Economic Outlook:
“Patient” Fed as Economy Weakens
May 2019

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Fed Maintains “Patient” Stance, bypassing May (March and January)
Fed raised rates 25bps to 2.25%-2.50% in December, the fourth rate hike in 2018 and the ninth rate hike since liftoff in December 2015.

Liftoff in December 2015
1 hike in 2016
3 hikes in 2017
4 hikes in 2018

9 hikes or 225bps in four years

Source: Federal Reserve Board /Haver Analytics
March Dot Plot

The latest March dot plot showed no further Fed action in the remaining months of the year, just one rate hike in 2020 and nothing in 2021.

March 20th FOMC Dot Plot

Source: Federal Reserve
“Economic growth and job creation have both been a bit stronger than we anticipated, while inflation has been somewhat weaker. Overall, the economy continues on a healthy path, and the Committee believes that the current stance of policy is appropriate.”

– Federal Reserve Chairman Jerome Powell, May 1st FOMC Press Conference
“Although first-quarter gross domestic product (GDP) rose more than most forecasters had expected, growth in private consumption and business fixed investment slowed.”
- Federal Reserve Chairman Jerome Powell, May 1st FOMC Press Conference
### Moderate U.S. Growth

U.S. GDP:
- 2018: 2.2%/4.2%/3.4%/2.2%

Q1 GDP rose **3.2%**, a two-quarter high

Real private domestic sales up **1.3%**, a nearly six-year low

Consumption rose **1.2%** in Q1, down from 2.5% in Q4 and a four-quarter low

Business investment rose **2.7%**, a two-quarter low

Housing investment fell **2.8%**, the fifth consecutive quarterly decline

Inventory rose $128.4B (0.7%)
- Net trade was flat (1.0%)
- Government rose 2.4% (0.4%)

**Avg growth:**
- 2015 2.0%/2016 1.9%
- 2017 2.5%/2018 3.0%

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**Source:** Bureau of Economic Analysis/Haver Analytics

*Excludes inventories, trade and government spending*
2.3% average growth since the Great Recession, the lowest average growth rate compared to previous recoveries.
With declining trends in consumption and investment, GDP will expectedly slow in the coming quarters.

The Fed lowered its 2019 GDP forecast to 2.1% from 2.3% and its 2020 forecast from 2.0% to 1.9%, while its longer-run forecast was unrevised at 1.9% in the latest March SEP.

Growth is likely to lose considerable momentum in 2019 with the risk of recession rising in 2020 and beyond.
"Strong" labor market conditions
- Federal Reserve Chairman Jerome Powell, May 1st
FOMC Press Conference
Payrolls Jump in April

Job gains “solid, on average”
- May 1st FOMC Statement

The latest April jobs report marked the 103rd consecutive month of positive job creation in the U.S.

Payrolls rose 263k in April, a three-month high, and following a 189k rise in March

Smoothing out monthly volatility, the three-month average slowed from 186k to 169k

Source: Bureau of Labor Statistics/Haver Analytics
Unemployment at 3.6%

Unemployment rate has “remained low” - May 1st FOMC Statement

U.S. unemployment fell two-tenths of a percentage point to 3.6% in April, the lowest since December 1969

The unemployment rate has been well within the Fed’s full employment range since October 2014 and now falling below the Fed’s target range since March 2017

Source: Bureau of Labor Statistics /Haver Analytics
Participation Rate Still Low

Participation rate at a multi-decade low, **62.8%** in April and lower than almost every other advanced country.

The prime-age participation rate while improved from a low of 80.6% in September 2015, remains depressed at **82.2%** in April, a multi-decade low.

20-55 year olds account for the majority of the decline in the labor force, **8.0m** Americans (only 59% of working age population).

Source: Bureau of Labor Statistics /Haver Analytics
Where Have All the Workers Gone?

An aging population. 10k Baby Boomers a day reach retirement age. According to the Census Bureau, by 2035, there will be 78.0 million people 65 years and older compared to 76.4 million under the age of 18, the first time in U.S. history older Americans will outnumber children.

Rising rate of disability. According to the Conference Board, increasingly more Americans consider themselves disabled. The portion of working age adults who say they’re not in the labor force because of a disability has risen to nearly 20%. Currently, over 24M Americans consider themselves disabled.

Childcare costs. According to the Bureau of Labor Statistics (BLS), childcare costs have risen 168% over the past 25 years. According to care.com, in just the past two years, after-school care costs have gone up nearly 20% and the cost of child care centers or daycare services have risen more than 40%.

