Office of the Comptroller of the Currency

Economic Update

Minority Depository Institution Advisory Committee Meeting

David Krisch, Senior Financial Economist
September 24, 2024

Takeaways

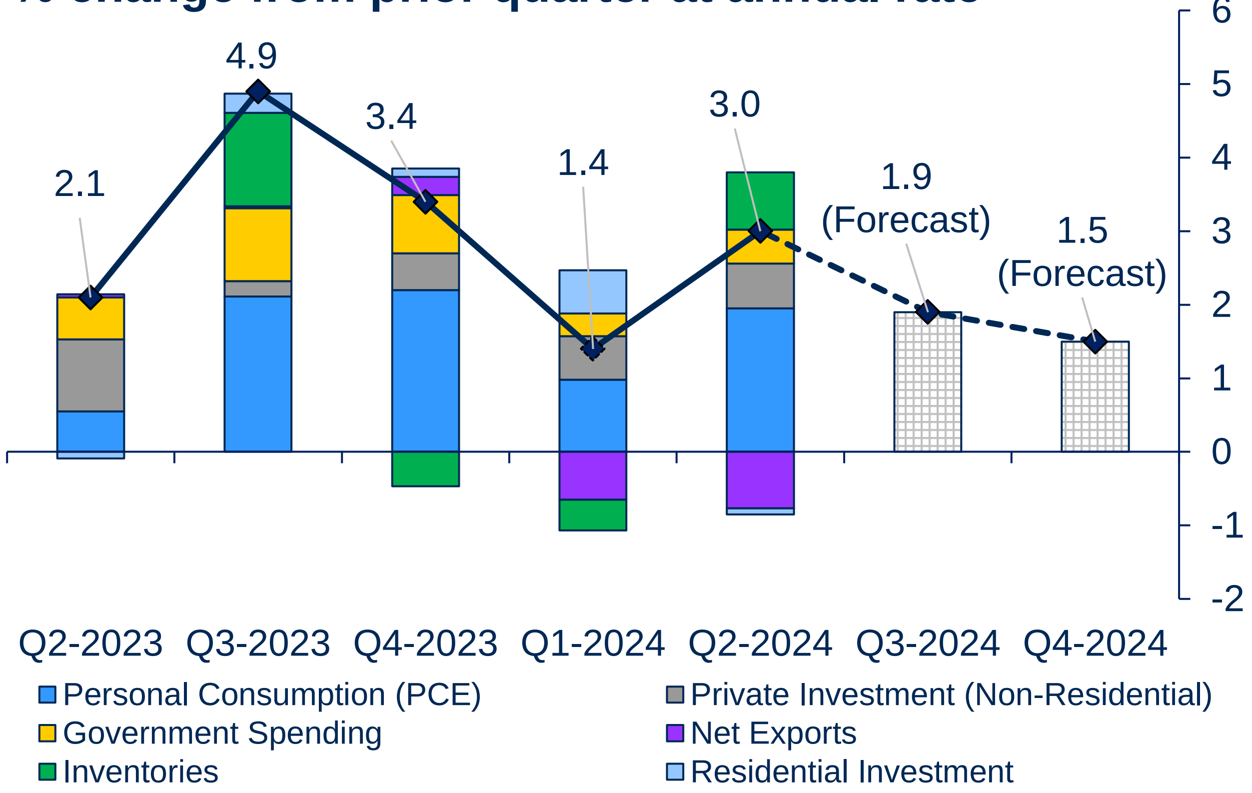
- **U.S. economic growth remained resilient, but some measures of activity imply that momentum is slowing**
  - Real GDP growth picked up in Q2 2024 on strong domestic demand, but forecast to downshift in the coming few quarters
  - The labor market is moving closer to balance, with unemployment rate still low
  - Inflation rates continue to trend lower, in line with the pace of prior disinflations
- **Financial conditions are consistent with a soft landing and the Fed started easing with a sizable reduction in interest rates**
  - Markets and forecasters expect an aggressive easing through the end of 2025
  - Banking system NIMs typically decline during easing cycles
- **Office sector vacancies are forecast to increase, peaking in 2027; multifamily sector expected to stabilize**

Agenda

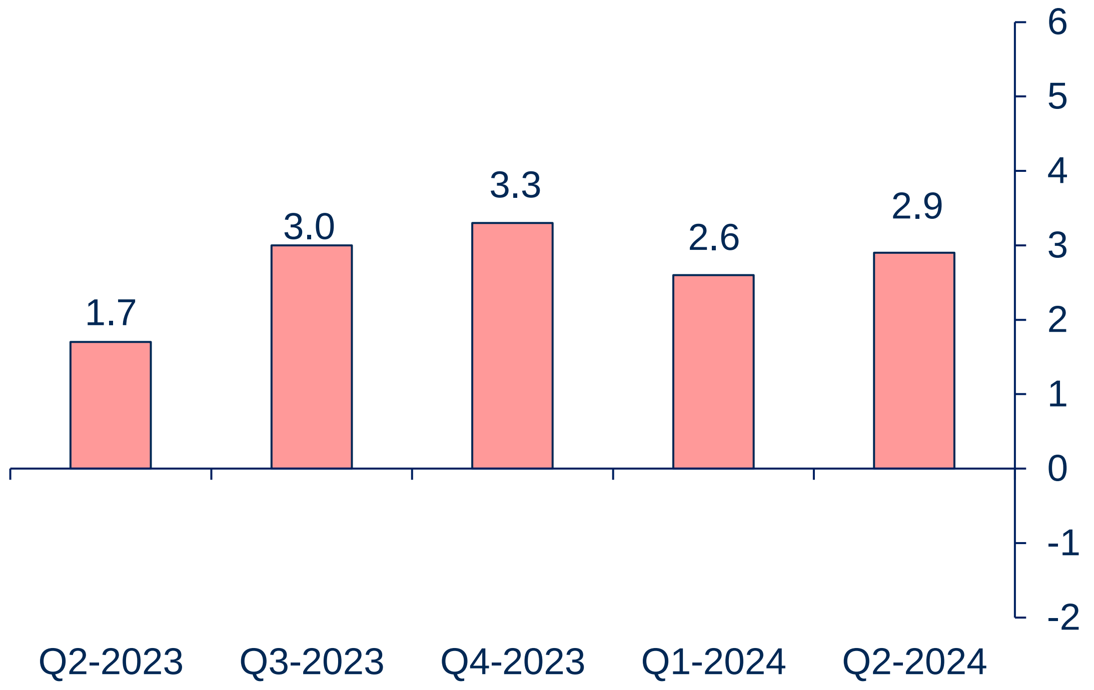
- U.S. Economic Conditions
- Macro Financial Dynamics and Banking Performance
- CRE Update

Private domestic demand led to acceleration of economic growth in the second quarter

Real GDP,
% change from prior quarter at annual rate



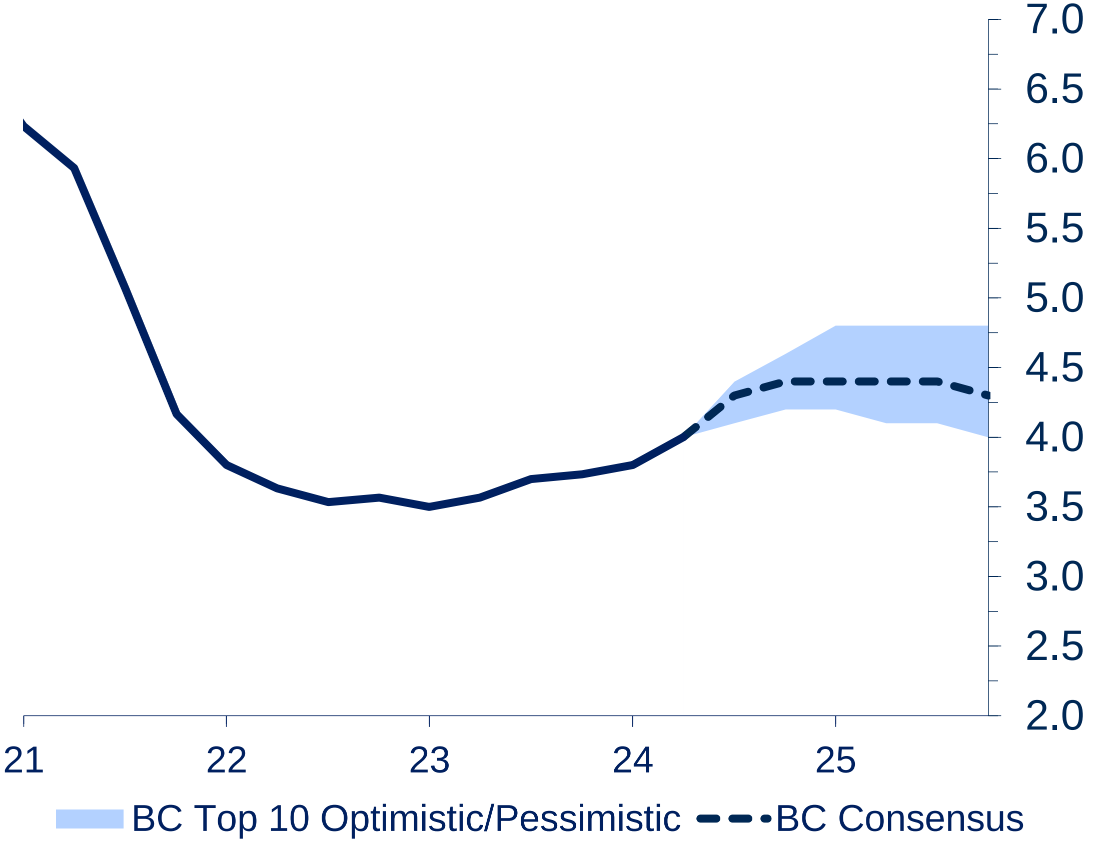
Real Private Domestic Demand,
% change from prior quarter at annual rate



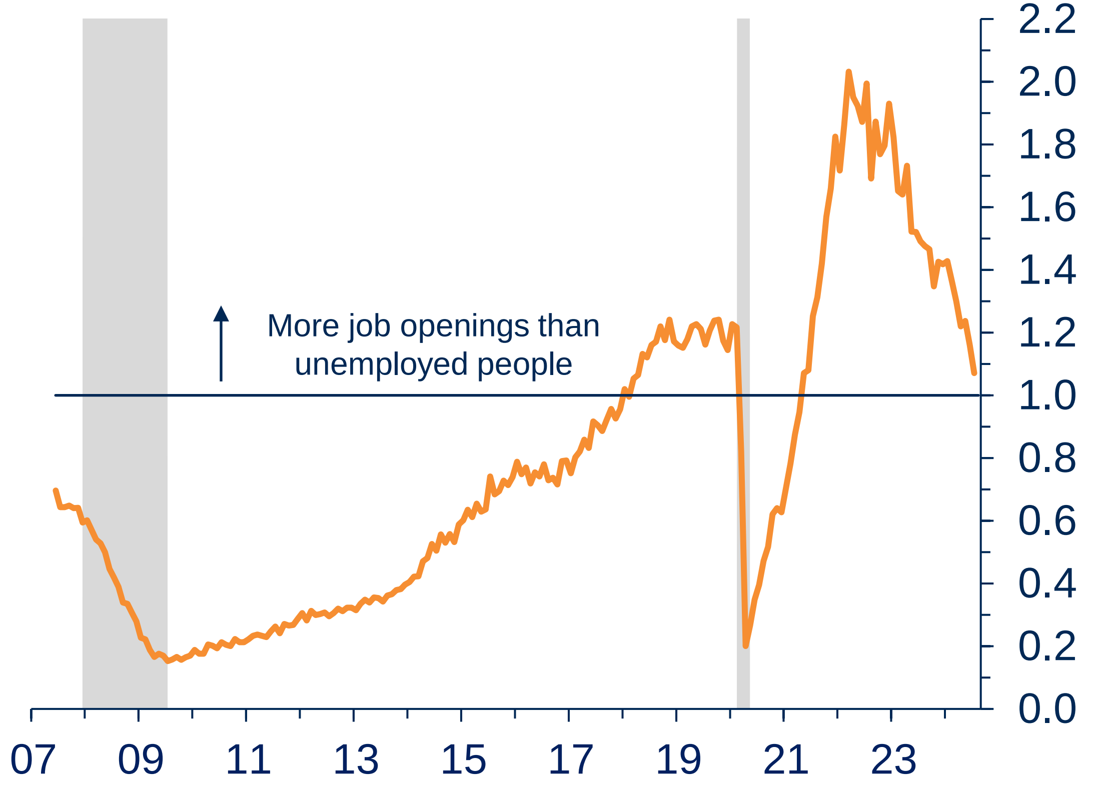
Sources: BEA (2Q:2024); Blue Chip Consensus Forecast (September 2024) Note: Real private Domestic Demand is Final Sales to Private Domestic Purchasers which is the sum of personal consumption expenditures and gross private fixed investment.

The labor market has cooled, bringing it into better balance

Civilian Unemployment Rate, Quarterly Average, Percent



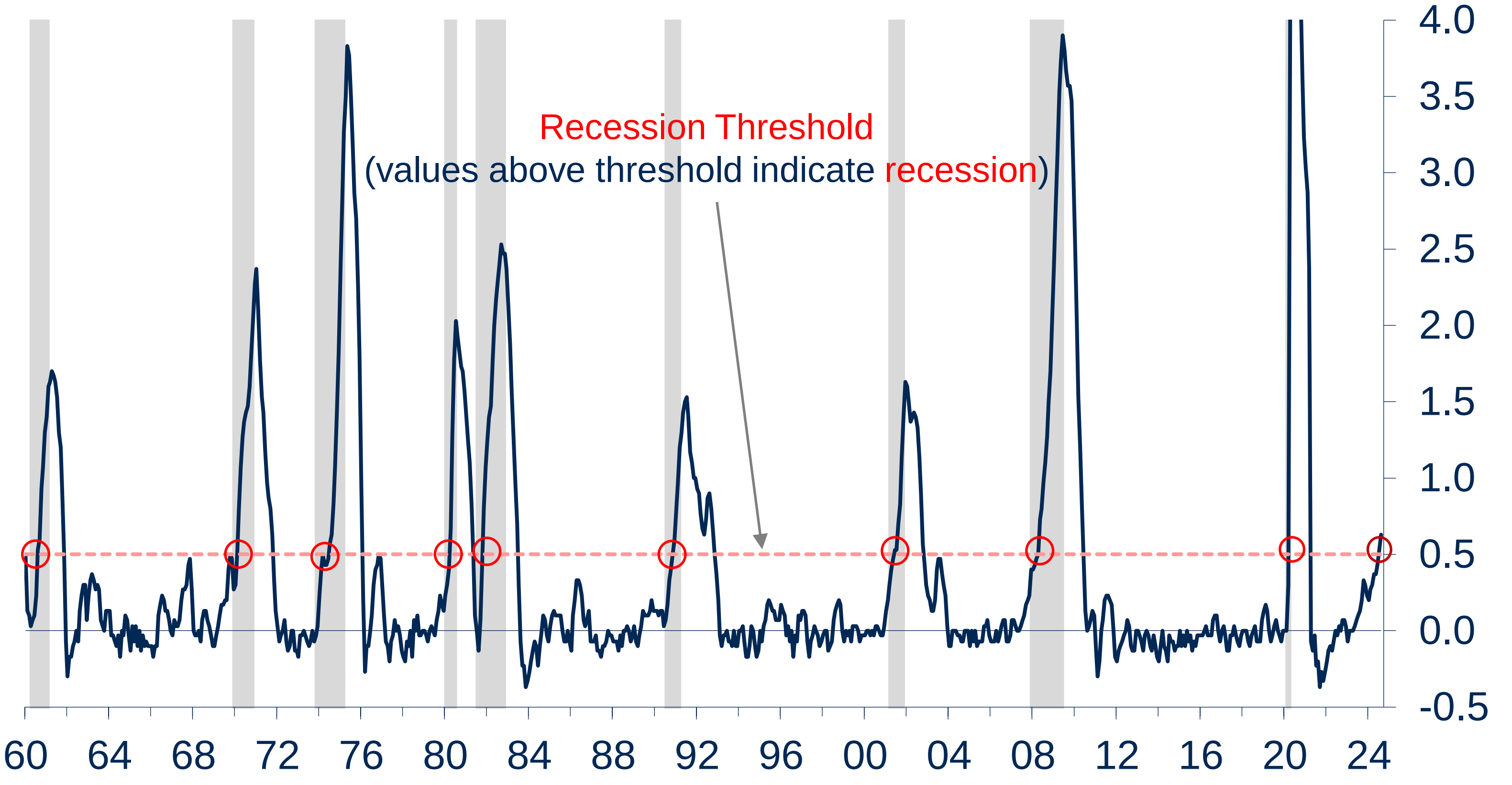
U.S. Total Job Openings to Unemployed Persons



