Economic Outlook

United States

Second Quarter 2014
Economic Analysis

- Developed economies moving along as expected, but slight downward revision to Chinese growth weighing on emerging market outlook
- Monetary policy in the U.S. remains the central focus, with the power to sway a still vulnerable economic recovery
- With the exception of a downward revision to inflation, U.S. forecasts remain mostly unchanged with risks biased to the upside

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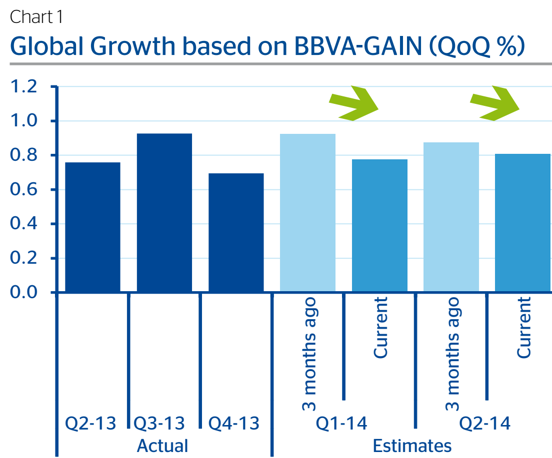
Closing Date: May 13, 2014

1. Global Outlook

Deceleration in China and Fed's Monetary Policy Define the Global Scenario

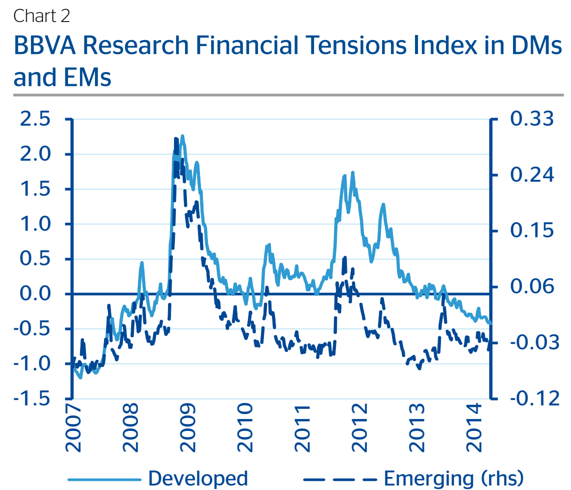
The global economy has grown at an annual rate of 3.2% in the first quarter of 2014, half a point less than we were expecting three months ago but with no interruption to the slight improvement that started in 2013. Our global activity indicator (BBVA-GAIN) suggests that we should see this pace maintained for the first part of the year, reflecting the cyclical improvement in the developed markets (DMs), which has offset the deceleration in some emerging markets (EMs) in Asia and Latin America. Meanwhile, in the last few months, financial markets have performed very differently in the two regions, and with more differentiation between the EMs. Capital flows, asset prices, interest rates and financial tension indicators have fundamentally performed in line with the outlook for rate hikes in the U.K., but have also been affected to a greater or lesser extent by geopolitical risk events in Eastern Europe and China's slowdown expectations. Altogether, tightening financial conditions have differed in each economy as a function of the degree of external vulnerability and financial integration. This is all related to higher deficits on current account, dollar-linked liabilities and flexible exchange rates.

Chart 1
Global Growth based on BBVA-GAIN (QoQ %)



