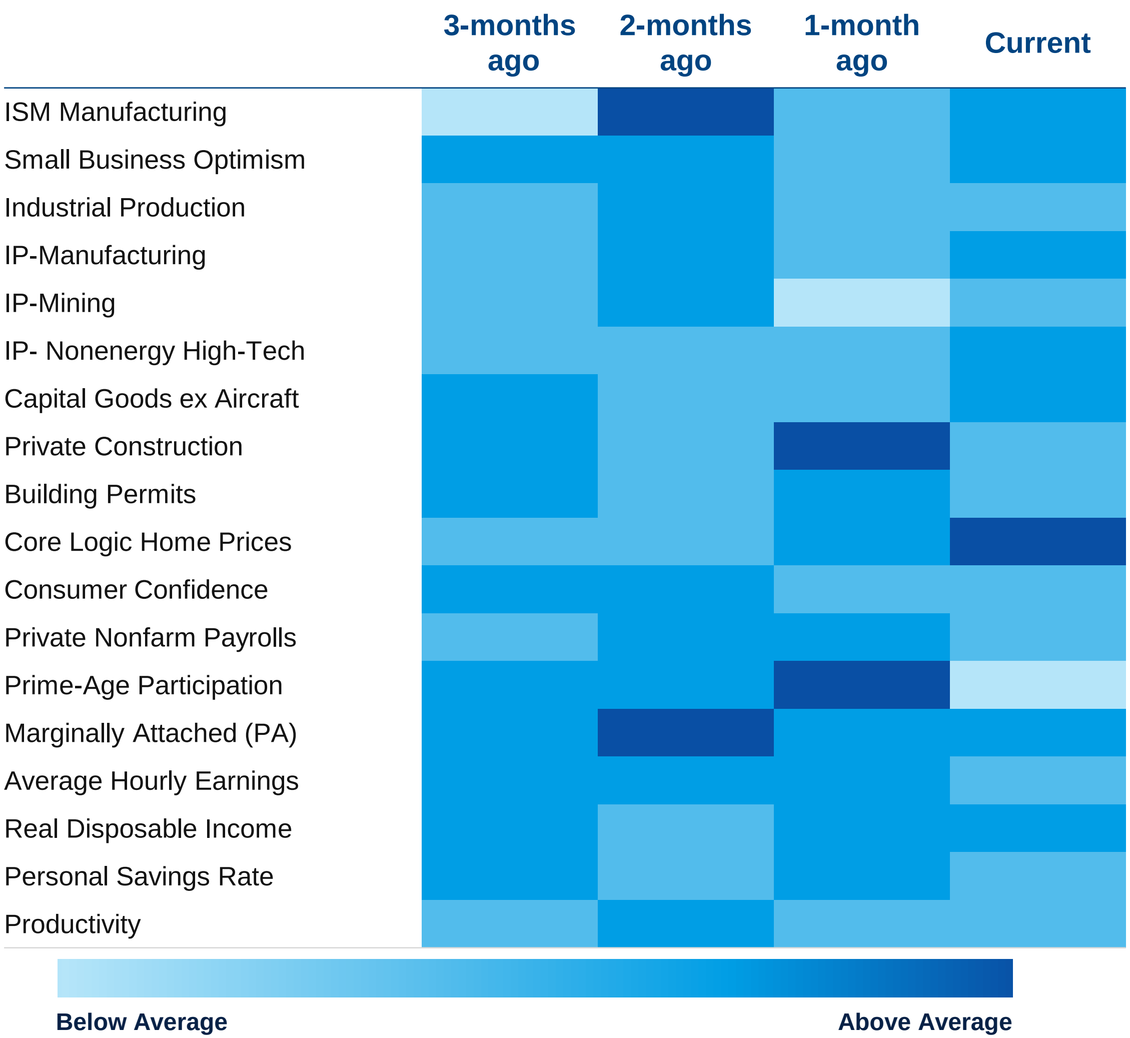
Creating Opportunities

Economic Outlook

- GDP growth outlook for 2019 and beyond tilted to the downside
- Models suggest rising risk of recession, qualitative analysis indicates downside risks are also increasing
- FOMC remains poised to raise rates in December. Likelihood for shallower rate path in 2019 rising
- Labor market slack minimal; unemployment rate trending near 50 year lows
- Inflation pressures continue to ease in 4Q18, but tariffs and rising nonlabor price pressures should support the inflation outlook over the medium-term
- Upward trend in 10-year Treasury yields unexpectedly reversed in December
- Analysts and future markets have lowered their expectations for oil prices

Economic activity

Real-Time Economic Momentum Heat Map

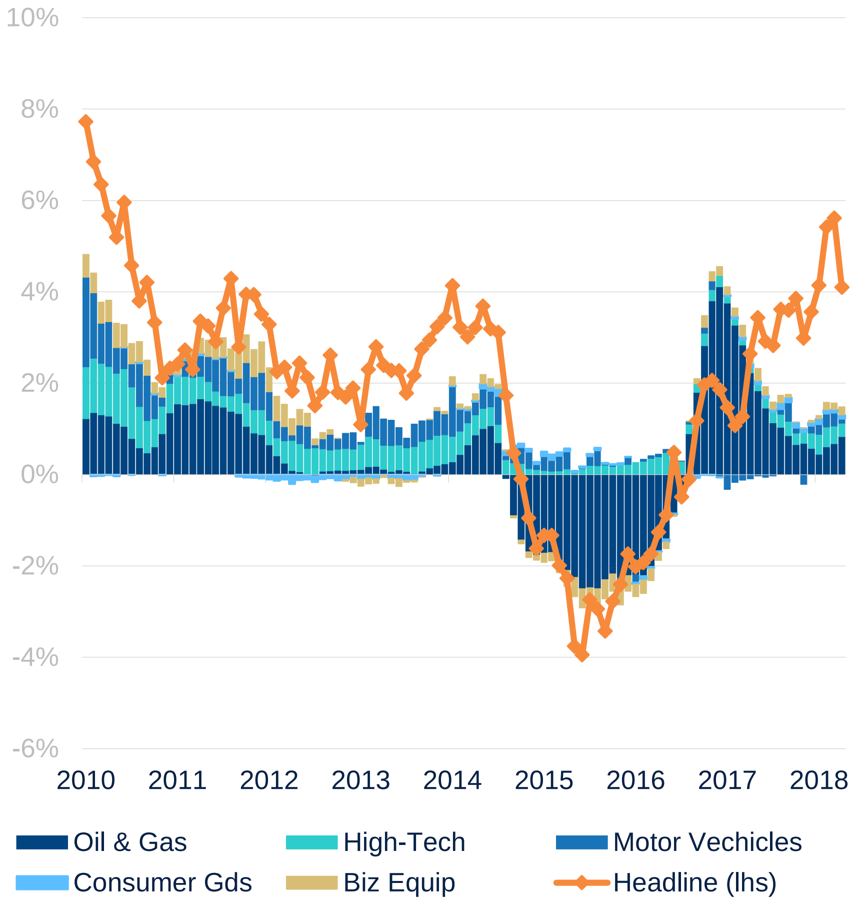


Source BBVA Research

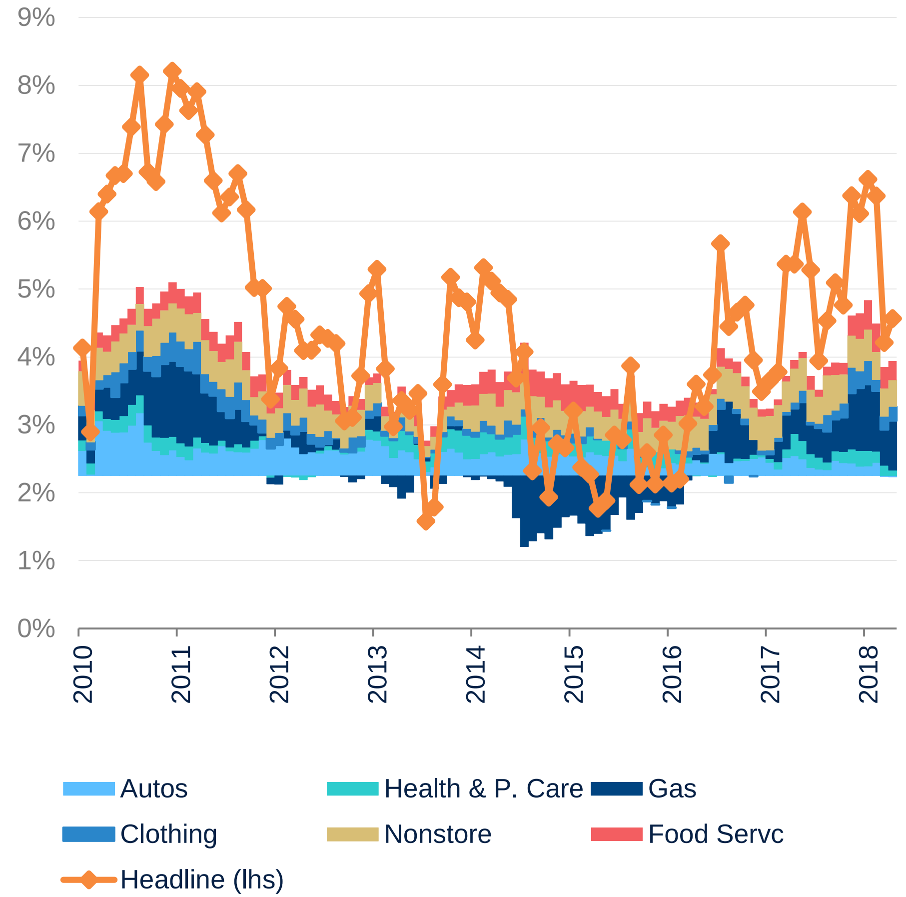
- Industrial production momentum slowing due to headwinds from trade frictions and decreasing commodity prices
- Residential housing continues to slow despite long-term rates dropping
- After strong gains early in the year, prime-age participation gains are slowing
- Productivity remains subpar, but in line with recent averages
- Consumer and small business confidence weakening

Economic trends: Industrial production and consumption moderating

Industrial Production
(Year-over-year %)



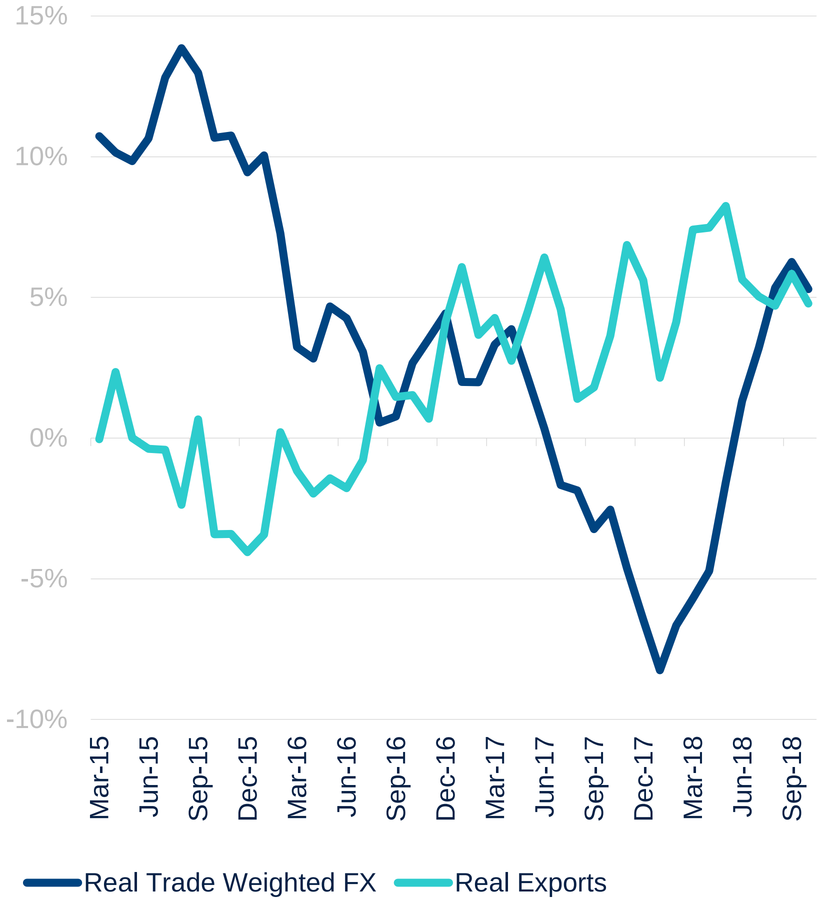
Retail Sales
(Year-over-year %)



