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2019 U.S. Economic Outlook
A Focus on Rural America

Homestead Funds

Prepared January 2019

Economists with the National Rural Electric Cooperative Association's (NRECA) Business and Technology Strategies Department examine a number of issues expected to be particularly impactful for rural electric co-ops and likely to play a big role in shaping the economic health of the communities they serve.

These insights are paired with a broad view of the health of the U.S. economy overall and portfolio management perspectives from RE Advisers, NRECA's money management subsidiary and the investment adviser for Homestead Funds. In comparing these different vantage points, you'll notice that an economic backdrop of uncertainty or increased volatility may present an opportunity for active money managers with a long-term view.

NRECA's Business and Technology Strategies Department offers insights on trends affecting operations, technology, consumer expectations and policy. The team engages directly with internal and external stakeholders, and represents cooperative needs in key forums to help ensure the longevity and success of America's electric cooperatives.

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Created by NRECA, Homestead Funds offers a range of professionally managed strategies that can be used by cooperatives and individuals to meet their short-, intermediate- and long-term investment needs.

The State of the U.S. Economy

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Several issues look set to dominate the year ahead. One is a possible shift from synchronized global growth to synchronized global slowing, with a pullback in China being a key influence. The pace of global growth will have a large effect on oil and other commodity prices, as we saw in 2015 to 2016.

Monetary policy will also be a factor. The Federal Reserve has nine rate hikes under its belt as it gradually tightens back to a normalized interest rate range, and other major central banks are shrinking their balance sheets as they ease out of extreme-liquidity mode. If the global economy is downshifting in momentum this year, further tightening could be problematic.

In the U.S. economy, signs of weaker activity in the housing, industrial and retail markets put investors on edge, despite continued strength in employment.

What to watch for in 2019:

- The Federal Reserve has said it may continue to hike interest rates in 2019, but it is in "watch and wait" mode given the year-end volatility in economic and market indicators.
- U.S. gross domestic product is expected to grow about 2.4 percent, according to the Survey of Professional Forecasters.[1]
- Recession risk is up from recent years. The yield curve, which reflects interest rates for different bond maturities, is flatter than normal, a key indicator.

[1]https://www.stlouisfed.org/publications/regional-economist/fourth-quarter-2018/forecasters-gdp-growth-2019

Economic Drivers Within Electric Cooperative Service Areas

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According to the U.S. Department of Agriculture (USDA), counties served by electric co-ops account for nearly 70 percent of all agricultural sales in the U.S., and based on data from the U.S. Census, more than 30 percent of the total value of manufacturing shipments comes from co-op counties.

Not unexpectedly, the co-op economy features these two industries prominently, with the USDA Economic Research Service classifying 19 percent of all counties served by electric co-ops as economically dependent on farming, and 18 percent dependent on manufacturing.

USDA County Typology Code	Share of Co-op Counties
Nonspecialized	35%
Farming	19%
Manufacturing	18%
Federal/State Government	12%
Recreation	9%
Mining	7%

From an employment perspective, 2.3 million working-aged civilians served by electric cooperatives are in the health care and social assistance field, 2.1 million are in retail trade, 2.1 million work in manufacturing, 1.6 million provide educational services and 1.4 million work in construction. Approximately 3 percent of co-op members work in agriculture, forestry, fishing or hunting, which is more than double the percentage for the rest of the nation.

While the economic outlook for areas served by electric cooperatives is certainly dependent upon the strength of these industries, large economic trends, potential policy changes, and other national or regional factors can have a significant impact as well. In general, co-op areas are affected by many of the same economic trends as the rest of the country, but the implications of some changes can be more pronounced than others, given the locations and demographics served by co-ops.