Source: BBVA Research

Chart 2
BBVA Research Financial Tensions Index in DMs and EMs



Source: BBVA Research

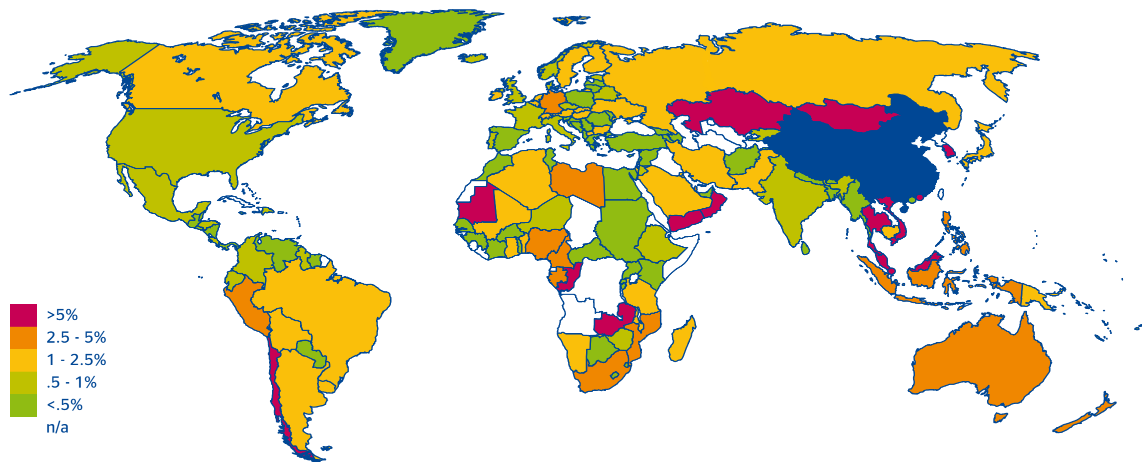
Our global economic scenario is a result of a combination of the policies introduced domestically but having cross-border implications, not only in terms of more or less demand for goods and services (international trade), but also to the extent in which they help to alter global risk-aversion, which is reflected in the volatility of capital flows and/or the prices of financial assets and raw materials. On the one hand, the cyclical recovery is gaining pace in DMs on the back of less restrictive fiscal consolidation, fewer concerns about the sustainability of debt levels (thanks to contained financial costs) and progress on the implementation of a banking union in the EMU. However, the normalization of U.S. monetary policy via quantitative measures and interest-rate expectations is resulting in a rebalancing of financial portfolios at a global level, which is having a relevant impact on funding conditions and asset prices in EMs. This contagion is nothing new, but has raised its head again in a new environment: one with more financial integration in EMs and an extraordinarily lax monetary policy in the U.S. Symmetrically, the exit from this exceptional period will also have an impact on the financial variables. In this latter group, we are also starting to see concerns about the economic slowdown in China since the Chinese New Year, given the increased emphasis that the authorities are now placing on reducing vulnerabilities – via medium-term macro-prudential policies – rather than in sustaining growth in the short term.

Expectations in developed economies are supported by the favorable combination of political and monetary policy and by financial conditions that in general are not acting as a brake on activity. The U.S. economy is overcoming the impact of an unusually cold winter while the perspectives for an improvement in the eurozone have increased. Growth in the eurozone in the latter part of 2013 was driven by the recovery in exports, which has also favored the improvement in investment. Looking at the first quarter of 2014, our short-term models point to an acceleration of around 0.5% QoQ, although the boost from the external sector could moderate in the coming months due to: i) euro appreciation, with a slight impact on growth but clearly differentiated by country; ii) reduced demand from China, also with diverging direct effects; and iii) geopolitical risks in the East if the crisis in Ukraine continues. Altogether, we maintain our forecasts for the eurozone in 2014 at 1.1%, and 1.9% in 2015, in a scenario of contained financial tensions and fiscal and monetary policies that do not put a brake on growth. In this gradual recovery, domestic demand will play a growing part, with accelerating investment and enhanced consumption, in line with the steadiness of the labor market in 2014 and then job creation in 2015. As already established, this scenario requires progress on the achievement of an effective banking union, starting with the maximum transparency of bank balance sheets through asset quality reviews under common regulations and stress tests under common adverse scenarios.

There is slightly more uncertainty about the growth outlook for Japan, which has had a QE program underway since January 2013, together with fiscal stimuli to return to having inflation and favoring consumption and investment. The recent tax increases on consumption to control the public deficit could put the recovery of private demand at risk, although there are still some measures to take to offset this, including an even more intense monetary expansion. Altogether, we have revised down our outlook for growth in 2014 by four basis points to 1.1%, and we are maintaining our estimate for 2015 at 1.3%.