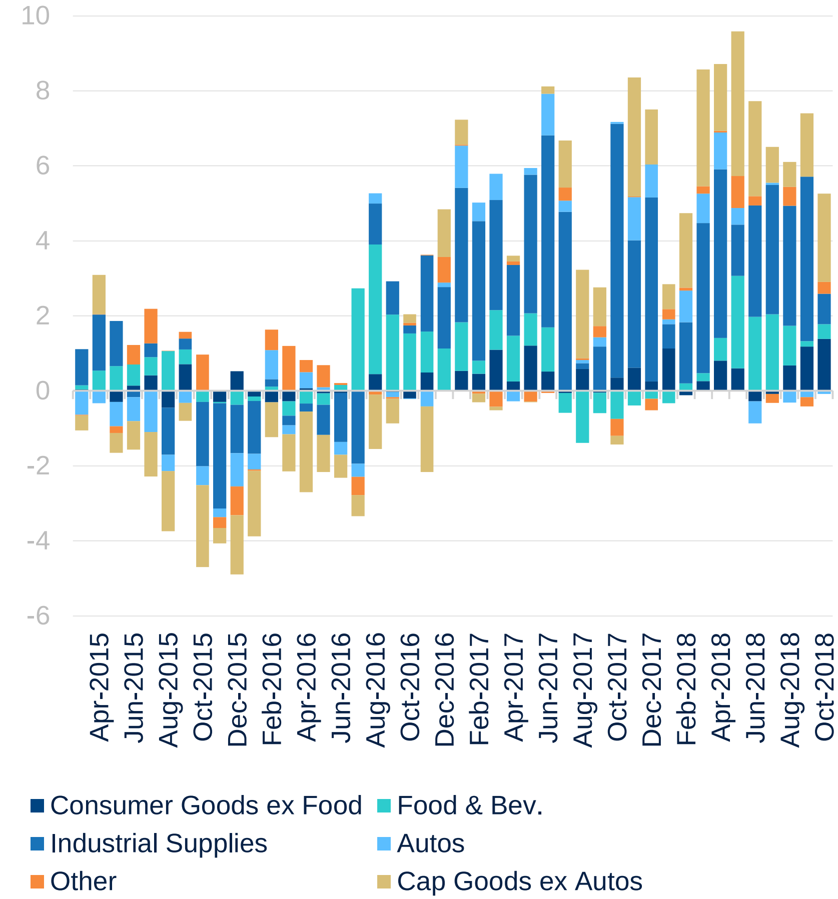
Source: BBVA Research, FRB & BEA

Economic trends: Strong foreign demand buoying exports

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



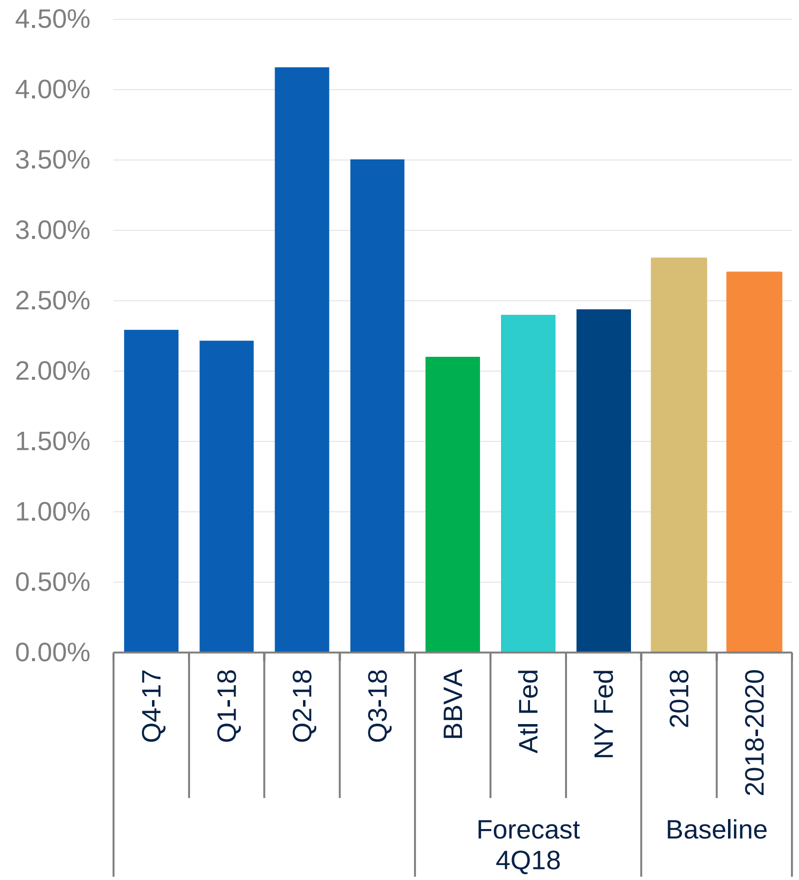
Real Exports
(Contribution to year-over-year %)



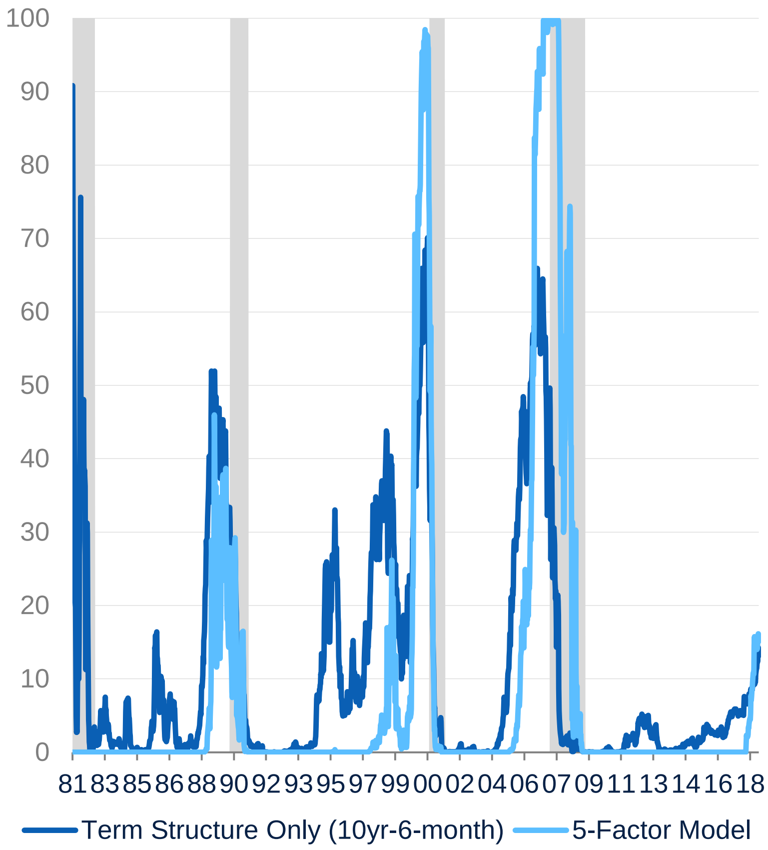
Source: BBVA Research, FRB & Census

Economic trends: Growth in 4Q18 to moderate, recession probability up to 15% in next 12-months

Real GDP
(QoQ SAAR, %)



Probability of Recession in 12 Months
(%)

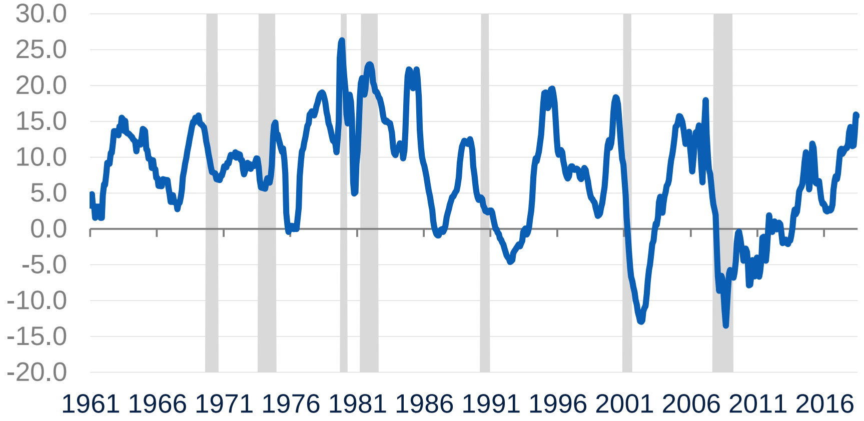


Source: BBVA Research, and ATL & NY Fed

Consumer credit cycle: Small upticks in consumer delinquencies. Consumer fundamentals remain strong

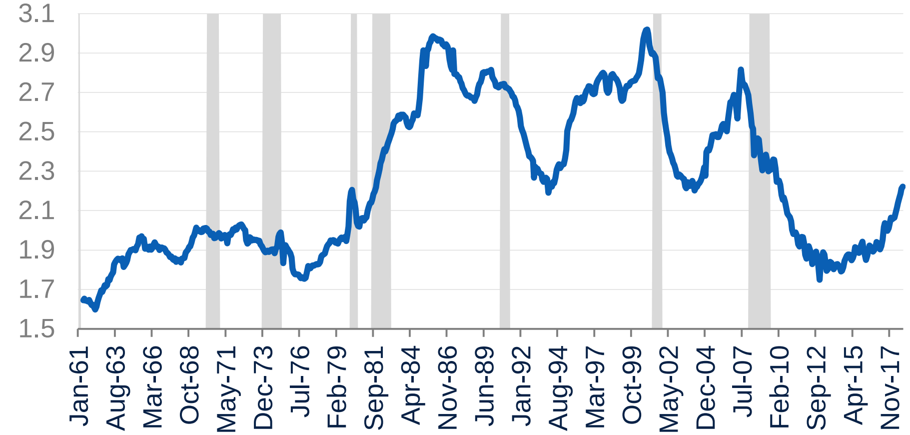
Personal Interest Expense

Year-over-year %



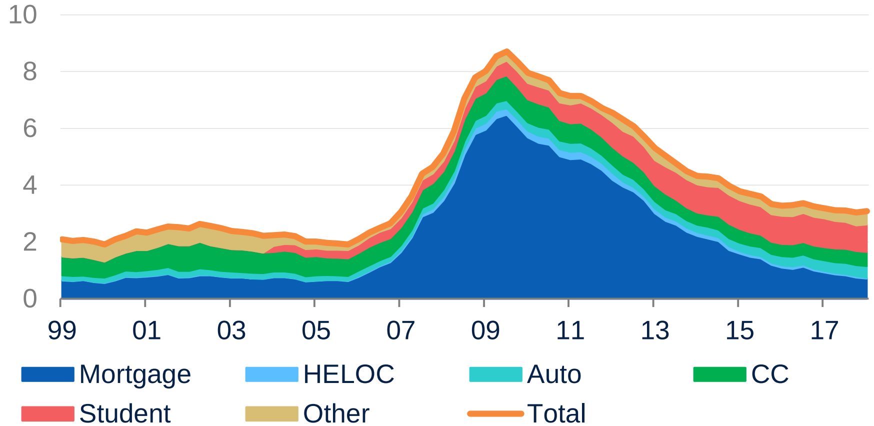
Personal Interest Expense to Disp. Income

Ratio, %



New 90+ Day Consumer Delinquencies Rates

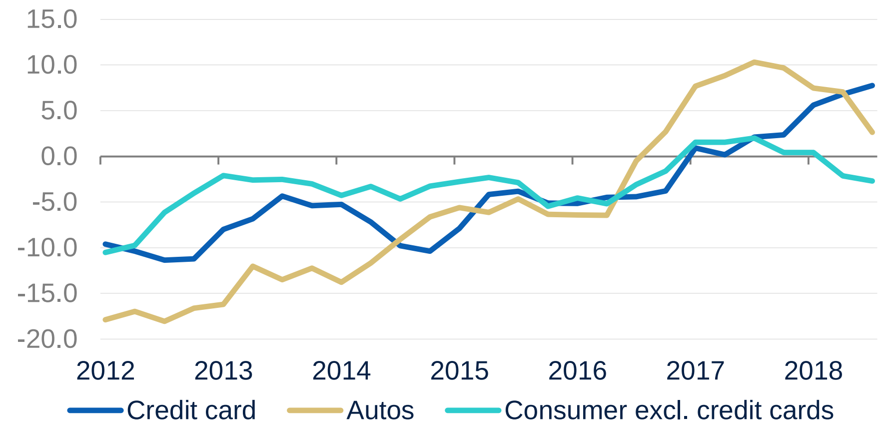
%



Source: BBVA Research, FRB, NY Fed & BEA

Senior Loan Officers Lending Standards

+ tightening / - loosening

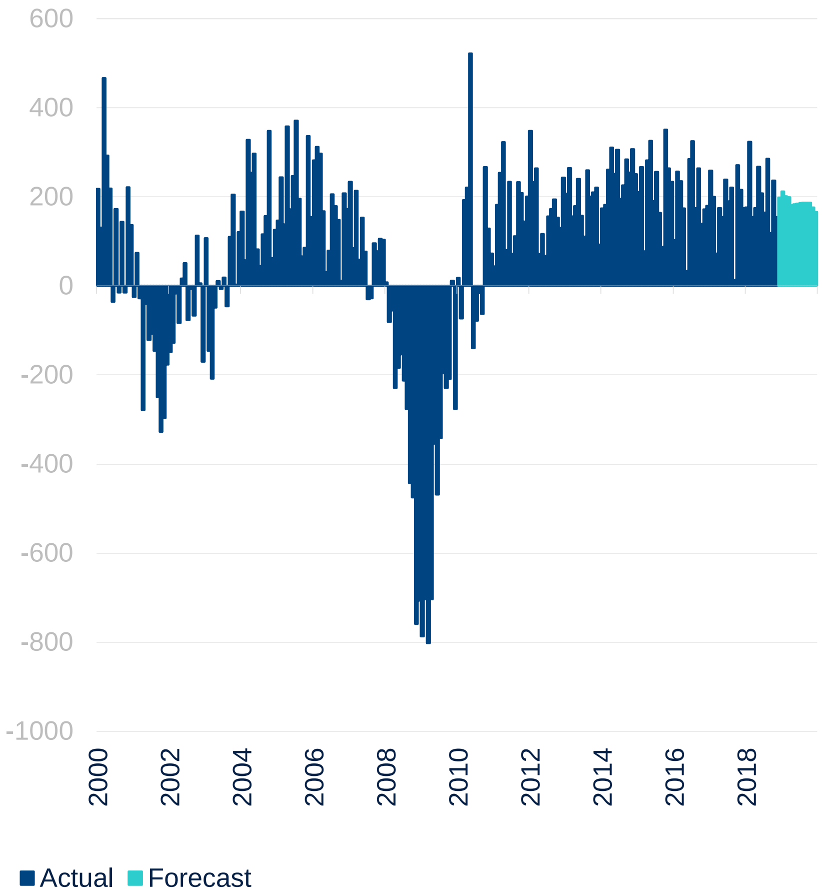


Labor Market

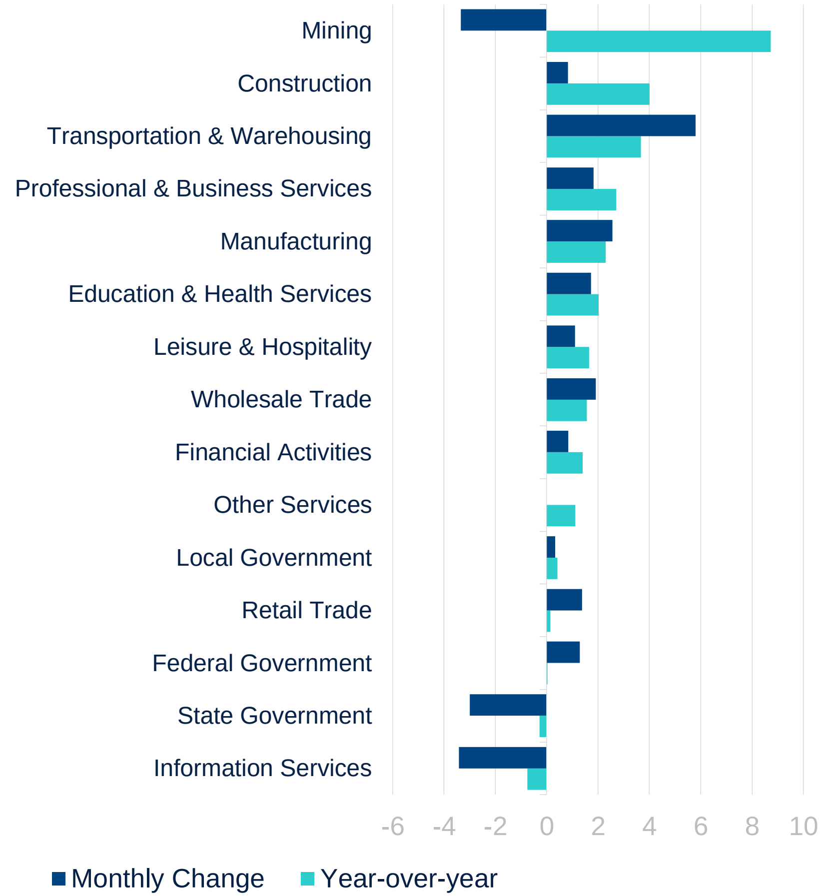
- In November, nonfarm payroll slowed to 155,000 from 237,000 in October
- Major industry gains: professional business services (32K), health care (32K), manufacturing (27K), and transportation and warehousing (25K)
- Upward revision in September and downward revision in October resulted in a net loss of 12,000 jobs over those months
- The unemployment rate was unchanged for the third consecutive month at 3.7%
- Both the labor force participation rate and the employment-to-population ratio remained unchanged at 62.9% and 60.6%, respectively
- We expect the UR to remain close to its current rate of 3.7%, as the pace of employment growth eases in the 1H19