Source: BLS (unemployment rate through 2Q:2024); BLS (August 2024); Blue Chip Consensus (September 2024)

Popular recession indicator, the Sahm rule, flashes warning as unemployment rose

Three-month moving average unemployment rate less the prior 12 month low, percent

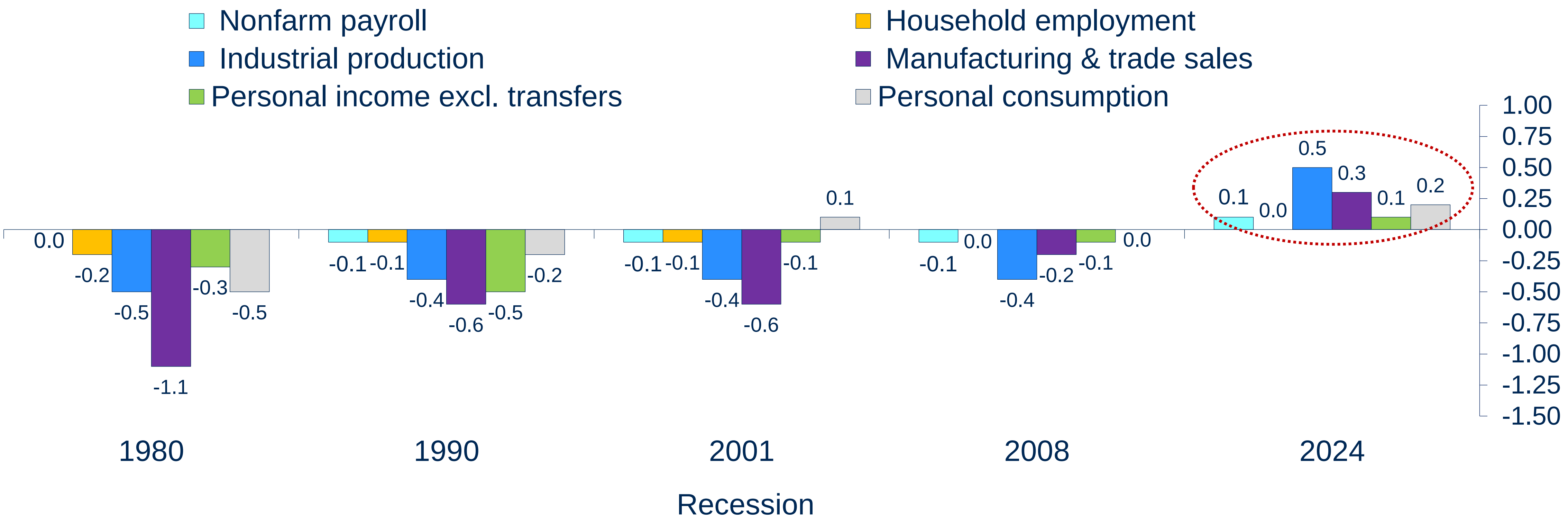


Source: Haver Analytics (data through August 2024)
Note: The unemployment rate (U-3) is the current-time Sahm rule indicator using historically revised data

- The rule states that the economy is ***currently*** in a recession using changes in the total unemployment rate (U-3) well before the NBER cycle dating committee declares the start of a recession
- Indicator shows an empirical pattern, not an economic law
- Rule's creator says it is "likely overstating the labor market's weakening due to unusual shifts in labor supply caused by the pandemic and immigration"

Other common recession indicators report economic growth

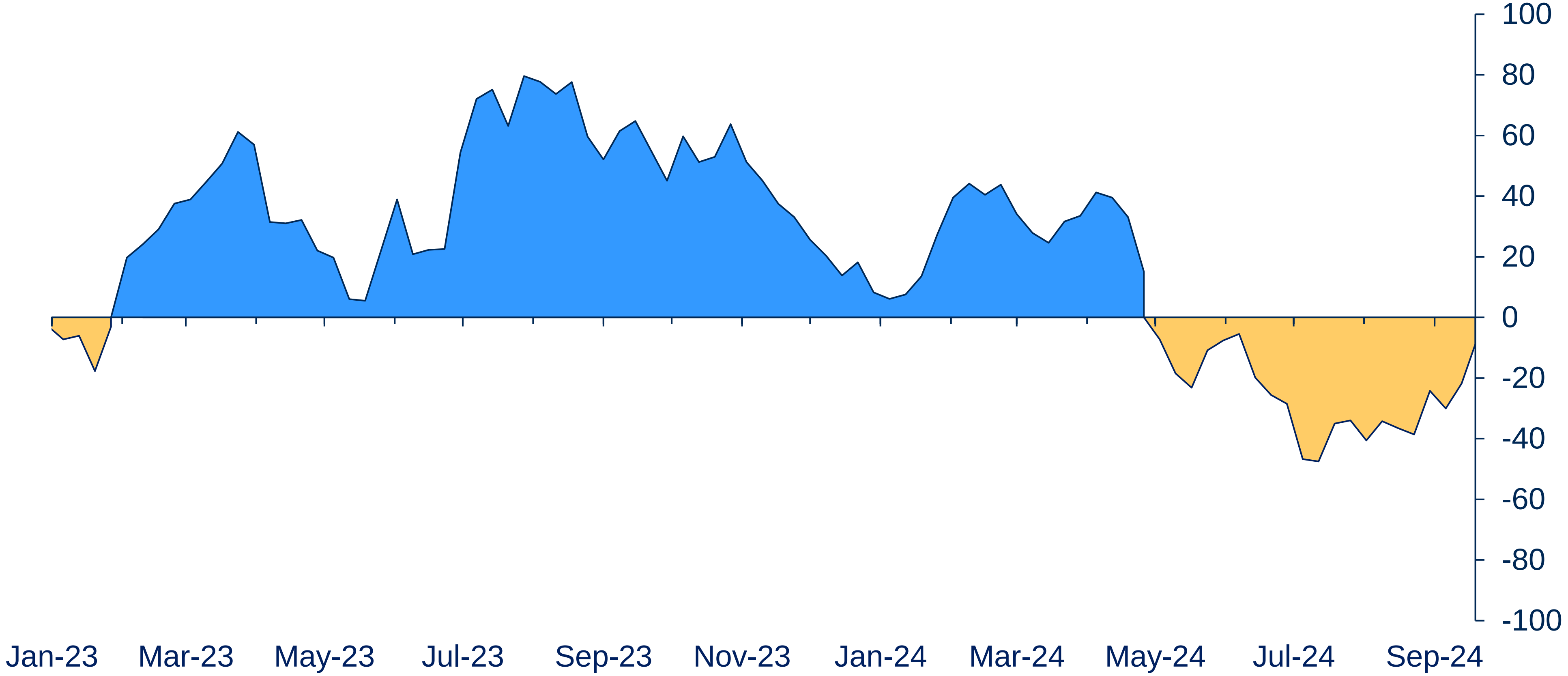
Recession indicators before Sahm rule triggered, average change over four months



Source: Federal Reserve Board (July 2024); BEA (July 2024); BLS (July 2024)
Note: Based on a WSJ analysis where the month-over-month percent change of the four prior months up to, and including, the month the Sahm-rule was triggered. The National Bureau of Economic Research, or NBER, is a private, non-profit, non-partisan organization dedicated to conducting economic research and designated as the official U.S. recession arbiter. According to NBER, a recession is a significant decline in economic activity that is spread across the economy and lasts more than a few months. The six-monthly indicators generally used by the NBER are presented above.

Economic releases were consistently above consensus estimates until Q2 2024 when economic activity cooled more quickly than expected

Citi Economic Surprise Index

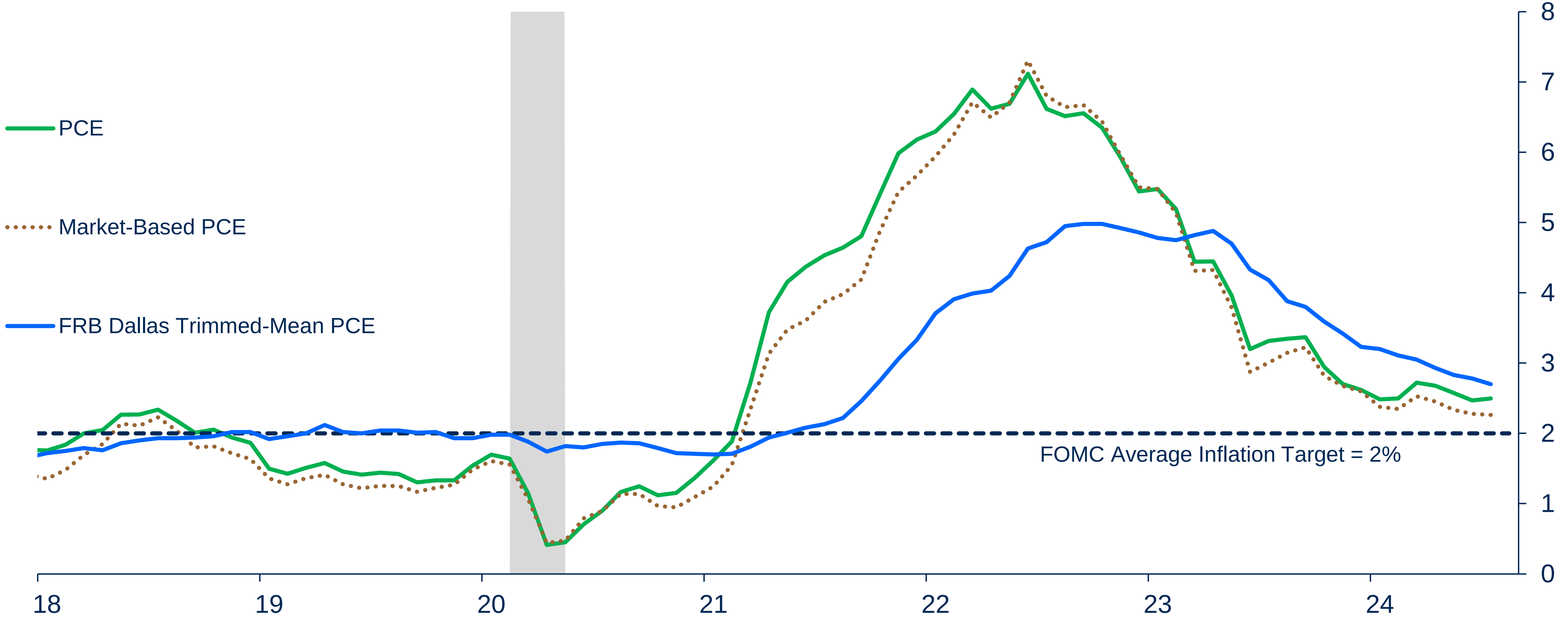


Positive values indicate economic releases above consensus estimates.

Source: Bloomberg; Citibank (September 19, 2024)

Price measures show disinflation progress

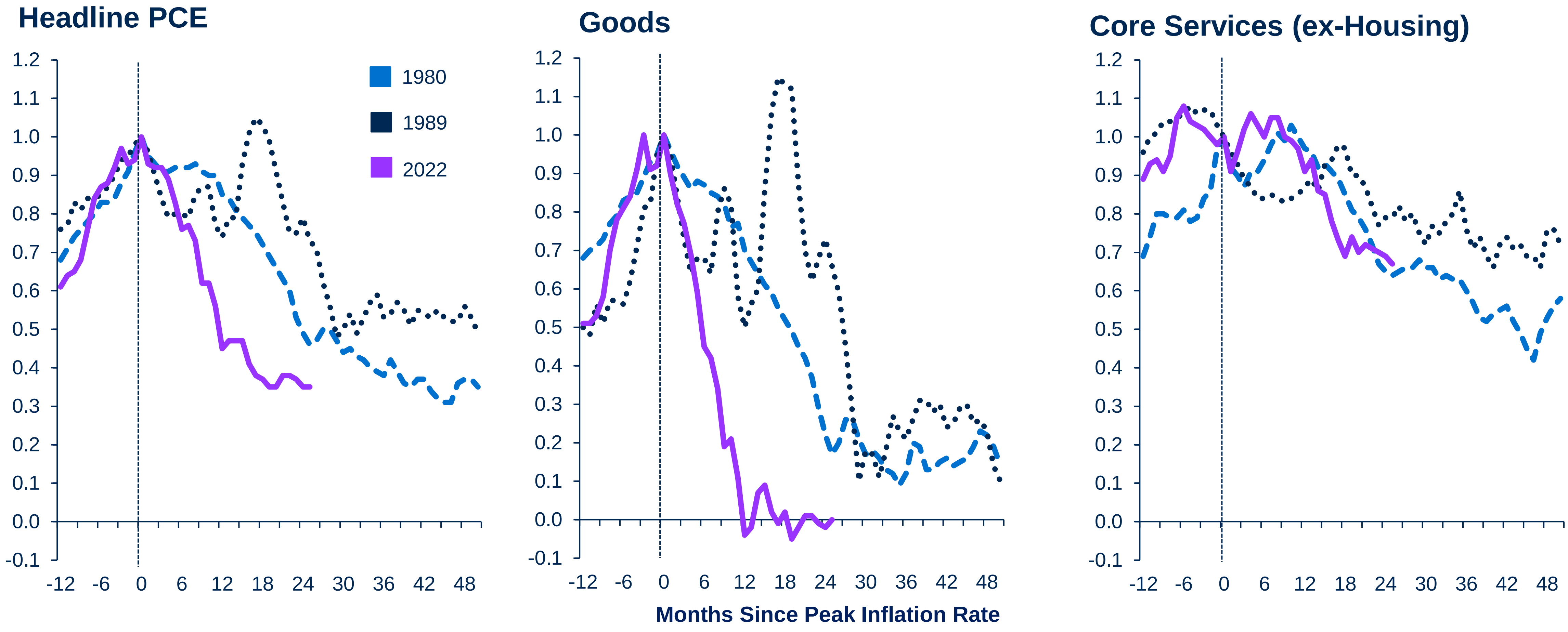
Measures of PCE Inflation, Year-over-Year Percent Change



Source: BEA; Bloomberg; Federal Reserve Bank of Dallas (data through July 2024)

Disinflationary path similar to historical disinflations achieved by tighter policy

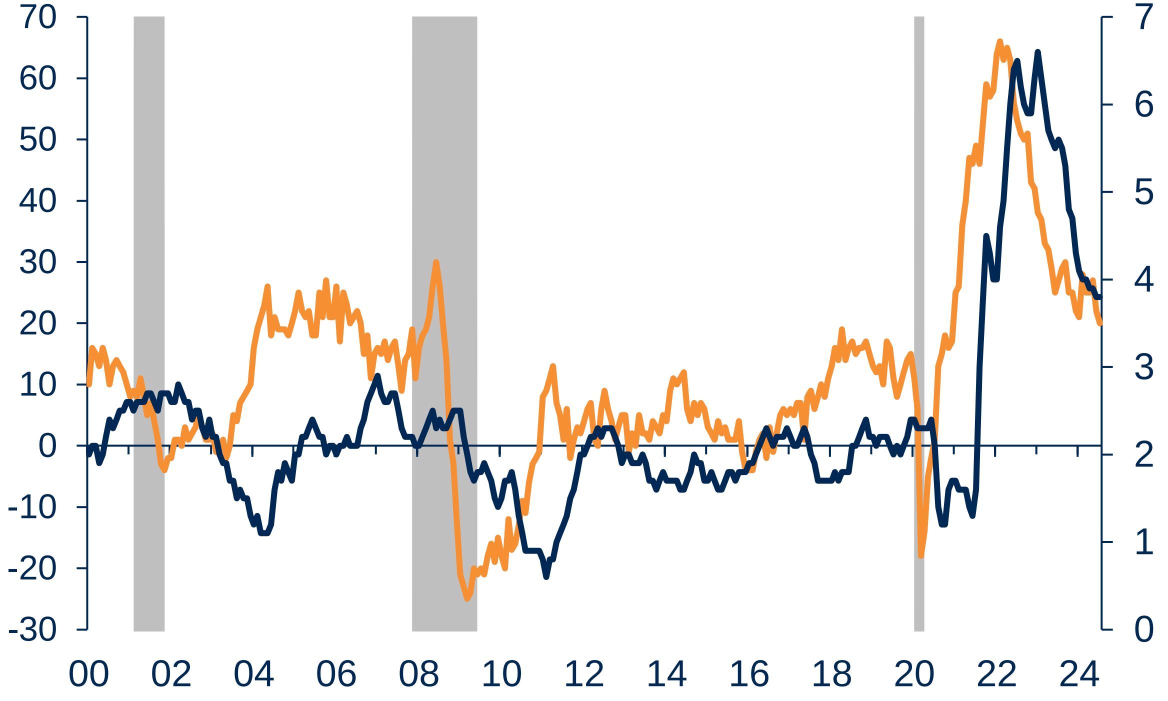
Monthly path of disinflation by component inflation rate (PCE peak by cycle = 1)



