

**Economic Outlook:**  
*“Solid” Recovery Prompts Further Fed Action*  
February 2018

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**STIFEL** | Fixed Income  
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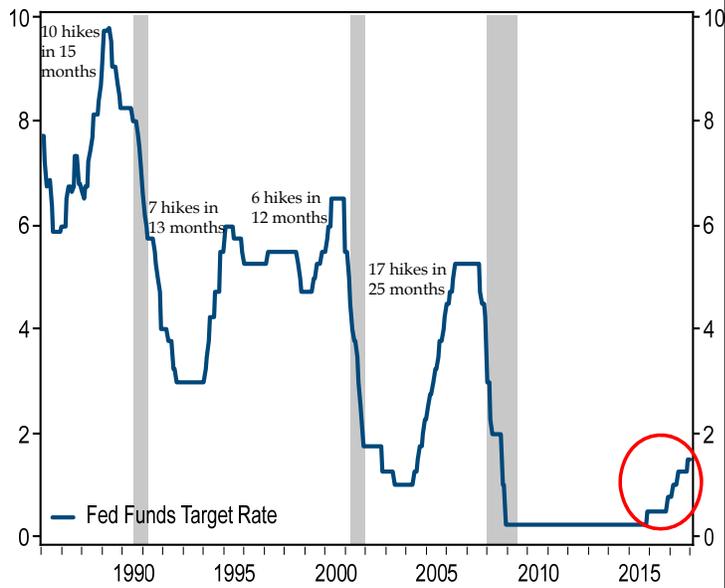
**Fed Keeps Rates Steady at January Meeting after  
Raising Rates at Year-End**

## Historically Low Rates

Fed keeps rates steady at a range of 1.25% to 1.50% at latest January meeting

Fed raised rates 25bps to a range of 1.25%-1.50% at December meeting, the third rate increase in 2017 (March & June) and the fifth rate hike since December 2015

Fed raised rates 25bps to 0.75% in December 2016 after seven consecutive meetings of unchanged policy



2

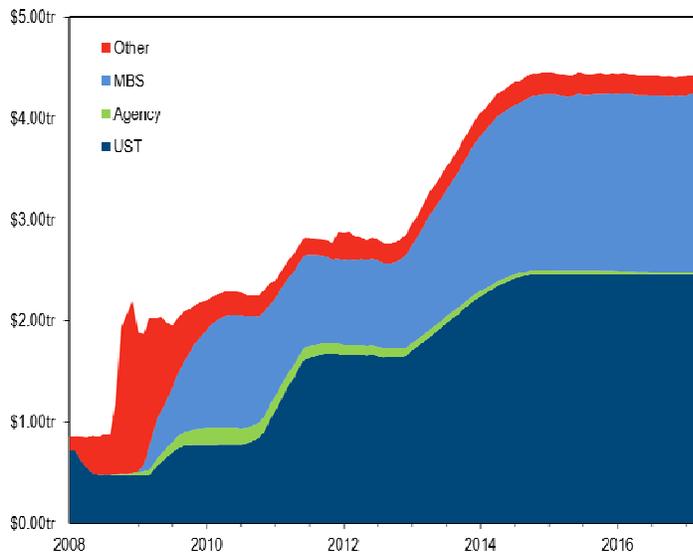
## Focus Shifts to "Normalize" Balance Sheet

UST: Cap of \$6bn per month increased by \$6bn every quarter until it reaches \$30bn in October 2018

2017 monthly avg. Fed purchases of UST: \$16.82bn

MBS: Cap of \$4bn per month increased by \$4bn every three months until it reaches \$20bn

2017 monthly avg. Fed purchases of MBS: \$25.07bn



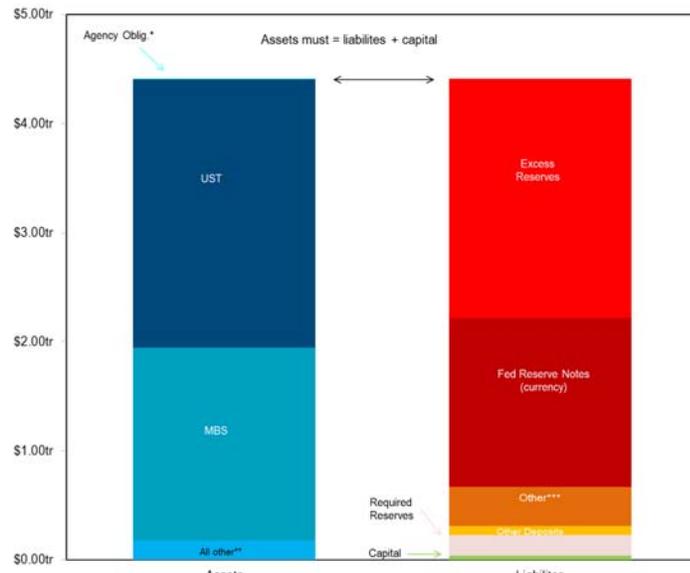
\*Other includes discount window lending, lending to other institutions, assets of limited liability companies (LLCs) that have been consolidated onto the Federal Reserve's balance sheet, and foreign currency holdings associated with reciprocal currency arrangements with other central banks (foreign central bank liquidity swaps)

3

## 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



\*\*Agency refers to the current face value of federal agency obligations held by Federal Reserve Banks. These securities are direct obligations of Finance Man, 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: term deposits and other deposits held by depository institutions, official foreign deposits, and the U.S. Treasury general account.