The opioid epidemic.
The Cleveland Fed concluded that “prescription opioids can account for 44% of the realized national decrease in men's labor force participation between 2001 and 2015” and a 17% decline for prime age women.
Household Spending “Slowed in the First Quarter”
Household spending “slowed in the first quarter”
- May 1st FOMC Statement

February sales fell 0.2%, a two-month low, and following a 0.7% increase in January

Y/Y sales rose 2.2% vs. 2.8% in January

Ex autos, sales fell 0.4% in February and rose 2.2% Y/Y vs. 3.4% in January

Late 2017 avg: 0.8%
Early 2018 avg: 0.1%
Mid-2018 avg: 0.5%
Late 2018 avg: -0.1%

Consumption rose 1.2% in Q1, a four-quarter low
Total household debt rose 3.0% in Q4 from a year earlier to reach $13.54 trillion, the eighteenth consecutive quarterly increase.

Total debt now stands at $869 billion or 6.9% higher than the previous peak of $12.68 trillion in the third quarter of 2008.

Debt balance per capita currently stands at $50,210, on par with the $50,930 in 2007.

Source: FRBNY Consumer Credit Panel/Equifax /Haver Analytics

*Includes mortgages, home equity, auto loans, credit card & student loan debt as well as consumer finance and retail loans
Wages remained relatively robust, rising 3.2% from a year earlier in April, the ninth consecutive month of at least 3% annual wage gains and marking the longest stretch of pay improvements since the recession ended in 2009.

Wage gains somewhat segmented: wages for accounting and IT rose 2.5% and 3.6% in March, while manufacturing wages continue to lag at near 2%.

Source: Bureau of Labor Statistics /Haver Analytics
“Early” Signs of Weakness in the Housing Market
Home Price-Income Spread has Narrowed

U.S. existing home sales rose 11.8% in February from 4.93m to a 5.51m unit pace, an eleven-month high.

Down 1.8% YoY, the twelfth consecutive month of decline.

U.S. home prices rose 3.6% in January, down from a 4.1% rise the month prior.

Income growth has averaged 2.8% since the beginning of 2017.

Sources: Standard & Poor's, Bureau of Labor Statistics /Haver Analytics
Price Gains/Losses Localized

Home prices in the San Francisco area rose 14.2% over the past 12 months in Q3, while home prices in the Chicago area rose at an annual rate of 4.1% in Q3, an eight-quarter low.
Business Investment “Slowed in the First Quarter”
Uneven Business Investment

Business investment “slowed in the first quarter”
- May 1st FOMC Statement

Investment rose 6.4% in 2014,
-0.7% 2015
1.8% 2016
6.3% 2017
7.0% 2018

Investment rose 2.7% in Q1, following a 5.4% rise in Q4, thanks to an 8.6% rise in intellectual property investment and a 0.2% gain in equipment investment in Q1

Source: Bureau of Economic Analysis /Haver Analytics
“Overall inflation and inflation for items other than food and energy have declined and are running below 2 percent” ... although “our baseline view remains that...inflation will return to 2 percent over time.”

-May 1st FOMC Statement and Press Conference
Dis-Inflation Momentum

The PCE rose 0.2% in March and rose 1.5% year-over-year, a three-month high, but down from the 2.1% peak reported in February of 2018.

The core was flat in March and rose 1.6% year-over-year, the weakest pace since January 2018.

- 2017: 1.8% PCE YoY%
- 1.7% Core PCE YoY%
- 2018: 1.8% PCE YoY%
- 2.0% Core PCE YoY%

Strongest components in 2018: gasoline, financial services & food services

Strongest components in 2017: gasoline & financial services

Weakest components in 2018: motor vehicles & parts, and recreational services

Weakest components in 2017: clothing & footwear and grocery purchases

Source: Bureau of Economic Analysis /Haver Analytics
Weak Energy Prices

Over the past 12 months, oil prices declined 3.6% in April to $63.86 a barrel.

“As expected, overall inflation fell at the start of this year as earlier oil price declines worked through the system.”

- Federal Reserve Chairman Jerome Powell, May 1st FOMC Press Conference

Crude Oil Prices YoY% ($/Barrel)

Source: Energy Information Admin/Chicago Mercantile Exch /Haver Analytics
“In light of global economic and financial developments and muted inflation pressures, the Committee will be patient.”

-May 1st FOMC Statement
“While concerns remain in all of these areas, it appears that risks have moderated somewhat...[there has been an] accommodative shift in monetary policy, and in some cases fiscal policy. Recent data from China and Europe show some improvement, and the prospect of a disorderly Brexit has been pushed off for now. Further, there are reports of progress in the trade talks between the United States and China.”