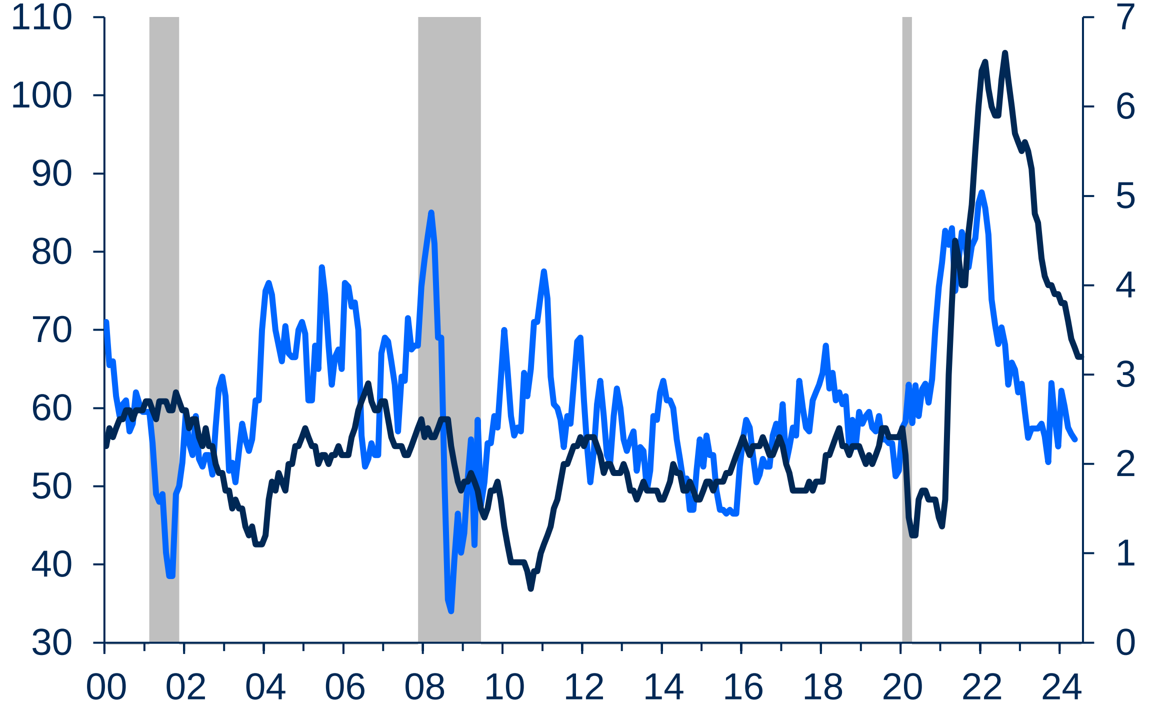
Source: BEA; Haver; E&PA Calculations (data through July 2024)
Note: Year-over-year change in inflation rate indexed to 1.0 at PCE inflation peak by disinflation cycle.

Business surveys of price pressures confirm disinflationary trend

Small Businesses Planning to Raise Prices and Core CPI YoY Percent Change Inflation (5M Lag)



ISM Prices Paid (2M Leading) and Core CPI YoY Percent

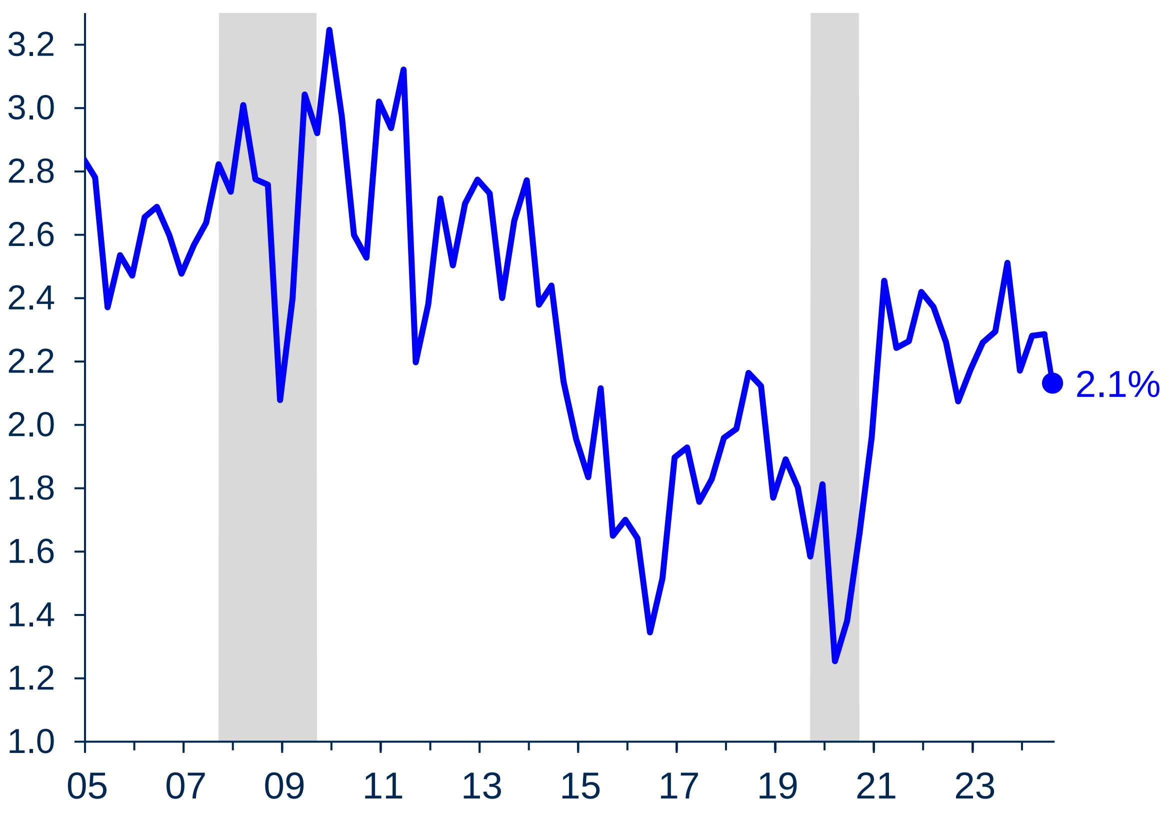


Source: BLS (August 2024); Federal Reserve Board of Governors (July 2024), NFIB Full Survey Results (August 2024)

Measures of inflation expectations are off their expansion highs

Common Inflation Expectation (CIE), Percent

5Y Forward 5Y Breakeven Inflation Rate , Percent



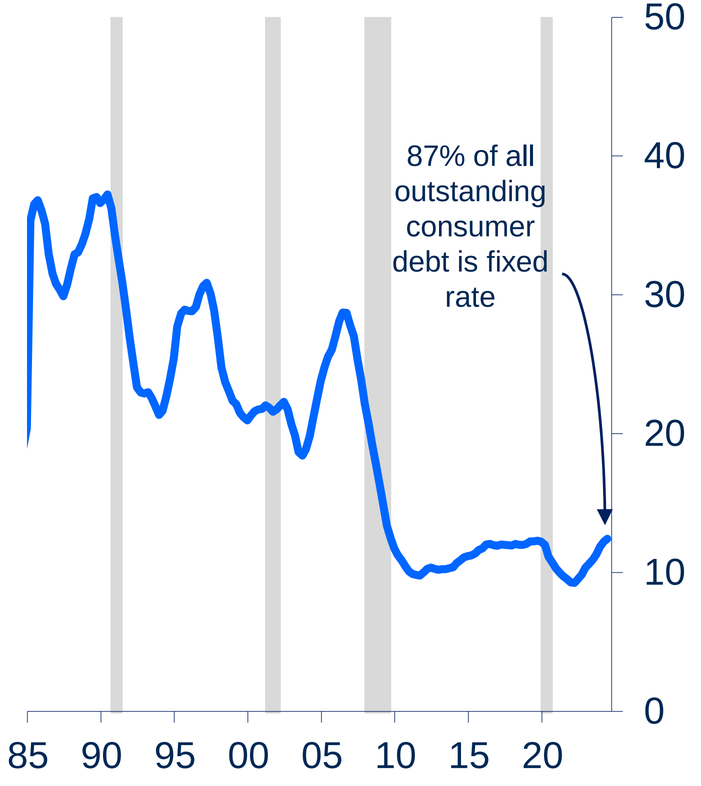
Source: Federal Reserve Board of Governors, Bloomberg (August 2024)
Note: See Ahn, Hie Joo, and Chad Fulton (2020). "Index of Common Inflation Expectations," FEDS Notes. Washington: Board of Governors of the Federal Reserve System, September 02, 2020, https://doi.org/10.17016/2380-7172.2551

Agenda

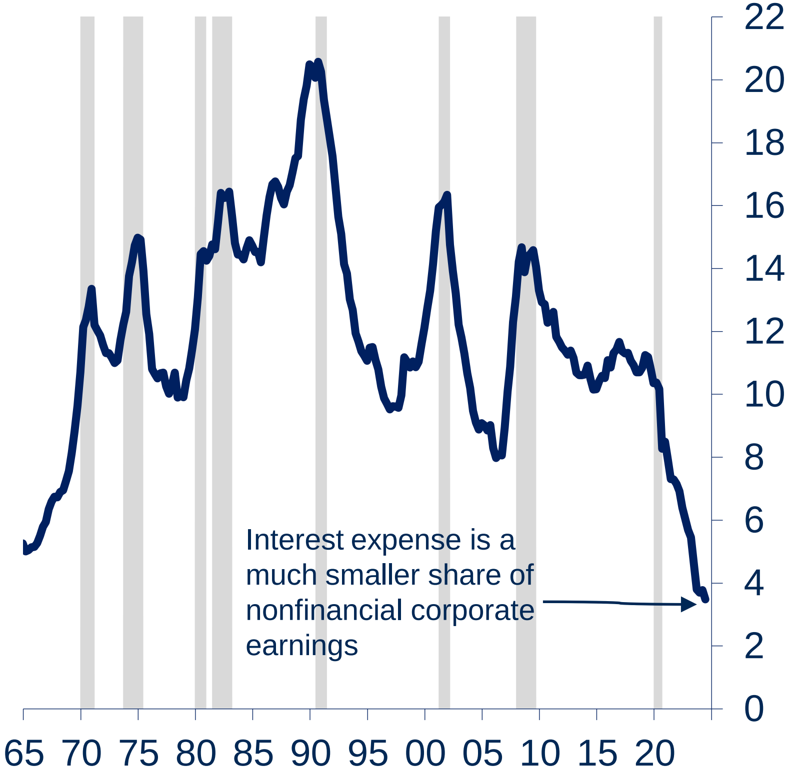
- U.S. Economic Conditions
- Macro Financial Dynamics and Banking Performance
- CRE Update

Why are high interest rates not slowing economic activity more? Firms and households are less sensitive to rising rates

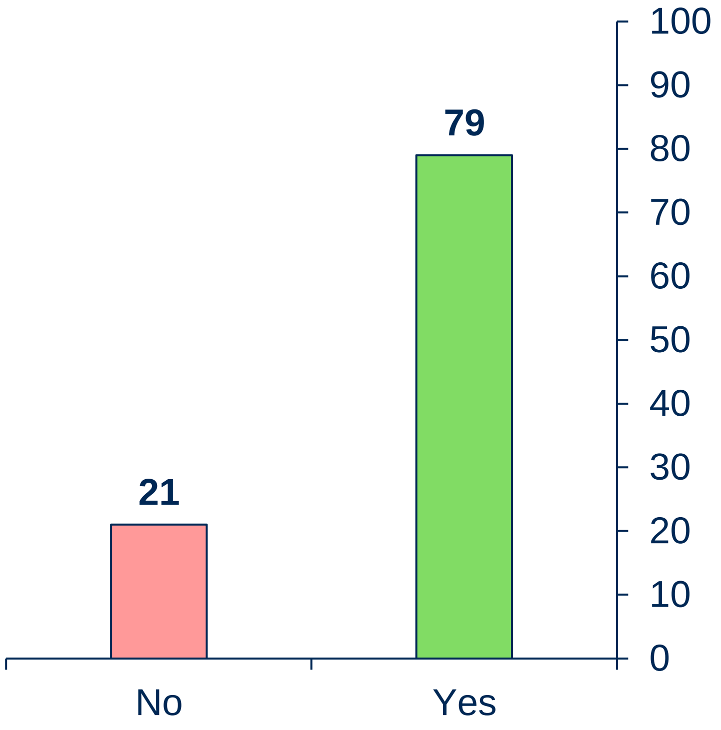
Share of household debt that adjusts with market interest rates, %



Nonfinancial corporate business net interest expense as a share of profits before taxes, %



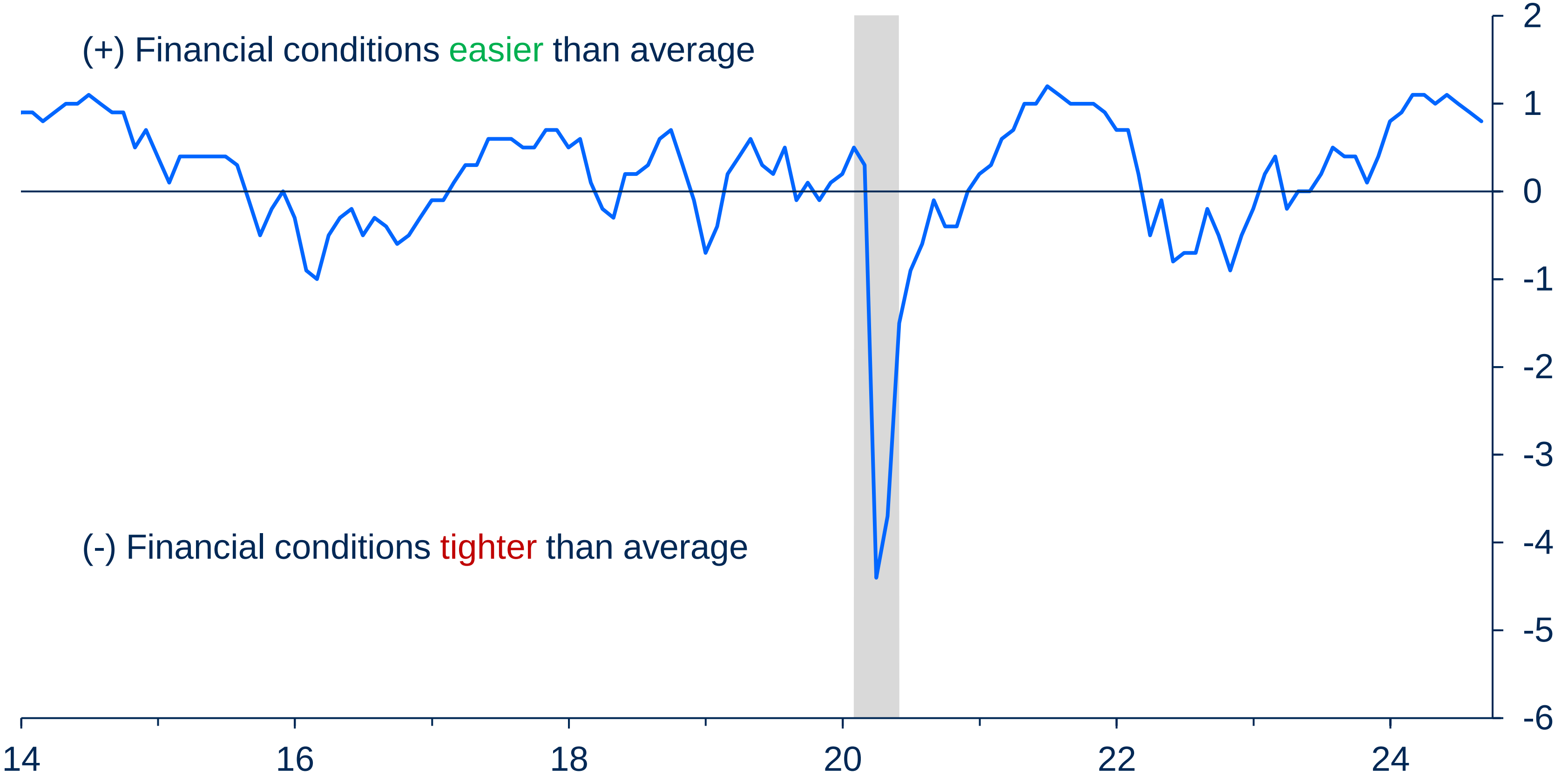
Has the U.S. economy yet to feel previous interest rate hikes? BC Respondents, Percent



