BANK OF THE WEST
BNP PARIBAS

U.S. Outlook

Bank of the West Economics | 415.765.8020 | bankofthewest.com **October 19, 2018**

Date	Indicator	For	Estimate	Consensus*	Previous Period
22-Oct-2018	Chicago Fed Nat Activity Index	Sep	NA	0.25	0.18
23-Oct-2018	Richmond Fed Manufacturing Index	Oct	24.0	25.0	29.0
24-Oct-2018	FHFA House Price Index MoM	Aug	0.3%	0.3%	0.2%
24-Oct-2018	Markit US Manufacturing PMI	Oct P	55.3	55.5	55.6
24-Oct-2018	Markit US Services PMI	Oct P	53.0	54.0	53.5
24-Oct-2018	Markit US Composite PMI	Oct P	NA	NA	53.9
24-Oct-2018	New Home Sales	Sep	625k	630k	629k
24-Oct-2018	U.S. Federal Reserve Releases Beige Book				
25-Oct-2018	Advance Goods Trade Balance	Sep	-$74.8b	-$74.6b	-$75.5b
25-Oct-2018	Wholesale Inventories MoM	Sep P	0.7%	NA	1.0%
25-Oct-2018	Durable Goods Orders	Sep P	-2.1%	-1.0%	4.4%
25-Oct-2018	Durables Ex Transportation	Sep P	0.1%	0.3%	0.0%
25-Oct-2018	Initial Jobless Claims	20-Oct	213k	NA	210k
25-Oct-2018	Pending Home Sales MoM	Sep	-0.1%	-0.2%	-1.8%
25-Oct-2018	Kansas City Fed Manufacturing Activity	Oct	12.0	NA	13.0
26-Oct-2018	GDP Annualized QoQ	3Q A	3.4%	3.3%	4.2%
26-Oct-2018	GDP Price Index	3Q A	2.0%	2.5%	3.0%
26-Oct-2018	U. of Mich. Sentiment	Oct F	99.0	98.6	99.0

*Consensus from Bloomberg

Is Tighter Monetary Policy Already Beginning to Bite?

The September FOMC minutes, released on Wednesday, revealed an upbeat assessment of current U.S. economic conditions and the outlook. Noting that labor market conditions continued to strengthen, real consumer spending is "rising strongly", and financing conditions for large nonfinancial firms, commercial and residential real estate, and consumer credit remained largely accommodative.

At the same time, the Fed dismissed the downside risks to the U.S. economy from Hurricane Florence, the China-U.S. trade war, and foreign economic developments as having only a small net effect on U.S. real GDP growth. In short, the upside risks on household spending and business investment from the tax cuts largely offset and cancel out the downside risks from trade policies and foreign economic developments. All in all a Goldilocks assessment of our economic and financial future that will give the FOMC the room they need to keep gradually raising interest rates into 2019 and beyond. If this sounds like a fairy tale where everyone lives happily ever after at the end of the story, it probably is.

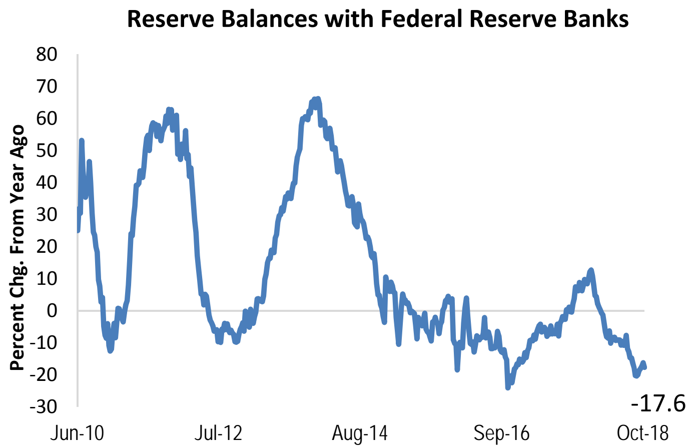
The truth is the Federal Reserve has already turned the handle on the monetary spigot several times to slow the amount of monetary support to the economy. But since monetary policy changes can sometimes take six months to over a year to have an overall impact on the U.S. economy, it will still be quite some time before we see the impacts that the Fed tightening to-date has had on our economic and financial conditions. It has been said that conducting monetary policy is like driving a car forward while looking through the rear-view mirror.

The Fed does this primarily by squeezing the bank credit channel of the economy, reducing the amount of excess reserves in the banking system and making it less

The discussions and information contained in this document are the opinions of the author and should not be construed or used as a specific recommendation for the investment of assets, and is not intended as an offer, or a solicitation of an offer, to purchase or sell any security or financial instrument. Nor does the information constitute advice or an expression of the Bank's view as to whether a particular security or financial instrument is appropriate for you or meets your financial objectives. Economic and market observations and forecasts, such as those offered by Bank of the West Economics reflect subjective judgments and assumptions, and unexpected events may occur. There can be no assurance that developments will transpire as forecasted. Nothing in this document should be interpreted to state or imply that past results are an indication of future performance.

profitable for banks to lend and more expensive for consumers and businesses to borrow.

