

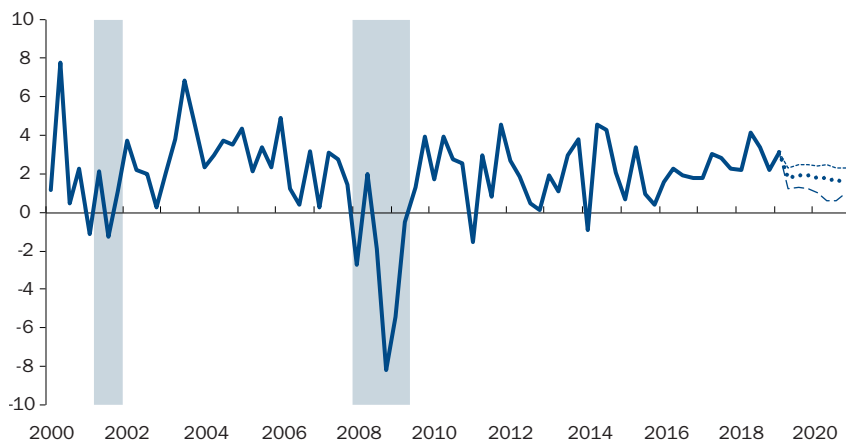
# Section II: U.S. Economy, Financial Markets, and Banking Industry Overview

## U.S. Economic Overview

- *Economic fundamentals remain favorable, even as growth slows.*
- *Consumer spending and strong labor market conditions continue to support economic growth.*
- *Business investment moderated after strong growth in 2018.*
- *Housing markets continue to slow in 2019 despite lower interest rates.*
- *Changes to international trade policy offer both upside and downside risks.*

**Chart 1**  
**Real Gross Domestic Product Growth Was Strong**

Seasonally Adjusted Annualized Growth Rate, Percent



Sources: Bureau of Economic Analysis, (Haver Analytics), Blue Chip Economic Forecasts

Notes: Dotted lines represent the Blue Chip forecast range as of July 2019. Recessions shaded.

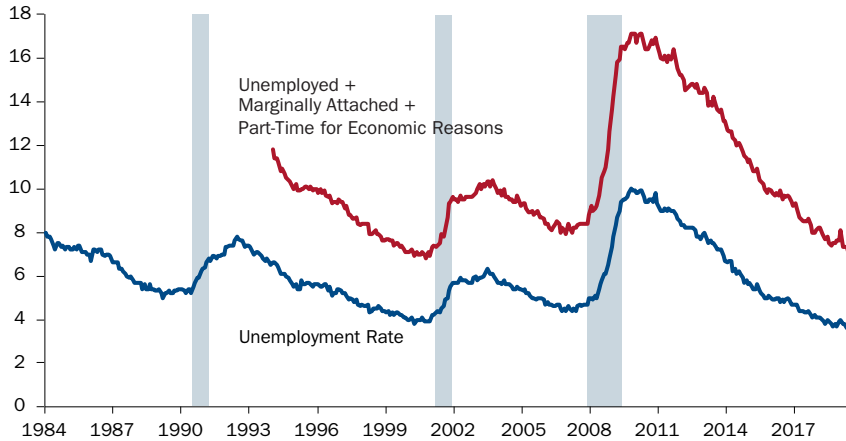
**The 2019 outlook is for economic growth to continue at a slower pace than recent highs.** Consensus forecasts suggest the pace of economic growth will moderate to 2.5 percent in 2019 supported by favorable economic fundamentals (Chart 1). The expected slowdown in 2019 follows near 3 percent growth in 2018, which was helped by tax cuts under the Tax Cuts and Jobs Act enacted in late 2017.

The current economic expansion turned ten years old in July 2019 and is the longest expansion on record since the 1850s.<sup>6</sup>

<sup>6</sup>National Bureau of Economic Research, U.S. Business Cycle Expansions and Contractions.

## Chart 2 The Unemployment Rate Is at Its Lowest Level in Decades

Civilian Unemployment Rate, Percent



Source: Bureau of Labor Statistics (Haver Analytics)  
Note: Recessions shaded. Monthly data through June 2019.