Labor market: Job growth decelerates to more sustainable levels after strong growth in October

Nonfarm Payrolls
(Monthly Change, K)



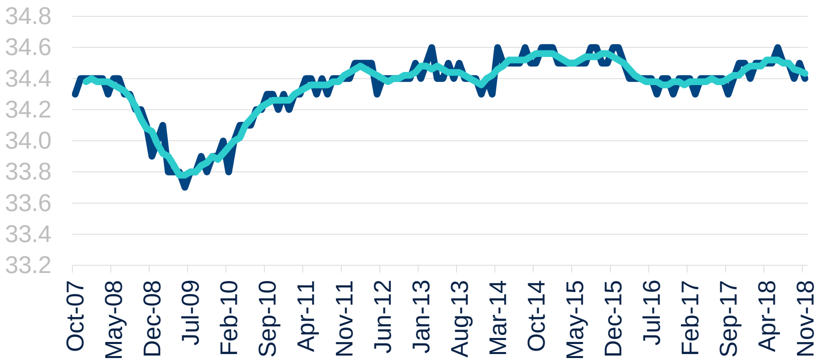
Industry Employment
(Annualized % change)



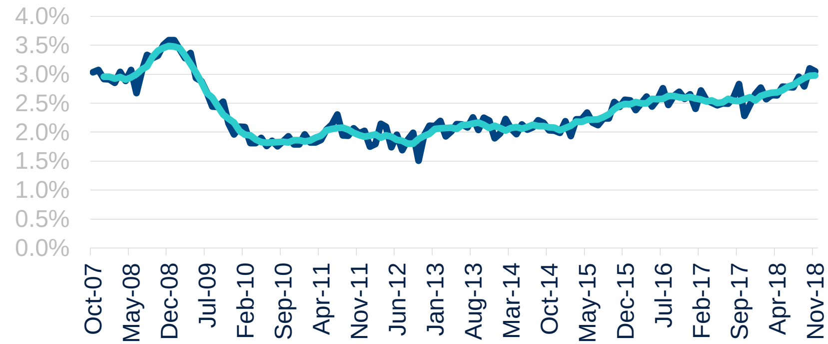
Source: BBVA Research & BLS

Labor market: Average hourly earnings continue to rise while hours worked decline

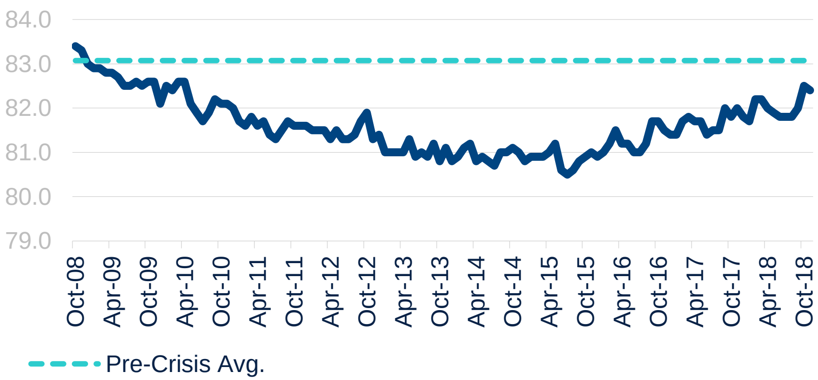
Average Weekly Hours
(number & 5mcma)



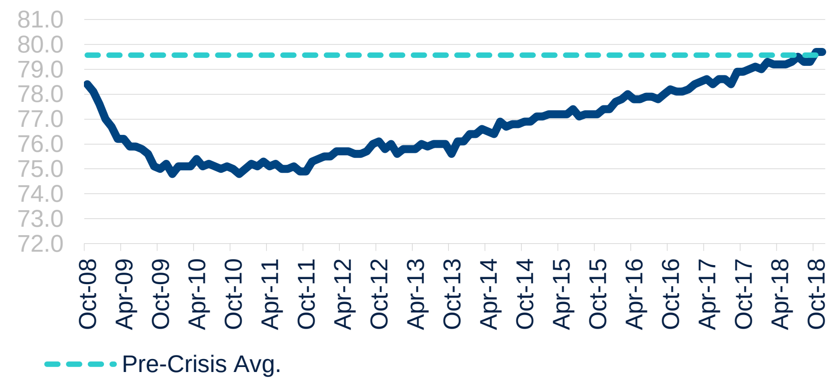
Average Hourly Earnings
(YoY% & 5mcma)



Prime Age Labor Force Participation
(%)



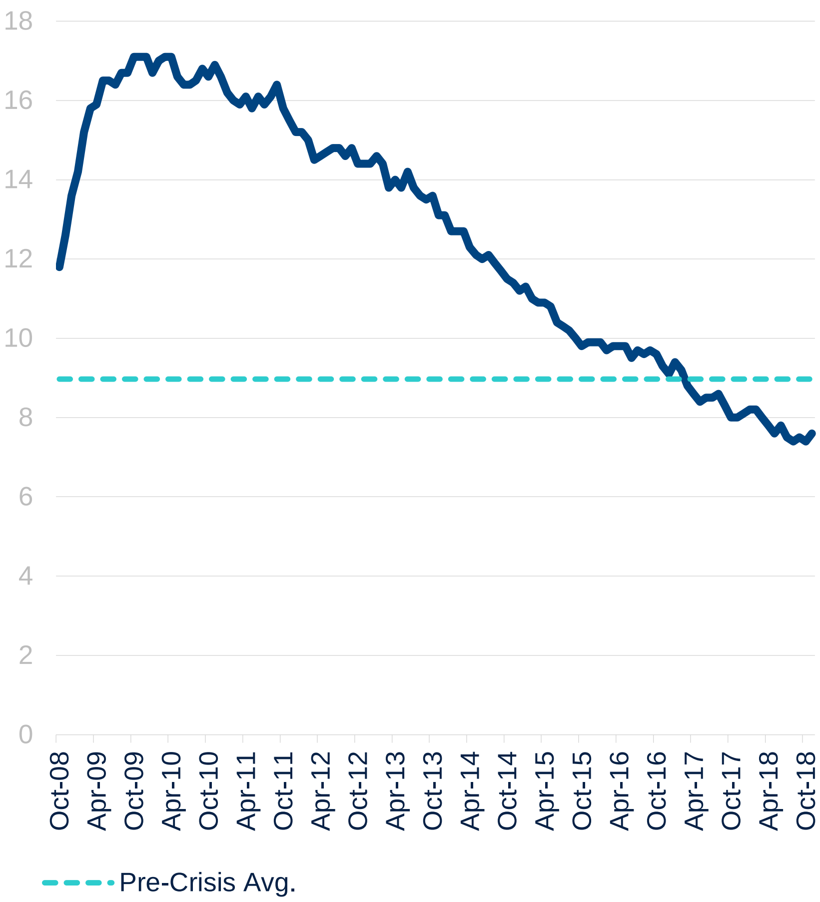
Prime Age Employment-to-Population
(%)



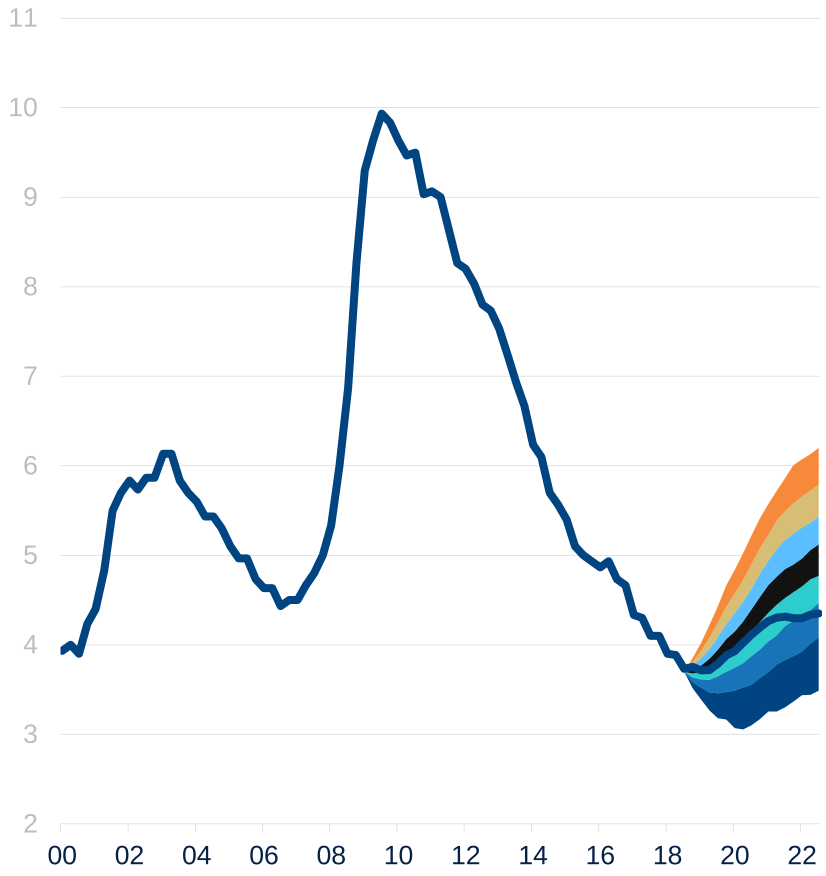
Source: BBVA Research & BLS

Labor market: Further downward adjustments in the UR becoming more difficult with increased labor force inflows

U-6
(%)



Unemployment Rate
(%)



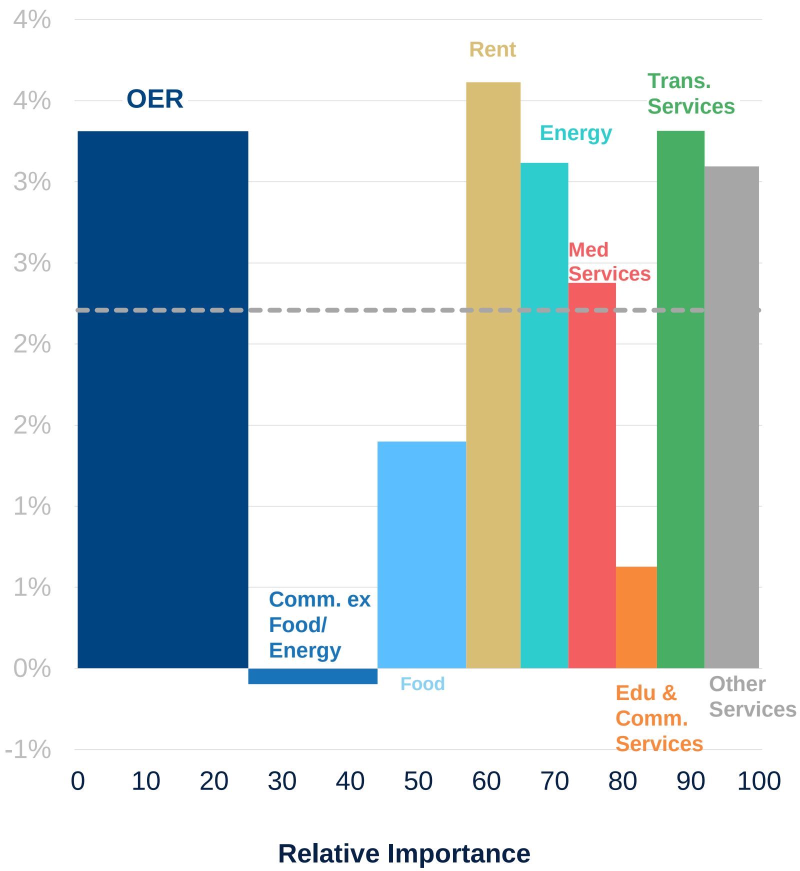
Source: BBVA Research & BLS

Inflation

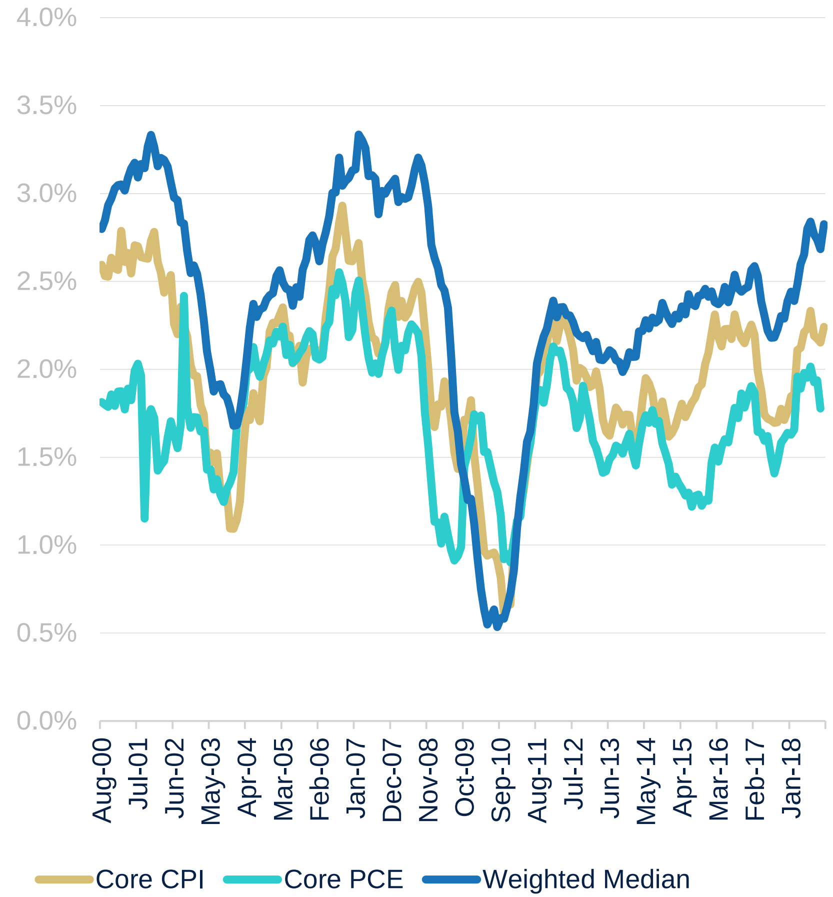
- Core and headline CPI converged to 2.2% in November, as gains in shelter and medical care prices offset energy price declines
- Core PCE inflation trending below target, after soft reading
- The probability of entering high-inflation regime remains remote
- Implied 5-year and 10-year inflation expectations have declined to 1.6% and 1.8%, respectively; their lowest level in more than 12 months
- Downside risks to inflation growing as tailwinds from an expansionary fiscal policy remain absent and pass-through from rising input costs remain muted

