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MONETARY POLICY REPORT

Economic and Financial Developments

Economic activity has strengthened in the second half of 2018, and the labor market remains strong with near record low unemployment and almost 900,000 jobs added to the economy in the second half of this year. Inflation remains below the Federal Open Market Committee's (FOMC) long-run target of 2 percent.

Labor markets

Since the current recovery began in July 2009, unemployment rates have declined, although they appear to have leveled off. In the last half of 2018, the official unemployment rate has remained around 3.9%, while the U6 rate, which includes discouraged workers and part-time workers who want to work full-time, was at 7.5% at the beginning of July and 7.6% at the start of December. Since July 2009, the differential between these rates hit a high of 7.4% in September 2011 and has hovered around 3.8% in the last half of 2018. This is shows that more people who want to work full time are finding full-time work.

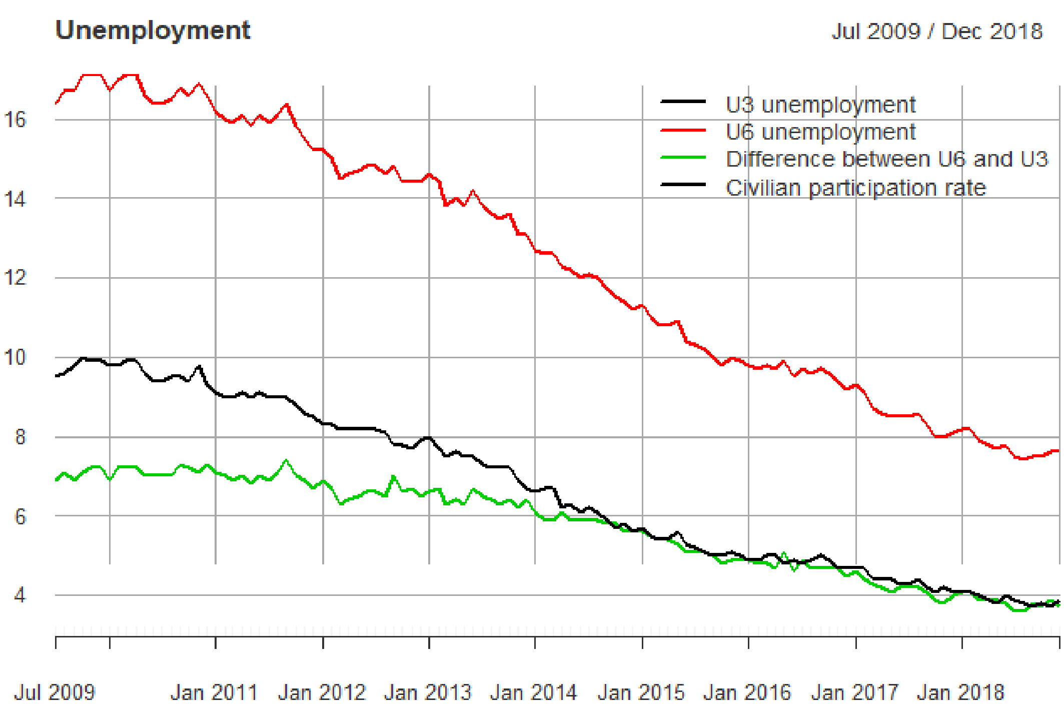

FIGURE 1

The official unemployment rate remains below the 4.5% to 5% threshold considered optimal. This should have the effect of raising wages, but overall, wages have stagnated with only very modest increases. This could be an effect of the declining civilian labor force participation rate (LFP.) The LFP has fallen from a high of 65.5% in July 2009 and remained steady around 62.9% over the last half of 2018. This is not a new phenomenon, as the participation rate began dropping from a 50 year peak of 67.3% in February 2000, with a rapid decline from 66.4% in January 2007 until flattening out at the current rate in March 2016, where it has stayed. This decline indicates that people are leaving the workforce for any number of reasons and not returning. The decline seems to be occurring mostly among those workers between the ages of 25 and 54, and most notably among people of color, those without a college degree, and veterans.

From the beginning of July through the beginning of December 2018, the economy added a total of 897,968 jobs, an average of 149,661 jobs a month.

FIGURE 2

Inflation

The Consumer Price Index (CPI) started July 2018 at 251.286 and reached 252.733 by the start of December. During 2018 (excluding December, which has not yet been reported), inflation rose by 1.38%, short of the desired 2%. The core CPI, which excludes food and energy, started July 2018 at 25.930 and ended November at 260.027. Based on data so far for 2018, this indicator rose 1.8229%. The core CPI is considered a better indicator on how inflation affects individuals and correlates well with where inflation is headed. Since the start of the economic recovery on July 2009, the CPI has increased by 15.0384%, an annual average of 1.58%, while the core CPI has increased by 15.68%, averaging 1.65% per year.