The Impact of Chinese Tariffs on Farmers in Electric Cooperative Service Areas

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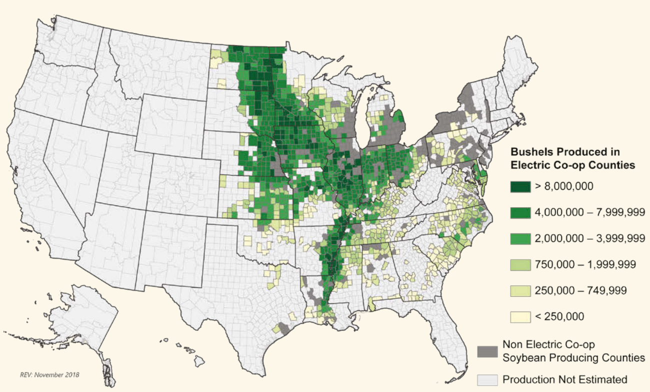
During the summer of 2018, the Chinese government imposed a 25 percent tariff on imported U.S. agricultural products and other goods in retaliation for U.S. tariffs on Chinese manufactured goods. U.S. soybean exports are expected to be hit especially hard.

Nearly $20 billion in U.S. agricultural exports went to China in 2017 — with soybeans accounting for $12 billion. Soybeans are grown mostly in the Mississippi River watershed, including the states of Illinois, Iowa, Minnesota, Nebraska, North Dakota, South Dakota, Indiana, Missouri and Ohio, according to the Federal Reserve Bank of St. Louis. About 80 percent of the nation's soybean production is from counties served by electric cooperatives.

Soybean Production in Counties Served by Electric Cooperatives



With expected record U.S. soybean production in 2018, the import tariffs have made an already-tough soybean price outlook all the tougher. The price of soybeans fell to a 10-year low of $8.55/bushel shortly after the tariffs were announced.

The USDA has implemented a Market Facilitation Program through the Commodity Credit Corporation (CCC) to assist farmers from damages stemming from the tariffs. During the initial payment period, nearly $4.7 billion was allocated to farmers with $3.6 billion or 77 percent of these relief funds directed to soybean farmers. Additionally, the CCC can designate a second payment period with similar funding in late 2018. A two-period facilitation program could provide total assistance of $1.65/bushel up to a cap of $125,000 per farm. In December, however, concern heightened that the federal government shutdown would postpone the ability of farmers to get paid.

Importantly, the Chinese tariffs only apply to American products. Brazil, the world's largest soybean exporter, benefits from the Chinese taxes on imported U.S. soybeans. As a result, China is shifting its demand to Brazil. It may be difficult for U.S. farmers to reclaim the market share lost to Brazil, particularly if the tariffs extend well into 2019.

The trade war with China has contributed to recent stock market volatility.

It did not seem to detract materially from gross domestic product growth in 2018 overall, but the longer-term effects could be more potent. Cargill, a major agricultural player, repeatedly idled its workers in the fall because grain volumes were down so much. Beyond agriculture, we are seeing companies make changes to their supply chain to avoid tariffs. Some are able to pass additional costs on to consumers, but not all. Ultimately, the trade war could have the biggest impact on sentiment. If companies see too much uncertainty, they'll delay investments.

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Oil Prices and the Outlook for Oil and Gas Development in Electric Co-op Areas

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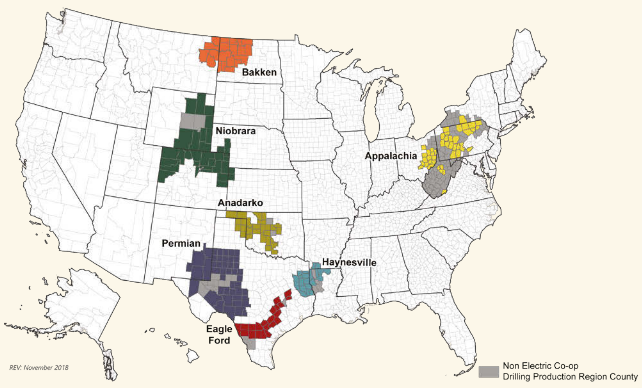
Oil prices were off to a tough start in 2019 after plunging from the mid-$70s to the mid-$40s. Global growth trends will be a big factor for the commodity in the year ahead, affecting the outlooks for oil and shale gas regions in the U.S.