For emerging markets, we have revised down our growth forecasts mainly as a reflection of cutting our estimations for China, where we are now expecting GDP growth of around 7.0% in both 2014 and 2015, vs. 7.5% previously. This change mainly reflects the renewed impulse for the introduction of policies oriented on a medium-term horizon to reduce the existing vulnerabilities and increase the role of the market in assigning economic resources, rather than continuing to deal with slowing growth in the short term.

Chart 3
Exports to China in 2012 (% of GDP)



Source: World Bank, UN Comtrade, & BBVA Research

In line with our forecasts in our last quarterly report, uncertainties about the cyclical strength of the Chinese economy have materialized, with a deceleration in activity during the first quarter of 2014. The latest data from indicators on both domestic and foreign demand show the loss of momentum, more so in investment than in consumption, in an environment of lower than expected inflation. At the same time, the authorities are starting to introduce measures to deal with the weaknesses arising from economic policy decisions taken in the last few years to support growth in the short term. This has involved postponing the deleveraging of local governments and companies, and continuing to approve infrastructure projects and excess installed capacity which are unlikely to be profitable while families, who are financing the process, are receiving negative real interest rates on their savings. This is an inefficient allocation of resources, which also encourages the development of financial systems in parallel with the more regulated one and which may be a source of problems in the future. To this end, regulations on the non-banking financial sector, shadow banking, and environmental protection are all being toughened.

The increasing importance of China as a source of world demand in the last few years is undeniable. But the differentiation between areas is unchanged, with higher exposures in Southeast Asia, some South American and African countries and, among developed economies, Germany. According to our estimates, the impact on world growth of each point of Chinese growth lost is around 4 percentage points, principally as a result of lower demand from China itself. Note also that the expected adjustment in the local scenario is limited, and clearly not enough to unleash episodes of global financial uncertainty, something which, should it occur, would raise the impact above the forecast.

To sum up, our assessment of the global scenario has a downward bias compared with our evaluation three months ago, which is reflected in the adjustments to our forecasts. After growing at 3.0% in 2013, global GDP should start to accelerate again in 2014 and 2015 to hit 3.4% and 3.8%, respectively, figures that demonstrate both the variations in growth expectations in diverse regions and the increased, although slight, contribution to global growth from developed economies. Although there have been no significant changes in either the U.S. or the eurozone, the downward pressures in our forecasts are above all visible in the EMs in 2014 and 2015, in both Asia and Latin America. In this context, there are still short- and medium-term downside risks to our forecast. Some factors with a global impact could make themselves felt more intensely than expected in the base scenario on a short-term time horizon, such as a tighter monetary policy on the part of the Fed, reduced growth of the global demand stemming from economic slowdown in China or geopolitical risks derived from Eastern Europe.

(Note: for a more in-depth analysis of Europe and the emerging markets, see our latest Global Outlook)

2. U.S. Outlook

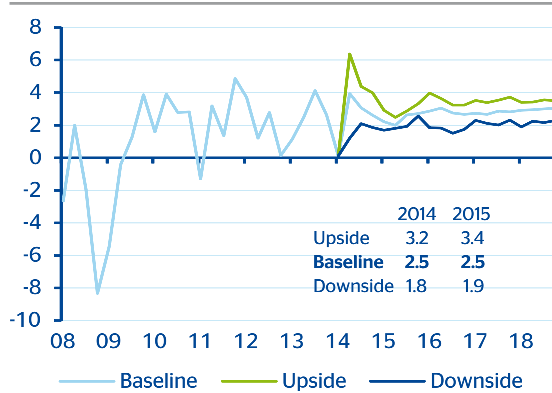
Healthier Post-Winter Outlook for 2014, Though Vulnerabilities Linger