- Federal Reserve Chairman Jerome Powell, May 1st FOMC Press Conference
International Weakness

IMF forecast revised down for the third time in six months from 3.5% to 3.3%

“Growth has slowed” in some major foreign economies, particularly China and Europe

Chinese growth rose 6.4% in Q1, matching the pace in Q4 and marking the slowest pace since Q1 2009

The Eurozone rose four-tenths of a percentage point in Q1 and 1.2% over the past 12 months with Italy emerging from recession and Germany narrowly escaping recession

*Germany GDP data will be released on May 15, 2019
The U.S. imposed 25% tariffs on $50B worth of goods from China and 10% tariffs on $200B worth of goods from China.

China retaliated with 25% tariffs on $50B worth of U.S. products and with tariffs of 5-10% on $60B of U.S. goods.

China has resumed buying U.S. soybeans and appears to be easing its high-tech industrial push of "Made in China 2025".

Beijing is also expected to cut tariffs from 40% to 15% on American autos and car parts.

On May 5th President Trump threatened to raise tariffs from 10% to 25% on $200 billion in Chinese goods starting on May 10th.

“The Trade Deal with China continues, but too slowly as they attempt to renegotiate. No!”
- President Trump, Twitter post, May 5, 2019

“Over the course of the last week or so, we’ve seen an erosion in commitments by China.”
- U.S. Trade Representative Robert Lighthizer, May 6, 2019
“Unresolved Policy Issues”

• U.S.-China trade negotiations – President Donald Trump has threatened to raise tariffs on $200 billion in Chinese goods to 25% from 10%, saying trade talks are moving too slowly.

• Beijing announced billions of dollars in stimulus measures including tax cuts and infrastructure spending aimed at reducing the risk of a sharper economic slowdown. Officials have increasingly relied on tax policy to support growth; the latest move is expected to deliver a boost upwards of six-tenths of a percentage point to GDP.

• ECB announced TLTRO III starting in September 2019 and ending in March 2021, the third injection of stimulus from the ECB since 2014. The 19-member region has been plagued by political developments, including Brexit and waning momentum with Italy the latest casualty to recession, all of which has “derailed” the ECB’s plans to remove accommodation.

• Brexit deadline – March 29th – extension granted until October 31st – beyond May 24-26 EU parliament elections – May’s withdrawal agreement rejected for a third time. U.K. inflation has remained below the BOE’s 2% target since January, currently at 1.9% as of March; U.K. GDP rose 0.2% in Q4, rising market concerns of a no-deal Brexit. Irish backstop – avoiding a physical barrier between Ireland (EU) and Northern Ireland (U.K.).

• Debt ceiling – U.S. officially hit the debt ceiling on March 2nd at just over $22T. The U.S. deficit rose from $666B in FY 2017 to $779B in FY 2018, the largest since 2012, when it topped $1T. National debt topped $22T for the first time, thanks to higher spending, stagnating receipts and rising financing costs (higher Fed funds). “Extraordinary measures” will keep the government running and prevent the U.S. from breaching the debt ceiling until late September or early October.
“Unresolved Policy Issues”

- Gridlock – a divided Congress, historically positive but this time could be different.

- Earlier policies of the Trump administration, including regulatory reform and tax cuts, are not expected to be undone; less likely that tax cuts will be made permanent (expires in 2025) and reduces the probability of additional reform.

- No funding for infrastructure. Both sides of the aisle have championed the need for investment but funding remains an issue. The American Society of Civil Engineers (ASCE) gave the country’s roads, bridges and waterways a D+ while noting that there’s a $2 trillion infrastructure funding gap between now and 2025.

- More regulation? California Democrat Maxine Waters, chair of the House Financial Services Committee. A “foe” of Wall Street, calling for increased regulation of the nation’s major banks.

- Distractions – investigative probes vs. presidential harassment? – President Trump’s company, presidential campaign and inaugural committee are still the focus of ongoing investigations. Muller report found no evidence “that the Trump campaign, or anyone associated with it, conspired or coordinated with the Russian government,” however, “while this report does not conclude that the president committed a crime, it also does not exonerate him.”

- Its not the economy, stupid. 2020 focused on the social direction of the economy; identity politics energizing the fringe – Green New Deal – aimed at making the United States carbon neutral in 10 years as well as provide universal health care, and a family-sustaining guaranteed income. Costing $6.6-$93 trillion or more. Failed to reach the 60 votes needed to begin the debate with 42 Democrats and Senator Bernie Sanders (I-Vt.) voting “present” and 57 lawmakers voting against. Medicare for all at $1.1-$3.3 trillion. Republican border wall $5.7 billion -$?.
“We think our policy stance is appropriate at the moment and we don’t see a strong case for moving in either direction.”