The price of West Texas Intermediate (WTI) oil is projected to decline in 2019, according to the U.S. Energy Information Administration (EIA). This may not bode well for oil and gas exploration in seven tight oil and shale gas regions in the continental U.S. Production in these regions is unique due to both the advanced fracking technologies used and the fact that wells often produce both oil and natural gas. These regions comprise 239 counties served by electric cooperatives across 15 states.

Active rig counts in these regions have been steadily increasing since mid-2016 when the WTI price averaged $45/barrel. Drill rig activity in turn is an important indicator of local economic activity as exploration spending ripples through local communities creating jobs, growth and other economic benefits.

The average WTI price in 2018 was $65/barrel. The EIA projects prices to decrease in 2019 to about $54/barrel. Importantly, a survey by the Federal Reserve Bank of Kansas City finds the average oil price needed to be profitable is $55 with a range of $35 to $85. The projected decline in prices, if realized, will likely limit the expansion of new oil and gas development and the economic growth associated with new resource development.

U.S. Oil and Gas Production Regions Served by Electric Cooperatives



In the same way the price of the commodity fluctuates, exploration and production trends are prone to cyclicality, and there are material regional differences.

Oil prices dropped sharply at the end of 2018, a shock to energy company earnings. Fortunately, they have recent experience with such a phenomenon: The energy market went through major adjustments from 2015 to 2016 when oil prices were depressed. Many companies emerged considerably stronger after that period of mergers and re-capitalizations. We think company managements are well prepared for headwinds and volatility, and many firms are operating with better efficiency than before.

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Cooperative Retail Electric Sales Projected to Outpace Industry

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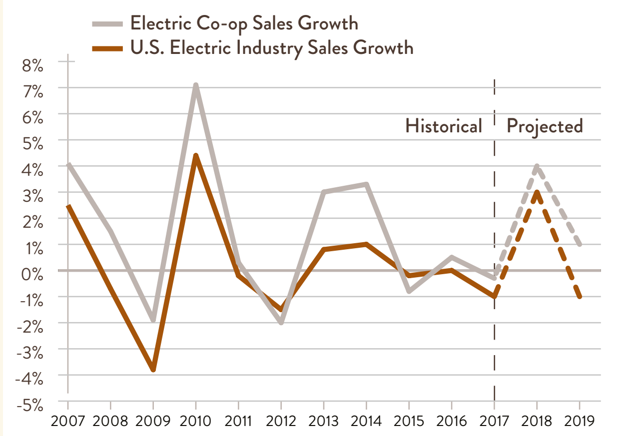
Although electricity sales are inherently important for the health of the electric industry, the demand for electricity is also an indicator of the strength of the economy. Indeed, electricity sales in the U.S. have historically moved in tandem with changes in gross domestic product (GDP), though extreme weather, increased energy efficiency and the deployment of distributed generation have also had an impact in recent years.

In 2017, the U.S. electric industry saw a 2 percent decline in kWh sales due primarily to lower residential sales, though industrial sales went down as well. Data for 2018 reflect an extremely hot summer across much of the country. The U.S. Energy Information Administration (EIA) projects nearly 3 percent growth in 2018, which would result in a record high for annual sales. With milder weather expected in 2019, the EIA projects a 1 percent decline in sales from 2018's high.

Electric cooperative kWh sales tend to grow at a quicker rate than the industry average in most years. This trend has been driven by faster growth in consumers, largely at co-ops serving suburban and exurban communities near growing metropolitan areas, as well as those serving resort areas in or adjacent to beaches and ski areas. In recent years, co-ops serving regions with booming shale oil and gas production have also seen higher growth.