Economic activity is starting to show signs of life after suffering through a rough winter. Now that we are midway through the second quarter, it is clear that our expectation for stronger spring activity is materializing. Most economic indicators, from consumption to industrial production and confidence, have regained traction, with the exception of the housing market. Residential investment has been particularly weak, with housing starts and sales yet to find the strength to recoup winter losses. Much of this can be attributed to a mix of rising home prices and slightly higher mortgage rates that have pushed down affordability near recovery lows. While we do expect growth to accelerate throughout the year, the recovery remains vulnerable to a range of factors including the possibility of a disturbance from the Fed's monetary policy strategy as well as a slowdown in global demand.

Real GDP growth for 1Q14 came in well-below expectations at 0.1% on a seasonally adjusted annualized basis, weighed down primarily by exports and residential investment. On the bright side, personal consumption growth remains strong. Therefore, we maintain our baseline scenario mostly unchanged, reflecting balanced risks with 70% probability. Risks to the upside are slightly elevated, with a 20% probability against the downside risk (10%) for a more uneven and unsustainable expansion. These scenarios have particular importance when it comes to the Fed, seemingly in the driver's seat when it comes to setting the tone for continued strength in the economic recovery. Our upside risk environment implies a more hawkish stance within the FOMC and therefore the possibility of an earlier and more aggressive trajectory for the federal funds rate. On the downside, we could see the Fed stuck in this prolonged period of low rates well past 2015, particularly if inflation does not edge closer toward the 2.0% target.

Chart 4

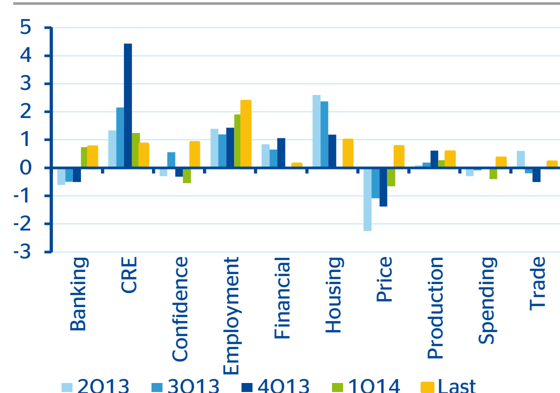
Real GDP Growth, Baseline and Risk (QoQ % SAAR)



Source: BEA & BBVA Research

Chart 5

BBVA Research USA Monthly Activity Index



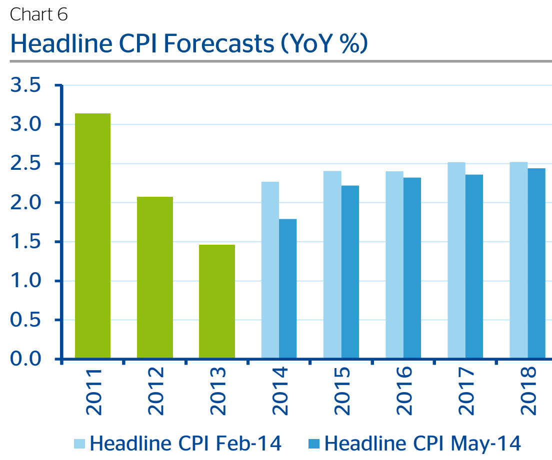
Source: BBVA Research

Risks to growth are very much aligned with the underlying trends in employment conditions. While the unemployment rate has declined much more rapidly than expected (hitting 6.3% in April), other indicators suggest that the improvement does not truly reflect an increase in hiring. It is possible that excess slack in the labor market is appropriately captured by the unemployment rate, but our baseline scenario assumes only a partial reflection. The participation rate continues to hover near 30-year lows as the long-term unemployed and discouraged workers lose confidence in the job market. In addition, many baby boomers are making their way into retirement, even though the crisis forced some

to continue working well past the usual retirement age. The gloomy post-recession job outlook also caused many college graduates to delay entry into the workforce, a group that otherwise would have helped to at least partially offset the older retirees. At the same time, the gap between job openings and hiring remains significant and implies that businesses are more willing to increase their workforce but have struggled to find qualified individuals to fill these roles, at least in certain industries which are more dependent on high-skilled labor. Ultimately, we do expect to see some upward pressure on the participation rate throughout the year, which in turn should slow down declines in the unemployment rate as job growth is not expected to accelerate significantly in 2014.