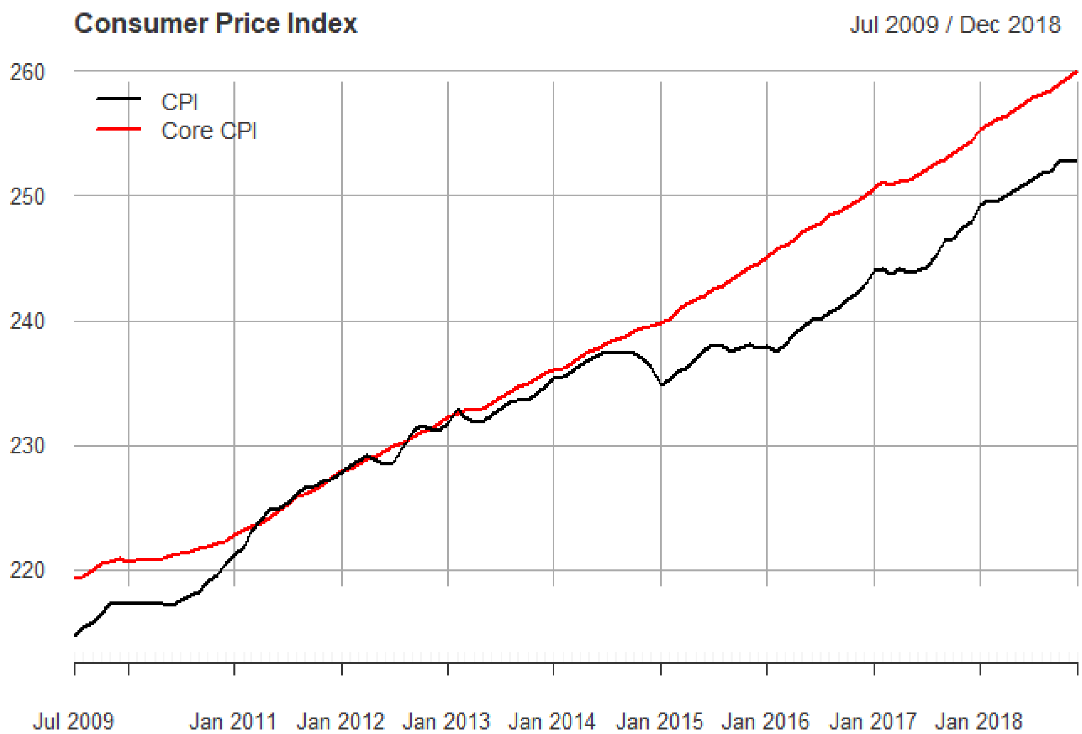

FIGURE 3

Economic growth

Numbers for the real Gross Domestic Product (real GDP) in the 3rd and 4th quarters for 2018 have not yet been released. At the end of 2017, the real GDP was estimated at $18,323.96 billion; by July 2018, the estimate had increased to $18,664.97 billion, an increase of 1.83%. This GDP was based on the 2012 dollar. Real GDP has shown steady growth so far since the start of the economic recovery in the second quarter of 2009, when it stood at $15,189.22 billion. This represents an increase of 18.62% over that nine years.