**Consumer spending continues to support economic growth.** Consumer spending makes up the largest portion of U.S. gross domestic product (GDP), contributing roughly 70 percent to GDP historically. Consumer spending was a bright spot for economic growth in 2018, though it slowed in first quarter 2019. Robust employment growth has supported gains in consumer spending during this economic expansion. Stronger labor market conditions with high employment and wage gains have supported overall economic growth and demand for mortgages, consumer loans, and lines of credit. Steady hiring has pushed the unemployment rate to the lowest level in decades (Chart 2). Wage growth picked up recently, a further sign of labor market strength. Despite the increased cost pressures on businesses, higher wages have contributed to growth in consumer spending. Broader measures of underemployment, including workers who are part-time for economic reasons, marginally employed workers, workers in jobs below their skill level, and those who have given up looking for employment, also have returned to pre-recession levels. Labor markets do not show signs of overheating, as the recent growth in wages has been moderate in spite of demographic issues such as an aging workforce and lower labor force participation. Household leverage remains modest, as debt levels have lagged gains in asset values, suggesting

consumers in aggregate are not overextending their finances and that fundamentals for consumer spending are sound. These conditions supported consumer sentiment, which helped support consumer spending and broader economic activity.

**While consumer sentiment and spending remained strong, business sentiment and investment moderated in 2019.** Business investment and confidence picked up in 2018 helped by a boost from tax cuts, but moderated in 2019 as the tax effects waned and businesses faced higher uncertainty around the economic outlook. Capital spending growth declined and manufacturing conditions weakened in 2019, as industrial production slipped in late 2018 and contracted during the first part of 2019. Business sentiment indicators, which affect future investment and hiring decisions, also weakened. Slower business investment may ultimately weaken economic conditions and reduce business demand for banking services.

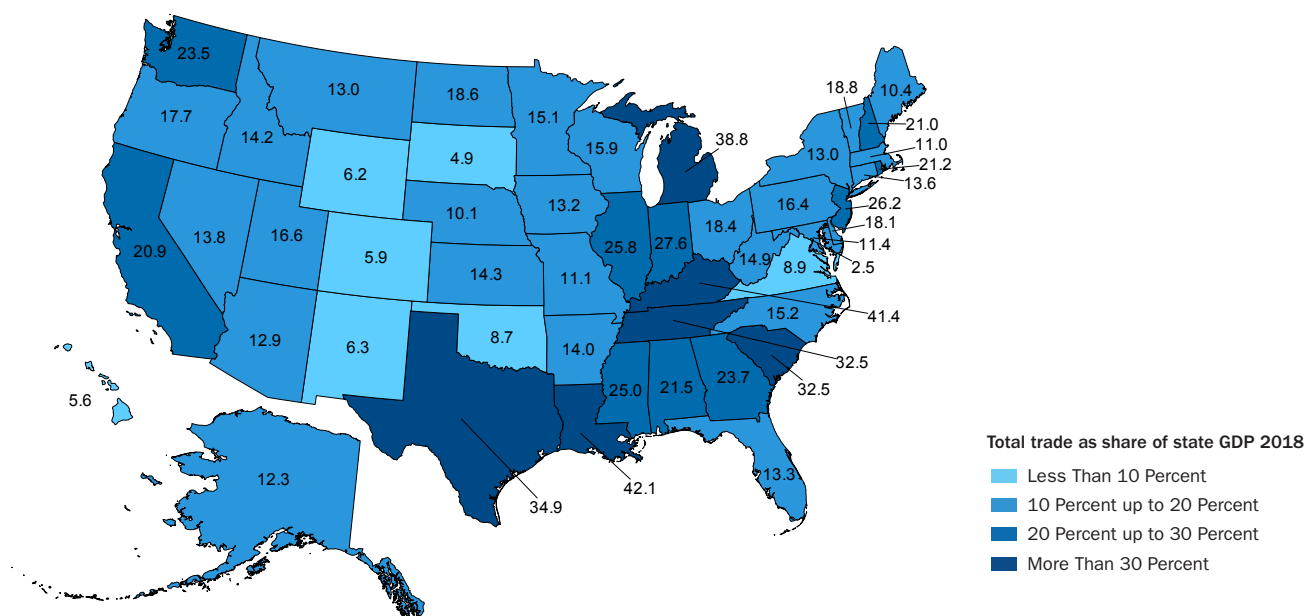
**Inflation softened in 2019 after increasing in 2018.** Higher inflation in 2018, supported in part by higher oil prices, contributed to the Federal Reserve's decision to increase interest rates four times in 2018. Inflationary pressures softened by late 2018, with lower oil prices reflecting increased shale production, a depressed outlook for global demand, and strong global supply.