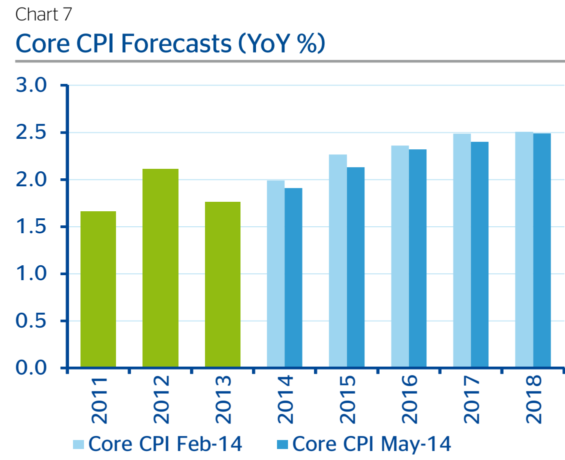
Inflation has been a hot topic throughout the past few quarters as prices continue to surprise to the downside. For the first quarter of 2014, headline and core CPI averaged 1.40% and 1.61%, respectively, on a YoY basis. PCE inflation held slightly lower at 1.07% and 1.14% for the headline and core, respectively. Clearly, both price indices are growing at a much slower rate than the Fed's target, but the question remains as to why this is the case in an environment of stronger growth expectations. Given the latest developments on the inflation front, we have revised down our forecasts for both headline and core CPI (Charts 6 and 7), with the biggest adjustments occurring in 2014 and 2015.

Chart 6
Headline CPI Forecasts (YoY %)



Source: BLS & BBVA Research

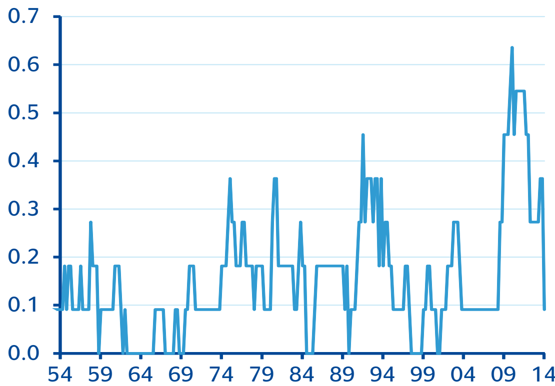
Chart 7
Core CPI Forecasts (YoY %)



Source: BLS & BBVA Research

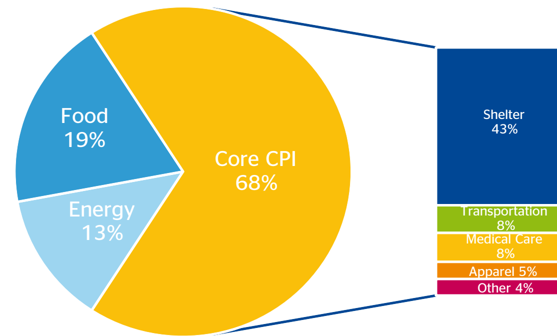
Our recent in-depth inflation analysis highlights the fact that low inflation in the U.S. has not always been associated with slow growth, and as such we do not see that is has major impediments for economic growth. Furthermore, our deflation vulnerability index (Chart 8) has dropped significantly throughout the first quarter of 2014, suggesting that the current slowing inflation rate should be considered fairly transitory. In the short-term we expect to see temporary influences fade and moderate inflationary pressures arise from the usual contributors to the index, such as medical care, shelter, and energy (Chart 9). However, we expect that inflation will stabilize at new historic lows over the long term as a result of economic structural changes (i.e. lower costs of production and labor-to-capital ratios driven by globalization and infiltration of technology). Our models suggest a slow increase in prices, with core PCE inflation remaining below the Fed's 2.0% target even as we head into 2016. Still, low inflation by itself should not divert the FOMC from the current policy timeline on tapering and the projected path of the federal funds rate. Inflation expectations appear to be well-anchored, though sizable deviations in the inflation rate could prompt a change in the trajectory of the Fed's monetary policy strategy.