Source: Federal Reserve Board/Haver Analytics

*“Solid” Growth*

## GDP Components

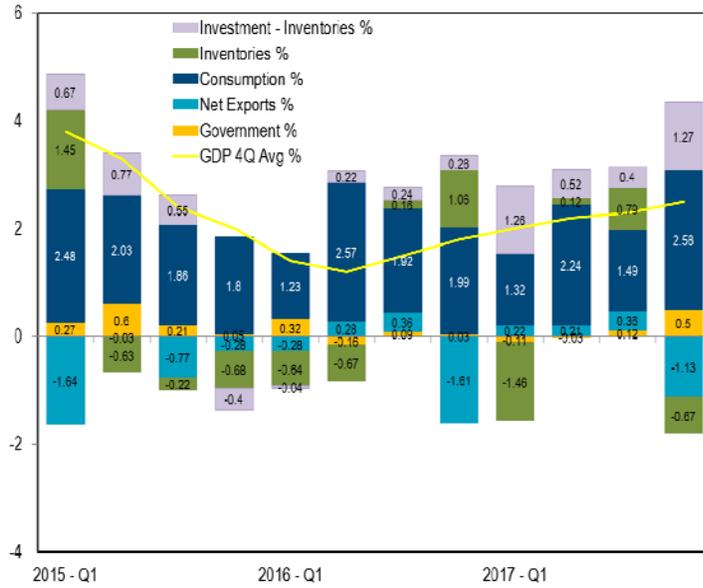
U.S. GDP in Q4 rose 2.6% following a 3.2% rise in Q3

Wisconsin GDP rose 3.2% in Q3, a four-quarter high

U.S. growth in 2017 averaged 2.5%

4Q avg U.S. GDP: 2.5% in Q4 vs. 2.3% in Q3

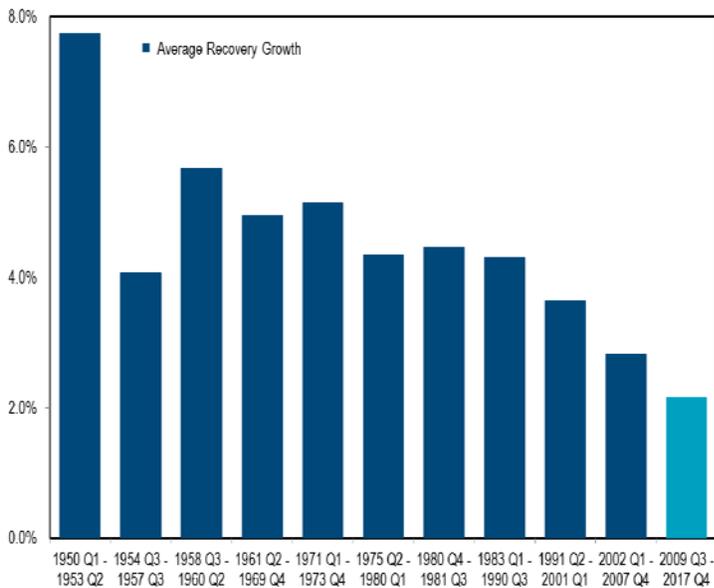
2015 avg growth: 2.0%  
2016 avg growth: 1.9%  
2017 avg growth: 2.5%



Source: Bureau of Economic Analysis/Haver Analytics

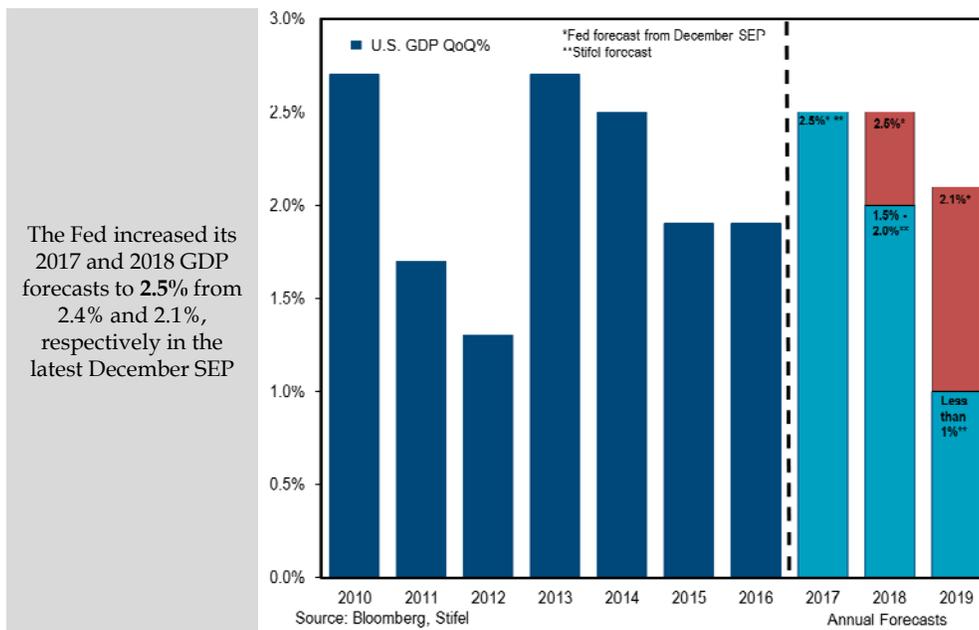
## Average Growth vs. Previous Recoveries

2.2% average growth in the U.S. since the Great Recession, the lowest average growth rate compared to previous recoveries



Source: NBER/ Haver Analytics

## GDP Forecast



8

*“Labor Market Has Continued to Strengthen”*

9

## Job Growth Continues Downward Trend

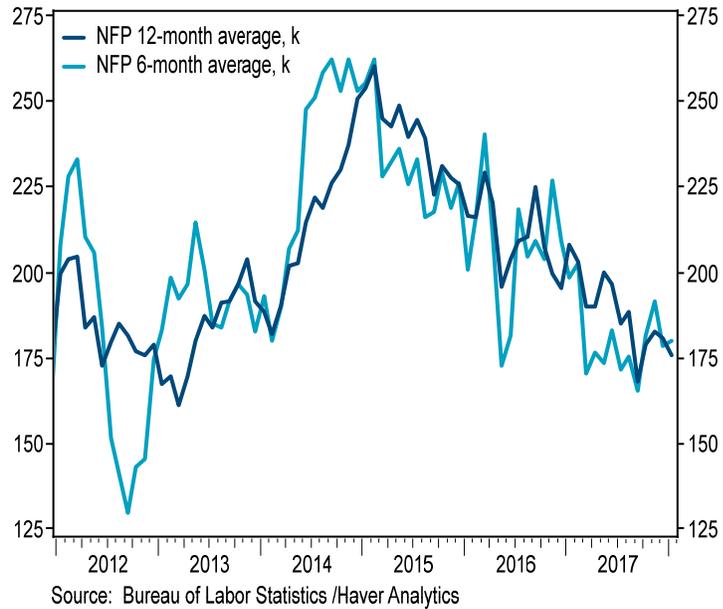
88 consecutive months of positive payroll growth