Inflation expectations based on consumer surveys suggest consumers do not expect prices to increase significantly in the near term.<sup>7</sup>

**Housing markets continue to slow in 2019.** Home price growth slowed in many major markets as high prices reduced affordability, and home sales are down from year-earlier levels despite lower mortgage rates. However, housing market fundamentals remain positive. Higher employment and rising wages supported housing demand. Lack of housing supply, due to increased costs of materials, limits on available land for new construction, and shortages of skilled construction workers, continue to weigh on sales. The 2017 tax legislation, which changed state and local tax exemption limits and the home mortgage deduction, reduced certain tax benefits for some homeowners. While the overall effects are hard to predict, areas with higher housing costs or property taxes could see decreased demand and a slowdown in price increases, or outright price declines. Housing supply is expected to remain tight and prices are expected to continue to rise but at a slowing pace in most areas.

**Changes in long-standing U.S. trade policy in 2018 and early 2019 dampened trade activity.** Steel and aluminum tariffs were implemented in March 2018, and several rounds of tariffs were imposed on Chinese goods during the year. These tariffs contributed to a slight decline in U.S. exports in the second half of 2018 and a small estimated effect on inflation and economic growth. In 2019, trade developments weakened business sentiment and manufacturing conditions.<sup>8</sup> Another round of tariffs that were imposed on China in May 2019 could further impact the economy, particularly in states that are most dependent on trade (Map 1). The U.S. also announced a trade agreement with Canada and Mexico to replace the North America Free Trade Agreement (NAFTA). The United States-Mexico-Canada Agreement (USMCA), if approved, may affect output, exports, and employment, particularly for the auto industry in the South and Midwest. The effects will vary by industry but should have a positive effect overall on the economy. The USMCA could especially benefit states along the U.S.-Mexico border. However, specific provisions regarding rules of origin and wage labor content may result in a decline in specific trade flows in other regions and industries.

**Map 1**  
A Large Share of State GDP Is Dependent on Trade



Sources: U.S. Bureau of Economic Analysis, U.S. International Trade Administration, FDIC staff analysis

<sup>7</sup>Surveys on inflation expectations include the Survey of Professional Forecasters, conducted by the Federal Reserve Bank of Philadelphia; the University of Michigan Surveys of Consumers; and the Survey of Consumer Expectations, conducted by the Federal Reserve Bank of New York.

<sup>8</sup>Federal Reserve Board of Governors, Monetary Policy Report, Box 1, "The Persistent Slowdown in Global Trade and Manufacturing," July 2019.

A substantial amount of cross-border activity and investment occurs between the United States, Mexico, and Canada, particularly related to manufacturing. The USMCA may augment the existing tariff-free, export-oriented manufacturing program, an important part of U.S. corporate strategy to achieve competitively priced goods in the world marketplace. Increased uncertainty about either tariffs or trade agreements may have larger long-term effects as consumers and businesses delay purchases and investment decisions.

Vulnerabilities persist for industries and regions with high trade exposure. Sectors such as agriculture, computers and electronic products, and transportation equipment have significant volumes of imports and exports with China, the European Union (EU), Canada, and Mexico, jurisdictions that could become the target of additional tariffs. Tariffs have disrupted supply chains, which has increased production costs in certain industries and regions, and may result in adverse regional economic effects.

