2015 economic outlook and the impact on financial institutions

December 4, 2014
Agenda

- 2015 economic outlook on:
  - US and global financial conditions
  - Direction of hiring and wages in 2015
  - Policy direction that will impact financial services in 2015

- How does the future of banking look based on the economic factors we just heard?
Polling question

- What asset size is your financial institution?
  A. <$100 million
  B. $100-$500 million
  C. $500M-$1 billion
  D. $1-$5 billion
  E. $5 billion+
2015 Economic Outlook
US Economic Outlook

• **Above trend U.S. growth near between 2.5-3.0 percent in 2015**
  • Base case remains secular stagnation
    • Slow growth, low inflation and low rates.
  • Cyclical trend is 2.3 percent.
  • Long-term trend is 2.1 percent.
• **Unemployment to slowly decline**
  • Individuals re-entering the labor force cause of falling unemployment rate.
  • Underlying trend in job growth of 225,000 to 250,000 per month likely to continue into 2015
• **Fiscal Outlook**
  • No risk of interest rate shock and funding problem this cycle
  • Deficit to GDP near thirty year low
  • Major long term structural challenges over the horizon
US Economic Outlook

- **Composition of hiring improves**
  - Higher wage jobs outpacing low wage hiring.
  - Middle market employers the main driver in hiring.
  - Real wages to see modest increase in 2015.
- **Inflation to remain muted**
  - Positive supply shocks in energy and technology inherently deflationary.
- **Long-Term challenges remain**
  - Long term underemployment and unemployment
  - Problems in housing and labor market to keep Federal Reserve accommodative for some time.
US Economic Outlook

- Near term boost to spending due to falling oil and gasoline prices
  - Should place an additional $90 billion in additional disposable income in US households
- Solid manufacturing outlook to continue
  - Demand for autos remains robust
  - Backlogs of orders in civilian aircraft indicates several strong years of production ahead
- Housing recovery to remain muted
  - Residential investment to accelerate due to base effects
  - Lending remains tight
  - Key is employment status of 25-34 year olds
- Inventory accumulation and defense spending likely to slow in current quarter

Source: McGladrey

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Global Growth Forecast 2014-2016

Source: McGladrey, Bloomberg
U.S. Unemployment Forecast 2014-2018

Actual vs. Forecast

Percentage

Source: McGladrey, BLS

McGladrey

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Inflation Expectations Deteriorating

Source: McGladrey, Federal Reserve
Labor Market Remains a Policy Challenge

Involuntary Part Time Employment
- 20-Year Average

Source: McGladrey, BLS
Risks to the Economic Outlook

- European recession risk
- Potential tightening global financial conditions due to the economic conditions in Europe
- Risks to U.S. growth prospects via the financial and trade channels
  - Could subtract a full 1 percent from growth in 2015
- Global manufacturing decelerating
  - Possible major problem in Europe
- Reduced demand from China and Europe affecting Emerging Markets
- Premature US fiscal or monetary tightening
- Geopolitical Tensions
Risk of Euro-zone Recession Elevated

Source: McGladrey, Bloomberg
Condition of the U.S. Consumer

- **Condition of the U.S. Consumer Improving**
  - Cumulative job creation
  - High wage jobs vs. low wage jobs
- **Disposable Income Per Capital Improving**
  - Good but not great
- **Falling Gasoline Prices to Boost Holiday Consumption**
  - Possible $90 billion boost to household income
  - Will benefit those with greatest marginal propensity to consume
Polling Question

- Where do you think the 10 year treasury bond yield will be at the end of 2015?
  A. under 2%
  B. 2%-2.5%
  C. 2.5%-3%
  D. above 3%
US Financial Conditions

• **US Financial conditions remain solid**
  - European risk remains
  - Asian financial conditions a drag on overall economic activity

• **US Private credit creation on upswing**
  - Up 5.1 percent through the end of Q2’14.