Chart 8
Deflation Vulnerability Index (%)



Source: BBVA Research

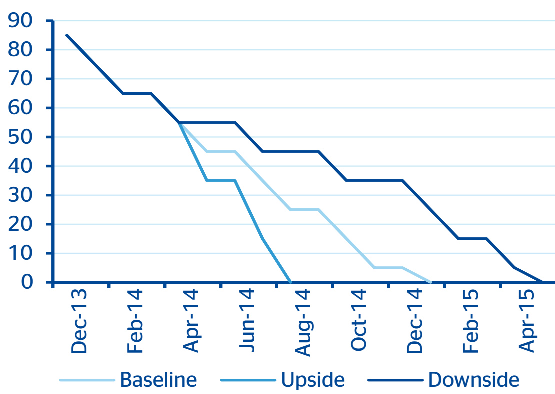
Chart 9
CPI Components (%)



Source: BLS & BBVA Research

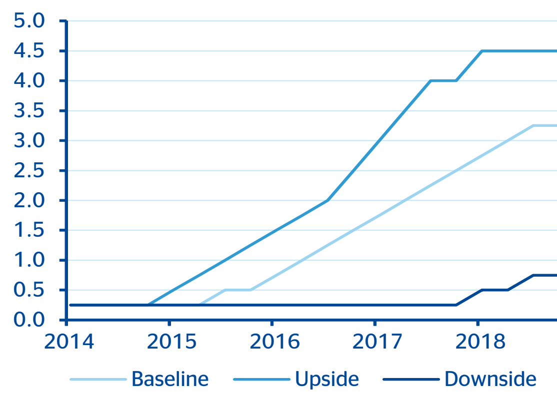
As the Fed moves toward monetary policy normalization over the course of the next few years, they continue to keep a close eye on economic activity, particularly as it relates to the labor market and inflation. Following our expectations as well as its own preset tapering path, the FOMC announced in April another $10bn reduction to the monthly pace of asset purchases, adding $45bn per month to its balance sheet in May and June ($20bn in mortgage-backed securities and $25bn of longer-term Treasury securities). At this rate, and pending any immediate deterioration in economic data, we expect that the Fed will conclude the QE3 program in 4Q14. However, the situation is a bit more unclear when it comes to raising interest rates. Chair Yellen's prior comments regarding a possible six-month timeframe between the end of QE3 and the first rate hike have mostly blown over, and it has become clear that this was not something discussed in depth during FOMC meetings. Surprisingly, the current state of forward guidance seemed to satisfy all FOMC voters in April as they pulled together a unanimous vote. We expect that the upcoming meeting minutes will reveal the Committee's discussion on enhancing the effectiveness of forward guidance and other forms of communication regarding the trajectory of the federal funds rate. Still, the relevance of these discussions on the future course of monetary policy is questionable, with two FOMC voting members leaving and another two new members coming in for the next meeting in June. Changes to the Summary of Economic Projections should be rightfully anticipated. Furthermore, we maintain our expectation for the first federal funds rate increase in mid-2015, though the risks have tilted toward an earlier hike.