Inflation: Although core CPI remains stable, headline drops due to decline in energy prices

Consumer Price Inflation
(12m change)



Core Inflation Measures
(12m change)

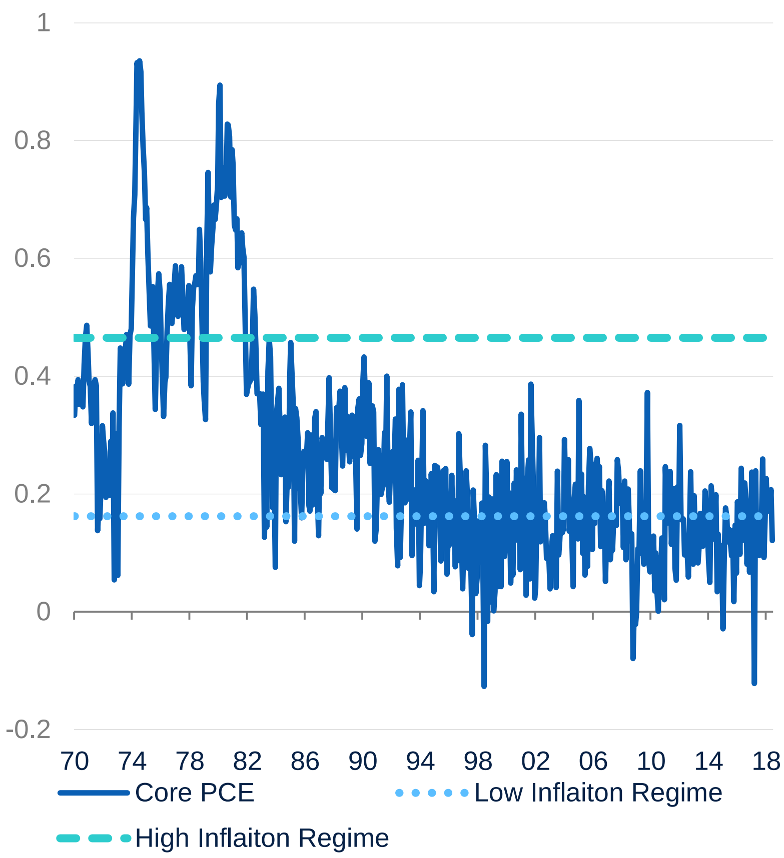


Source: BBVA Research, BLS & BEA

Inflation: Probability of high inflation regime declining

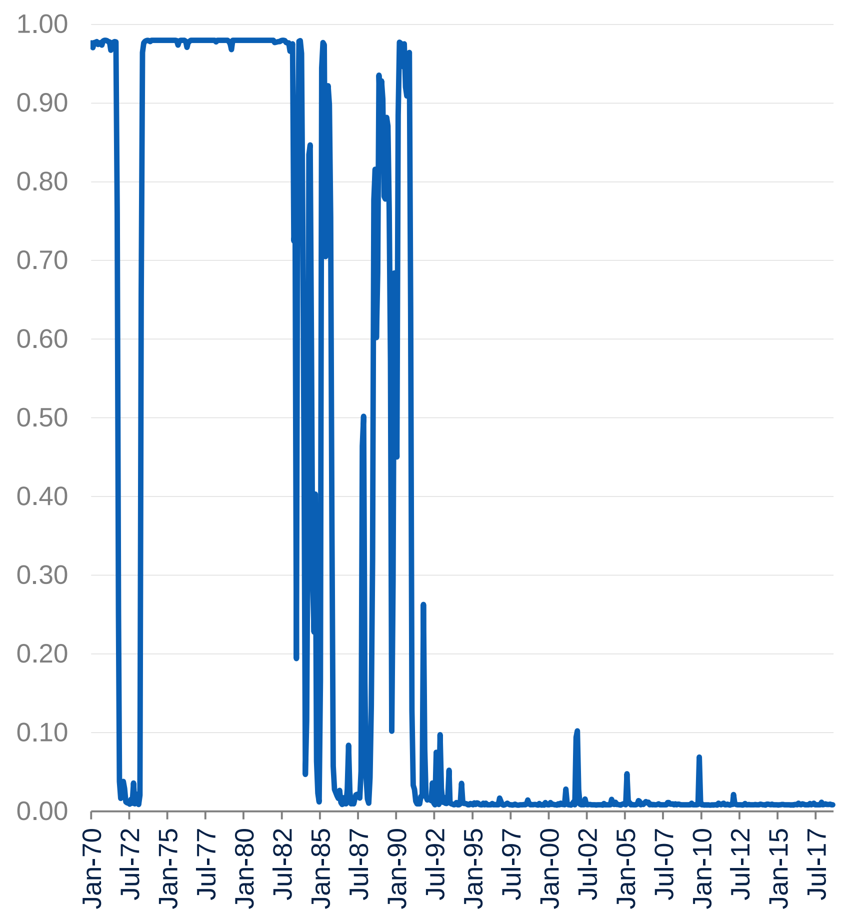
Core PCE Price Index & Inflation Regimes

Month-over-month %



Inflation Regime Change Probability

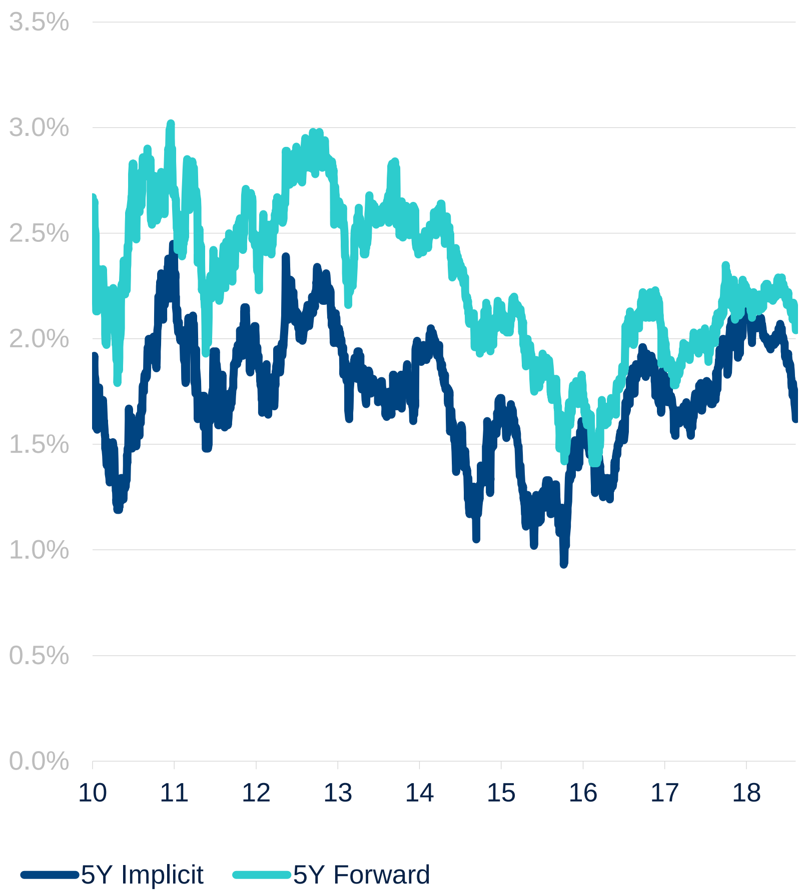
%



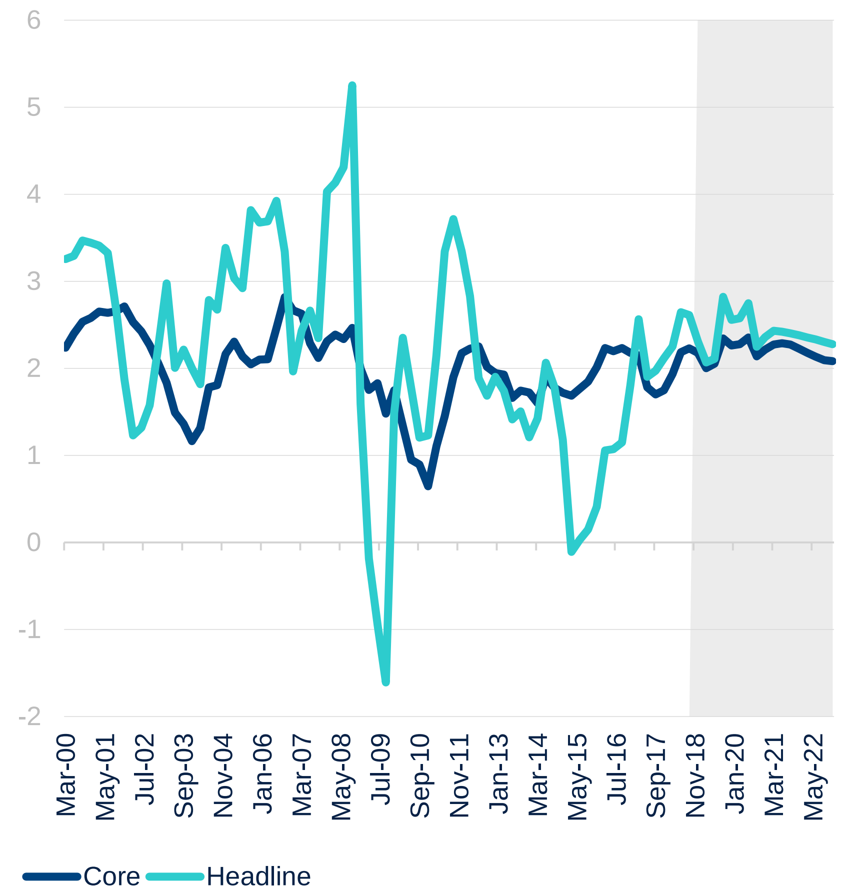
Source: BBVA Research & BLS

Inflation: Baseline remains for modest overshooting in 2019, but increasing risks of faster convergence to 2%

Inflation Expectations
(%)