January payrolls rose **200k**, following a 160k gain in December

12-month average fell from 181k to **176k** in January, a three-month low

Above 200k in April, June, August, October & November 2017

On a 6-month average basis, the trend has slowed from 250k in 2014 to 232k in 2015 to 203k in 2016 to 169k in 2017



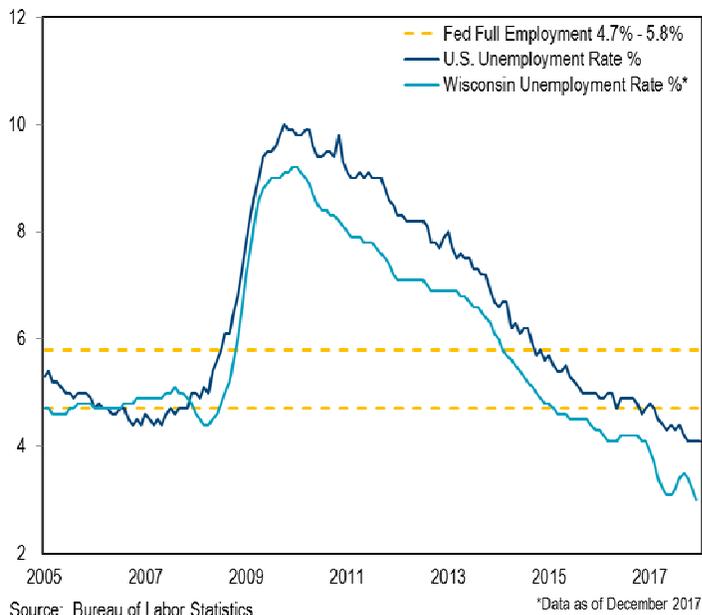
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## Unemployment at 4.1%; Wisconsin 3.0%

Unemployment remained at **4.1%** in January for the fourth consecutive month, the lowest since December 2000

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

Unemployment rate in Wisconsin at **3.0%** as of December, a two-month low and further below the peak of 9.2% in January 2010



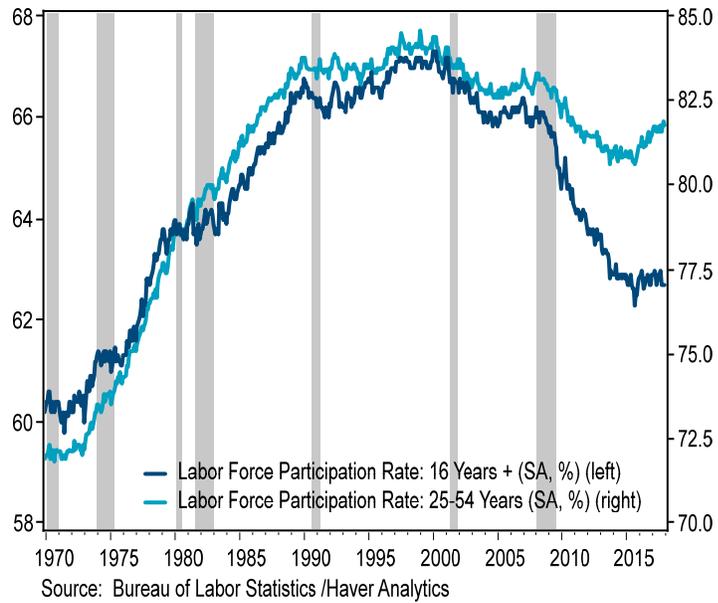
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## Participation Rate Still Declining

Participation rate at a multi-decade low, **62.7%** in January

The prime-age participation rate while improved from a low of 80.6% in September 2015, remains depressed at **81.8%** in January, 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)



*“Solid”* Gains in Household Spending

## Retail Sales Rise in December

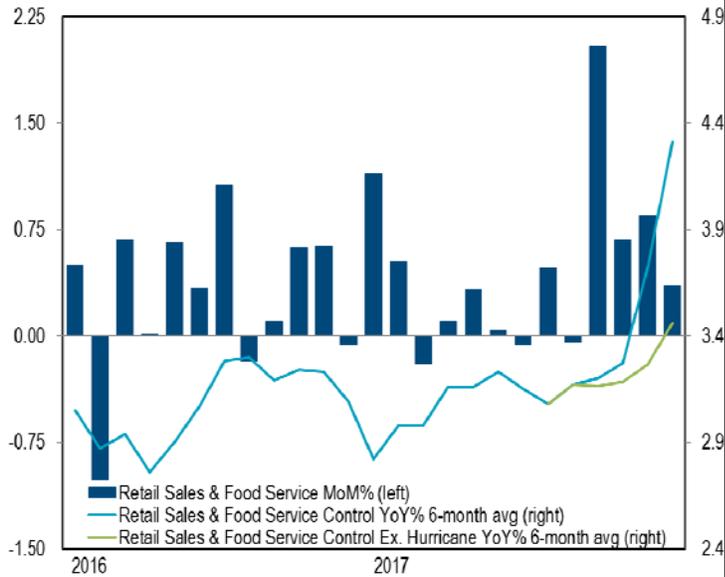
December sales rose **0.4%** following a 0.9% rise the month prior  
Y/Y sales rose **5.4%** vs. 6.0% in November

Control group\*  
December sales rose 0.3%  
Y/Y up **5.6%** in December, following a 5.7% increase in November

Control group 12-month avg: **0.5%**

Three months of flat or negative sales since end of Q1 2017

\*Control group excludes auto, building materials, & gas stations sales



Source: Census Bureau/Haver Analytics

## Gas Prices Give Muted Boost

January price of **\$2.56** near 2009 low

**\$2.52** six-month average vs. **\$2.77** long-term average

Down **\$1.13** and **31%** from a peak monthly average of \$3.69 in June 2014 (star)