The trade effects have weighed most on the transportation and agricultural sectors, as these sectors have been subject to China's tariffs. In 2017, transportation equipment accounted for 23 percent of total U.S. exports to China, and agricultural products accounted for 12 percent. Transportation equipment exports facing tariffs fell 8 percent in third quarter 2018. Soybean production is heavily concentrated in the Midwest, with Illinois and Iowa production accounting for more than \$11 billion, or just over 28 percent, of all domestic soybean production in 2018. Prices of soybeans fell more than 10 percent in 2018 after the enactment of Chinese soybean tariffs in the summer. For many U.S. soybean farmers, prices were below production costs in 2018.<sup>9</sup>

**The slowdown in U.S. economic growth in 2019 is expected to be small compared with other major economies.** Global economic growth has slowed in 2019, led by weaker growth in China and Europe. Trade uncertainty weighs on the global economic outlook. China's economic slowdown that began in 2018 reflects tighter credit conditions and reduced investment. Political risks in Europe, including the as-yet uncertain terms of the United Kingdom leaving the EU (Brexit), could have broad-ranging effects on the global economy and banking system. While the direct impact of Brexit on the U.S. economy and banking sector may be limited, adverse financial market reactions to the terms of Brexit may pose indirect risks to U.S. markets and institutions. Central banks have responded to weaker economic conditions as global monetary policy remains accommodative overall. Both the Bank of England and the European Central Bank have eased plans announced in 2018 to tighten monetary policy, causing interest rates to decline globally. These global factors are contributing to slower global growth and may reduce U.S. economic activity.

---

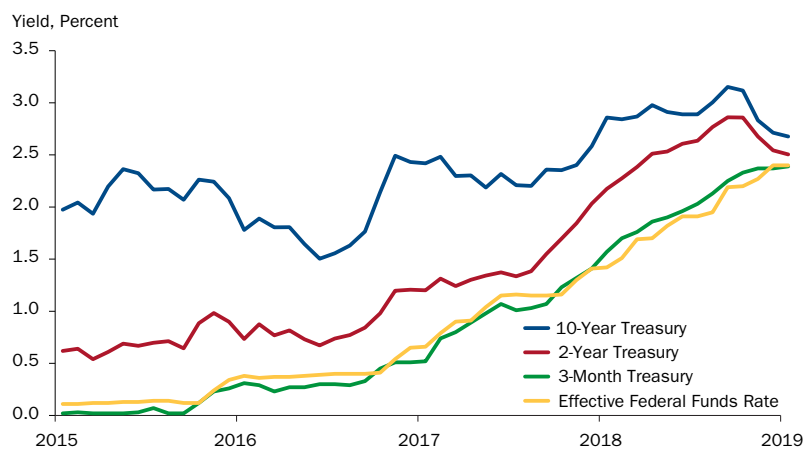
<sup>9</sup>United States Department of Agriculture. Soybean Costs and Returns data.

## Financial Markets

- *The U.S. Treasury yield curve flattened in 2018, signaling the possibility of a weakening economy.*
- *Volatility returned to financial markets in 2018 following several years of steady performance.*
- *Stocks and bonds reversed course in the fourth quarter and performed poorly on the year.*
- *Bank stocks were more volatile than the broader stock market in 2018.*

**Chart 3**

### The Gap Between Yields on Treasuries of Varying Maturities Narrowed in 2018



Source: Federal Reserve Bank of St. Louis

**The U.S. Treasury yield curve flattened significantly in 2018.** The Federal Open Market Committee raised the target range for the federal funds rate four times in 2018, increasing the upper end of the target range from 1.5 percent at year-end 2017 to 2.5 percent at year-end 2018. The three-month U.S. Treasury bill yield followed closely, rising from 1.4 percent in January 2018 to 2.4 percent in January 2019. At the two-year and ten-year maturity points, U.S. Treasury yields rose 59 basis points and 29 basis points, respectively, in 2018. These moves compressed the spread between the two-year and ten-year yields from 51 basis points at the start of 2018 to just 21 basis points at year-end (Chart 3). The spread between the ten-year and two-year yields is of particular interest because an inversion, or negative value, is considered a potential indicator of a recession. Historically, a recession occurs six months to two years after the curve inverts. Further, banks are

adversely affected by a flatter yield curve because they typically make longer-term loans while accepting shorter-term deposits.

**Despite the flattening yield curve, bank average net interest margins (NIMs) rose in 2018.** Banks were able to increase total interest income in 2018 by more than enough to offset the increase in funding costs, causing NIMs to expand. The average NIM for the industry was 3.5 percent in fourth quarter 2018, up 17 basis points from a year earlier. Deposit betas, which measure the percentage change in the federal funds rate that banks pass on to depositors, trended higher for most of 2018. According to some analysts, early signs point to continued increases in deposit costs in 2019 and, in a reversal from 2018, a decline in bank NIMs. Some banks have experienced a decline in asset yields as the yield curve has flattened, putting downward pressure on NIMs.