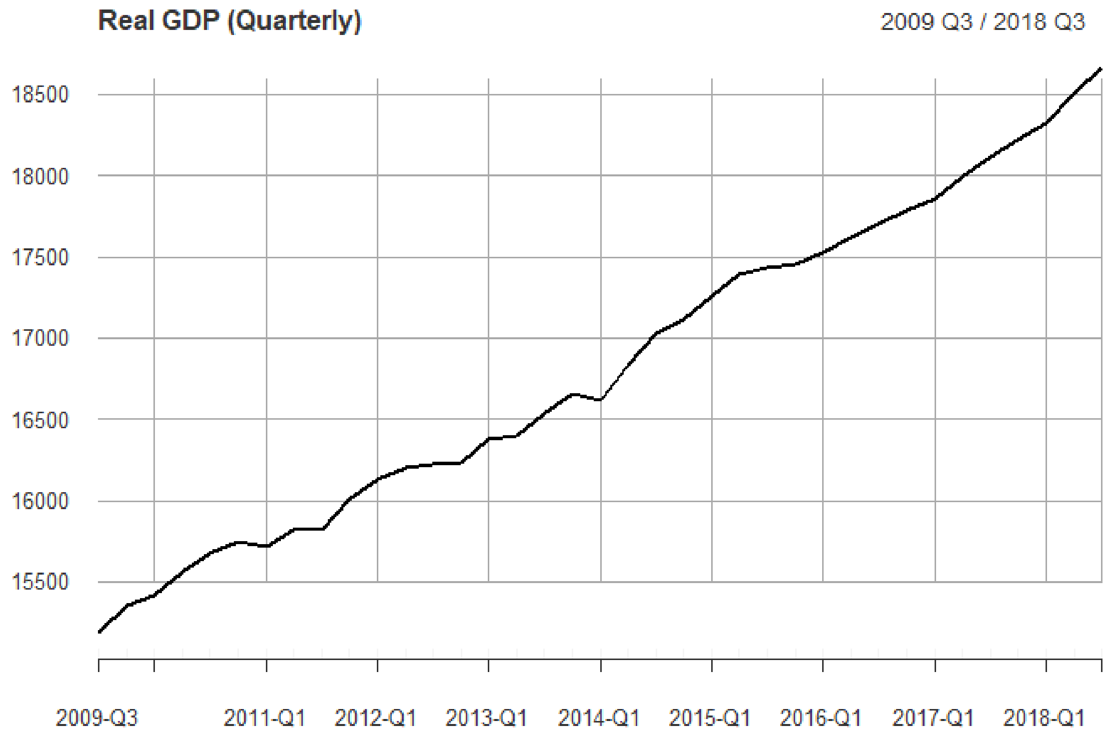

FIGURE 4

Personal consumption expenditures (PCE), measured in chained 2012 dollars, was estimated at $12,927.5 billion at the beginning of July 2018 and had risen to $13,083.3 billion by November, the latest data available. Overall, PCE rose 2.77% during the first ten months of the year, and 20.06% since the start of the recovery in July 2009. Increasing PCE can indicate rising cost of products with relatively inelastic demand such as fuel and food prices. In can also signal an unwillingness to save either short-term or long-term, which can rise from a lack of confidence in the economy.

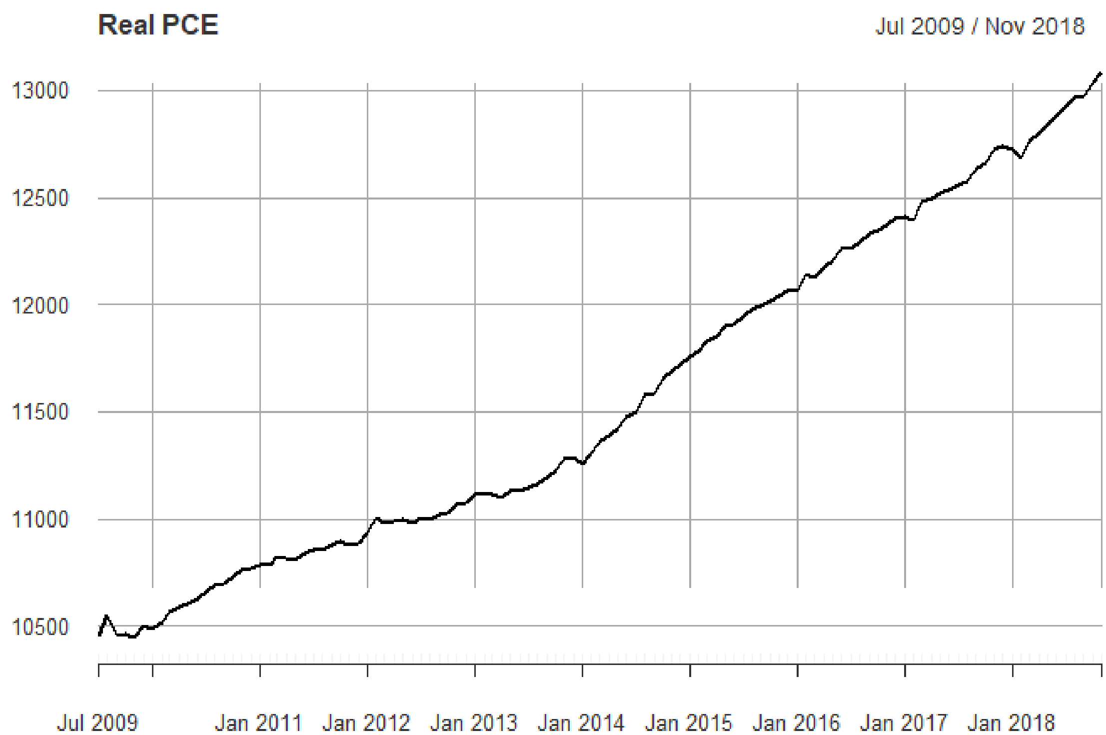

FIGURE 5

Net trade balance declined in the first quarter of 2018 (the only quarter for which data is available), with imports exceeding exports by $549.781 billion. At the start of the third quarter of 2009, when the economic recovery began, imports were $405.497 billion more than exports, so the trade imbalance has grown by a total of 26.24%, about 2.92% per year.

It is too early to determine how the current trade war, which started July 6, 2018, affects major economic indicators.

Financial conditions

On July 1, 2018, the seasoned AAA corporate bond yield as measured by Moody's was 3.87%; by the start of December, it had moved to 4.2%, an increase of 7.86%. Inflation-indexed long term average yields started July with a 0.86% yield and increased by 26.50% to 1.17% by December. Because higher rates often mean the issuer needs to attract more investors, higher yield rates can be an indication of lowering faith in the strength of the economy. In July 2009, when the current recovery began, Treasury yield rates were 2.31%, implying that people have more faith in today's economy than they did after the Great Recession.

The average interest rates on 30-year fixed rate mortgages, measured weekly, have dropped slightly however, moving from 4.52% on 05 July 2018 to 4.51% on 03 January 2019. During this period, the rate peaked at 4.90% in the first half of November. On 02 July 2009, at the start of the recovery, the rate was 5.32%. In between, however, the rates have been quite volatile, with a low of 3.32% on 29 November 2012. The rates for 30-year fixed rate mortgages are influenced by a number of factors, but the strongest influence is more customers competing for a limited number of loans.