- Federal Reserve Chairman Jerome Powell, May 1st FOMC Press Conference
“The Committee intends to slow the reduction of its holdings of Treasury securities by reducing the cap on monthly redemptions from the current level of $30 billion to $15 billion beginning in May 2019... The Committee intends to continue to allow its holdings of agency debt and agency mortgage-backed securities (MBS) to decline, consistent with the aim of holding primarily Treasury securities in the longer run. Beginning in October 2019, principal payments received from agency debt and agency MBS will be reinvested in Treasury securities subject to a maximum amount of $20 billion per month; any principal payments in excess of that maximum will continue to be reinvested in agency MBS.”

- March 20th FOMC Balance Sheet Normalization Principles and Plans
Consolidated Balance Sheet

An increase on both sides of the Fed’s balance sheet, as the Fed purchased bonds from primary dealers in reverse auctions but paid for them by essentially making a ledger notation in the dealers’ reserve accounts.

Essentially an equivalent impact had the Fed mandated purchases by the banks themselves.

Reducing at the cap of $50B per month, the balance sheet has shrank by $500B from $4.5T to $4.0T, still $3.1T above pre-crisis levels.

Growing liabilities provide a floor of $2.5-3 trillion.

The Fed has indicated right-sizing the balance sheet by September, provided the “economy and money market conditions evolve as expected.”

Source: Federal Reserve Board/Haver Analytics

**Agency refers to the current face value of federal agency obligations held by Federal Reserve Banks. These securities are direct obligations of Fannie Mae, Freddie Mac, and the Federal Home Loan Banks.

**Other assets: discount window lending, lending to other institutions, assets of LLCs that have been consolidated onto the Fed’s balance sheet, and foreign central bank liquidity swaps.

**Other liabilities: includes the liabilities of Maiden Lane LLC and Commercial Paper Funding Facility LLC to entities other than the Federal Reserve Bank of New York, including liabilities that have recourse only to the portfolio holdings of those entities.
“The average level of reserves after the FOMC has concluded the reduction of its aggregate securities holdings at the end of September will likely still be somewhat above the level of reserves necessary to efficiently and effectively implement monetary policy.”

- March 20th FOMC Balance Sheet Normalization Principles and Plans

Beginning to taper the taper in May, the Fed will slow the monthly reduction of its Treasury holdings from up to $30B to up to $15B

On the MBS side, the current $20B cap will remain in place for the time being

In October, however, proceeds as high as $20B per month would be reinvested in Treasuries, while runoffs in excess of $20B will be reinvested in agency-backed MBS

Roll-offs to be completed with roughly $1 trillion in excess reserves and a total balance sheet of $3.5 trillion
"If core inflation were to move down to, let’s just say, 1.5%," that would indicate that monetary policy “is actually restrictive in holding back inflation, and so that would naturally call for a lower funds rate.”

- Chicago Fed President Charles Evans, Speaking to Reporters, April 15, 2019

“If inflation was running persistently below” the Committee’s 2% target to “revolve around, say, 1.5% or some lower level,” that would be a factor driving a potential adjustment to monetary policy.

- Dallas Fed President Robert Kaplan, WSJ Interview, April 19, 2019

“…We have a dual mandate and the fact is, that inflation, for most of the past seven years, has been somewhat below our 2% objective,” even with last year’s 3% growth and a 50-year low in the unemployment rate. “It is important for us to demonstrate that inflation can get back to 2% and stay there on a sustained basis. If you look back at Fed history, there have been times when the Fed in the ’90s took out some insurance cuts. We saw that in ’95…We saw that in 1998. So, rate cuts are not always associated with recession.”

- Federal Reserve Vice Chairman Richard Clarida, CNBC Interview, April 11, 2019
Market Signals Policy Beyond “Neutral”

2s10s spread of **124bps** prior to liftoff and down to **19bps** following the May 2019 FOMC meeting

The Fed will arguably need to cut rates once if not twice to right the curve, leaving less momentum to combat eventual weakness

Projected to flatten further

In the beginning of December, the curve between U.S. two-year and five-year, and between three-year and five-year yields inverted for the first time since the financial crisis, and on March 22nd, the curve between the 3-month and 10-year yields inverted for the first time since 2007

Source: Bloomberg, Stifel
More Patient Fed Action amid Global Weakness, Market Volatility, Rising Threat of Disinflation with Future Threats of Domestic Weakness and a Flatter/Inverted Curve Raising the Probability of a Rate Cut
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