**Corporate bonds performed poorly in the 2018 rising rate environment.** Corporate bonds and bond funds lost value in 2018, as rising interest rates caused bond prices to fall. Other factors contributing to declining asset prices in 2018 were concerns about slowing economic growth, ongoing trade negotiations, increased tariffs, and higher oil prices. High-yield and investment-grade debt issuances were both down in 2018 compared with the previous year.<sup>10</sup> In late 2018, market conditions deteriorated and the primary market for debt issuance softened considerably. The high-yield bond market did not have a new issuance for 41 days at the end of 2018, the longest such period since 1995. Investment-grade bond issuance also stalled in December, declining more than 90 percent from previous months. The corporate bond market recovered in early 2019, and issuances returned to normal levels.<sup>11</sup> Prices for major corporate bond indices are positive for the year.

Measures of secondary market liquidity were generally positive in 2018. Corporate bond trading volumes continued on an upward trend, and bid-ask spreads remained tight. However, the growth of BBB-rated bonds is a concern. These bonds, which are rated just above speculative grade status, accounted for 49 percent of all investment-grade bonds in 2018, up from 33 percent in 2008. Market liquidity issues could occur if a significant portion of BBB-rated bonds are downgraded to speculative grade within a short period and mutual funds, insurance companies, and other investors with investment mandates are forced to sell a large volume of those bonds quickly.

**The leveraged loan market received increased scrutiny in 2018.** The U.S. leveraged loan market surpassed \$1.3 trillion in 2018, making it larger than the high-yield corporate bond market. Leveraged loans are usually arranged by a syndicate of banks and made to companies that are heavily indebted or have weak credit ratings. Leveraged loans typically are floating rate loans and generally are extended to fund leveraged buyouts, stock buybacks, or dividend payments. While the leveraged loan market has experienced a period of sustained growth since 2010, growth has accelerated over the past two years as the demand for adjustable-rate products has increased. Non-bank investors hold most institutional U.S. leveraged loans, with U.S. banks holding only about 7 percent of institutional leveraged loans issued in the first half of 2019.<sup>12</sup> In the United States, more than half of all leveraged loans are purchased and packaged into collateralized loan obligations (CLOs), which are sold to investors, including U.S. banks. The volume of CLOs outstanding at the end of 2018 reached an all-time high of \$616 billion.<sup>13</sup> Strong demand from CLOs and yield-seeking investors has allowed issuers to ease underwriting standards and documentation requirements. Loans with weak covenants are sometimes referred to as “covenant-lite” or “cov-lite.” Banks could be indirectly exposed to risks in leveraged loans through their holdings of CLOs as well as their loans to nonbank financial institutions. Banks also face exposure to leveraged loan borrowers through revolving credit lines.

---

<sup>10</sup>Securities Industry and Financial Markets Association research and data.

<sup>11</sup>Ibid.

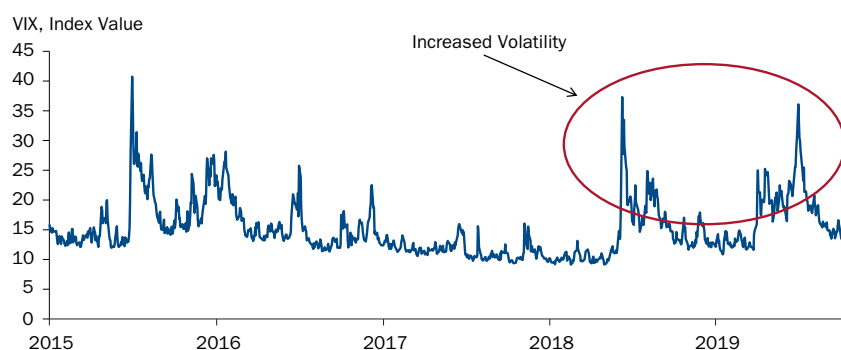
<sup>12</sup>Standard & Poor's Leveraged Commentary and Data (LCD).

<sup>13</sup>Securities Industry and Financial Markets Association research and data.