Sources: Moody's Analytics (data through Q2 2024); Federal Reserve Board Financial Accounts (Z.1 – Q2 2024); Blue Chip Consensus (September 2024)
Note: Nonfinancial corporate net interest includes miscellaneous payments. Corporate profits before taxes is adjusted for inventory valuation and capital consumption (IVA and CCAdj)

Broader financial conditions eased over the past year as market participants priced slowing QT and rate cuts

U.S. Financial Conditions Index

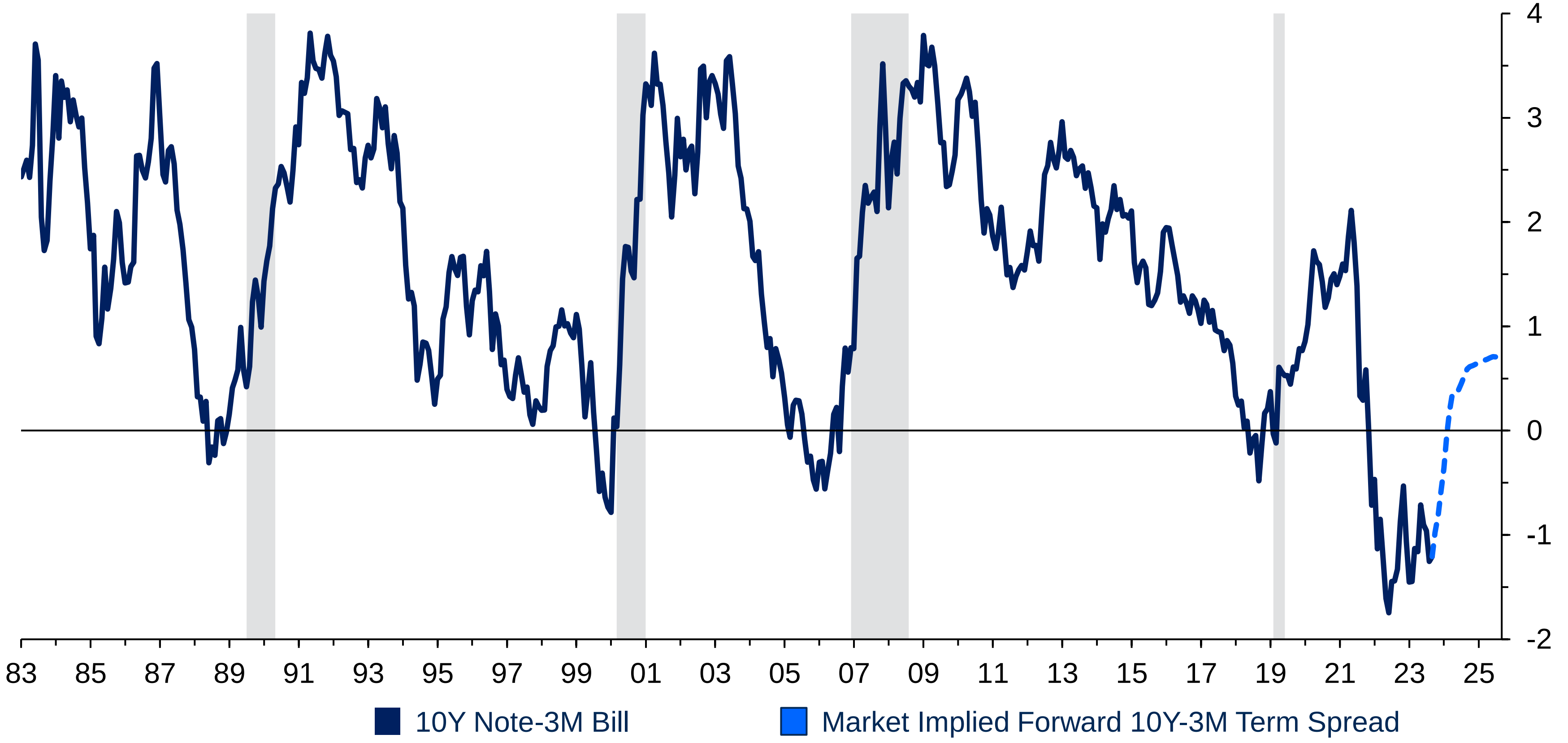


Source: Bloomberg (August 2024); Monthly averages of daily data
Note: The U.S. Financial Conditions Index tracks the overall level of financial stress in the U.S. money, bond, and equity markets to help assess the availability and cost of credit. A positive value indicates accommodative financial conditions while a negative value indicates tighter financial conditions relative to pre-2008 crisis norms.

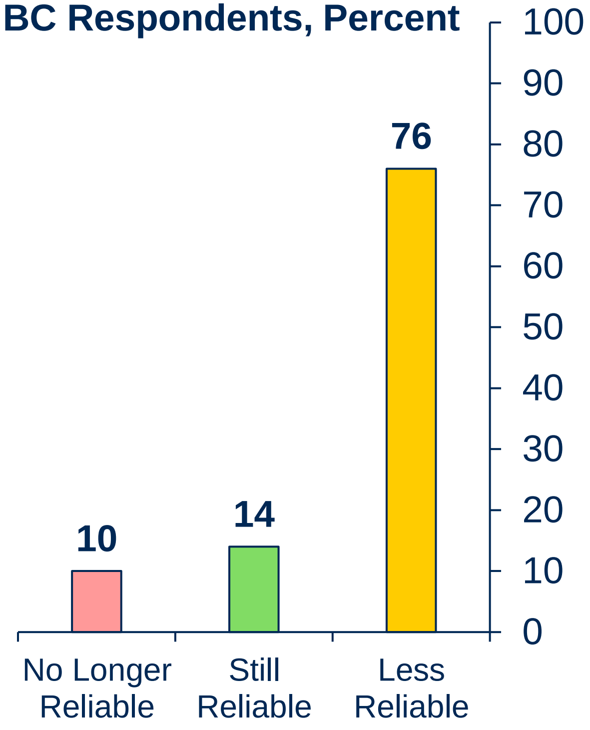
- Financial conditions are historically easy as markets priced in a Fed pivot in the third and fourth quarter
- Record equity market highs, favorable commercial paper spreads, low foreign exchange rate volatility, and tight credit spreads have all contributed to favorable conditions

Is this time different? Similar to the Sahm rule, Treasury term spreads are signaling recession too, but forward markets imply rapid steepening

Treasury Term Spreads, Percent



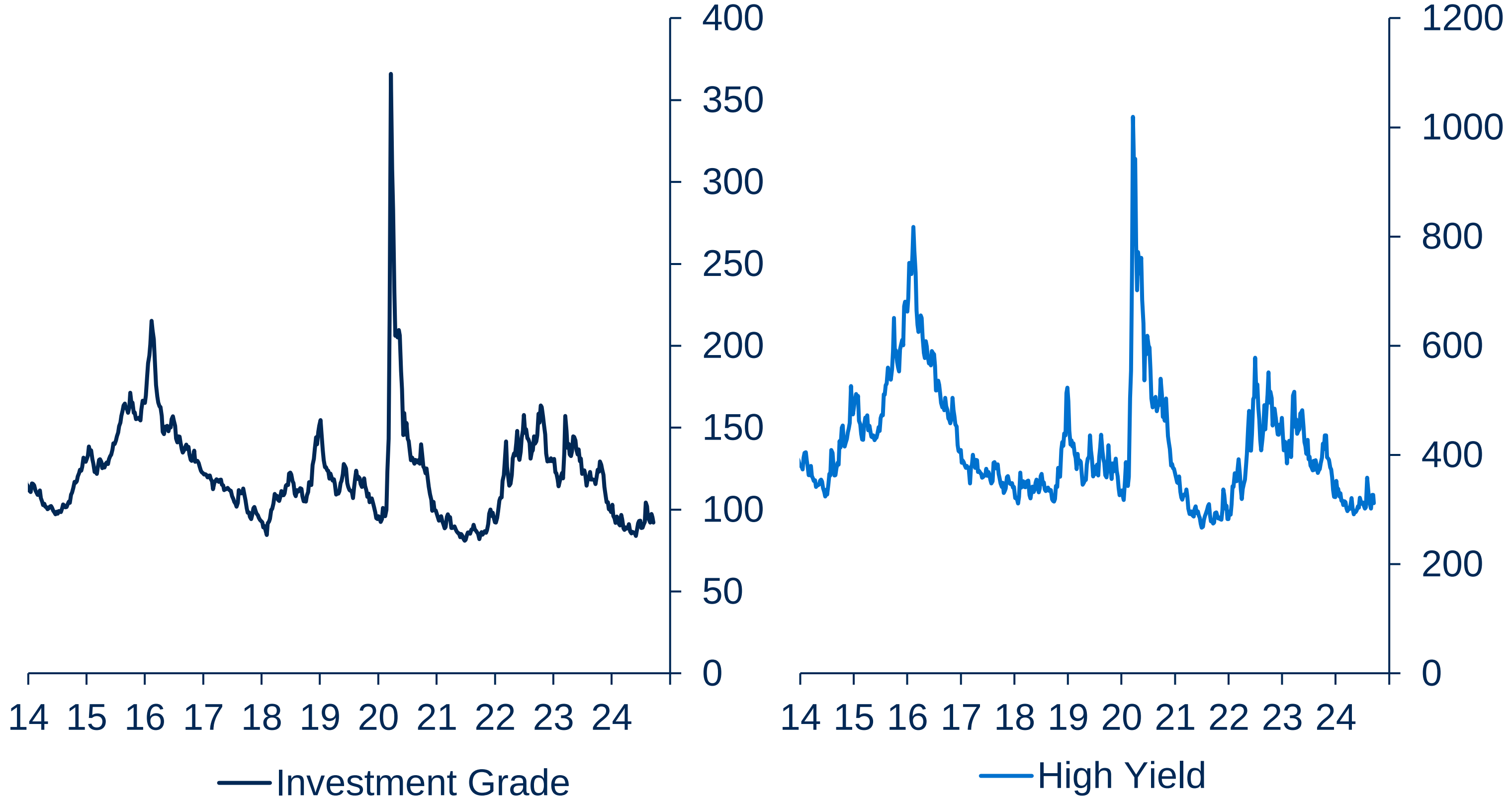
Is the 10Y-3M Treasury Term Spread still a dependable recession indicator?
BC Respondents, Percent



Source: U.S. Department of theTreasury; Bloomberg (September 19, 2024). Forward implied rate based on data for end of month forward Treasury rates.

Corporate spreads are near decade lows as recession risks are priced as a low probability outcome; credit stress is in the 14th percentile

U.S. Corporate Bond Risk Premia by Rating, Option Adjusted Spread (OAS)

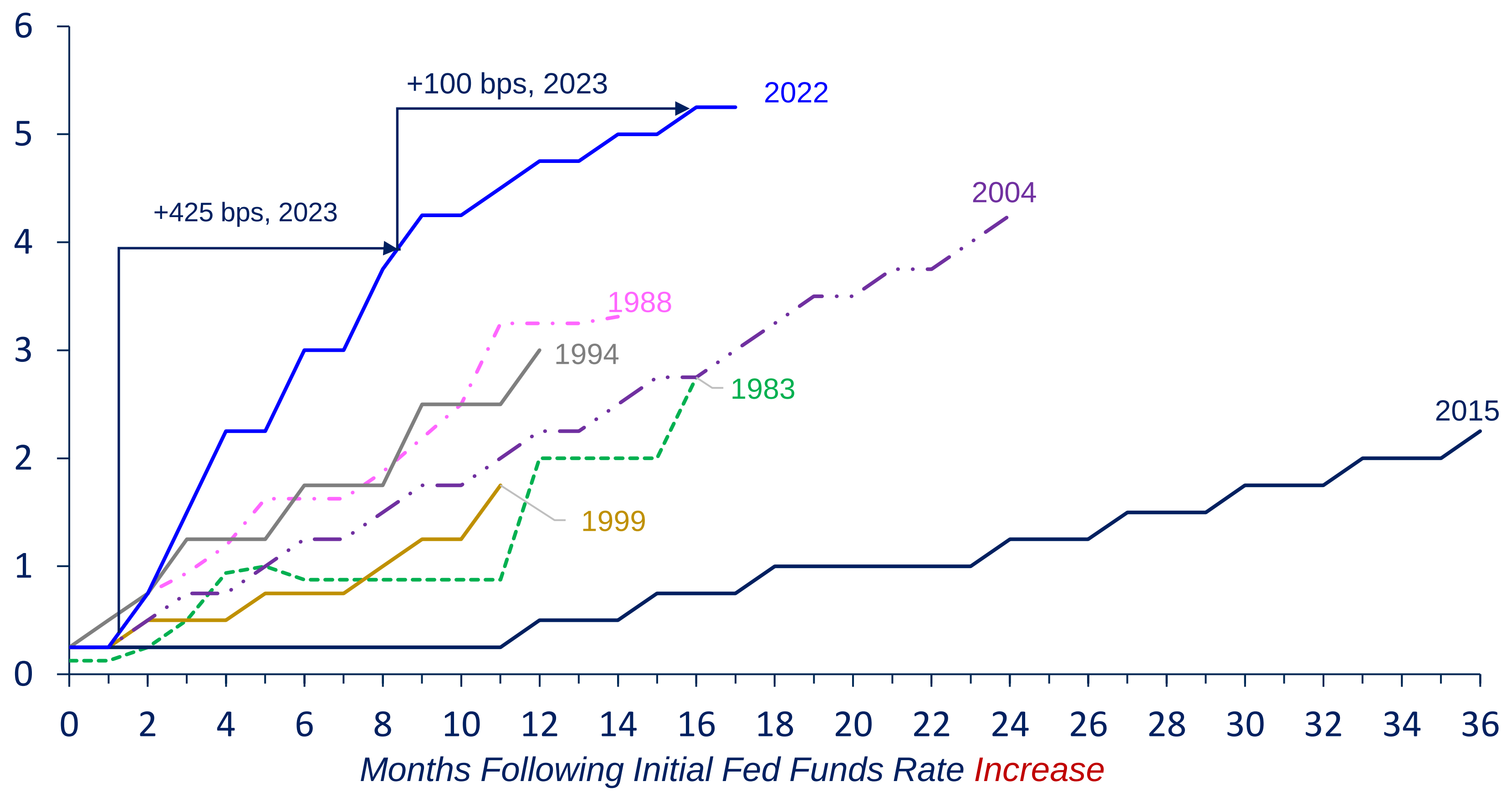


U.S. Corporate Bond Market Distress Index, Percentile

Source: Bloomberg (September 13, 2024); Federal Reserve Bank of New York (August 23, 2024)