Gas prices are up **9%** from **\$2.35** a year ago



Source: Haver Analytics

## Avg. Hourly Earnings Edging Lower

Wages rose **0.3%** in January, one-tenth of a percentage point more than expected

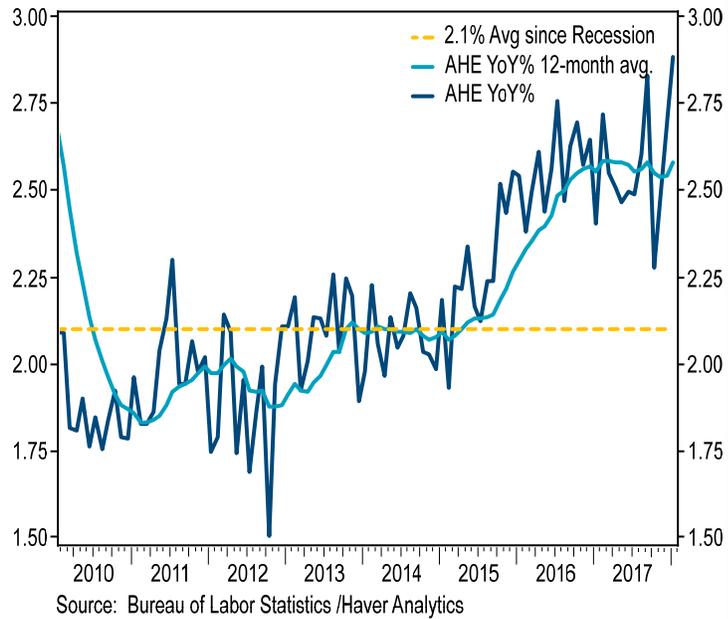
Wages in Wisconsin rose 1.2% in January and 2.2% year-over-year, down from 3.3% reported in July

Up **2.9%** Y/Y as of January, the highest since June 2009

**2.6%** 12-month average in January

**2.7%** 3-month average in January

**2.1%** average since Recession



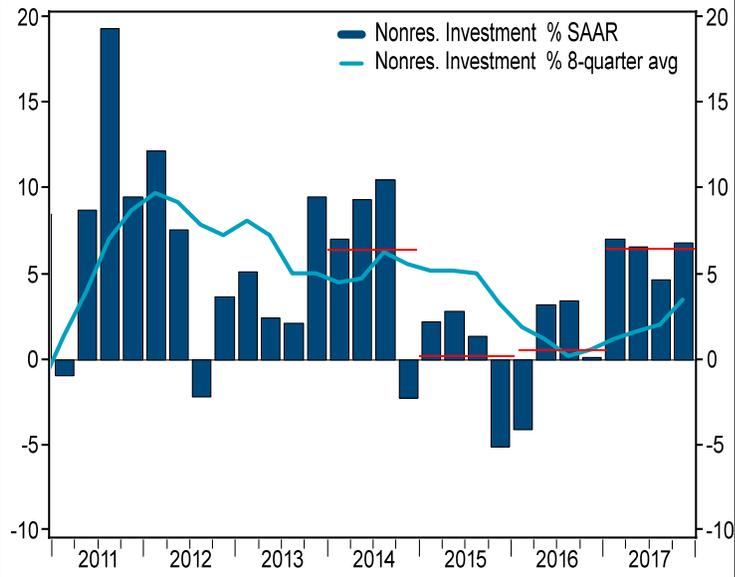
***“Solid”* Gains in Business Investment**

## Modest Business Investment

Nonresidential fixed investment fell 5.1% at end of 2015, the largest quarterly decline since Q2 2009

Investment rose 6.2% in 2014, 0.4% in 2015, 0.7% in 2016 & 6.3% in 2017

Investment rose 6.8% in Q4 following a 4.7% rise in Q3 2017, thanks to an 11.4% increase in equipment and a 4.5% increase in intellectual property investment in Q4

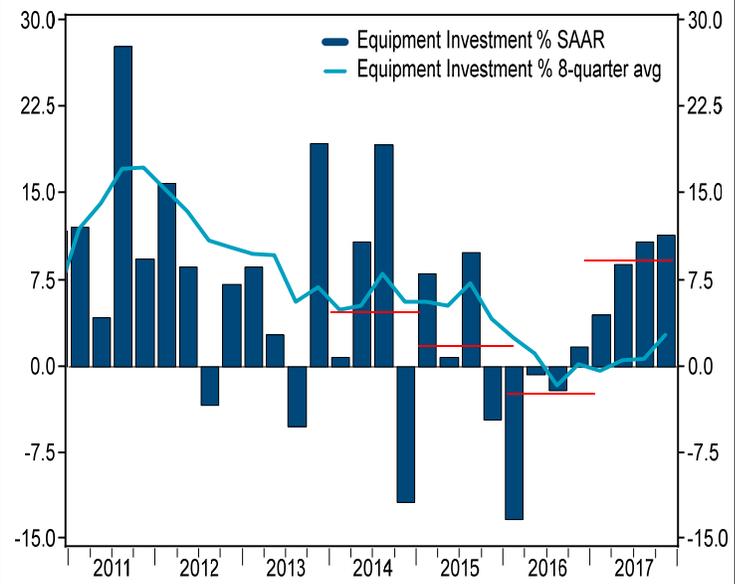


Source: Bureau of Economic Analysis /Haver Analytics

## Equipment Investment

Equipment investment rose 4.8% in 2014, increased 3.6% in 2015, fell 3.5% in 2016 & rose 8.9% in 2017

Equipment investment rose 11.4% in Q4, the highest since Q3 2014, and following a 10.8% rise in Q3 2017