In 2018, the stock market posted its first annual decline across all three major indices since the end of the financial crisis. The Dow Jones Industrial Average (DJIA), Standard and Poor's (S&P) 500, and National Association of Securities Dealers Automated Quotations (NASDAQ) index declined 5.6 percent, 6.2 percent, and 3.9 percent, respectively. Asset prices appreciated with historically low volatility in 2017, but 2018 brought increased volatility to financial markets. In early February 2018, the Chicago Board Options Exchange Volatility Index (VIX), one measure of market volatility, spiked more than 20 points, or 117 percent, in a single day to a level not seen since August 2015.<sup>14</sup> That same day, the DJIA dropped by a record 1,175 points. Analysts believe that the building popularity of “short volatility” bets, which use futures or options tied to the value of the VIX, has exacerbated volatility swings. In 2018, the VIX averaged 16.6, close to the historic median but higher than the 2017 average of 11.1 (Chart 4). Cross-asset correlations, which measure the tendency for prices of dissimilar assets to move together, trended higher in 2018, particularly when volatility was high. The S&P 500 experienced two corrections in 2018 when the index fell more than 10 percent from the previous high. Equity indexes rebounded in early 2019, approaching and in some cases setting record highs in April, as the Federal Reserve signaled a stabilization in interest rates.

Bank stock prices, which are sensitive to interest rate and economic conditions, fluctuated more sharply than the broader market throughout 2018. The Keefe, Bruyette, and Woods (KBW) Bank Index, a benchmark index for the banking sector that includes 24 banking stocks, fell 19.6 percent in 2018, outpacing the decline in the broader market despite the industry's solid earnings. The prospect of future interest rate increases and the potential for further flattening or inversion of the yield curve may have contributed to the banking sector's underperformance in 2018. The price of credit protection for banks increased in the first and fourth quarters of 2018, reflecting elevated market volatility and eroding financial market liquidity. Bank stocks have continued to lag the broader market in 2019.

**Chart 4**  
**Volatility Returned to Financial Markets in 2018**



Source: Yahoo! Finance  
 Notes: Daily data through March 2019. VIX is the Chicago Board Options Exchange Volatility Index, a measure of financial market volatility.

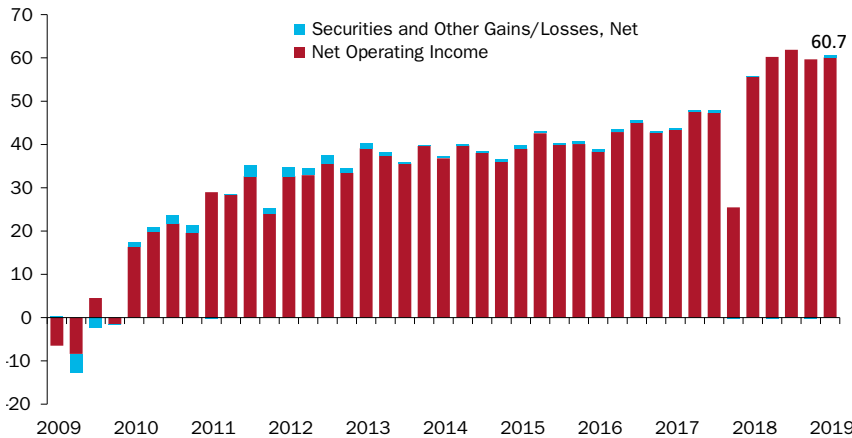
<sup>14</sup>The VIX is sometimes referred to as Wall Street's “fear gauge” because it tends to rise when equity prices fall.

# Banking Industry Overview

- *Net income for FDIC-insured institutions reached a record level in 2018.*
- *The industry continues to experience positive year-over-year loan growth.*
- *Loan performance indicators remain strong.*
- *Banks hold higher levels of higher-quality capital than in recent years.*

**Chart 5**  
**FDIC-Insured Institutions Earned Record Profits in 2018**

Quarterly Net Income, Billions of Dollars



Source: FDIC  
Note: Quarterly data through first quarter 2019.

The banking industry continues to report strong financial performance. As of first quarter 2019, the 5,362 FDIC-insured institutions benefited from greater net income, strong asset quality indicators, and additional capital formation (Chart 5). The number of problem banks is at the lowest level in more than ten years, and no banks failed in 2018.