The 2022 tightening cycle was the sharpest in 40 years

Cumulative Change in Fed Funds Rate During Tightening Cycle, Percent

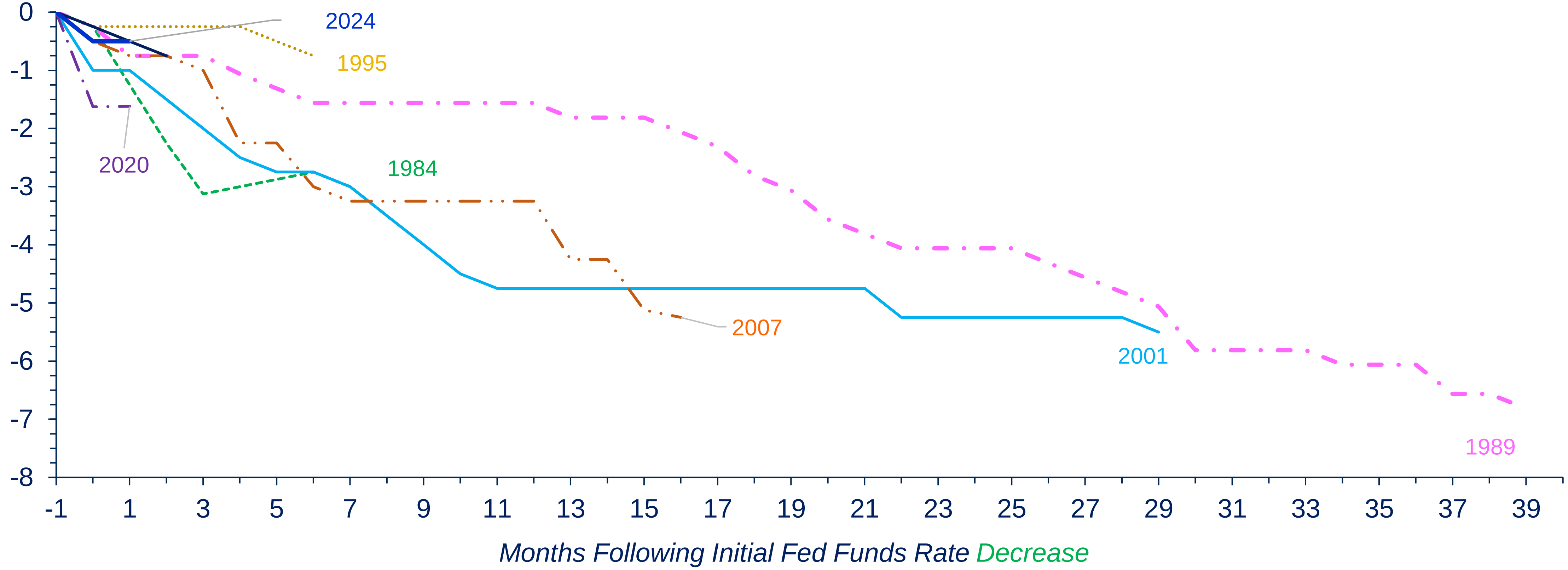


Source: Federal Reserve Board; Haver Analytics. OCC E&PA Calculations.
Note: Post-Volcker disinflation (1982) tightening cycles included.

- The Federal Funds rate increased by 425 bps in 2022 and an additional 100 bps in 2023 for 525 bps total
- These increases where the steepest in 40 years
- Forecasters expected to see a greater slowdown in consumption and labor market demand, which only (modestly) occurred in the last few months

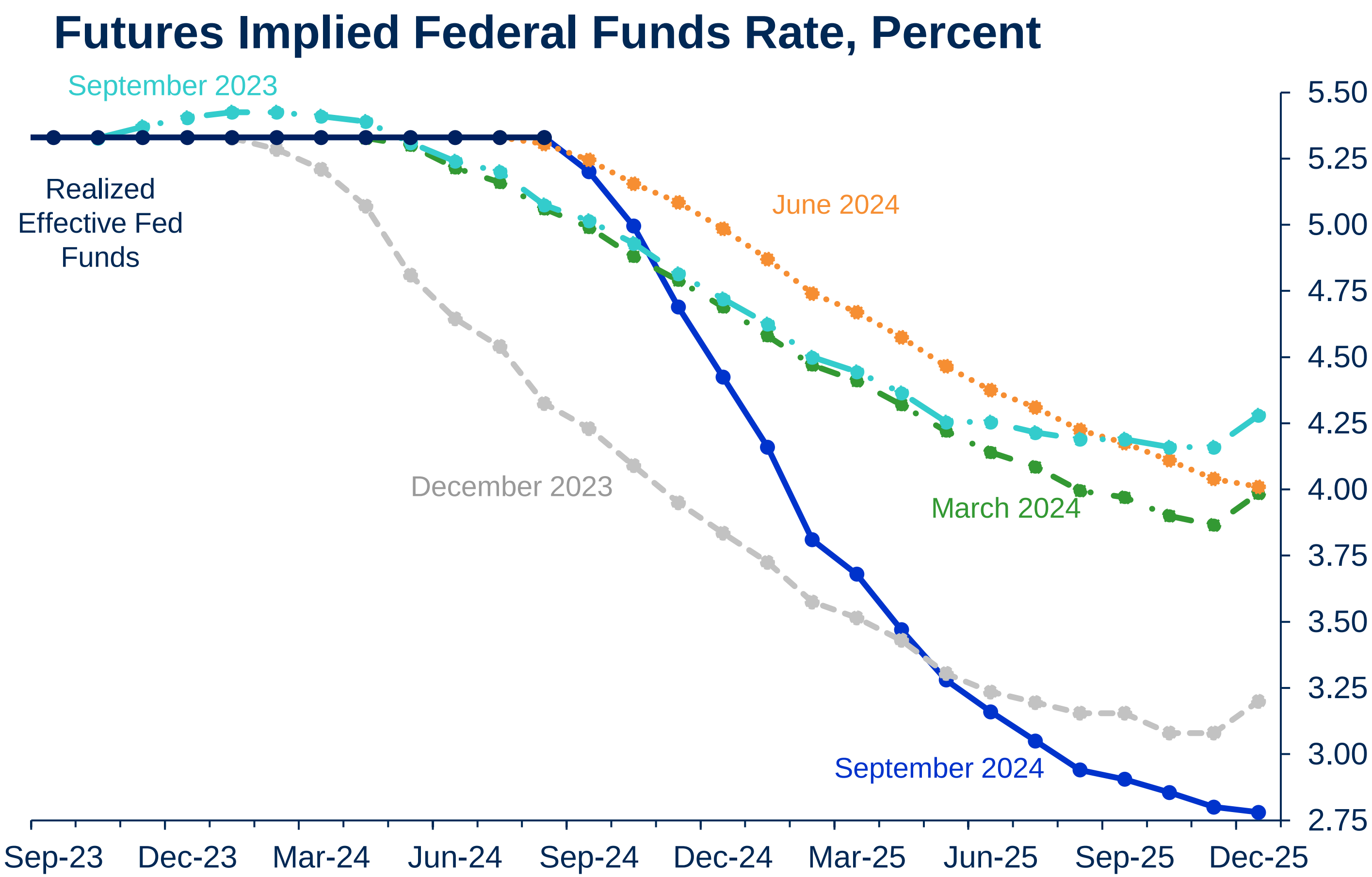
The Fed started reducing interest rates in September 2024 with a 50bps cut, but the pace and magnitude varies by easing cycle

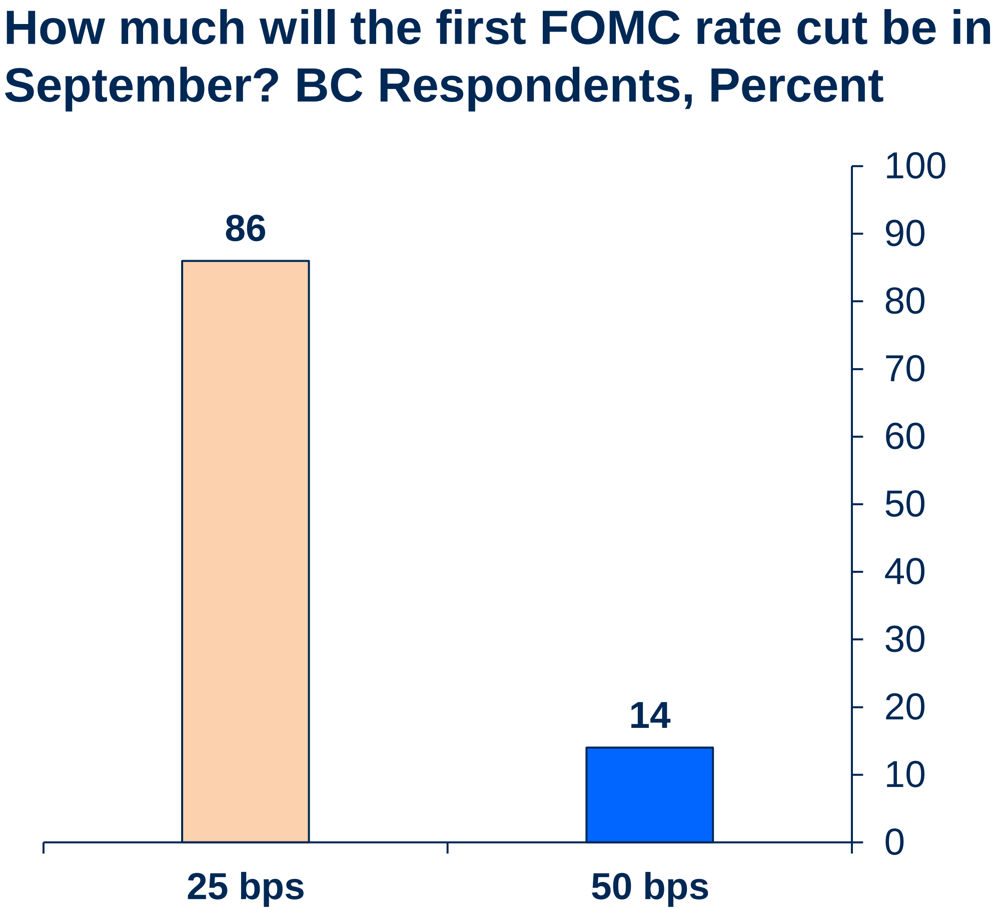
Cumulative Change in Fed Funds Rate During Easing Cycle, Percent



Source: Federal Reserve Board; Haver Analytics. OCC E&PA Calculations. Note: Post-Volcker disinflation easing cycles included. Intermeeting 25 basis point cut in 1998 due to the failure of Long-Term Capital Management (LTCM) excluded.

Futures market participants priced an aggressive easing cycle; only 14 percent of economists surveyed predicted a 50 bps cut

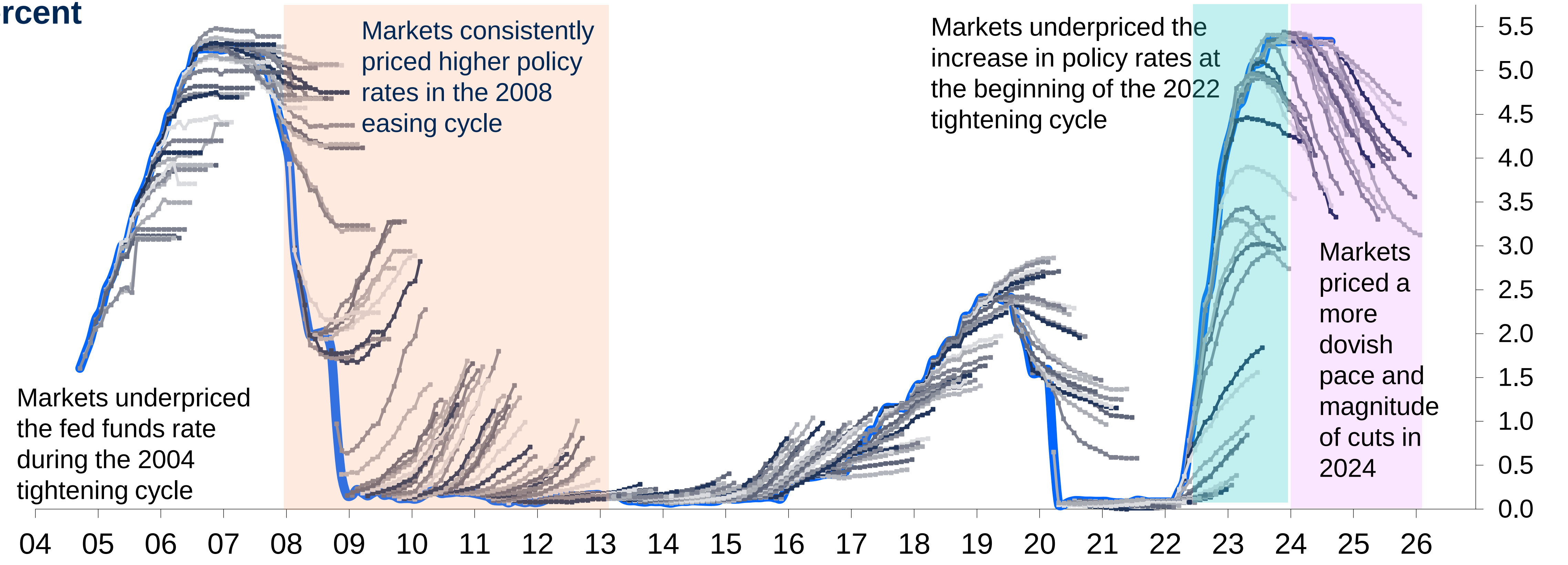




Source: Chicago Board of Trade; Bloomberg; Blue Chip Consensus (September 10, 2024); Note: 30-day Fed Funds Futures expiring on future horizons; 100% of forecasters surveyed by Blue Chip Consensus expected the FOMC to cut interest rate at their September 18, 2024 meeting

Futures market pricing of (expected) policy rates, however, have historically missed the mark

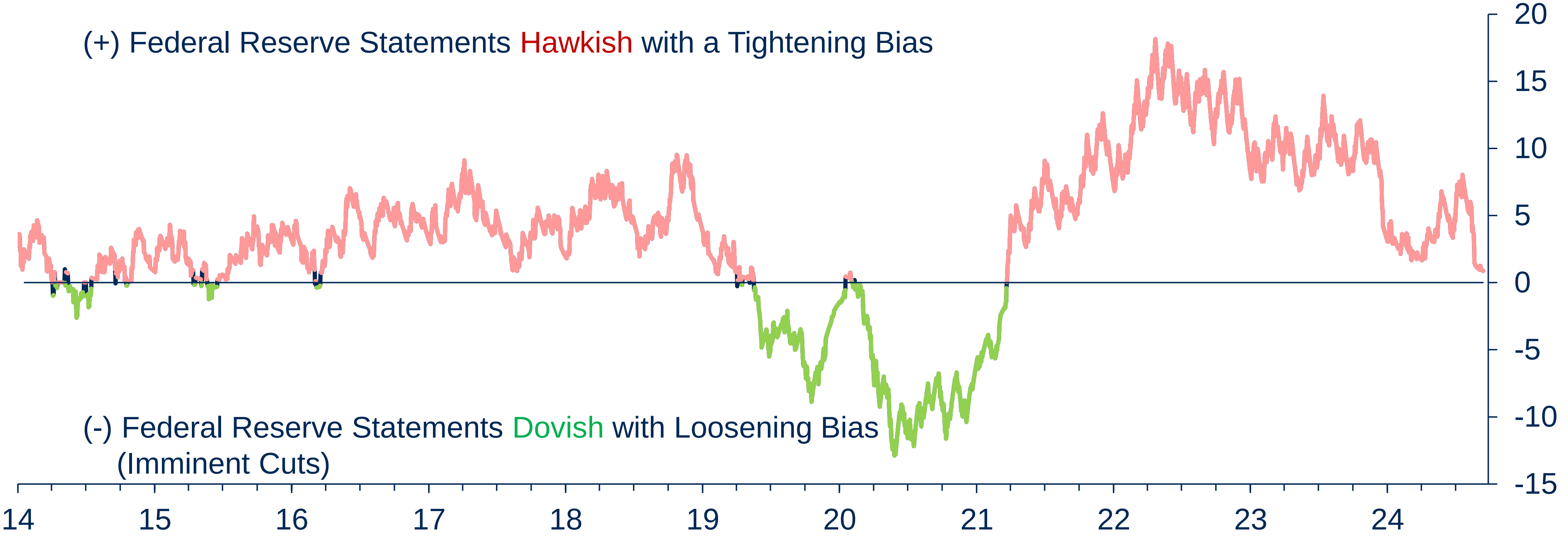
Implied Federal Funds Rate from Spot and Futures Prices, 18 Month Horizon by Contract Date, Percent



Source: Chicago Board of Trade; Bloomberg (End of Month, August 2024); E&PA Calculations
Note: 30-day Fed Funds Futures Curves by historical spot date; up to 18-month maturity shown for each curve (shown in grey); Spot front month (FF1) pricing is shown in blue.