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



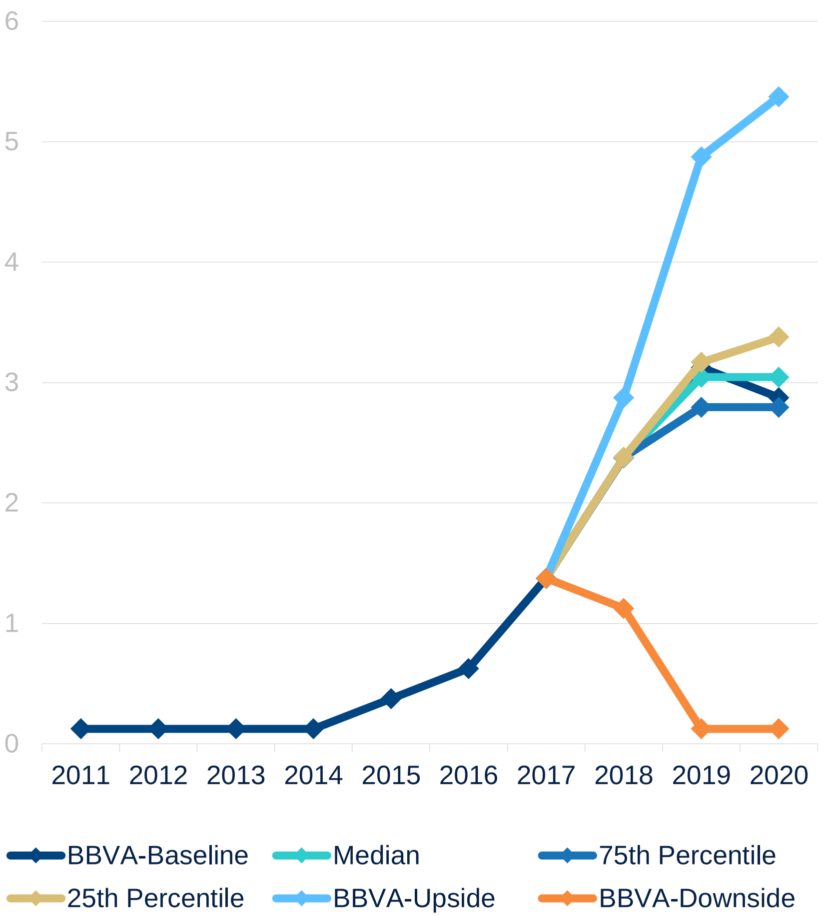
Source: BBVA Research & Haver Analytics

Monetary Policy: Federal Reserve

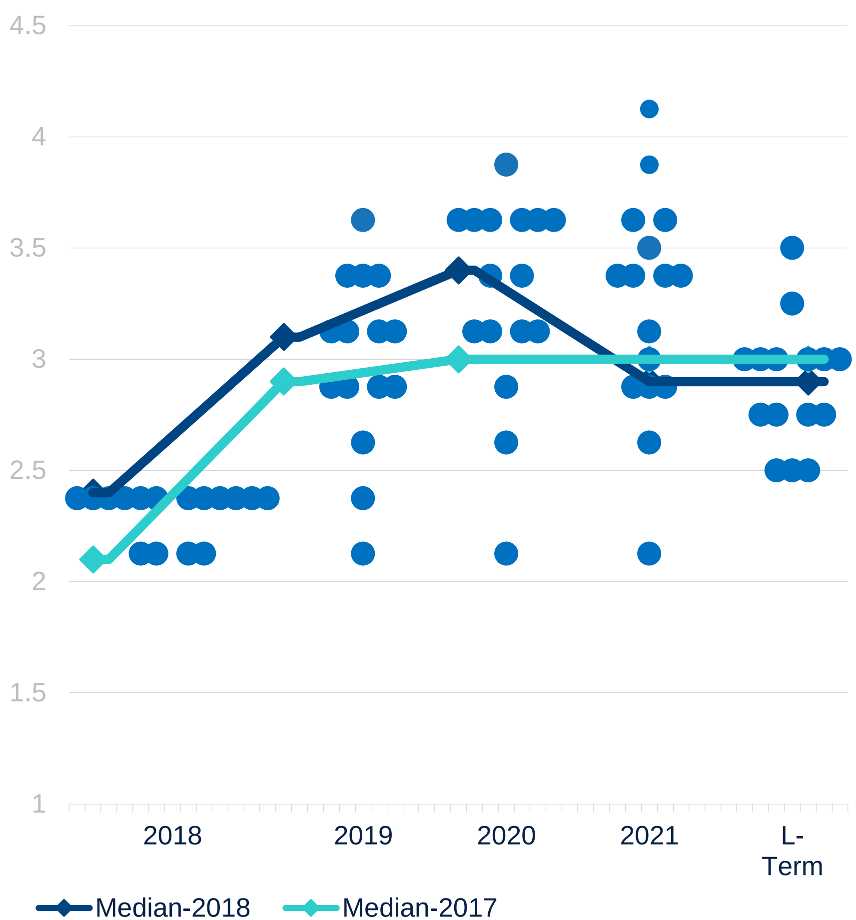
- The Fed is poised to raise rates for the fourth time this year, bringing the benchmark target to 2.25-2.50%
- The Fed is trying to calibrate the remaining stretch of its normalization path in order to ensure a soft-landing amidst an uptick in market volatility and growing concerns about financial stability
- Post-meeting communication will likely signal a greater willingness to pause in the short-run in an effort to allow the economy to absorb the removal of policy accommodation over the past 24 months
- Markets still pricing in high probability of December rate hike
- The probability of 3+ rate hikes in 2019 has decreased significantly (~5%)
- Given that the risk balance is tilting to the downside, our outlook for the Fed has also shifted downwards

Fed: External headwinds and financial volatility bias 2019 outlook to the downside

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



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

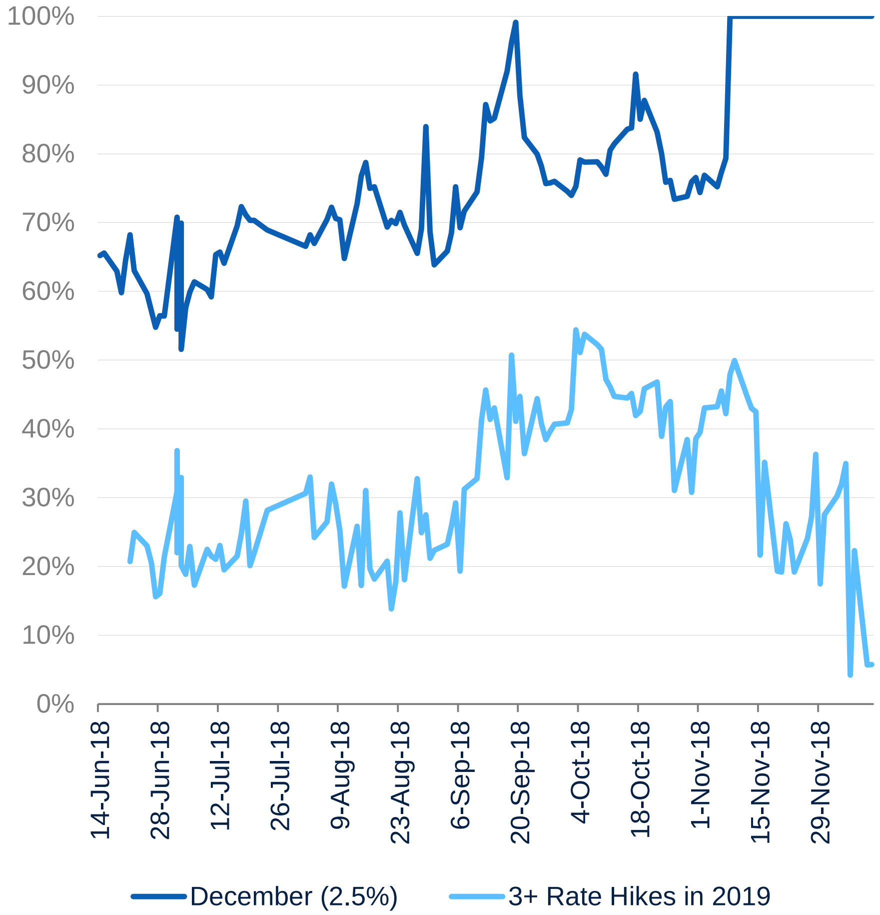


Source: BBVA Research & FRB

Monetary policy: Market probability of additional increase in Dec remains priced in, 3+ hikes in 2019 down significantly

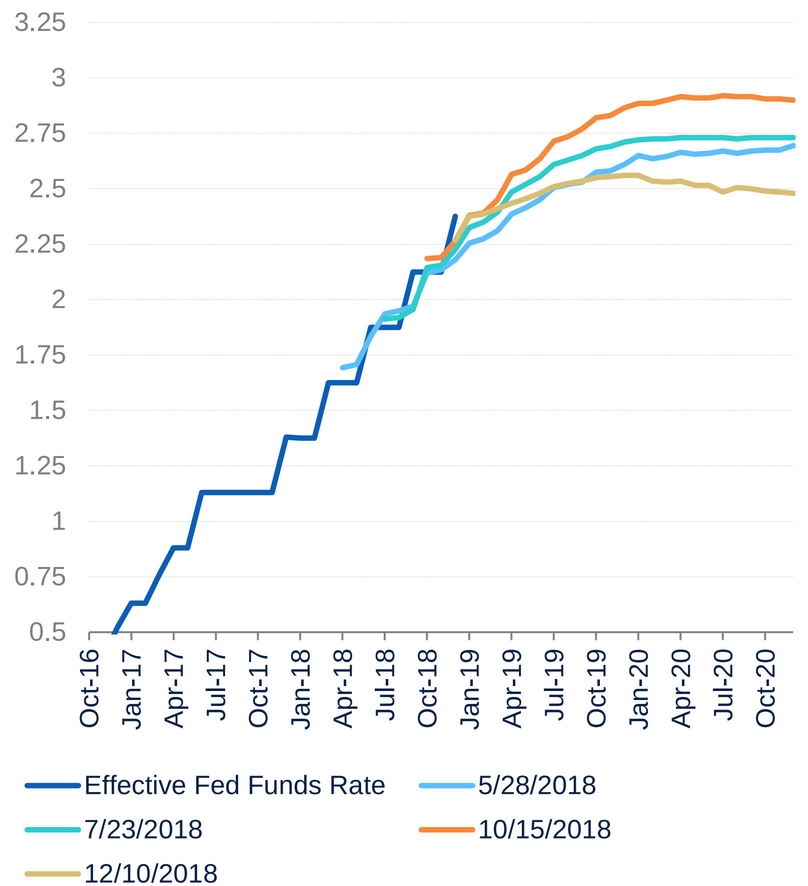
Fed Funds Implied Probability

(%)



Fed Funds Futures & BBVA Baseline

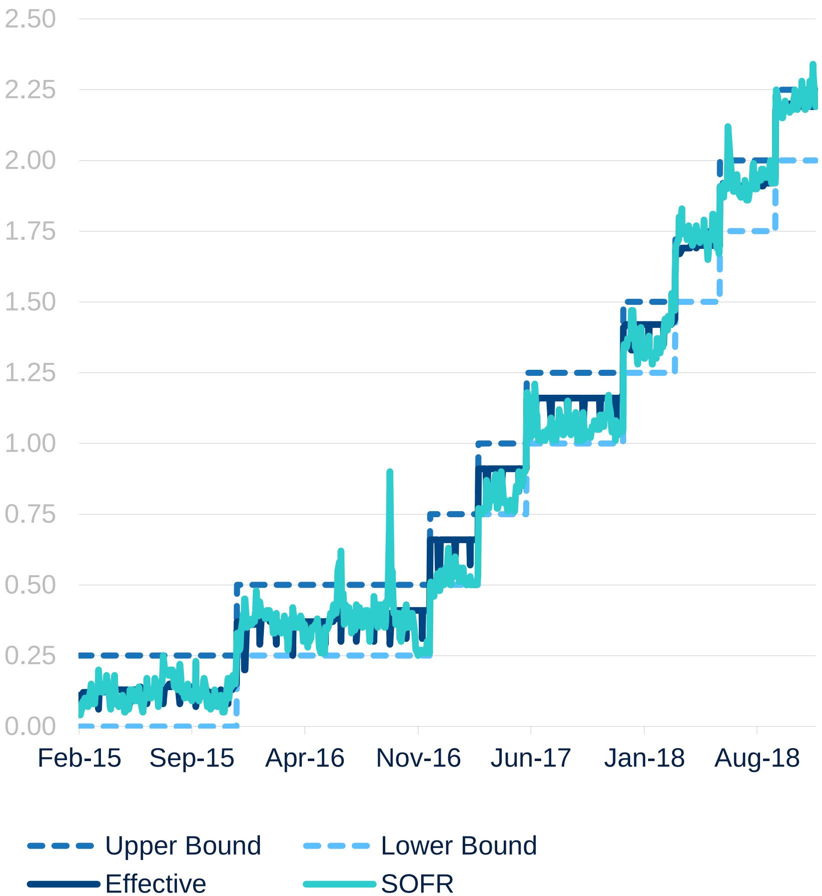
(%)



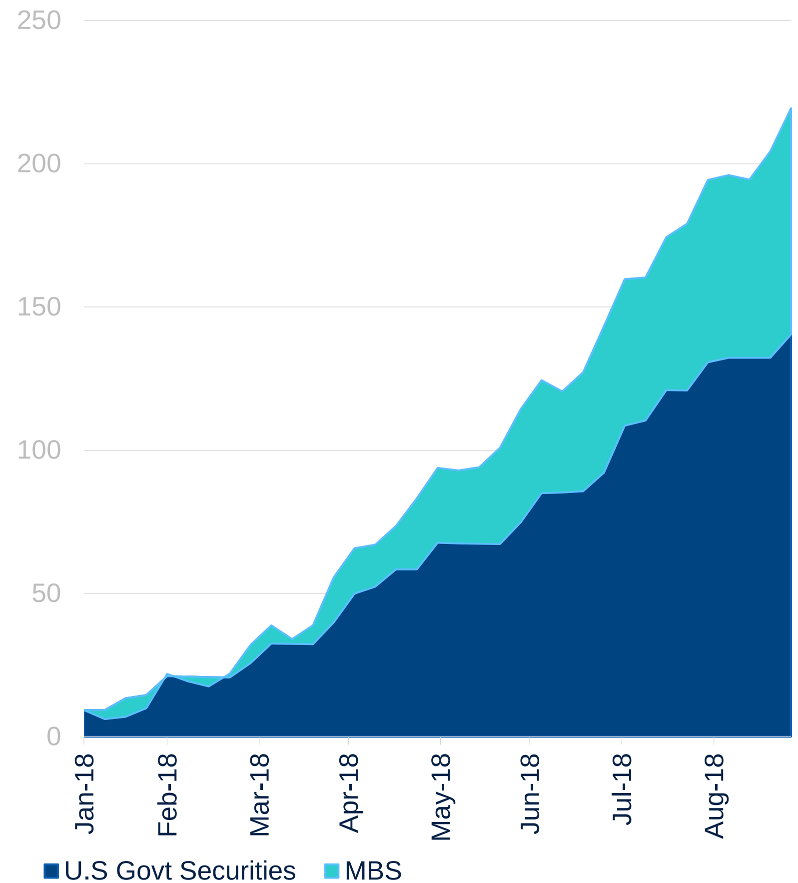
Source: BBVA Research & Bloomberg

Monetary Policy: Balance sheet attrition gaining momentum with over $310B in run-off to date

Fed Funds & Repo Rates
(%)



Balance Sheet Attrition
(US$bn, Cumulative)



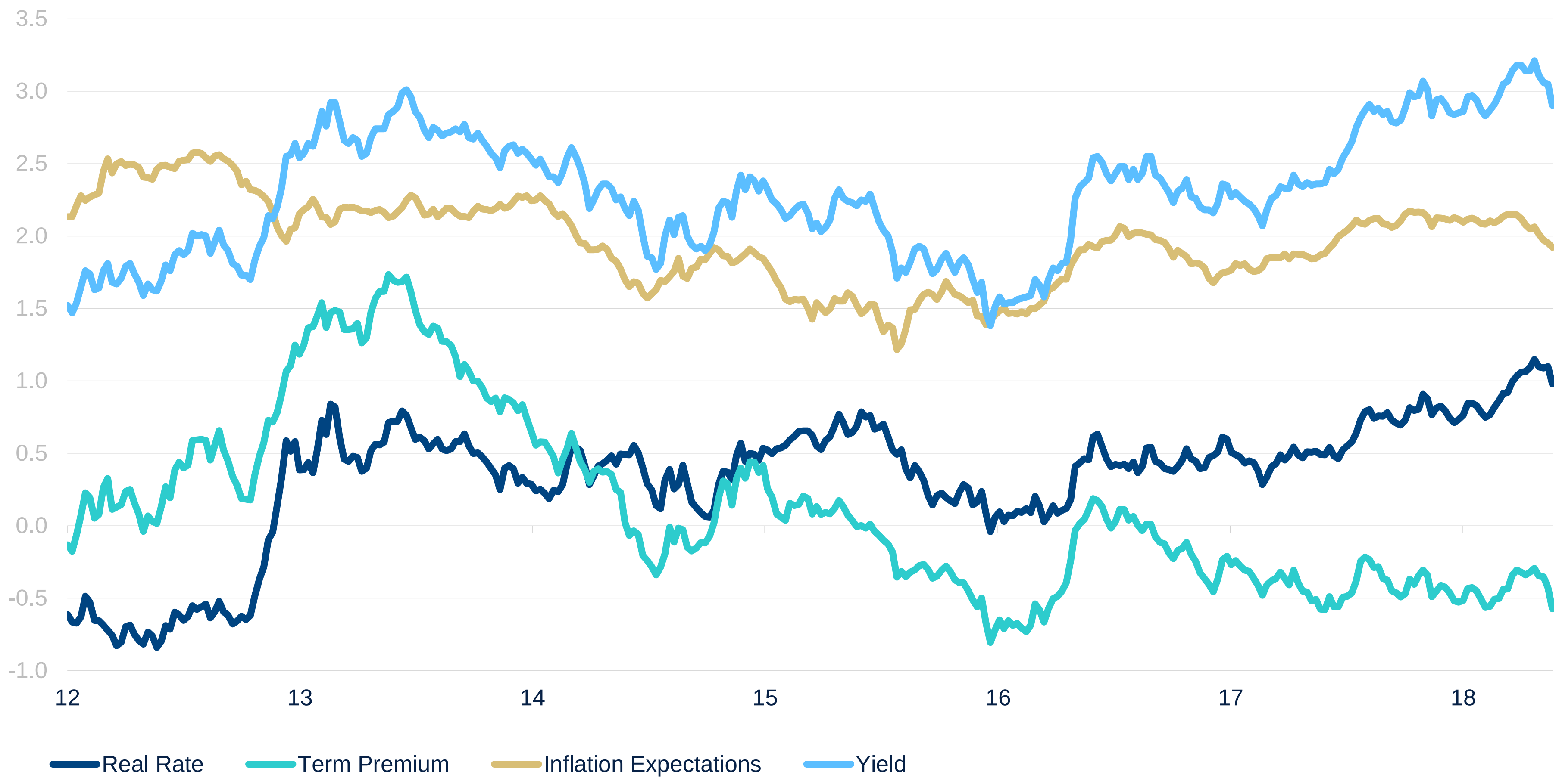
Source: BBVA Research & FRB

Interest Rates

- Continued upward momentum in short end of the yield curve, but tepid outlook for Fed implies lower terminal levels
- 10-yr Treasury yields below 3.0%, a drop of 35bp from recent peak
- Downward pressure on term premium renewed due to increased uncertainty, flight-to-safety and rebalancing of expectations
- Although baseline still assumes 10-year Treasury yields will edge higher, the bias continues tilting to the downside
- Yield curve will likely flatten further, but remain positive in our baseline scenario
- Nonetheless, periods of an inverted yield curve could be more frequent under the new normal