**Net income at FDIC-insured institutions rose 44 percent from 2017 to \$236.7 billion in 2018.** The record profits in 2018 were primarily due to higher net operating revenue and a lower effective tax rate following passage of the Tax Cuts and Jobs Act in December 2017. The FDIC estimates that absent tax reform effects, 2018 net income would have been 14 percent higher than in 2017. In first quarter 2019, bank profits rose \$4.9 billion (8.7 percent) compared with first quarter 2018, owing to higher net interest income, gains in securities portfolios, and lower

noninterest expense. The share of unprofitable banks fell to 3.9 percent from 4.1 percent a year earlier on higher earnings industry-wide.<sup>15</sup>

A combination of loan growth and widening NIMs continued to drive increases in net interest income among banks. Interest rate hikes so far have benefitted most of the industry, as assets have repriced faster than liabilities including deposits. This has been especially true for large banks, which hold a higher share of short-term assets on their balance sheets. However, interest rate increases have put upward pressure on rates paid by banks to depositors. As a result, banks are seeing a shift in their liability mix away from noninterest-bearing balances and toward interest-bearing balances. In first quarter 2019, the increase in average cost of funds exceeded the increase in average asset yields, resulting in a decline in NIM for the industry (Chart 6). In addition to

<sup>15</sup>The Tax Cuts and Jobs Act led to large increases in income tax expenses in fourth quarter 2017 because of one-time write-downs of deferred tax assets. The subsequent lower income taxes realized in 2018, coupled with the above-average tax expense in 2017, contributed to the growth and record levels of bank profits in 2018. See FIL-6-2018, New Tax Law: Accounting and Reporting Implications, <https://www.fdic.gov/news/news/financial/2018/fil18006.html>.



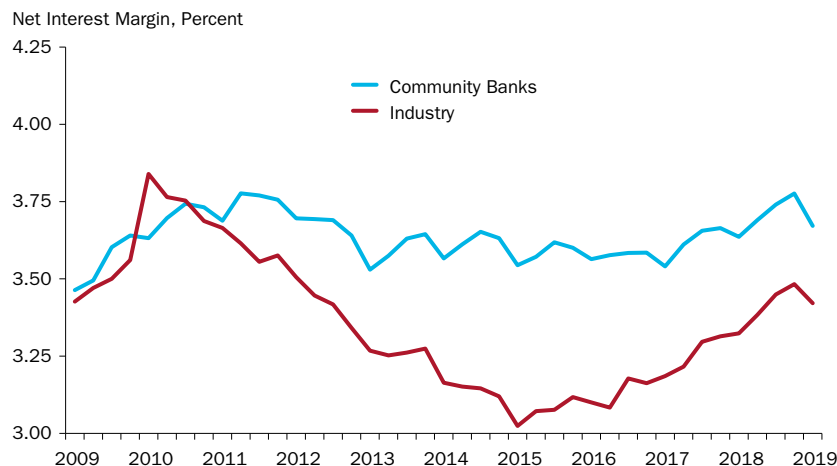
the rise in funding costs, asset yields have declined at some banks as the yield curve has flattened, putting further downward pressure on NIMs. The decline in NIMs in first quarter 2019 is also partly attributable to seasonal factors, as NIMs typically decline from fourth quarter to first quarter.

Banks' noninterest income declined year-over-year in first quarter 2019, primarily because of lower servicing fee income and other noninterest income. Slightly more than half the industry (52.6 percent) recorded year-over-year decreases in noninterest income, as recent market volatility caused declines in securitization income. These declines had the most pronounced impact on larger institutions that are more active in securitization. Noninterest expenses decreased for banks in first quarter 2019 from the year-earlier quarter, as increases in salaries and employee benefits were more than offset by declines in other noninterest expenses.