Based on an NRECA survey of generation & transmission cooperatives (G&Ts), co-ops will continue to outpace the rest of the industry, with sales to distribution cooperative members projected to grow 4 percent in 2018, and another 1 percent in 2019. These sales are a good indicator of distribution co-ops' retail sales to consumer-members. G&Ts in the Midwest and Southeast project the largest increases, though nearly all respondents expect a boost in electricity sales. This encouraging outlook for co-op sales suggests a strong economy in areas served by electric cooperatives.

Electricity Sales Growth (kWh)



GDP growth is a question mark for 2019.

It was better than expected in 2018, with tax cuts serving as a tailwind and driving company profits and the labor market to outpace expectations. All told, U.S. GDP probably grew nearly 3 percent in 2018, its best rate since 2010. Most forecasts expect growth to retreat somewhat in 2019, with predictions landing more in the 2 percent to 2.5 percent range. There are some signals from the bond market that the risk of recession is up; continued growth in the U.S. depends somewhat on global momentum, what happens with interest rate policy, and sentiment among consumers and businesses.

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The $16 Billion to $22 Billion Impact of Hurricanes Florence and Michael

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Hurricane Florence made landfall in North Carolina on September 14, 2018. Over a four-day period, Florence caused more than 1 million power outages in the Carolinas and Virginia, nearly 35 percent of which occurred in areas served by electric cooperatives. Less than four weeks later, Hurricane Michael hit the Florida Panhandle and would eventually result in service outages for 1.7 million customers in Florida, Georgia, Alabama, North Carolina, South Carolina and Virginia. Approximately 22 percent of these customers are electric co-op consumer-members.

In addition to outages and safety concerns, hurricanes and tropical storms cause substantial economic damages. These impacts include damage to homes and businesses, temporary unemployment, destruction of agricultural crops, and decreases in industrial production and consumer spending. Although these impacts tend to be short term and are unlikely to alter the course of the national economy, such damages can be significant for the communities hit hardest by the storms.

> **Insurers and reinsurers took some losses on recent catastrophes.**
>
> However, the industry in general looks to be well capitalized. These companies price policies to reflect risks, and pricing trends for insurers and reinsurers have actually been fairly stable, according to the January contract-renewal season. The net effect from last year's hurricanes has been increased earnings volatility. That can affect company share prices in the short term.
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> Wildfires are emerging as a separate risk category for California utilities, especially in light of the firestorms sparked by PG&E. The state's "inverse condemnation" law holds that the utility — not its insurers — can be held fully liable for damages from natural events such as wildfires.
>
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Moody's Analytics estimates that the economic impact of Hurricane Florence was $38 billion to $50 billion, including a $1 billion to $2 billion loss to gross domestic product (GDP), which amounts to a 0.2 percent hit to the combined GDP from North Carolina, South Carolina and Virginia. Based on the share of outages occurring in electric cooperative areas, this translates to $13 billion to $17 billion in economic damages for co-op consumer-members. Hurricane Michael's impact was less severe, but preliminary analysis from Moody's finds $15 billion to $21 billion in damages. About $3 billion to $5 billion of these damages occurred in areas served by electric cooperatives. In total, these two storms had an economic impact of $16 billion to $22 billion for electric cooperative communities in the region.

Worker Shortages in the Rural Southeast

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Labor shortages, and their potential consequences, may be of concern for local economies in areas served by electric cooperatives, which have a significant footprint in the rural Southeast. In October, companies in the Southeast were attempting to boost their staffing but were increasingly hampered by an inability to find sufficient employees, particularly in the low-skilled/hourly workforce. For certain businesses in the region, this shortage of low-skilled labor is hindering their ability to operate and expand.