Source: Bureau of Economic Analysis /Haver Analytics

**Inflation has Continued to “Run Below 2%” Target**

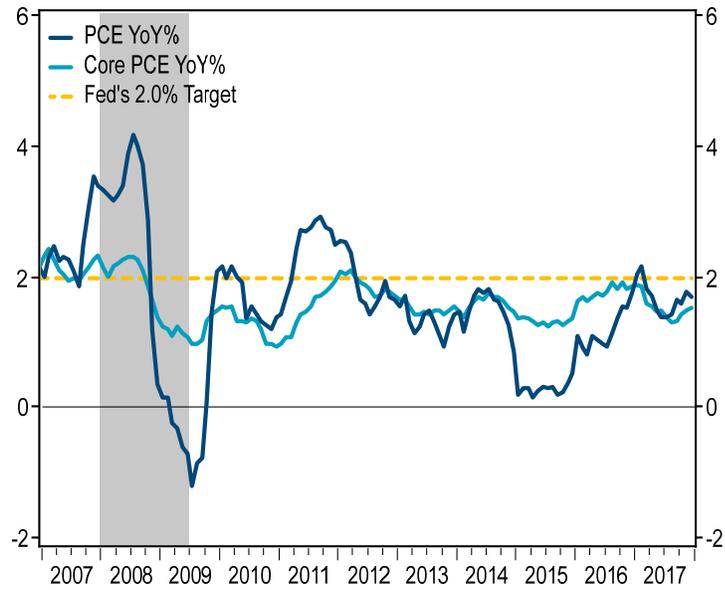
*“Inflation on a 12-month basis is expected to **move up** this year and to stabilize around the Committee’s 2 percent objective over the medium term” as well.*

*-January 31<sup>st</sup> FOMC Statement*

## Decline in Inflation Momentum: PCE

The PCE rose **0.1%** in December and rose **1.7%** year-over-year, a two-month low, and further below the recent peak of 2.2% in February, the first +2% reading since April 2012

The core PCE rose **0.2%** in December and rose **1.5%** year-over-year for the second consecutive month, down from a peak of 1.8% in January

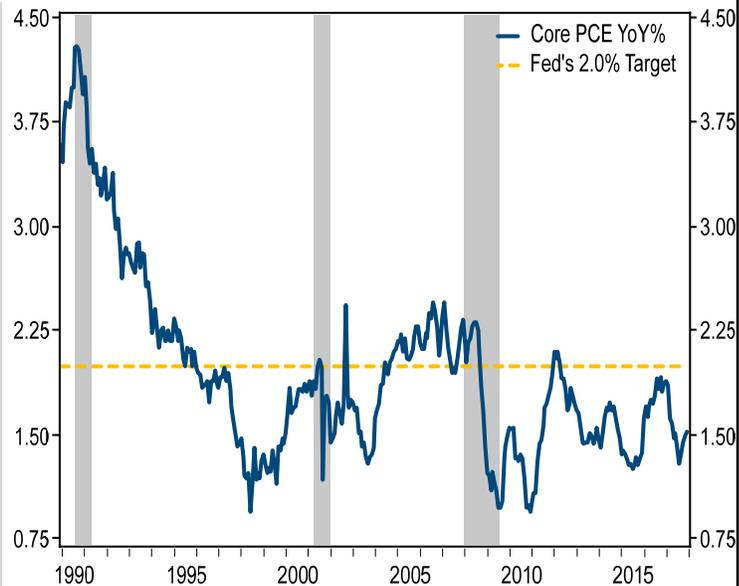


Source: Bureau of Economic Analysis /Haver Analytics

## Core Inflation Low for Decades

The core PCE remained at an annual pace of 1.5% in December for the second consecutive month

Inflation has been under 2% for 21 of 25 years



Source: Bureau of Economic Analysis /Haver Analytics

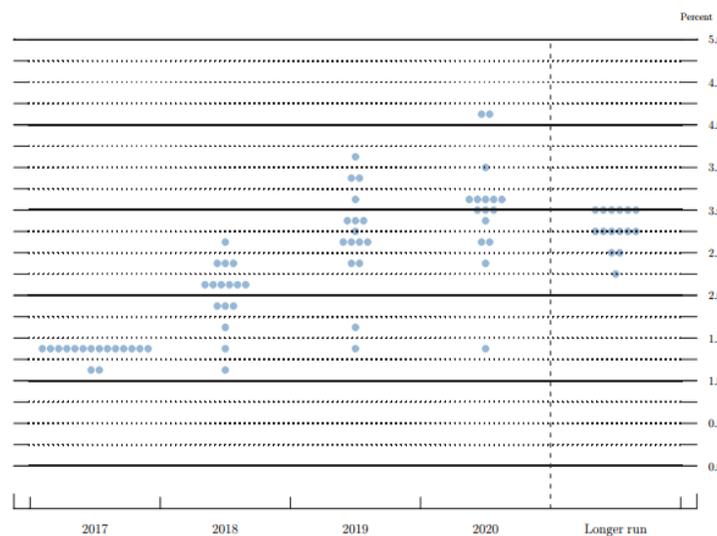
## Forward Guidance

## Fed Dot Plot Shows Three Hikes in 2018

The Fed continues to forecast three additional rate hikes in 2018

*“Participants continue to see gradual increases in the federal funds rate as being appropriate to sustain a strong labor market and bring inflation back to 2%.”*  
-Chair Janet Yellen, December 13<sup>th</sup> Press Conference

December 13<sup>th</sup> FOMC Dot Plot



Source: Federal Reserve

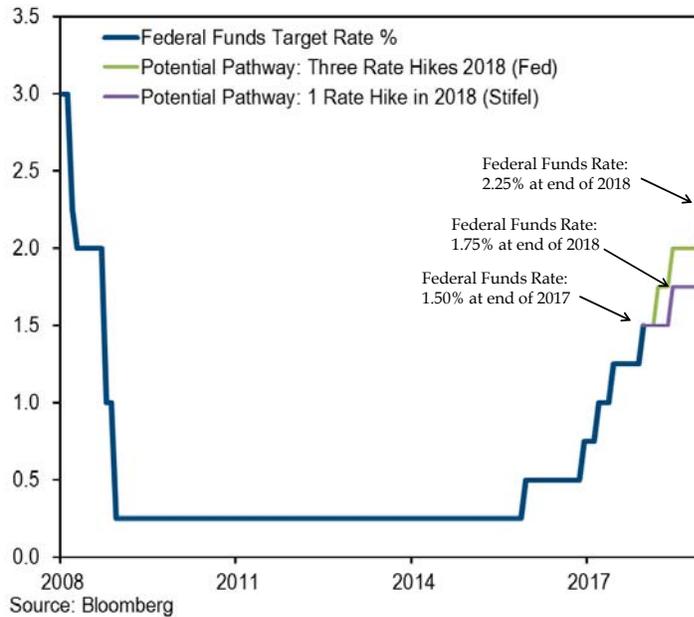
## The Fed Continues to Expect a “Gradual” Rise in Rates