• **Interest rates**
  - Fed to hike policy rate either in March or June 2015
  - Long term rates to remain below 3% in 2015 with downside risk

• **US Equity markets appear mildly overbought**
  - S&P 500 up modestly in 2014 despite recent volatility in global equity markets.

• **Stronger U.S. dollar**
  - Importation of deflation via trade channel a risk
  - Embarked on long run dollar bull cycle
Global Financial Conditions

Z-Score Below Zero Indicates Net Drag on Growth

Source: McGladrey, Bloomberg

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Credit Expansion Remains in Tact

Source: McGladrey, Federal Reserve

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Polling Question

- How do you project loan demand to be as compared to 2014?
  - A. about the same
  - B. somewhat increased
  - C. increased significantly
  - D. decreased slightly
  - E. decreased significantly
Credit Union Residential Lending Solid

Source: McGladrey, Federal Reserve

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U.S. Private Credit Creation

Adjusted $R^2= .64$

Source: Federal Reserve, McGladrey

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U.S. Equity Markets Appear Mildly Overbought

Source: McGladrey, Federal Reserve, Robert Shiller
U.S. Rates to Remain Historically Low

Source: McGladrey, Bloomberg
Small & Medium Size Firms Lead Way In Hiring

Source: McGladrey, ADP, BLS

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Real Median Income Below 1997 Levels

Inflation Adjusted US Median Household Income

Thousands (Seasonally Adjusted, Index=2013)

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U.S. Disposable Income Per Capita

Households Pull Compensation Forward to Avoid 2013 Tax Hike

Source: McGladrey, St. Louis Fed
U.S. High Wage Job Creation Improving

High Wage Jobs Outpace Low Wage in 8 of Past 10 Months

Source: McGladrey, BLS
Falling Gasoline Prices and Disposable Income

Wholesale Gasoline Futures Pointing Toward a Possible $90 Billion Boost to Personal Disposable Income

Source: McGladrey, Bloomberg

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Ominous Price Signal for OPEC

Source: McGladrey, Bloomberg
Stronger Dollar and Cheaper Oil

Trade Weighted Dollar and West Texas Intermediate

Source: McGladrey, Bloomberg
Global Central Bank Policy Outlook

• **US Federal Reserve**
  • Gradual and orderly rate hike campaign to commence in 2015
  • Lower for longer on rates

• **European Central Bank**
  • €1 trillion euro asset purchase program on the table
  • ECB must move decisively and overwhelmingly to address deflation on its doorstep

• **Bank of Japan**
  • Quantitative easing to continue
    • Surprise increase in balance sheet by one-third
  • Structural reform key to altering Japan’s economic growth path and pricing dynamics
Deflationary Risks Rising in Europe
European Central Bank at the Brink

Source: McGladrey, European Central Bank
Residential Investment

- Likely to rebound in 2015
  - Cumulative job creation
  - High wage jobs vs. low wage jobs
- Employment of those aged 25-34 remain the key
  - Job gains and wages
  - Behavioral shift?
- Federal Reserve to attenuate policy to conditions in residential investment
  - Focus on single family residencies
  - One of the major reasons why the Fed will keep rates low for much longer than most firms and investor’s anticipate.
Millennial's Key to Revival of Residential Investment

Source: McGladrey, Bloomberg

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Student Loan Debt a Drag on First Time Home and Auto Purchases

Source: New York Federal Reserve
How does the future of banking look like based on the economic factors we just heard?
Polling Question

- How does your 2015 budgeted net income compare to your 2014 results?
  A. about the same
  B. slight improvement
  C. significant improvement
  D. slight decrease
  E. significant decrease
How does the future of banking look like based on the economic factors we just heard?

- How do you see financial institutions approaching capital projects in light of the economy?

- How do you react to the rate environment as projected?

- What are key growth strategies and M&A considerations?

- How are banks looking at corporate culture as one mitigating factor to help manage risks since the recession?