> **Nationwide, the labor pool is tight.**
>
> Skilled trades, transportation and construction businesses are feeling the worker shortage and wage inflation pressures most keenly. We've noticed that companies are more likely to provide internal training and education to augment the skills of new hires. In the trucking industry, for instance, the growth of internet retail has increased demand for drivers. We're seeing more driving schools offered by trucking companies. We're also seeing wage hikes of 5 percent to 10 percent and increased cents per mile driven over the next three to five years as companies compete to retain workers and reduce turnover.
>
> *RE Advisers*

Growth constraints appear serious in construction, transportation and manufacturing. Construction firms are experiencing a shortage of workers with job-specific skills. Service industries such as hospitality and leisure also report difficulties recruiting staffers who do not have bachelor's degrees. Additionally, employers in rural towns are facing more trouble hiring than those in bigger cities. Although many positions go unfilled, wage growth remains moderate, as Southeast businesses report average merit raises of 3 percent to 4 percent for workers. Moreover, in December, a number of major firms indicated that they will boost starting wages for lower-paid workers. This has created pressures to increase pay across the Southeast, especially in the retail and hospitality industries.

Economic Growth Projected in the Midwest

NRECA

Each month, the Creighton University Economic Forecasting Group develops the Business Conditions Index (BCI) for the Mid-American economy, based on a monthly survey of supply managers in Arkansas, Iowa, Kansas, Minnesota, Missouri, Nebraska, North Dakota, Oklahoma and South Dakota. Approximately 38 percent of households and businesses in these nine states are served by electric cooperatives, making this index an important indicator of the outlook for co-op consumer-members in this region.

The index ranges from 0 to 100, and is calculated as a mathematical average of indices for new orders, production or sales, employment, inventories and delivery lead time. An index greater than 50 indicates that the economy is expected to grow over the course of the next three to six months. The most recent BCI, released in December 2018, fell to 54.1 from 54.9 in the previous month, due to potential negative impacts from tariffs, trade restrictions and rising short-term interest rates. However, the index continues to point to positive economic growth, remaining above 50 for the 24th consecutive month. Looking ahead six months, economic optimism, measured by a separate business confidence index, fell to a still-strong 55.5 after its November value of 59.6.

Economic Index	Dec–18	Nov–18	Dec–17
Overall Business Conditions	54.1	54.9	57.2
New Orders	51.2	57.8	67.6
Production or Sales	52.2	56.5	64.8
Employment	57.5	52.2	53.6
Inventories	53.3	47.9	56.1
Delivery Lead Time	56.5	60.5	42.6
Business Confidence	55.5	59.6	71.9

Source: Creighton University Economic Forecasting Group

Creighton University's Economic Forecasting Group also produces a series of monthly indices to characterize the rural economy. The indices are based on a survey of community bank presidents and CEOs in rural Colorado, Illinois, Iowa, Kansas, Minnesota, Missouri, Nebraska, North Dakota, South Dakota and Wyoming.

In December 2018, the overall Rural Mainstreet Index (RMI) rebounded back to 54.2, after having fallen just below growth-neutral for the first, and only, time in 2018 the previous month. The rural employment index fell slightly to 57.1, which still indicates healthy job growth in the rural economy. Over the last 12 months, the Rural Mainstreet economy added jobs at a 1.4 percent rate, on pace with the 1.5 percent rate for urban areas in these same 10 states.

In spite of the positive overall outlook for the rural economy, negative impacts of tariffs and low prices for agriculture commodities continue to weaken the farm sector. The farmland and ranchland index fell to 35.7, and the farm equipment sales index was 37.1, with both indices now remaining below growth-neutral for more than 60 consecutive months. The rural confidence index decreased to 44.3 from 47.0 the previous month.

Business confidence was down incrementally at the end of 2018, on the heels of stock market volatility and signs of slowing global growth.

More CEOs had a negative outlook than a positive one in January, according to a survey by think tank The Conference Board. However, manufacturing and service-sector metrics are still showing expansion. According to the Institute of Supply Management, December numbers for manufacturing and service-sector indexes were both down a bit from November, but they still reflected strong growth rates.

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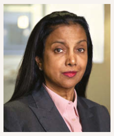

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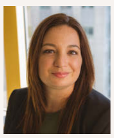

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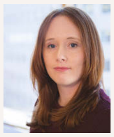

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