Interest rates: Term premium decompression short-lived, as 10-year Treasury dips below 3.0%

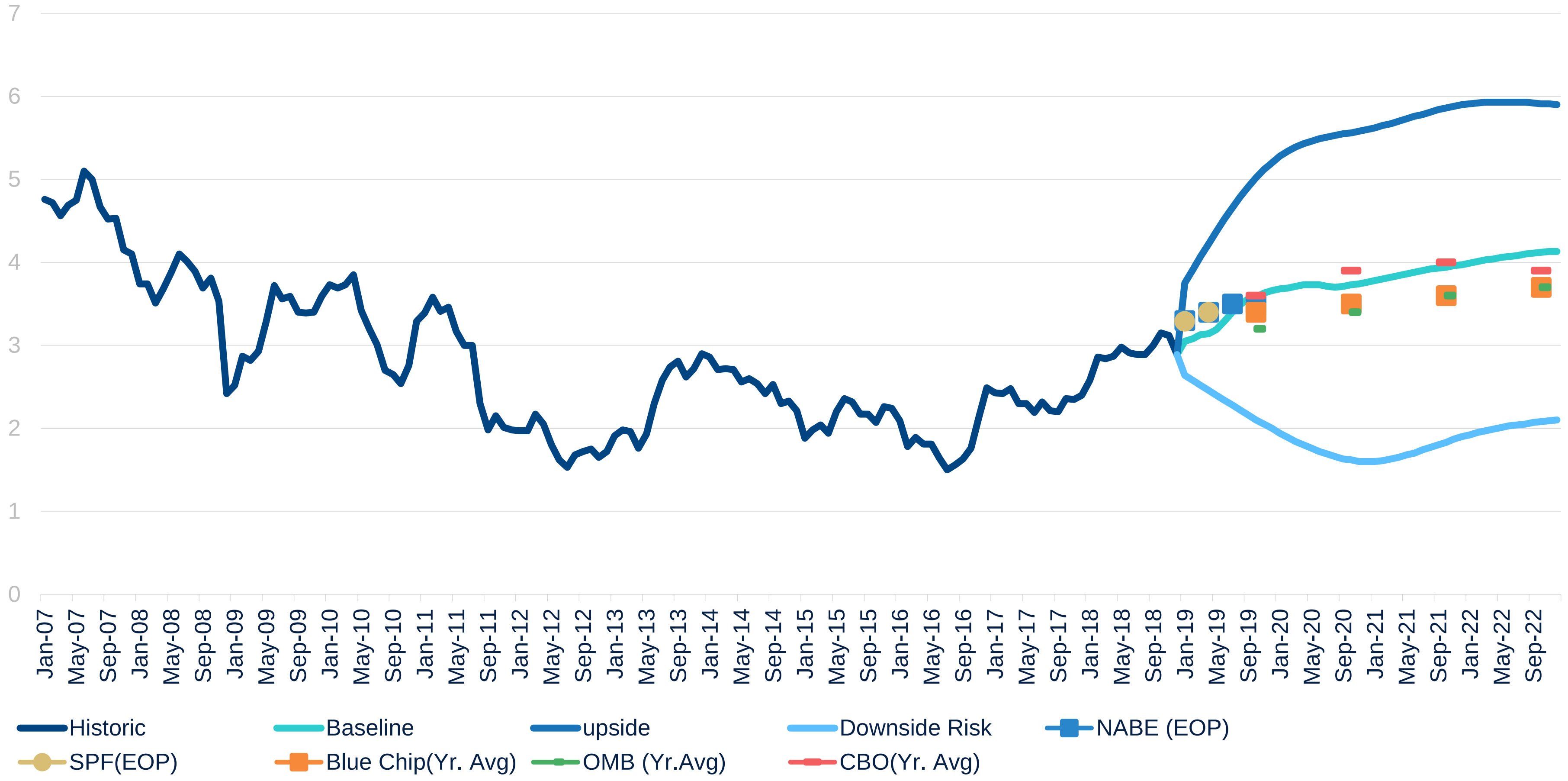
10-Year Treasury Yield Decomposition
(%)



Source: BBVA Research, ACM & Haver Analytics

Interest rates: Greater clarity on domestic policy making and monetary policy support modest upside

10-Year Treasury Yield
(%)

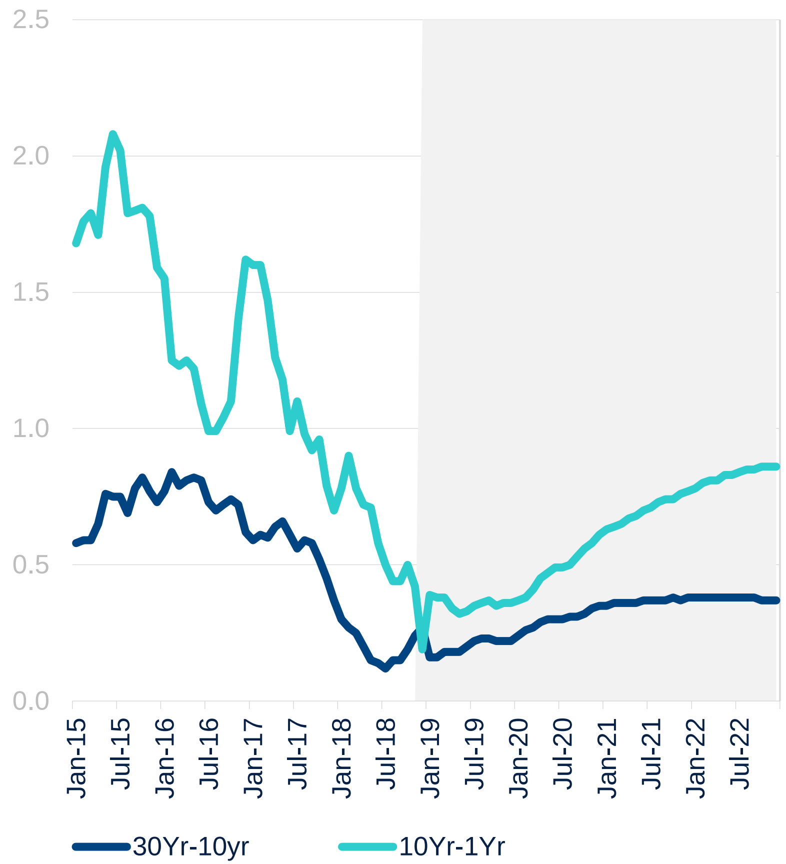


Source: BBVA Research, ACM & Haver Analytics

Interest rates: Threat of yield curve inversion rises, but slope remains positive in baseline scenario

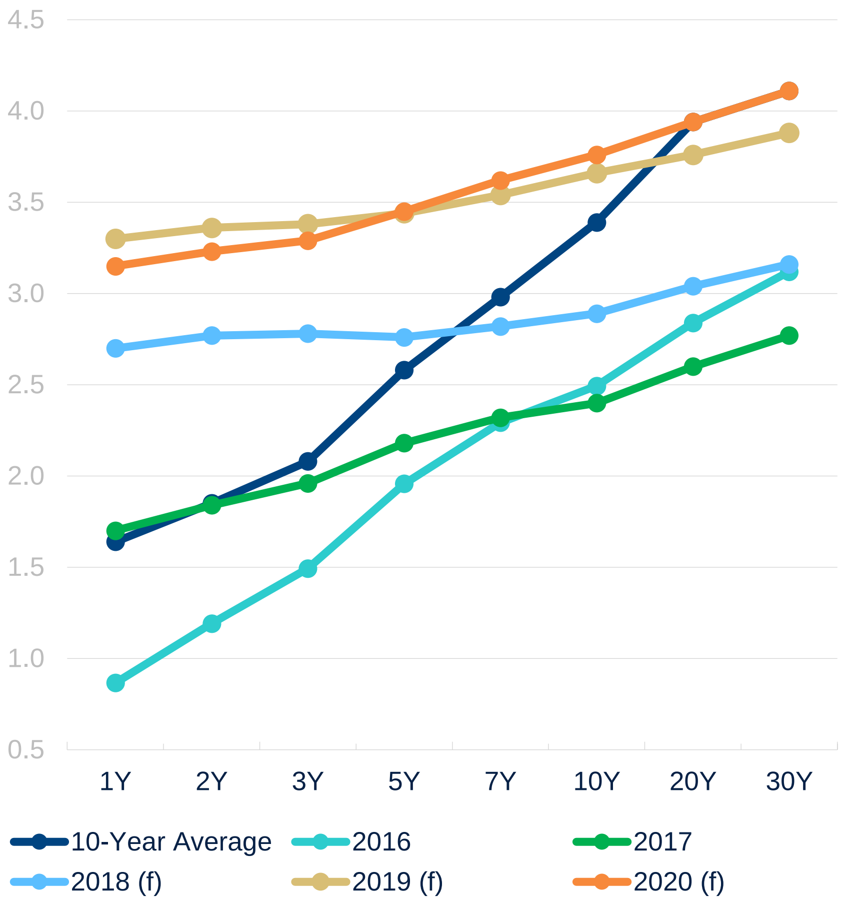
Yield Curve Slope

(Bp)



Yield Curve

(%, eop)



Source: BBVA Research

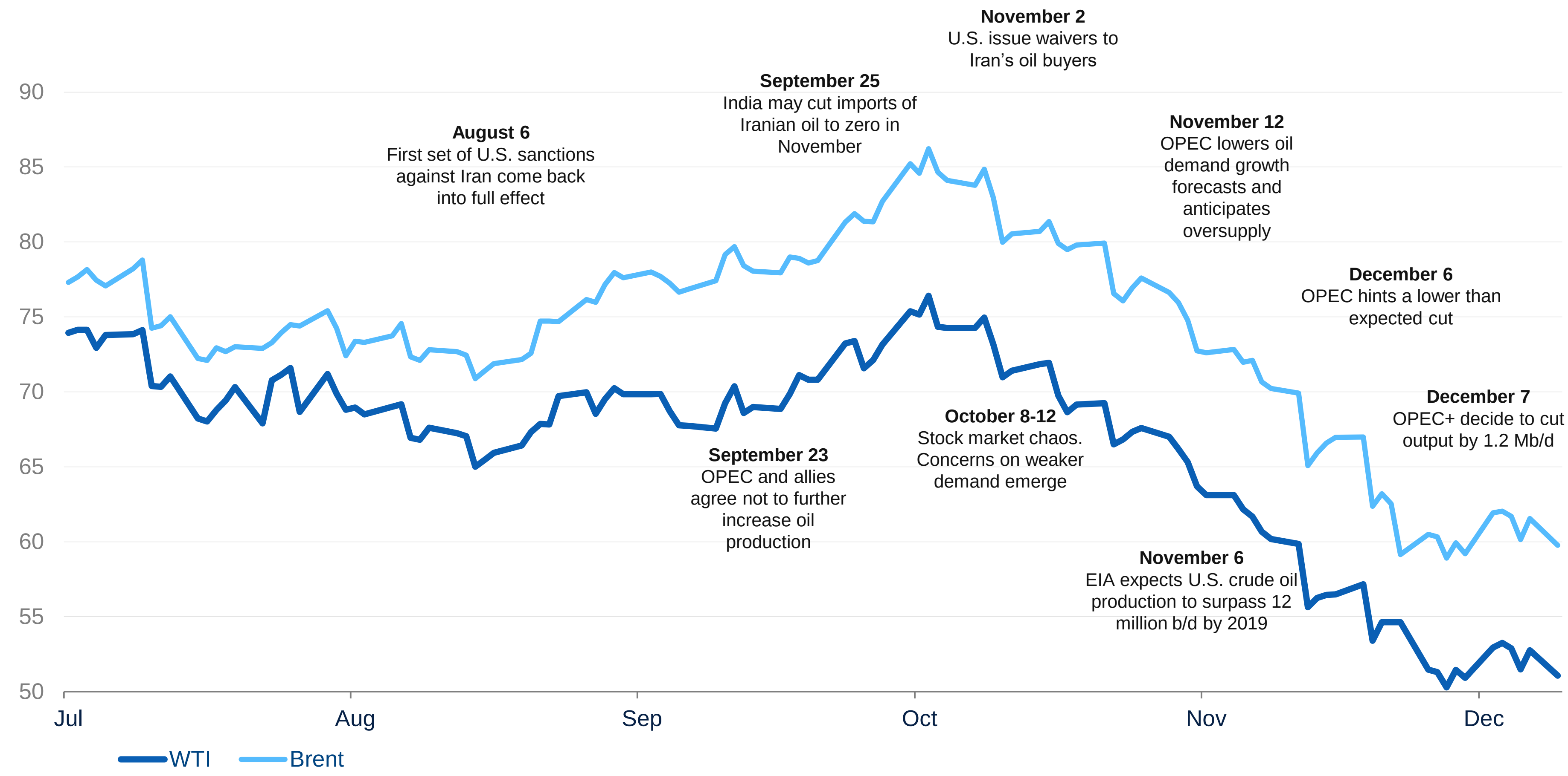
Oil Prices

- OPEC+ managed to contain the downfall, but risks are still tilted to the downside
- U.S. production remains strong and is expected to reach a record 12 million b/d threshold next year
- Robust demand supported by China, India and the U.S.; however, global economic growth will most likely decelerate in the following years
- Prices could move between $60 and $70 in 2019, but may decelerate further in 2020. We maintain our forecasts of convergence to long-term equilibrium around $60/b
- Elevated uncertainty around long-term equilibrium: lagged effect of subpar global CAPEX, protectionism, alternative energy sources, EM convergence, EVs, climate change, efficiency and technology