Hawkish rhetoric with an inflation bias has shifted to a neutral stance even as the Fed started cutting interest rates

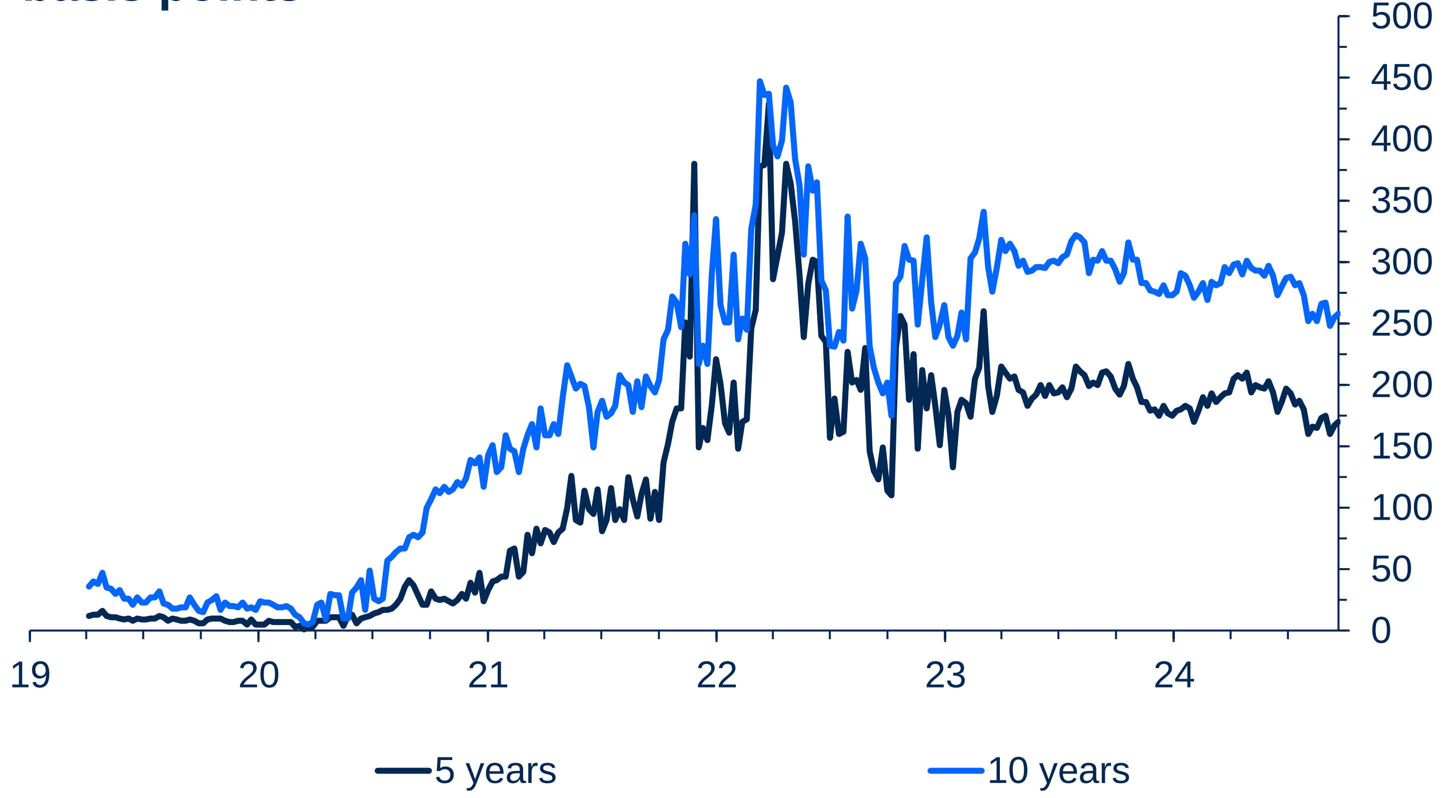
Natural Language Processing (NPL) Model Fed Speak Index



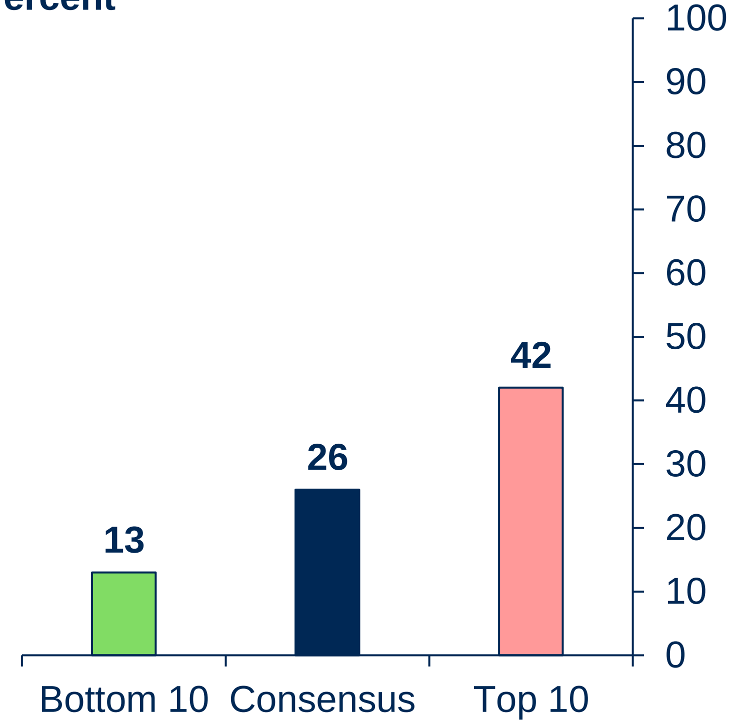
Source: Bloomberg Economics (September 18, 2024)
Note: Bloomberg developed a natural processing model trained on more than 60,000 Fed headlines. This index is updated daily

Swap market pricing of hedges for above target inflation over the next 5-10 years suggesting inflation tail risk; forecasters see a modest risk of a rebound in inflation

Cost to hedge bonds for inflation above 3 percent by maturity, basis points



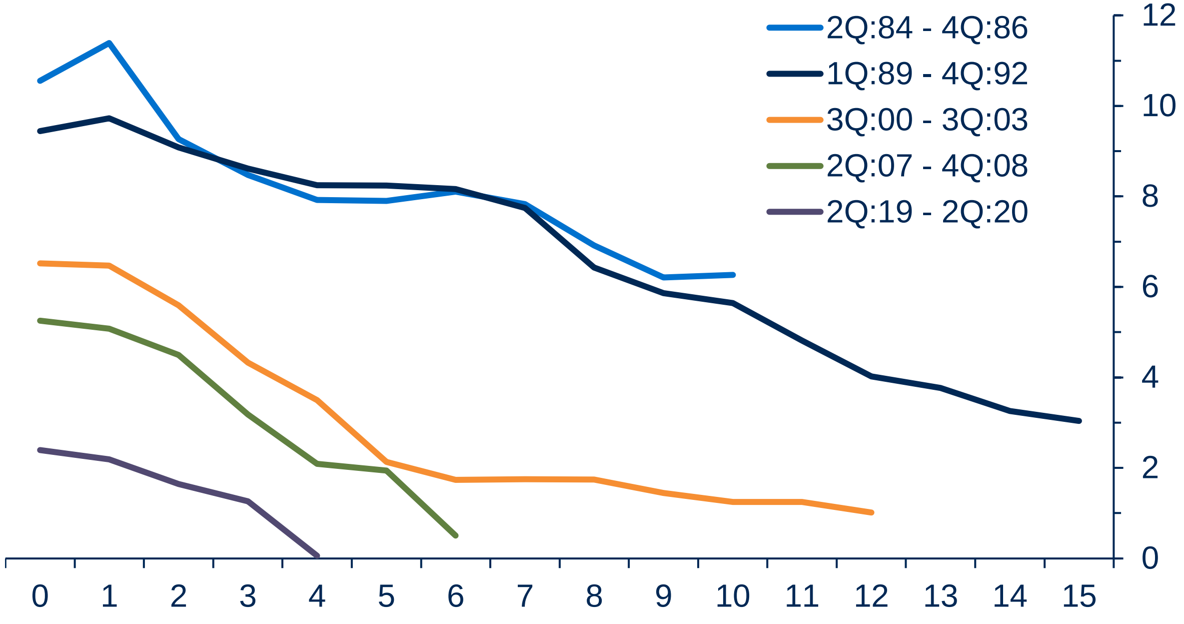
What is the probability that inflation readings turn up again in the second half of the year? Percent



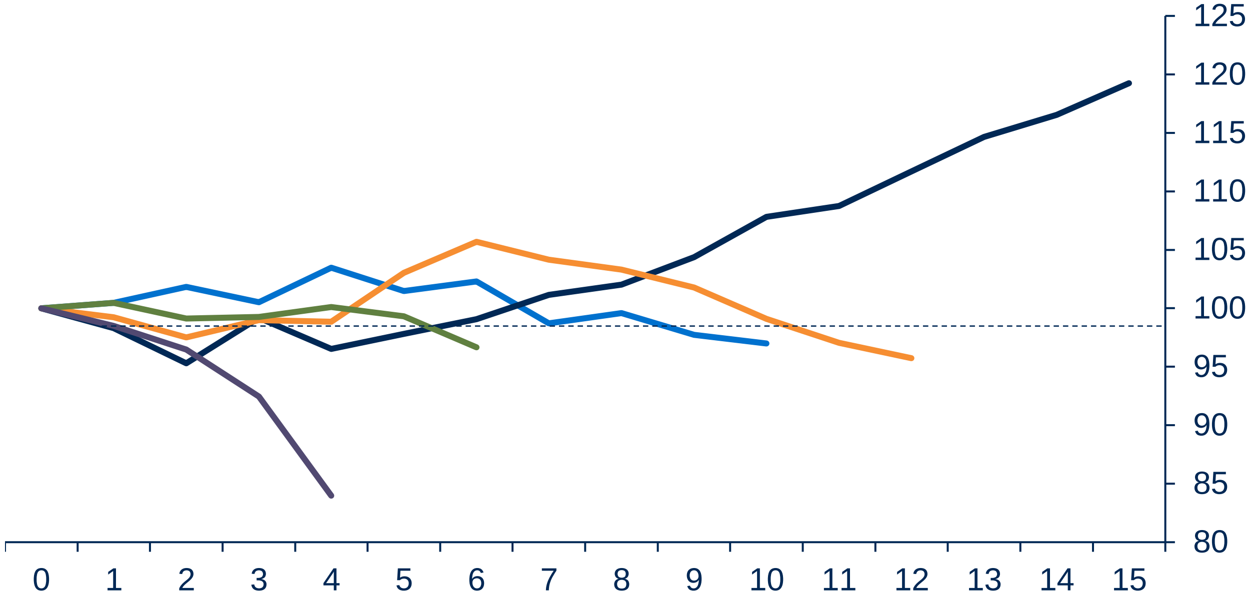
Source: Bloomberg (September 13, 2024); Blue Chip Consensus (September 2024)
Note: U.S. dollar inflation zero coupon inflation swap rate capped at three percent for both 5-year and 10-year horizons

NIM has generally moved together with interest rates in easing cycles, with the 1989 cycle being the notable outlier

Federal Funds Rate by Easing Cycle, Percent



FDIC-insured federal commercial banks NIM, Index



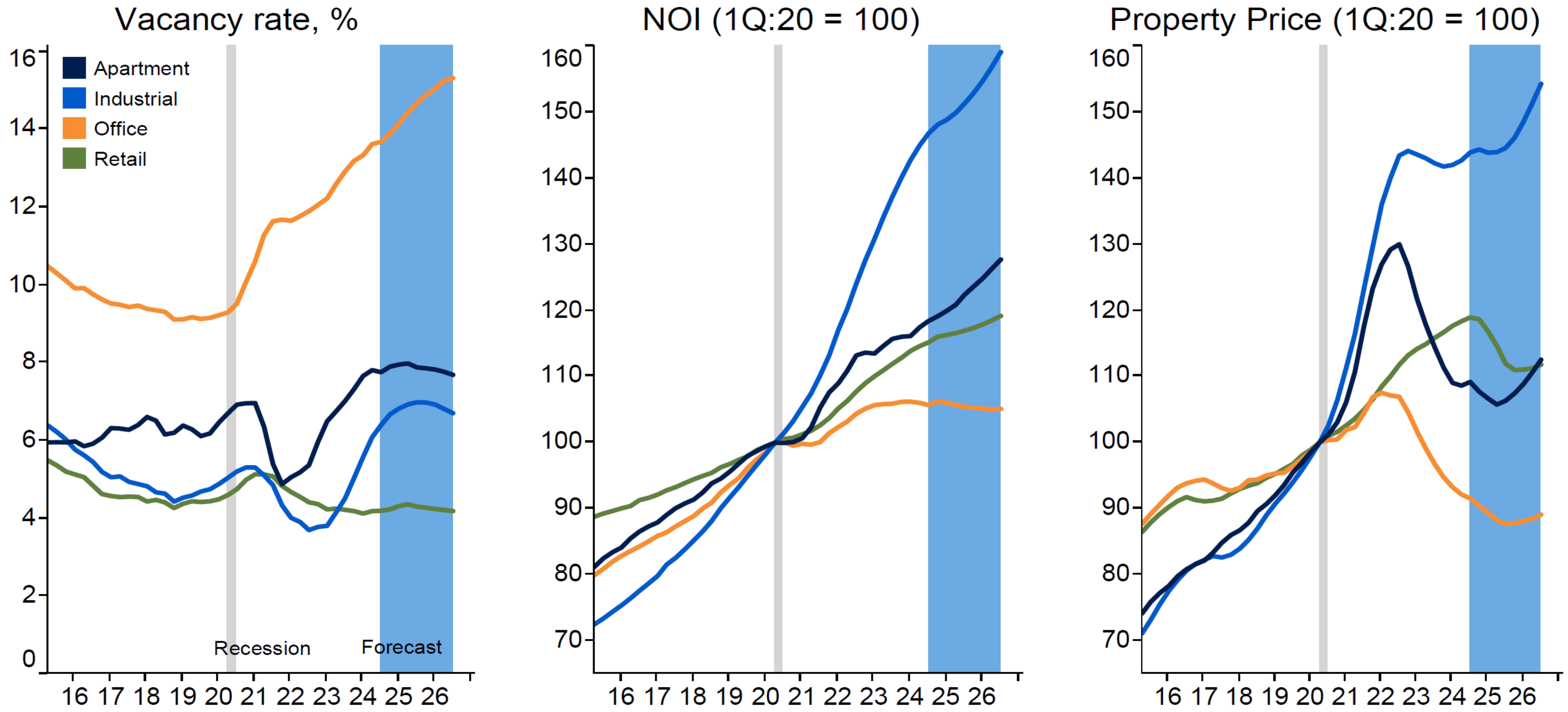
Source: Call Reports from OCC Integrated Banking Information System, Federal Reserve Board
Notes: Data are quarterly and merger adjusted for institutions in continuous operation within each rate cycle, and exclude specialists

Agenda

- U.S. Economic Conditions
- Macro Financial Dynamics and Banking Performance
- CRE Update

Office sector vacancies are forecast to increase, peaking in 2027; multifamily sector expected to stabilize