Bank Reserves Dropping Due to Fed Quantitative Tightening



Source: Federal Reserve System

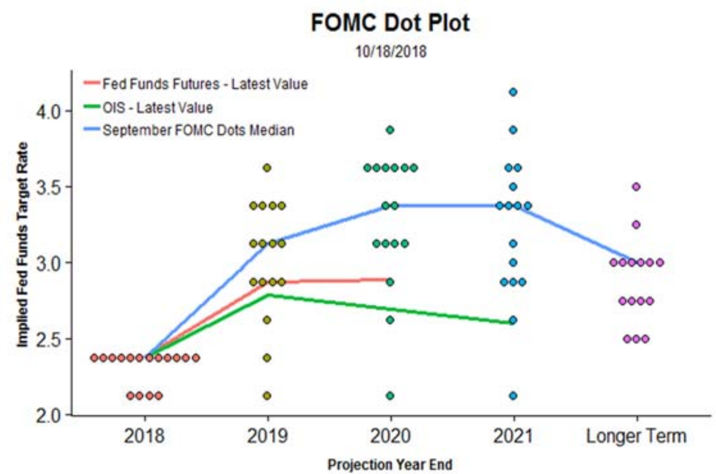
Another increasingly important channel is the chilling effect rising interest rates can have on equity and bond prices overall. The September FOMC minutes commented in several places about rising equity prices and loose financial conditions in the marketplace as a vulnerability and risk to financial stability. By gradually hiking interest rates and shrinking their balance sheet, the Fed hopes to cool the exuberance in the equity market down without triggering another financial crisis or recession.

The FOMC has already raised the Fed funds target rate eight times since December 2015 and has been methodically ramping up the quantitative tightening of their balance sheet over the past year. And while short-term interest rates remain low by historical standards at this stage of the economic cycle (especially in inflation-adjusted terms), we are already searching for signs the Fed's monetary tightening is beginning to have a chilling effect on monetary and financial conditions and eventually on economic activity.

The dot plot the FOMC released, along with its economic forecasts at the September meeting, lays it out in black and white. Each individual dot on the plot is a forecast from an FOMC participant with the blue line in the chart below signifying the median forecast of the FOMC on where the Fed funds rate is likely to be at the end of each year. Those FOMC participants that place their dots somewhat or far below the dot plot median could generally be described as somewhat dovish, while those predicting several additional rate hikes than the median could be seen as leaning toward the hawkish camp.

Notice that the Fed funds futures market forecast (the red line in the chart below) is still well below the FOMC median forecasts for 2019 and 2020. This is more in line with our own forecast that the recent period of overheated economic growth and labor market tightening will prompt the FOMC to increase the Fed Funds rate three more times by June 2019, but by then monetary and financial conditions will have deteriorated enough that the signs of economic cooling will be self-evident, forcing the FOMC to pause its rate hike plans.

Is the Dot Plot Wishful Thinking?



I would argue that the financial volatility we are seeing in equity markets today from China, Europe, and even here in the United States in recent weeks is an early warning that monetary and financial conditions that seemed so supportive of growth only months ago have suddenly become far less accommodative. Interest-rate-sensitive sectors of our economy from housing to auto sales are already slowing in part due to higher interest rates. From my chair, the FOMC dot plot median feels like an economist's fairy tale.

The discussions and information contained in this document are the opinions of the author should not be construed or used as a specific recommendation for the investment of assets, and is not intended as an offer, or a solicitation of an offer, to purchase or sell any security or financial instrument. Nor does the information constitute advice or an expression of the Bank's view as to whether a particular security or financial instrument is appropriate for you or meets your financial objectives. Economic and market observations and forecasts, such as those offered by Bank of the West Economics reflect subjective judgments and assumptions, and unexpected events may occur. There can be no assurance that developments will transpire as forecasted. Nothing in this document should be interpreted to state or imply that past results are an indication of future performance.