Buoyed by the expectation of firmer growth and prices to come, the majority of Fed officials anticipate three additional rate hikes in 2018, the same number reported in the September SEP

Fed may be “overselling” future hikes

In December 2014, the Fed’s median consensus for rate hikes in 2015 was 4 and we had 1 and in 2016 it was 4 and we had 1

Finally, in 2017 the Fed forecasted 3 hikes and we had 3 hikes



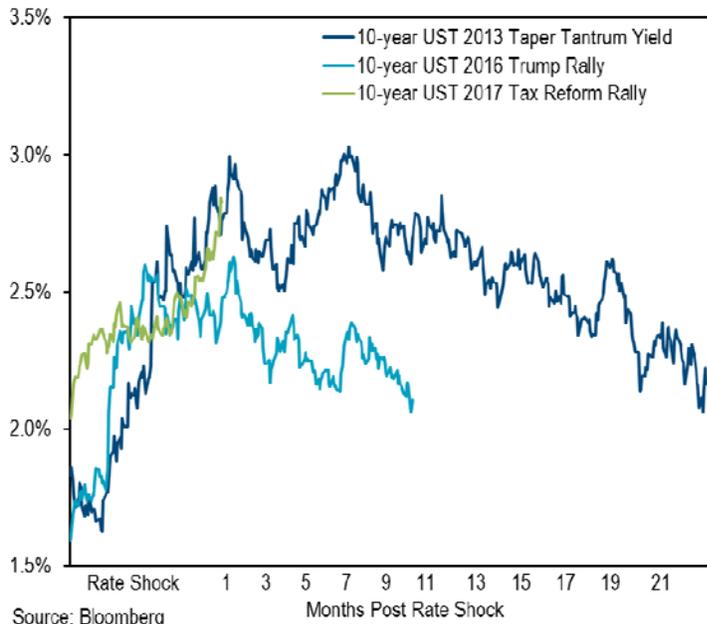
## Market Optimism

During the Taper Tantrum of 2013 yields rose more than 100bps January to December before recapturing 79bps 35 months later

10-yr yield rose 80bps from November 1, 2016 to 2.63% on March 13, 2017, the highest since July 2014

10-yr rose 80bps from September 7, 2017 to 2.84% on February 2<sup>nd</sup>, the highest since January 2014

10-yr down 1bp from peak at 2.83%

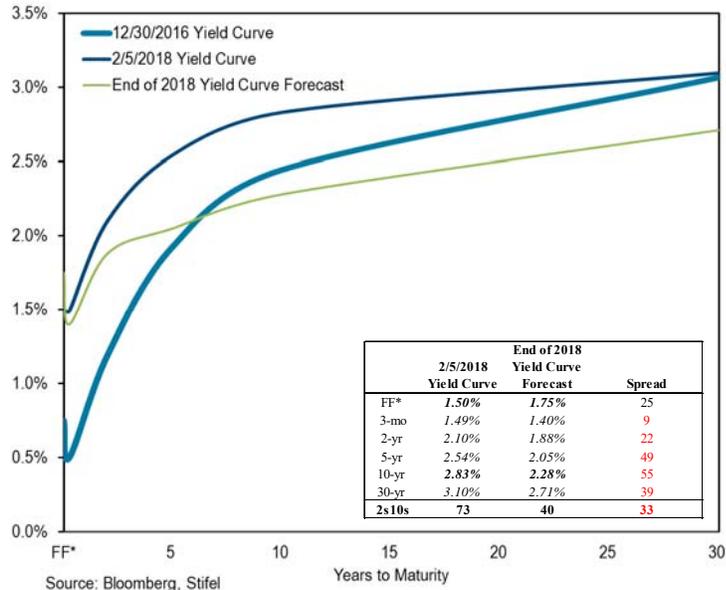


# Yield Curve To Flatten Further

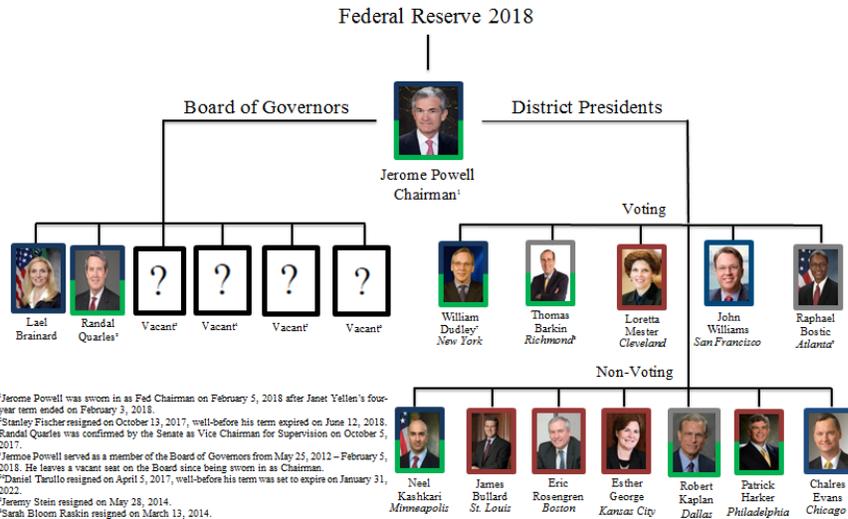
2s10s spread of **124bps** prior to liftoff and down to **73bps** following the January 2018 FOMC meeting

With the 2-year up 98bps since the start of 2017 and the 10-year up 38bps, the spread is at a near-term three-month high of 73bps but historically near an eleven-year low