Oil prices are 30% below their previous peak

Crude oil prices July to December 2018

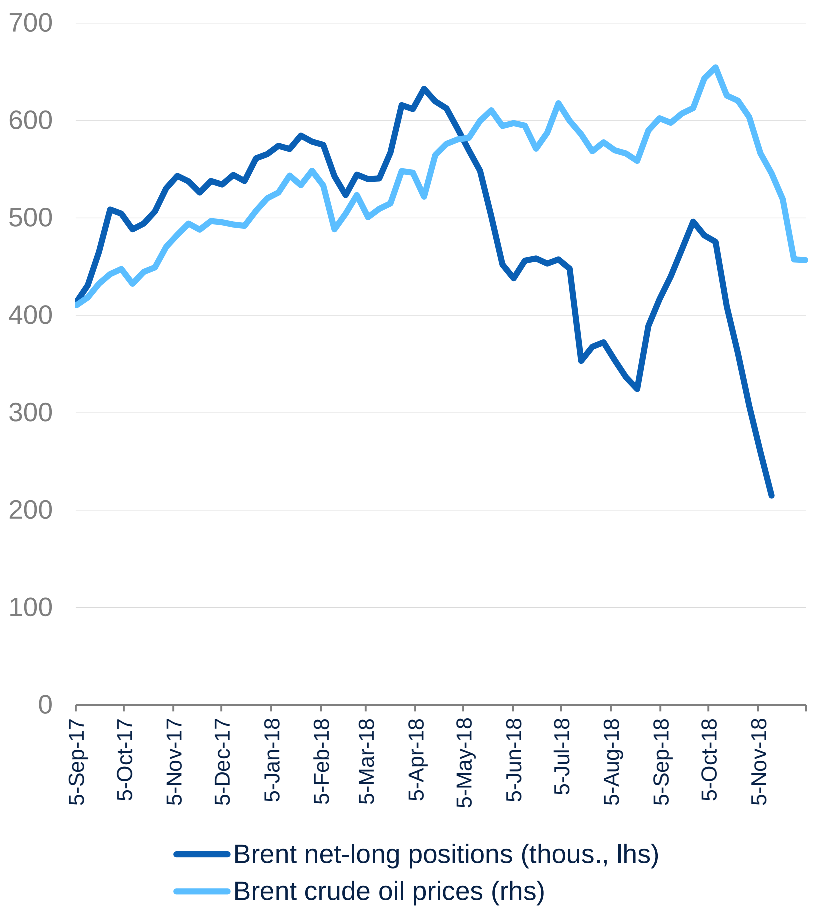
($ per barrel, 2018)



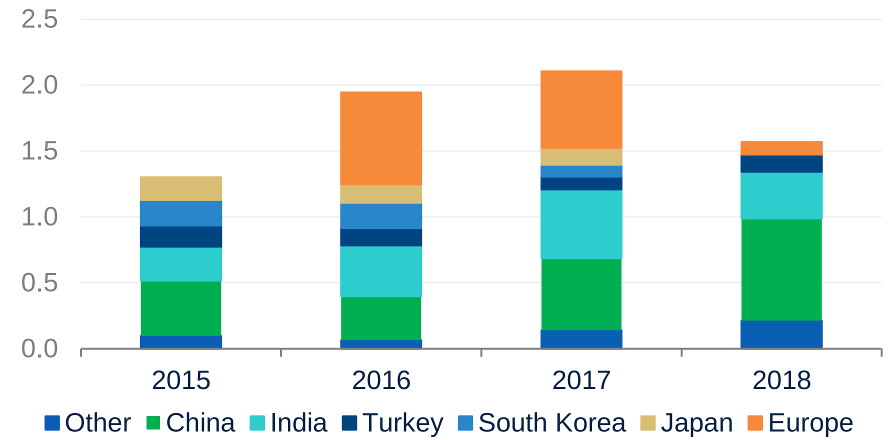
Source: BBVA Research and Haver Analytics

Temporary sanction waivers to eight importers of Iranian crude oil took the market by surprise

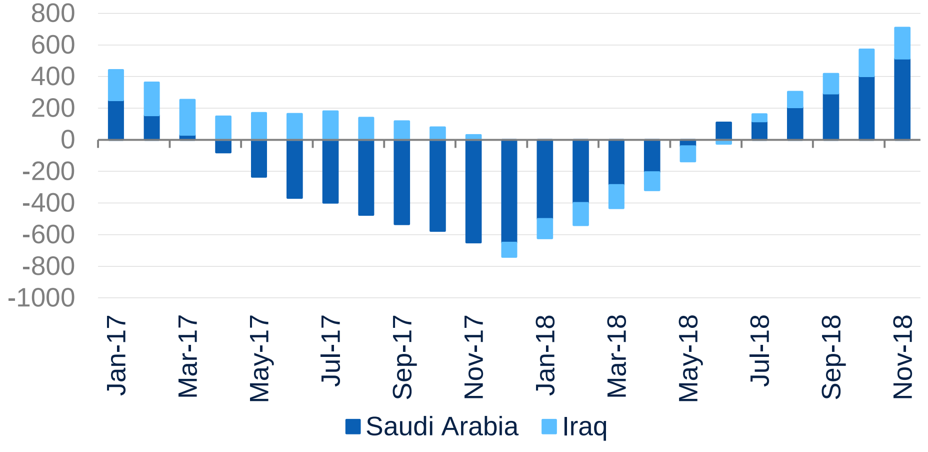
Brent and net long positions
($ per barrel and thousands)



Iran: exports of crude oil
(million barrels per day)



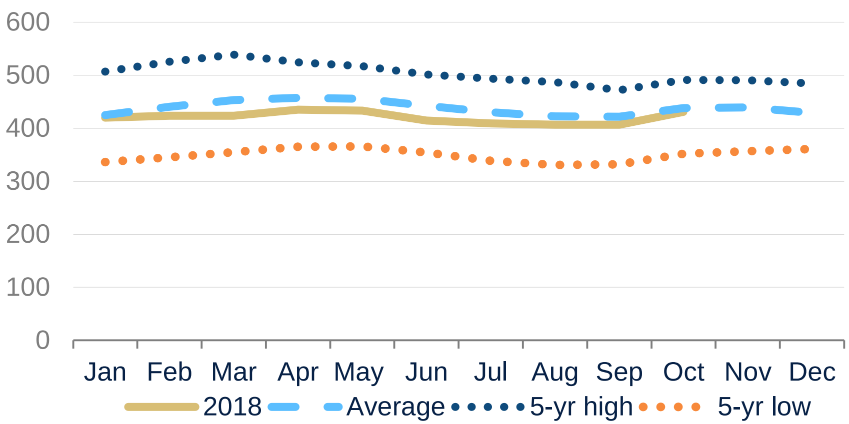
Crude oil production
(million barrels per day)



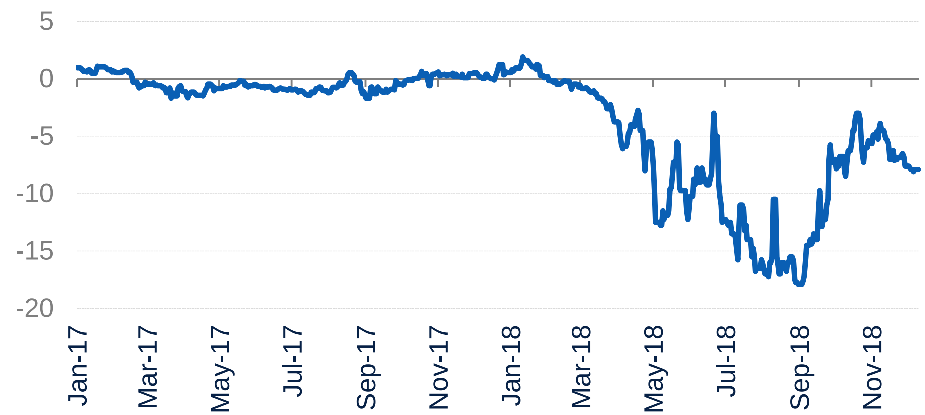
Source: BBVA Research, Haver Analytics, and Bloomberg

In the meantime, U.S. production reached record heights

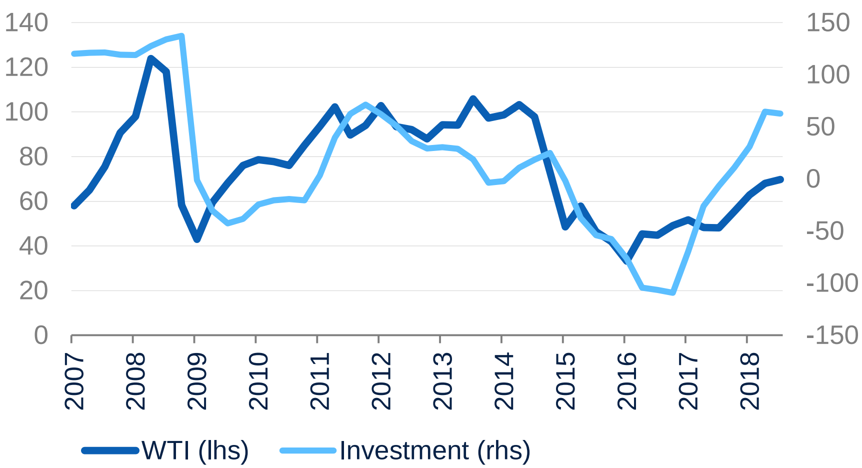
U.S. Crude oil inventories
(Excluding SPR, million barrels)



WTI Midland-Cushing differential
($/b)



U.S. Real private investment in E&P
(yoy $billion)

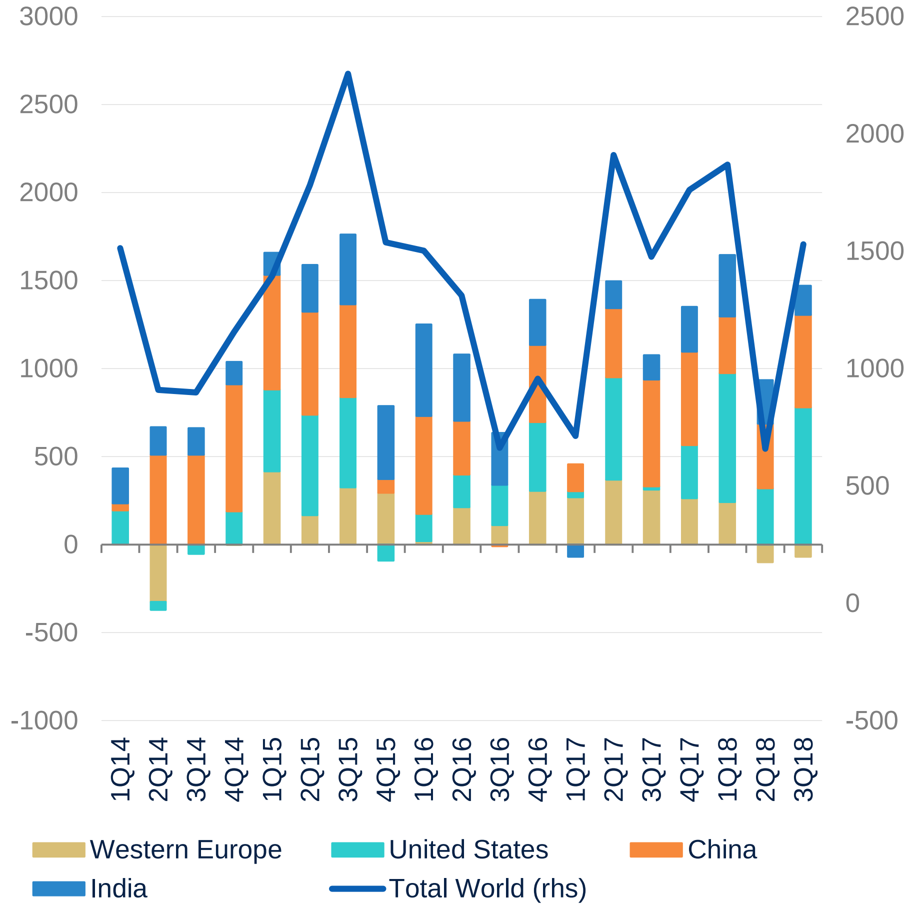


U.S. Estimated crude oil production
(Thousand barrels/day)

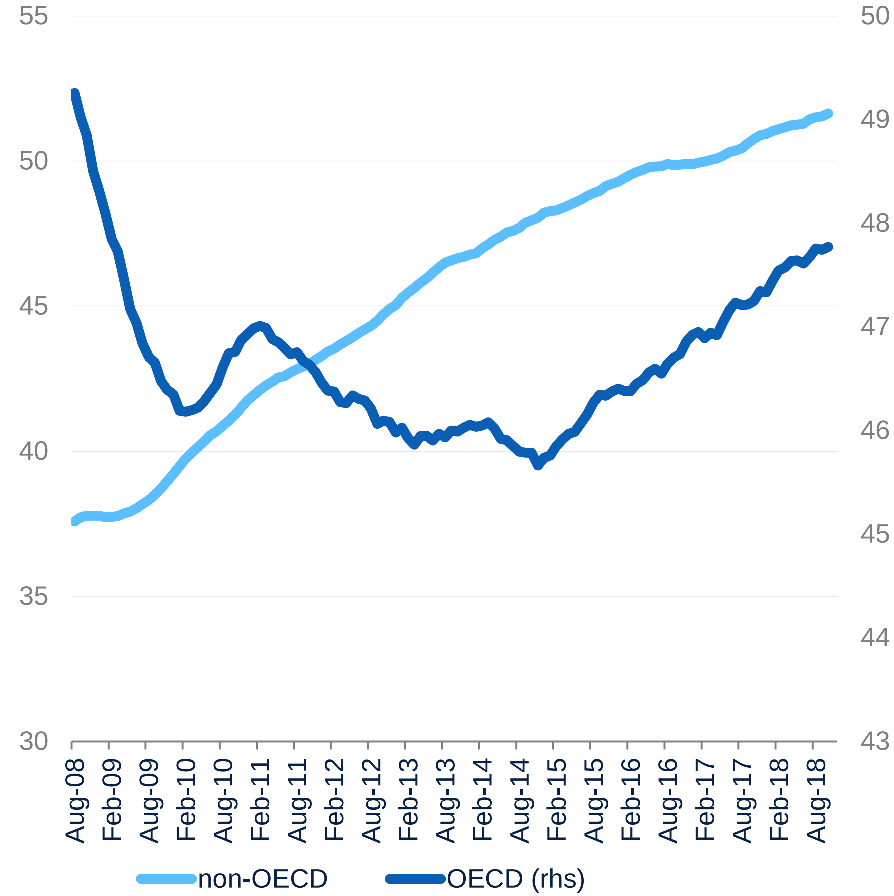
Source: BBVA Research and Haver Analytics

Demand remains supported by China, India and the U.S.