Major Economic Indicators

Economic Data	History						Forecast						Yr/Yr % chg or Annual Avg.			
	2017.1	2017.2	2017.3	2017.4	2018.1	2018.2	2018.3	2018.4	2019.1	2019.2	2019.3	2019.4	2016	2017	2018	2019
Real GDP*	1.8	3.0	2.8	2.3	2.2	4.2	3.4	2.4	2.2	2.1	1.9	1.8	1.5	2.2	2.9	2.4
Personal Consumption Expenditures*	1.8	2.9	2.2	3.9	0.5	3.8	3.5	2.6	2.3	2.3	2.1	1.9	2.7	2.5	2.6	2.6
Non-residential Fixed Investment*	9.6	7.3	3.4	4.8	11.5	8.7	2.8	4.8	3.8	4.1	3.7	3.4	-0.6	5.3	6.9	4.2
Private Housing Starts (000s units)	1,231	1,171	1,172	1,259	1,317	1,261	1,218	1,280	1,290	1,280	1,277	1,275	1,176	1,208	1,269	1,281
Vehicle Sales (mill. Units, annualized)	17.1	16.8	17.1	17.7	17.1	17.1	17.1	16.9	16.5	16.5	16.4	16.3	17.5	17.2	17.1	16.4
Industrial Production*	1.0	5.0	-1.5	7.7	2.5	5.3	3.3	2.6	2.2	2.0	1.7	1.5	-1.2	1.6	3.7	2.5
Nonfarm Payroll Employment (mil.)	145.9	146.3	146.9	147.4	148.1	148.7	149.3	149.9	150.4	150.9	151.3	151.7	144.3	146.6	149.0	151.1
Unemployment rate	4.7	4.3	4.3	4.1	4.1	3.9	3.8	3.7	3.6	3.6	3.7	3.8	4.9	4.4	3.9	3.7
Consumer Price Index* (percent)	3.0	0.1	2.1	3.3	3.5	1.7	2.2	3.0	2.5	2.0	2.1	2.1	1.3	2.1	2.5	2.4
"Core" CPI* (percent)	2.2	0.8	1.8	2.2	3.0	1.8	2.1	2.3	2.4	2.2	2.1	2.1	2.2	1.8	2.2	2.2
PPI (finished goods)* (percent)	5.7	1.0	1.6	5.7	3.6	2.7	2.2	4.1	1.9	1.8	1.7	1.7	-1.0	3.2	3.2	2.3
Trade Weighted Dollar (Fed BOG, major)	94.4	93.0	88.3	88.9	86.2	88.2	90.2	91.1	90.8	90.4	89.6	88.5	91.6	91.1	88.9	89.8
Crude Oil Prices -WTI ($ per barrel)	52	48	48	55	63	68	69	71	68	67	67	63	43	51	68	66

*Quarterly Data Percent Change At Annual Rate; Annual Data Year-on-Year % Chg, or Annual Average.

Financial Data	History							Forecast					Annual Average			
	2017.1	2017.2	2017.3	2017.4	2018.1	2018.2	2018.3	2018.4	2019.1	2019.2	2019.3	2019.4	2016	2017	2018	2019
S & P 500	2,326	2,398	2,467	2,603	2,733	2,703	2,850						2,093	2,449		
Dow Jones Industrial Average	20,406	20,994	21,891	23,689	25,127	24,556	25,595						17,916	21,745		
Federal Funds Rate (effective)	0.70	0.94	1.15	1.20	1.45	1.74	1.92	2.21	2.46	2.71	2.88	2.88	0.39	1.00	1.83	2.73
Treasury-3 Month Bills (yield)	0.61	0.91	1.05	1.23	1.58	1.87	2.07	2.22	2.48	2.73	2.90	2.89	0.32	0.95	1.94	2.75
Treasury-2 Year Notes (yield)	1.24	1.30	1.36	1.69	2.16	2.48	2.67	2.90	2.96	3.06	3.07	3.06	0.84	1.40	2.55	3.04
Treasury-5 Year Notes (yield)	1.95	1.81	1.81	2.07	2.53	2.77	2.81	3.03	3.15	3.25	3.27	3.21	1.34	1.91	2.78	3.22
Treasury-10 Year Notes (yield)	2.45	2.26	2.24	2.37	2.76	2.92	2.92	3.15	3.29	3.42	3.48	3.41	1.84	2.33	2.94	3.40
Treasury-30 Year Notes (yield)	3.05	2.90	2.82	2.82	3.03	3.09	3.06	3.31	3.51	3.65	3.64	3.57	2.60	2.90	3.12	3.59
Prime Rate	3.80	4.05	4.25	4.29	4.53	4.80	5.01	5.25	5.50	5.75	6.00	6.00	3.51	4.10	4.90	5.81
Libor 3-Mo. U.S. Dollar	1.07	1.21	1.31	1.46	1.93	2.34	2.34	2.43	2.66	2.91	3.02	3.03	0.74	1.26	2.26	2.91
Mortgage-30 Year (yield)	4.17	3.98	3.88	3.92	4.28	4.54	4.57	4.80	4.97	5.08	5.13	5.05	3.66	3.99	4.55	5.06
BAA Corporate (yield)	4.66	4.49	4.33	4.27	4.47	4.78	4.81	5.08	5.40	5.60	5.80	6.10	4.71	4.44	4.78	5.73

Source: Bank of the West Economics, Bloomberg, Federal Reserve