**Loan growth continued at rates below those reported in recent years.** Loan balances increased from a year earlier in all major categories in first quarter 2019.<sup>16</sup> The strongest growth rates were in the commercial and industrial (C&I), commercial real estate (CRE), and consumer loan categories. The growth rate of loans secured by real estate, while positive, has

been gradually slowing since 2016. The acquisition, development, and construction (ADC) loan category has slowed most within the broader CRE portfolio. ADC loan balances for the industry increased only 2.8 percent year-over-year in first quarter 2019 after increasing 12.1 percent in first quarter 2017 and 15.7 percent in first quarter 2016. Aggregate loan growth in first quarter 2019 was slightly negative (down 0.05 percent) compared with fourth quarter 2018 because of seasonal declines in consumer loans, specifically credit card loans. Credit card balances declined \$43.5 billion (4.8 percent) in first quarter 2019 as nearly 14 percent of banks decreased their credit card holdings. All other major loan categories reported quarterly increases.

**Chart 6**  
**Community Banks Continue to Record Higher Net Interest Margins Than the Industry**



Source: FDIC  
 Note: Quarterly data through first quarter 2019.

<sup>16</sup>Major loan categories include commercial and industrial loans, residential mortgage loans, consumer loans, and nonfarm nonresidential loans. Consumer loans include credit card, automobile loans, and all other consumer loans.

Community banks reported a merger-adjusted 6.6 percent annual increase in loan and lease balances in first quarter 2019, exceeding the growth rate of noncommunity banks by nearly 3 percentage points. Community banks reported a higher year-over-year growth rate than noncommunity banks in almost all loan categories. The largest increases for community banks were in ADC, multifamily, nonfarm nonresidential, and C&I loan portfolios. Compared to community banks, noncommunity banks reported a larger percentage increase in credit card loans. Loans and leases represented 56.1 percent of the banking industry's total assets as of first quarter 2019 and have remained a relatively stable share the past several years. Securities represented 21 percent of bank assets, a majority of which (60 percent) are mortgage-backed securities.

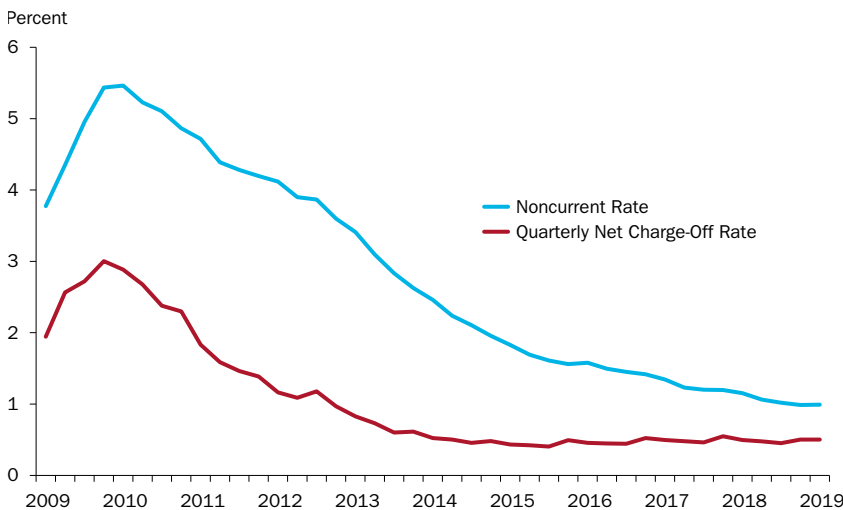
**The current economic expansion continues to support loan performance across the banking industry.**

Noncurrent loan balances in first quarter 2019 were below 1 percent and are at an 11-year low primarily because of improving performance for residential mortgages (Chart 7). However, first quarter 2019 also saw an increase in C&I noncurrent loans, which

increased the C&I noncurrent rate by 14 basis points to 0.82 percent. The dollar amount of noncurrent farm loans continues to rise as the agriculture industry struggles amid low commodity prices. While low overall, the noncurrent rate for farm loans at community banks (1.28 percent) is at the highest first-quarter rate since 2011.<sup>17</sup> Net charge-offs remain low and stable.

**Banks hold higher levels and higher-quality capital than during the financial crisis, owing to post-crisis regulatory capital requirements.** This capital provides the banking industry resiliency to sustain potential future losses.

**Chart 7  
Noncurrent Loan Rate and Quarterly Net Charge-Off Rate Remain Low**



Source: FDIC

<sup>17</sup>Agriculture loan volume, delinquency, and charge-off data are seasonal, and therefore historical comparisons are best made on a same-period basis.