Projected to flatten to **40bps** by end of 2018



# Composition of the Fed



<sup>1</sup>Jerome Powell was sworn in as Fed Chairman on February 5, 2018 after Janet Yellen's four-year term ended on February 3, 2018.  
<sup>2</sup>Stanley Fischer resigned on October 13, 2017, well-before his term expired on June 12, 2018. Randal Quarles was confirmed by the Senate as Vice Chairman for Supervision on October 5, 2017.  
<sup>3</sup>Jeanne Powell served as a member of the Board of Governors from May 25, 2012 – February 5, 2018. He leaves a vacant seat on the Board since being sworn in as Chairman.  
<sup>4</sup>Daniel Tarullo resigned on April 5, 2017, well-before his term was set to expire on January 31, 2022.  
<sup>5</sup>Feremy Stein resigned on May 28, 2014.  
<sup>6</sup>Sarah Bloom Raskin resigned on March 13, 2014.  
<sup>7</sup>William Dudley will retire in mid-2018, about six months prior to the expiration of his term on January 19, 2019.  
<sup>8</sup>Thomas Barkin began serving as the new Richmond Fed President on January 1, 2018 after Jeffrey Lacker resigned on April 4, 2017.  
<sup>9</sup>Raphael Bostic took office on June 5, 2017 after Dennis Lockhart resigned on February 28, 2017.

Legend:  
■ Dovish tendency  
■ Hawkish tendency  
■ Unknown tendency  
■ Wall Street Experience

## Candidates for Fed Chairman



Janet Yellen

- Current Fed Chair
- Nominated by former President Obama
- Champion of low rates
- Against deregulation



Jerome Powell

- Current Fed Governor
- Only Republican on Board of Governors
- First Fed chair since Volcker in the 1980s to lead the Fed without a PhD in economics
- Champion of low rates: *"If the economy performs about as expected, I would view it as appropriate to continue to gradually rise rate."* - June 1, 2017
- Advocate for deregulation: *"I will support and I do support adjustments designed to enhance the efficiency and effectiveness of regulation without sacrificing safety and soundness or undermining macro-prudential goals."* - April 20, 2017



John Taylor

- A Stanford economist known for the rate-setting rule, *"Taylor Rule"*
- A member of the President's Council of Economic Advisors during the George W. Bush Administration



Kevin Warsh

- Former Fed Governor
- Known hawk
- Son-in-law to Estee Lauder empire



Gary Cohn

- Current director of the National Economic Council
- Former Goldman Sachs executive
- Currently administering the overhaul of the federal tax code

## Wild Cards

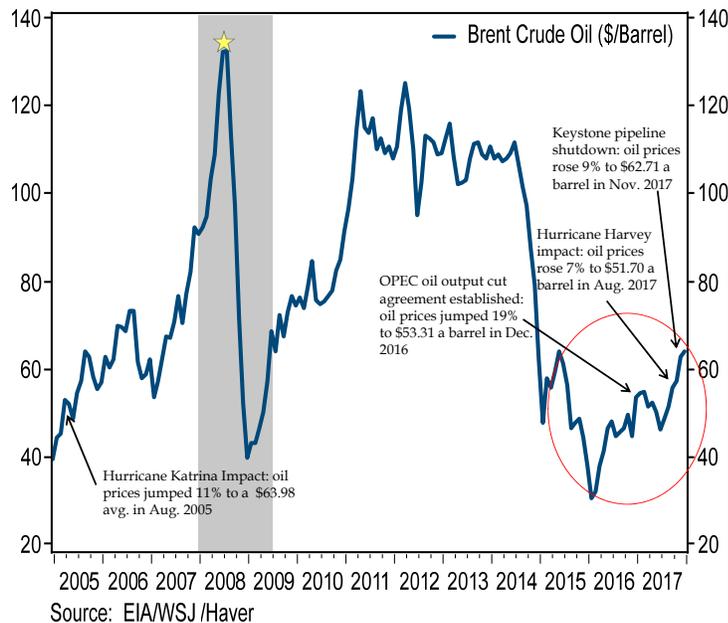
## Crude Prices on the Rise

Monthly prices for December averaged **\$64.39**, the highest since November 2014, and following a \$62.71 monthly average in November

The price of oil is down **50+%** from 2008 high

Prices pushed above \$55 for the first time since July 2015

Oil prices up **110%** (\$33.69 a barrel) from a low in January 2016



32

## Trump's Key Agenda Points

- Reduce regulation, repeal Dodd-Frank and sweeping bank reforms, and eliminate ones that *"needlessly kill jobs."*
- A four pillar framework for immigration including a path to citizenship for Dreamers, building a *"wall,"* ending the visa lottery program and moving towards a merit-based immigration system (ending chain migration).
- *"Fair"* and *"reciprocal"* trading relationships, renegotiate trade deals that have left the U.S. disadvantaged; *"America First"* and protectionist policies defending American workers and their interests.
- Repeal & reform the Affordable Care Act. (Graham-Cassidy). End billions of dollars in payments to insurers; allow patients with terminal conditions access to experimental treatments and reduce the price of prescription drugs.
- Infrastructure spending to build roads, bridges, schools and airports *"second to none,"* totaling *"at least \$1.5 trillion."*