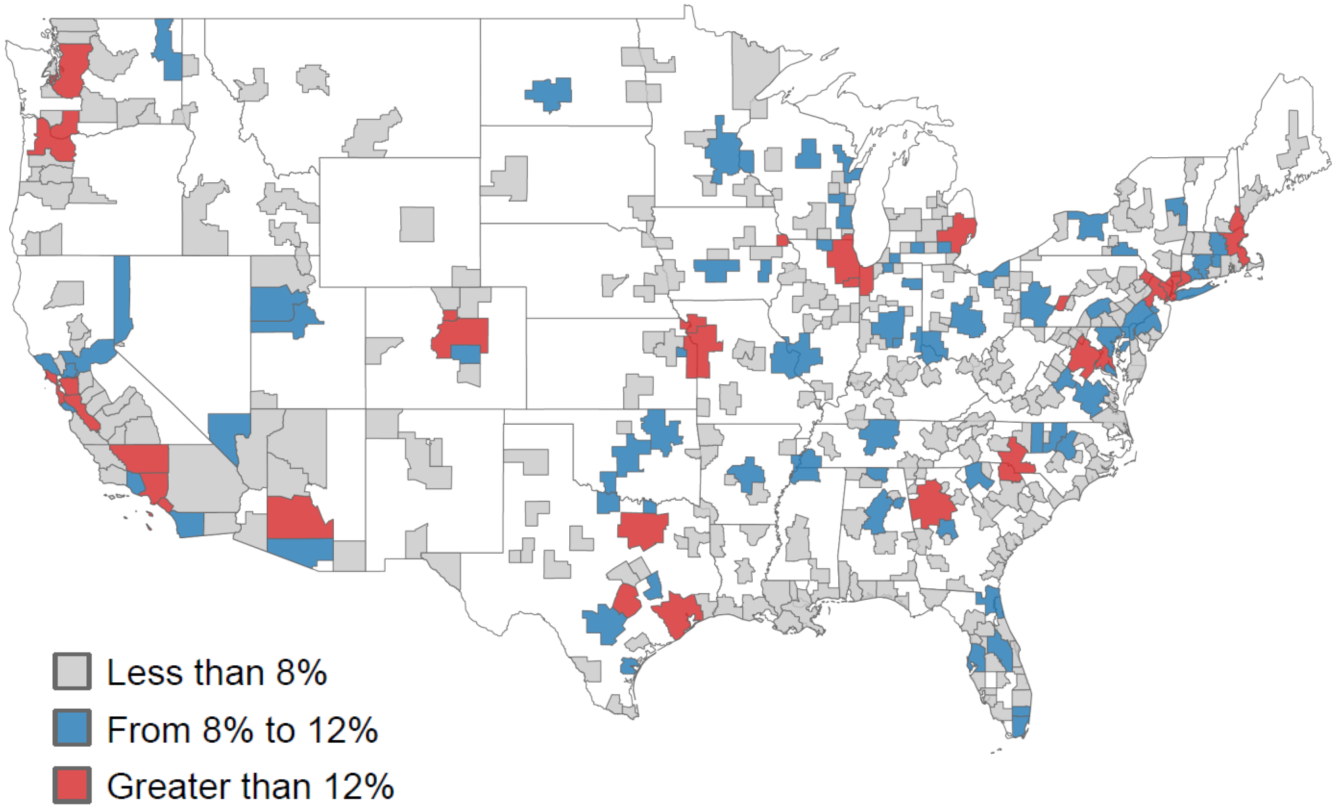
National CRE market fundamentals



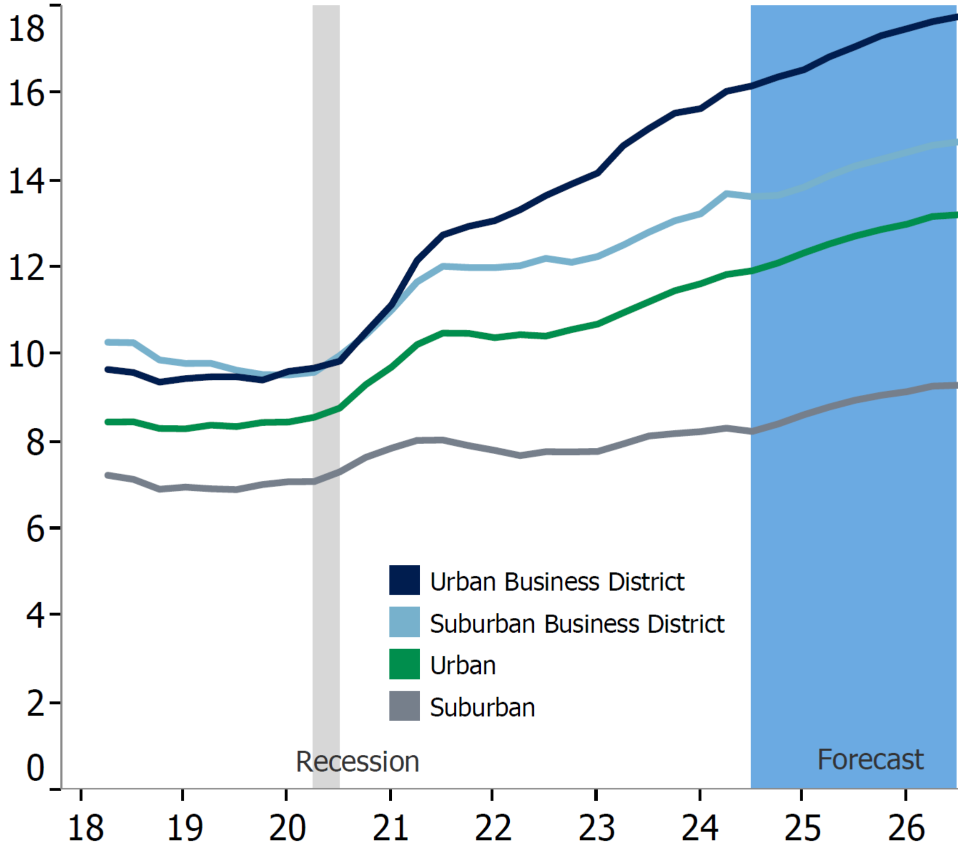
Source: CoStar Group (historical data through 2Q:2024, baseline forecast updated in July 2024)

Office vacancy rates are highest in the largest metropolitan areas, where urban & suburban business district fundamentals deteriorated most

U.S. office vacancy rate in 2Q:2024, %



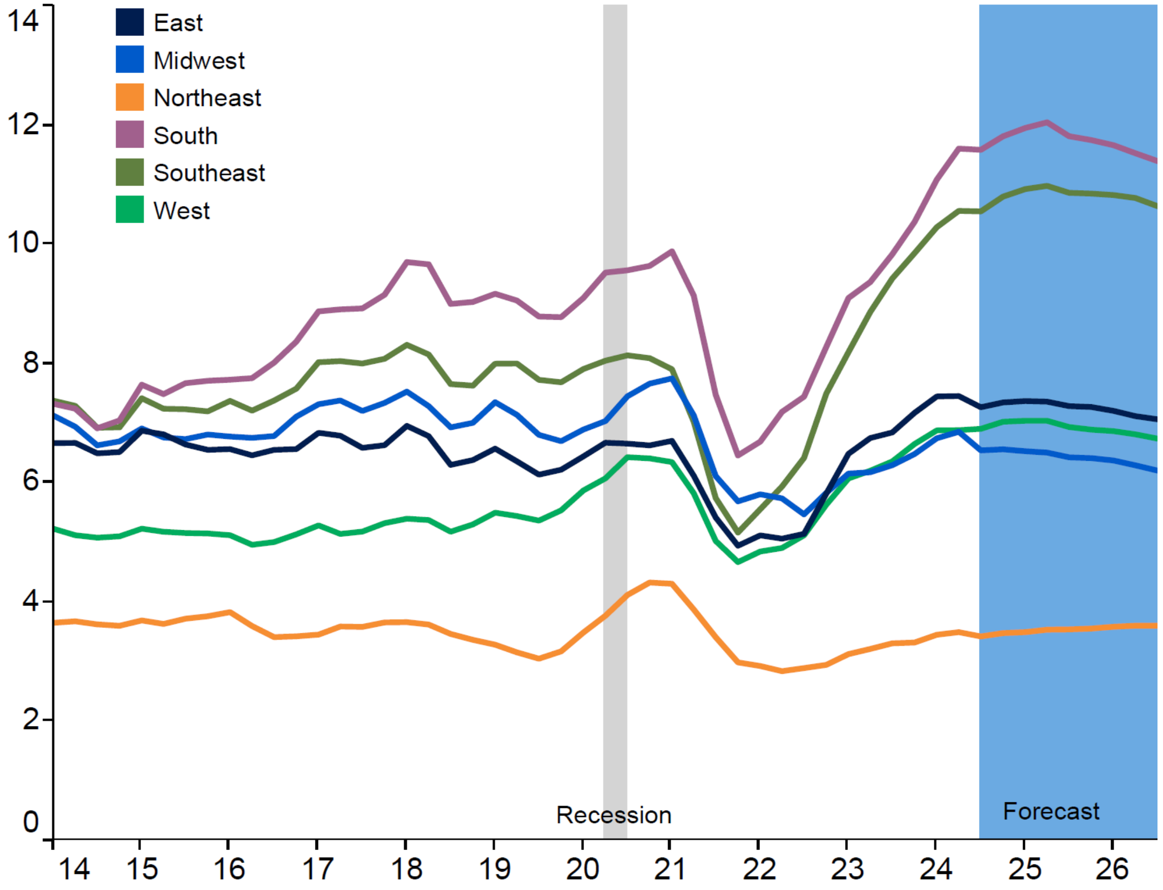
U.S. office vacancy rate, by market type, %



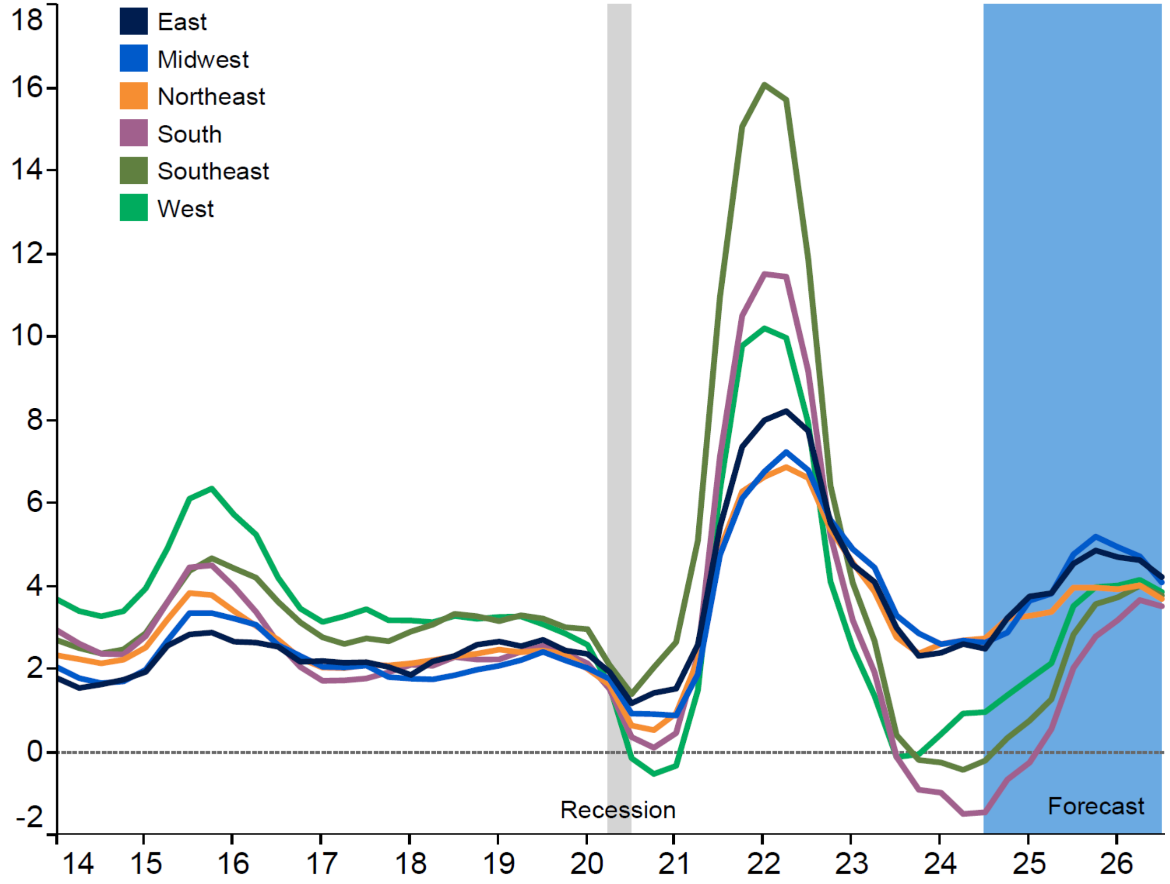
Source: CoStar Group (historical data through 2Q:2024, baseline forecast updated in July 2024)

Overbuild in South and Southeast metros caused apartment vacancy rates to rise above pre-COVID rates and rent growth to be negative in recently

U.S. apartment vacancy rate in 2Q:2024, %



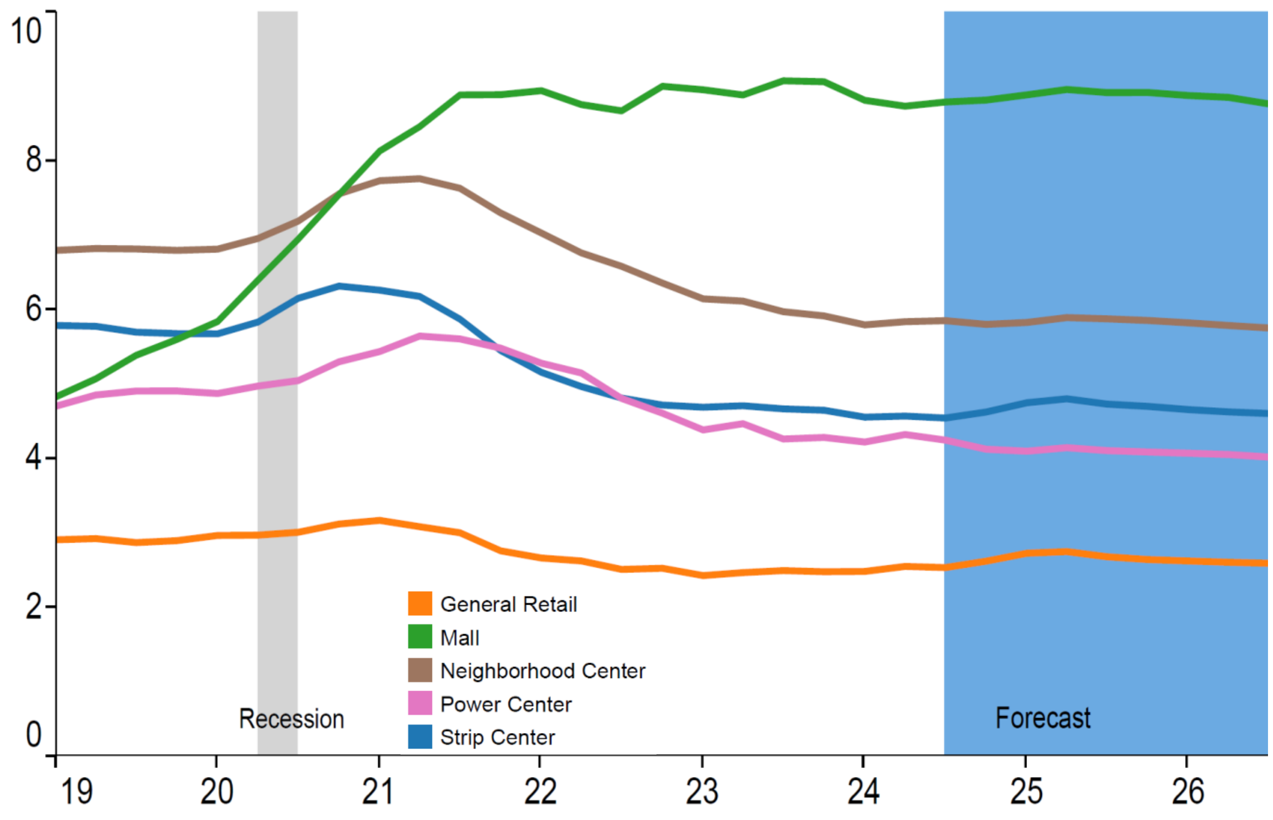
U.S. apartment asking rent growth, Y-o-Y %