Oil product demand: total world
(Thousand barrels per day, yoy change)



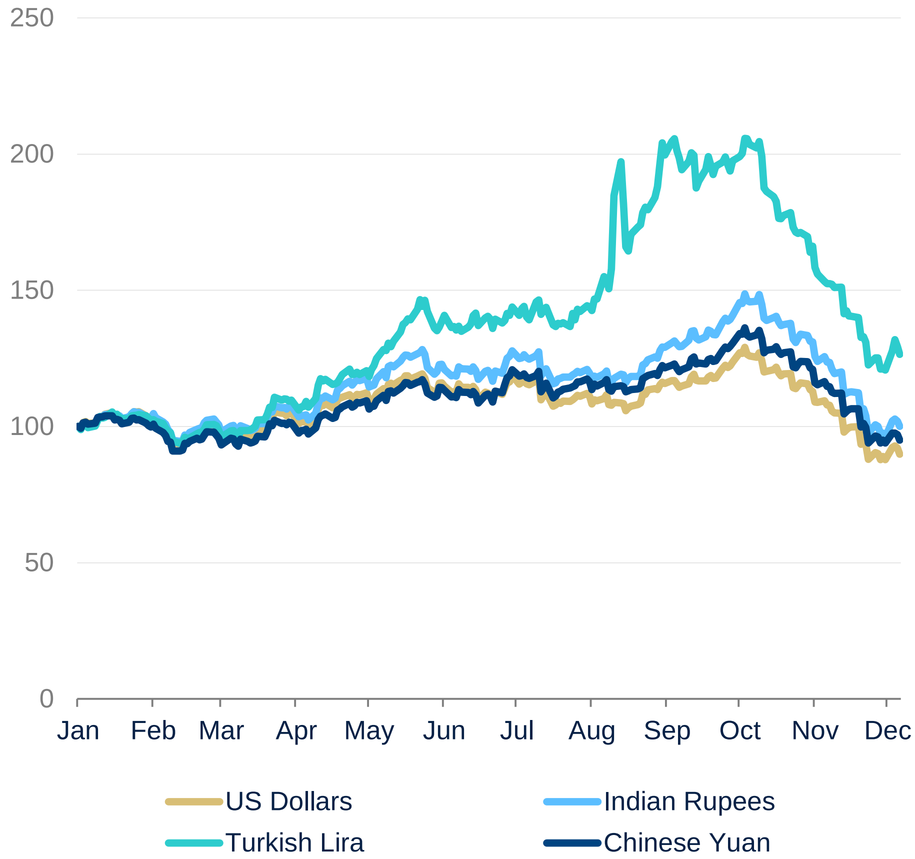
Oil product demand
(Million barrels per day)



Source: BBVA Research and Haver Analytics

The strength of the dollar is having a negative impact on net importers

Brent crude oil prices in different currencies
(Jan-2018 = 100)

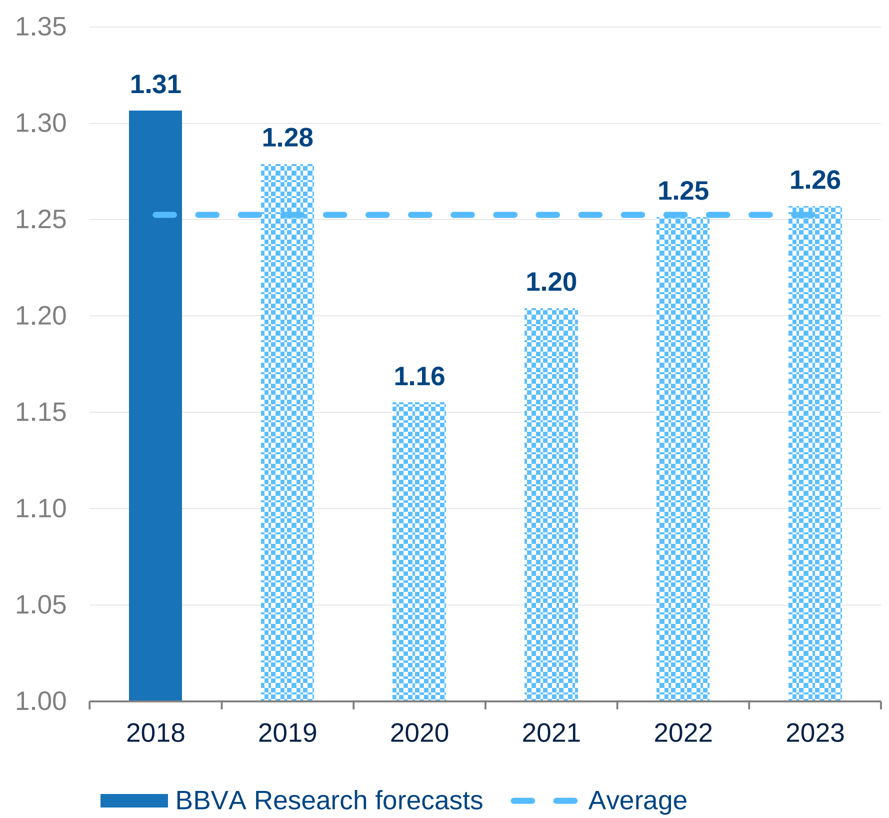


Stock market indicators
(2018)

Source: BBVA Research and Bloomberg

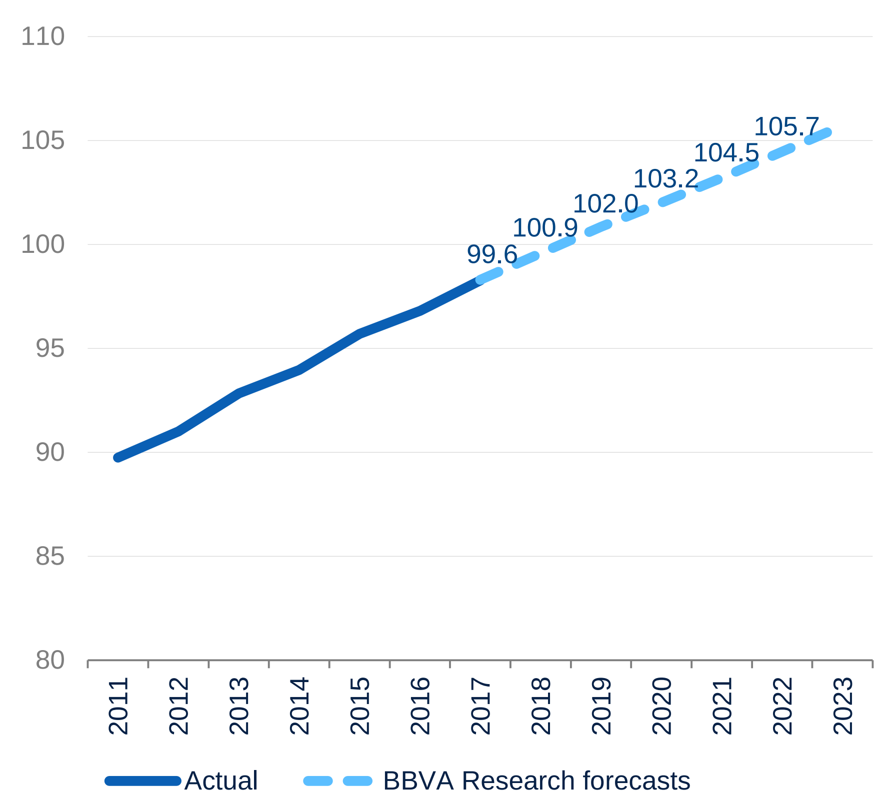
Our forecasts point to slower demand growth

Oil product demand
(YoY change, million b/d)



Source: BBVA Research

Oil product demand
(million b/d)



Source: BBVA Research

Short-term risks are now tilted to the downside…

>= $70/b*

- OPEC+ implements further cuts to production
- U.S. waivers expired and are not renewed
- OPEC+ is perceived incapable of offsetting the gap left by Iran and Venezuela
- Additional negative supply shocks (e.g. Libya, Nigeria)
- Stronger-than-expected global demand
- Takeaway issues prevent U.S. crude to reach global markets

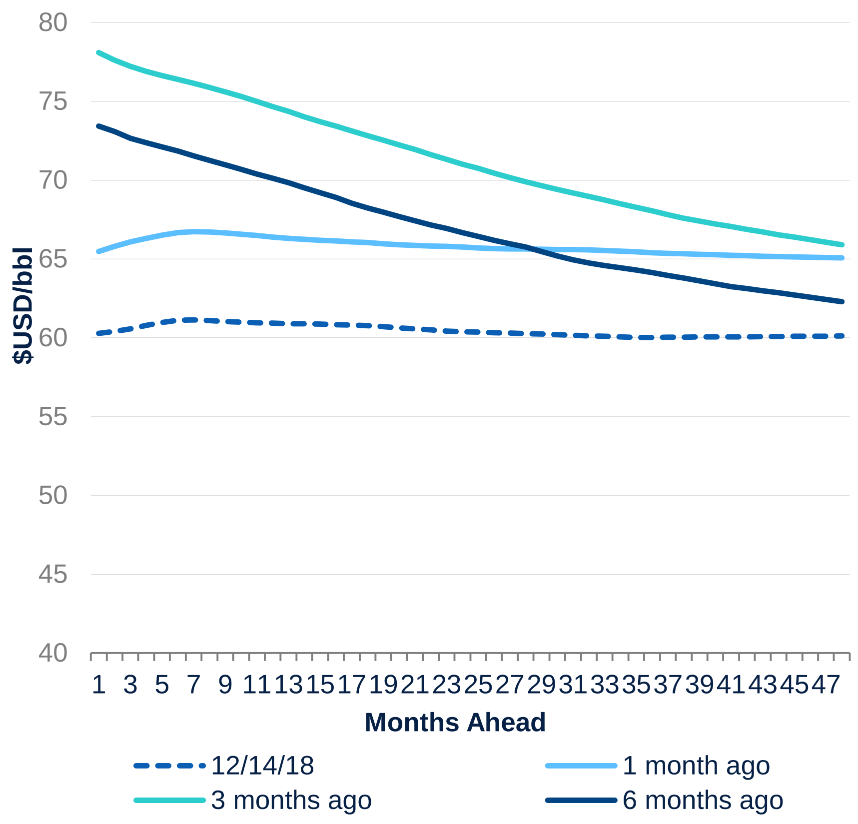
<= $60/b*

- Weaker global outlook after turbulence in emerging markets (e.g. Turkey, Argentina)
- Escalation of protectionism
- Dollar appreciation
- President Trump’s pressure on OPEC
- Limited enforcement of Iranian sanctions
- Higher-than-expected crude oil production in the U.S.

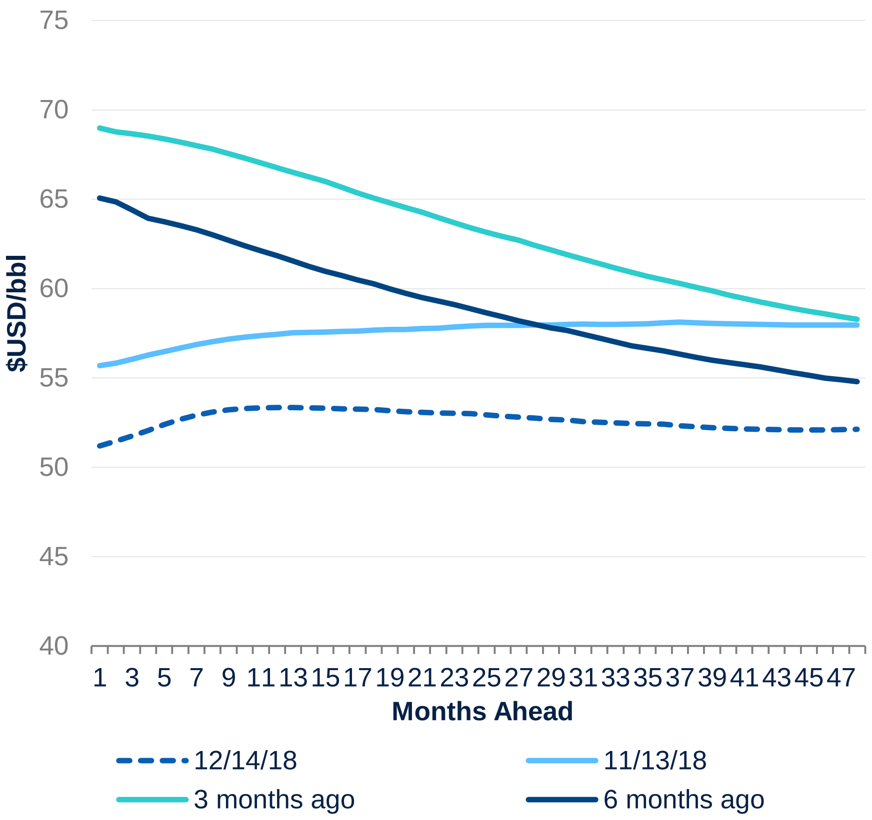
*Brent crude prices. Source: BBVA Research

Future markets have lowered their expectations

Brent Futures
($ per barrel)



WTI Futures
($ per barrel)



Source: BBVA Research and Bloomberg

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