33

## Tax Cuts and Jobs Act

	Prior to 2017 Reform	2017 Reform
Top Individual Tax Rate	39.6%	37%
Individual Tax Brackets	Seven (10%, 15%, 25%, 28%, 33%, 35% & 39.6%)	Seven (10%, 12%, 22%, 24%, 32%, 35% & 37%)
Child Tax Credit	\$1,000; 15% of earnings over \$3,000 are refundable	\$2,000; up to \$1,400 refundable
Personal Exemption	\$4,150 per taxpayer and dependent	Eliminates
Estate Tax	Top rate of 40% on estates above \$5.6 million	Increases threshold to estates above \$11.2 million
State & Local Tax Deduction	Income or sales and property taxes are deductible	All state and local tax deductions limited to \$10,000
Medical Expense Deduction	Can deduct out-of-pocket expenses in excess of 10% of adjusted gross income	Reduce the threshold to 7.5% of adjusted gross income for the tax years 2017 and 2018.
Student Loan Interest Rate Deduct.	Can deduct up to \$2,500	No change
Standard Deduction	\$6,500 / \$13,000 (singles/couples)	Nearly Doubles – \$12,000 / \$24,000 (singles/couples)
Mortgage Interest Rate Deduction	Can deduct interest payments on up to \$1 million of debt	Limited to payments on \$750,000 of debt
Charitable Donation Deductions	Able to deduct charitable contributions that are made to qualifying organizations	No change
Obamacare Individual Mandate	Penalty for not having health insurance	Repeals penalties starting in 2019
Alternative Minimum Tax	Alternative income tax calculation for businesses	Ends the AMT for corporations but keeps it for individuals, while boosting the exemption to \$500,000 for single taxpayers and \$1 million for couples
Corporate Rate	35%	21% in 2018
Top pass-through rate	Taxed at individual rates	20%, phasing out starting at \$315,000 of income for couples
New investment purchases	Complex rules for deducting over many years	Five years of full expensing, then phased out over five more years
Repatriation	The U.S. taxes multinationals on their global earnings at the corporate rate of 35%, but allows them to defer taxes on those foreign earnings until they bring them back to the U.S., or "repatriate" them	U.S. companies' overseas income held as cash would be subject to a 15.5% rate, while non-cash holdings would face an 8% rate; companies can make the payments in eight annual installments.

## Trump Tax Cuts

- Tax relief for middle-class families as well as for businesses, especially small businesses. The simplicity of "postcard" tax filing and ending incentives to ship jobs, capital and tax revenue overseas. Broadening the tax base and providing greater "fairness" for all Americans by closing special interest tax breaks and loopholes.
- "Our expectation should be that we will continue to increase our dividend and our share buybacks next year and the year after that and the year after that."  
-Wells Fargo CEO Tim Sloan, December 18, 2017 CNN Money interview
- According to the Tax Foundation, the GOP tax plan would increase the deficit by \$1.47 trillion on a static basis and by \$448 billion on a dynamic basis over the next ten years.

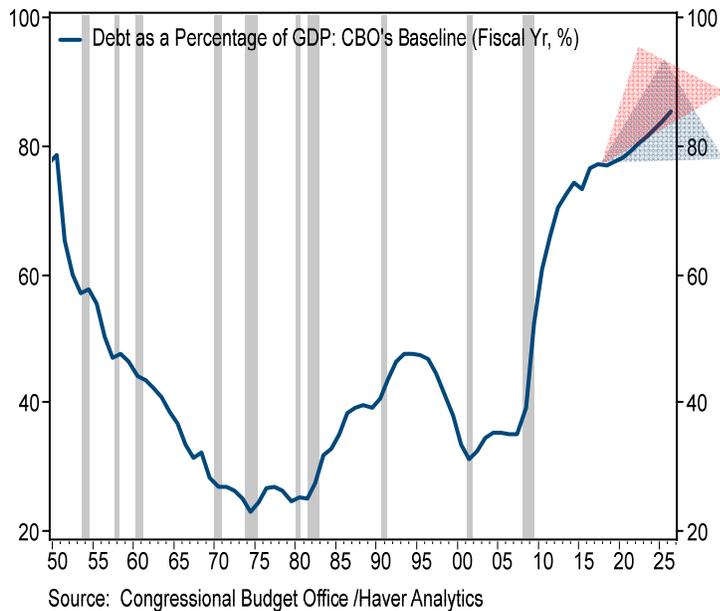
## Debt Appetite Diminished

77% of GDP, the highest level relative to the size of the economy since 1950

1950s decade-long expansion posting over 4.5% GDP vs. stagnant 2%

According to the CBO, financing the debt coupled with rising interest rates would result in a four-fold increase

Federal interest outlays totaled more than \$330b



## Positive Market Reaction: Equities Rally on Optimism

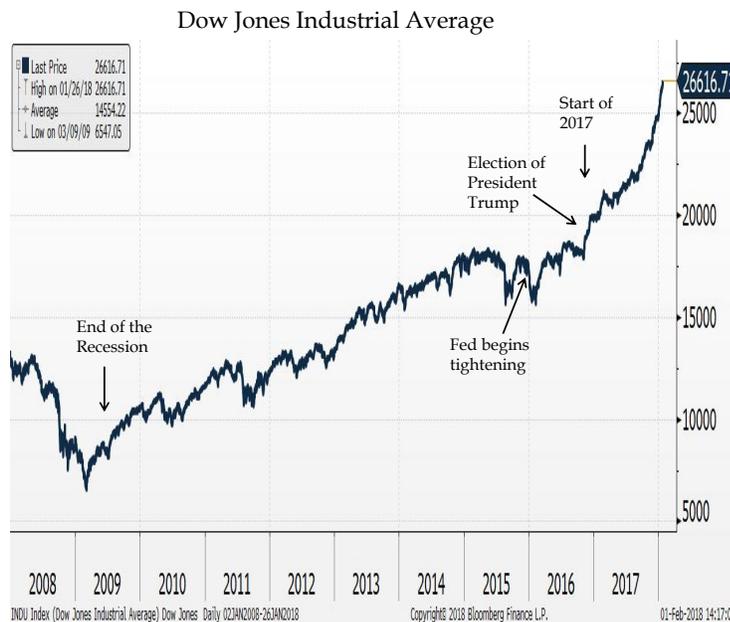
After an initial fallout on election day, equities have since rebounded, pushing the Dow to a record high as of January 26<sup>th</sup>

The Dow broke through 23,000 on an intraday basis for the first time on October 17<sup>th</sup> and closed above 23,000 on October 18<sup>th</sup>

The Dow closed above 25,000 for the first time on January 4<sup>th</sup>

The Dow closed down 1,175.21 pts (4.6%) on February 5<sup>th</sup>, marking the largest one-day point decline on record and following a 665.75 pt drop the prior trading day (Feb 2<sup>nd</sup>)

Since the start of 2017, however, the Dow is up 22% and up 32% since election day



**Continued Moderation, Subdued Inflation,  
and a Flatter Curve**

**Questions?**

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