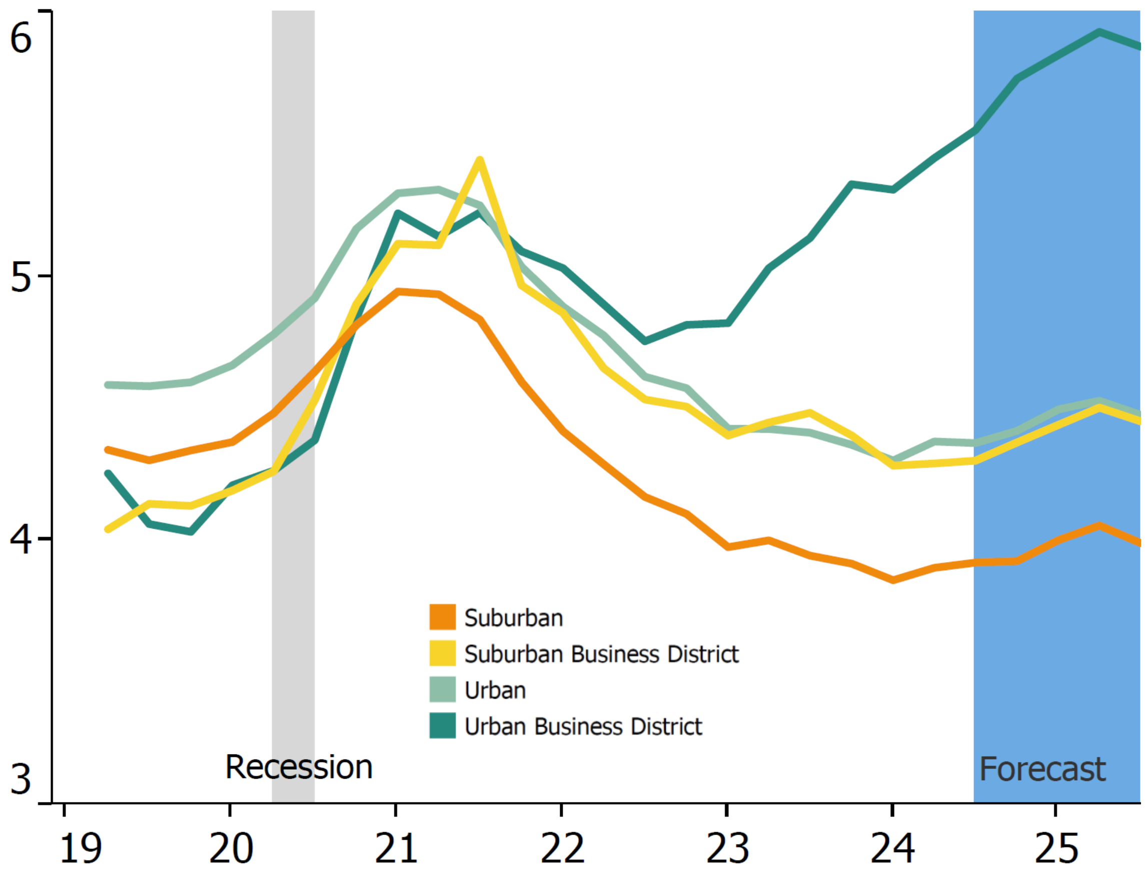
Source: CoStar Group (historical data through 2Q:2024, baseline forecast updated in July 2024)

Retail fundamentals remain solid overall; weaknesses forecast to remain contained to malls and urban submarkets

U.S. retail vacancy rate, by segment, %



U.S. retail vacancy rate, by market type, %

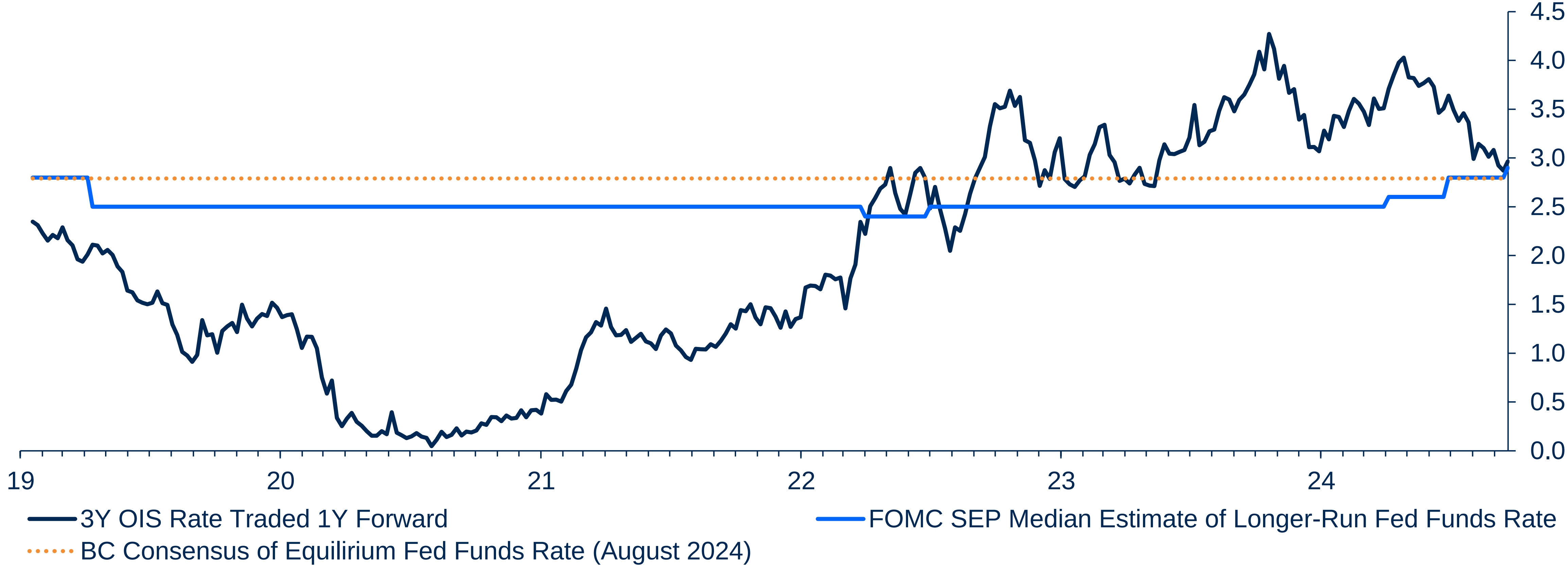


Source: CoStar Group (historical data through 2Q:2024, baseline forecast updated in July 2024)

Appendix

Market pricing long-run policy rates are converging with economist forecasts

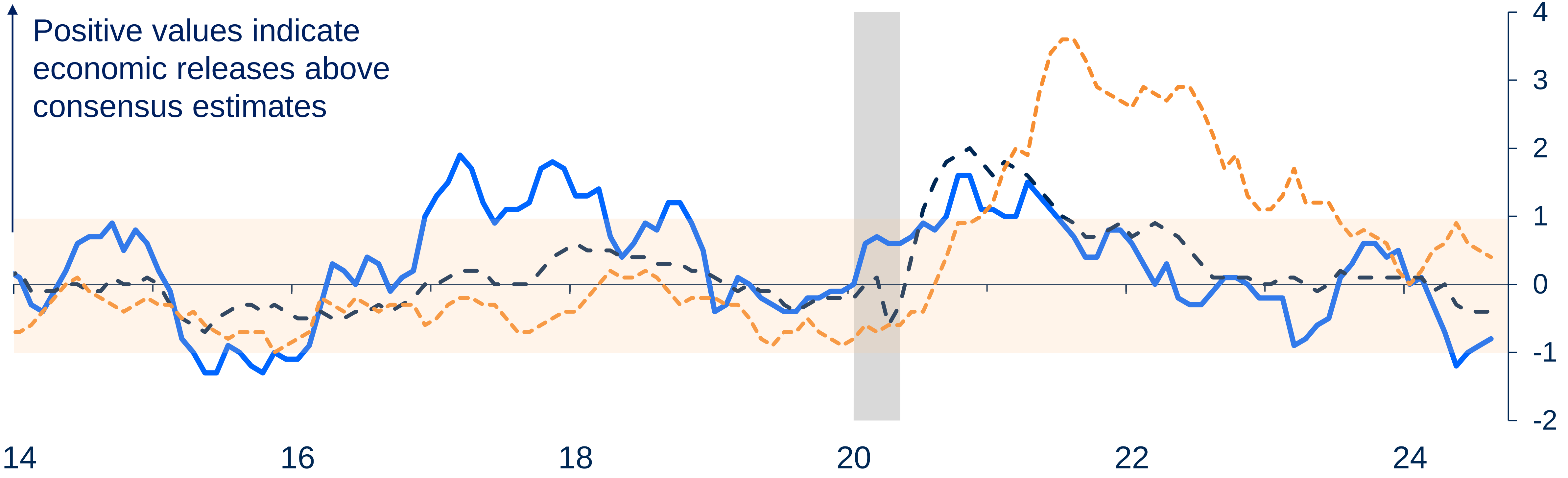
Long-run estimates of the equilibrium fed funds rate, percent



Source: Bloomberg (September 19, 2024)

Survey, inflation, growth measures of economic activity are within one-standard deviation of consensus forecasts

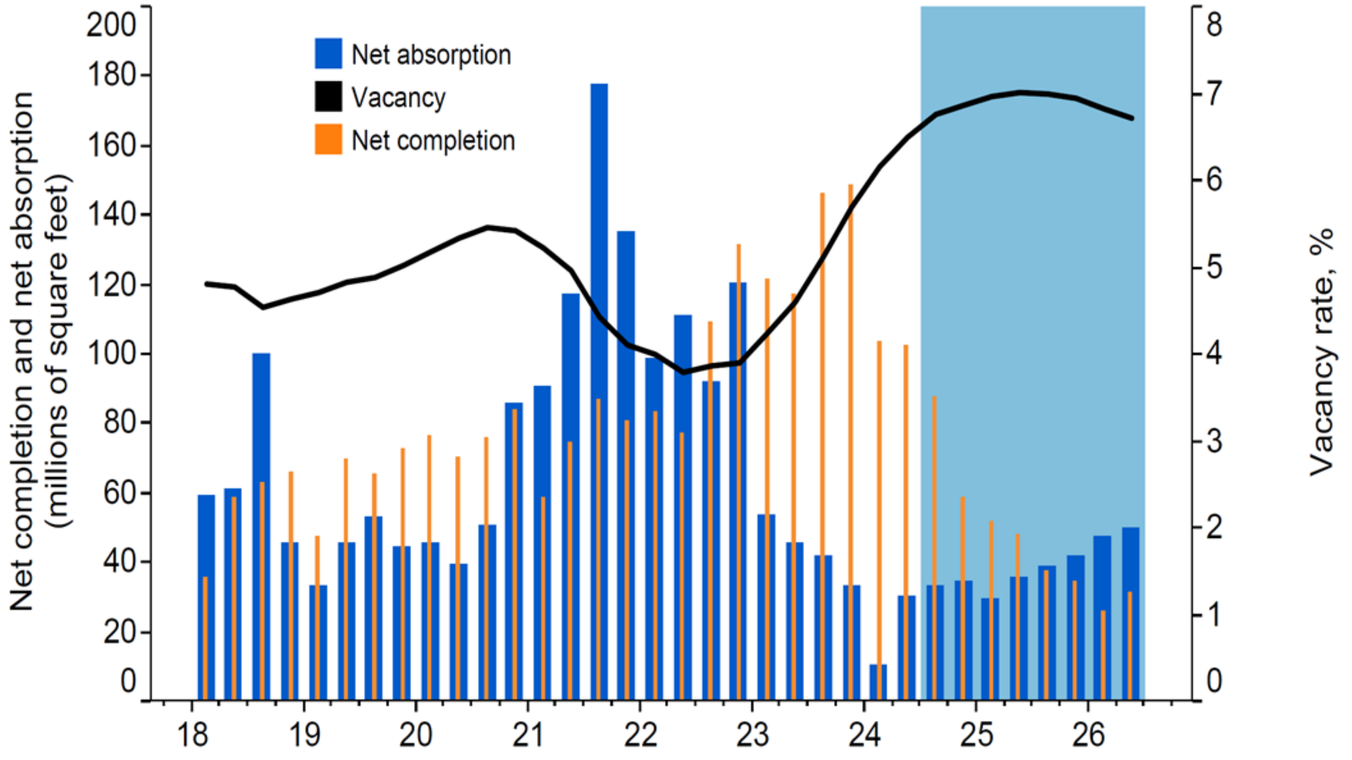
Bloomberg Economic Indicator Surprise Indices, Standard Deviation from Mean (z-score)



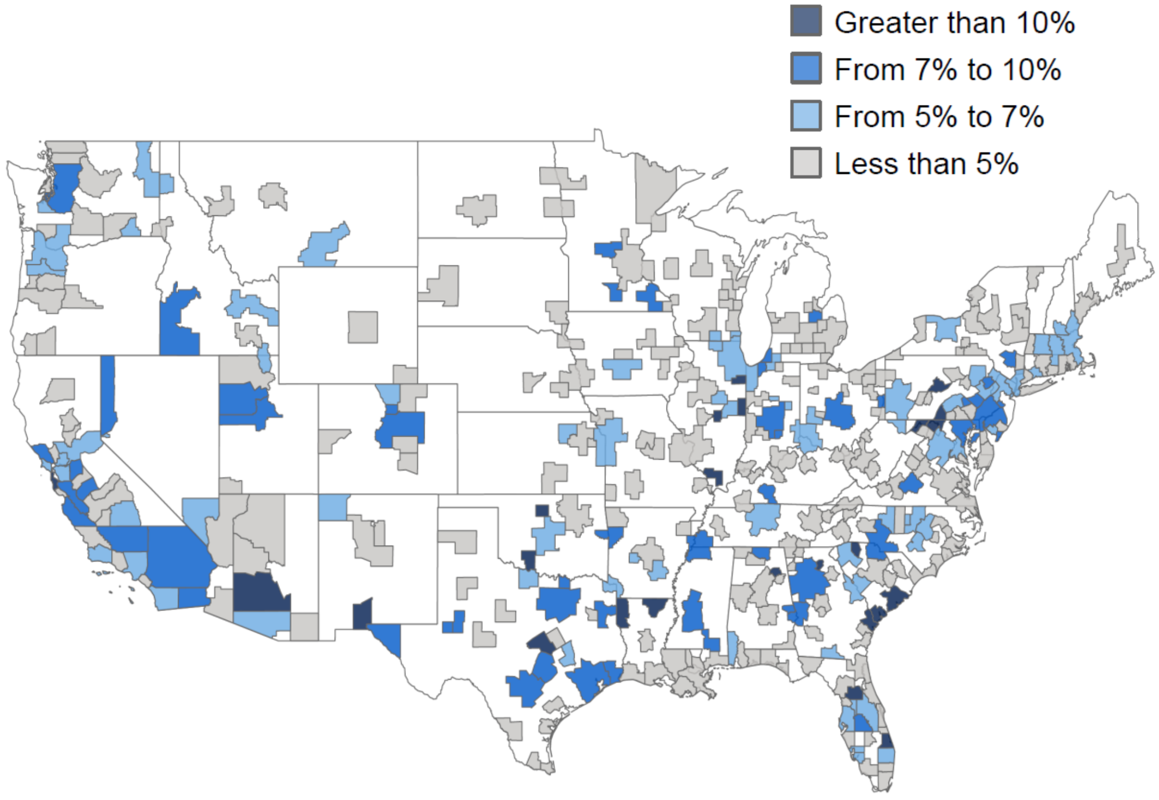
Source: Bloomberg (Monthly Averages of Daily Data, August 31, 2024); One standard deviation is shaded in yellow.
Note: Survey and business cycle indicator index is comprised of "soft" economic data which includes University of Michigan Consumer Sentiment, ISM Services, ISM Manufacturing, MNI Chicago PMI, Richmond Fed Manufacturing, Conference Board Consumer Confidence, Dallas Fed Manufacturing Activity, Conference Board Leading Economic Index, Philadelphia Fed Business Outlook

Cooling demand has translated into net completions far outpacing net absorption, pushing the average industrial vacancy rate higher

U.S. Industrial property net absorption and net completion, mil. sq. ft & Vacancy rate, %



U.S. Industrial vacancy rate in 2Q:2024, %



Source: CoStar Group (historical data through 2Q:2024, baseline forecast updated in July 2024)