Chart 10
QE3 Tapering Path (US $Bn)



Source: Federal Reserve & BBVA Research

Chart 11
Federal Funds Rate Forecasts (%)



Source: Federal Reserve & BBVA Research

As the recovery continues to search for solid footing, an increase in U.S. interest rates is getting closer, though not immediate. Furthermore, while it is widely expected and the Fed is working to improve transparency and communication, this does not mean that there will be no impact. There are certainly risks to both scenarios of tightening monetary policy too much too soon or keeping rates too low for too long. Contrary to the belief that early tightening might suppress economic growth, an earlier-than-expected lift of the near-zero rate might come with additional perks of quicker policy normalization, ultimately signaling a healthier economic environment. Conversely, an extended period of low rates would result in further growth of the Fed's balance sheet and indefinitely delay policy normalization, pushing the Fed further into unchartered territories of unconventional tools and economic effects with the zero lower bound. However, we expect that the impact in terms of financial uncertainty will be contained (less additional potential for market correction in a scenario of global recovery) and diverse, prompting us to put more emphasis on the upside risk scenario.

3. Economic Forecasts

Table 1

	2Q13	3Q13	4Q13	1Q14	2012	2013	2014	2015	2016	2017
Real GDP (% SAAR)	2.5	4.1	2.6	0.1	2.8	1.9	**2.5**	**2.5**	**2.8**	**2.8**
Real GDP (Contribution, pp)										
PCE	1.2	1.4	2.2	2.0	1.5	1.4	**1.7**	**1.1**	**1.2**	**1.2**
Gross Investment	1.4	2.6	0.4	-1.0	1.4	0.8	**0.6**	**0.9**	**1.1**	**1.1**
Non Residential	0.6	0.6	0.7	-0.3	0.9	0.3	**0.5**	**0.9**	**0.9**	**0.9**
Residential	0.4	0.3	-0.3	-0.2	0.3	0.3	**0.1**	**0.3**	**0.2**	**0.2**
Exports	1.0	0.5	1.2	-1.1	0.5	0.4	**0.5**	**0.9**	**0.8**	**0.8**
Imports	-1.1	-0.4	-0.2	0.2	-0.4	-0.2	**0.2**	**0.4**	**0.3**	**0.4**
Government	-0.1	0.1	-1.0	-0.1	-0.2	-0.4	**-0.2**	**0.0**	**0.0**	**0.0**
Unemployment Rate (%, average)	7.5	7.2	7.0	6.7	8.1	7.4	**6.6**	**5.9**	**5.6**	**5.2**
Average Monthly Nonfarm Payroll (K)	201	172	198	190	186	194	**195**	**210**	**231**	**250**
CPI (YoY %)	1.4	1.5	1.2	1.4	2.1	1.5	**1.8**	**2.2**	**2.3**	**2.4**
Core CPI (YoY %)	1.7	1.7	1.7	1.6	2.1	1.8	**1.9**	**2.1**	**2.3**	**2.4**
Fiscal Balance (% GDP)	-	-	-	-	-6.8	-4.1	**-3.0**	**-2.7**	**-2.9**	**-3.0**
Current Account (bop, % GDP)	-2.3	-2.3	-1.9	-	-2.7	**-2.3**	**-1.9**	**-1.7**	**-1.5**	**-1.1**
Fed Target Rate (%, eop)	0.25	0.25	0.25	0.25	0.25	0.25	**0.25**	**0.50**	**1.50**	**2.50**
S&P Case-Shiller Index (YoY %)	9.96	11.15	11.30	12.52	2.85	10.60	**8.78**	**6.20**	**4.62**	**3.78**
10-Yr Treasury (% Yield, eop)	2.30	2.81	2.90	2.72	1.72	2.90	**3.41**	**3.80**	**4.10**	**4.34**
U.S. Dollar / Euro (eop)	1.32	1.34	1.37	1.38	1.31	1.37	**1.35**	**1.32**	**1.37**	**1.36**
Brent Oil Prices (dpb, average)	102.7	110.3	109.3	108.2	111.7	108.7	**112.2**	**117.2**	**120.2**	**124.2**

Source: BBVA Research & Haver Analytics

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