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U.S. Economic Outlook

Monthly Update

September 11, 2014

Meeting Details

Topic: U.S. Monthly Economic Outlook
Date: Thursday, September 11, 2014
Time: 10:00 am, Central Standard Time (Chicago, GMT-06:00)
Meeting Number / Access Code: 356 270 161
Meeting Password: bbva 1234

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Economic Activity

The significant rebound in 2Q14 GDP growth is in line with our expectations; no changes to our baseline scenario

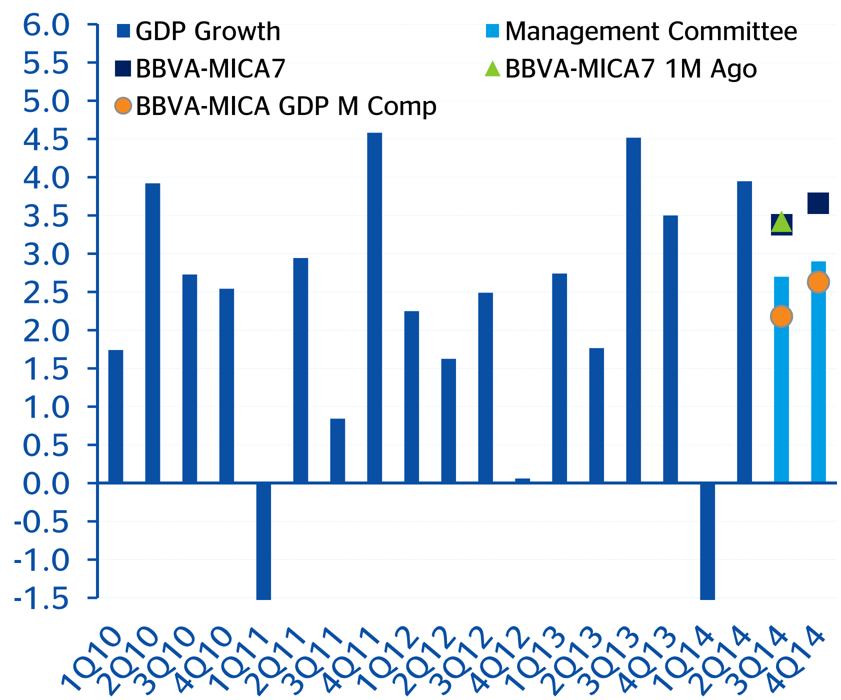
GDP Growth

QoQ SAAR and YoY, %

	2Q14	1Q14	2013
GDP	4.2	-2.1	3.1
PCE	2.5	1.2	2.8
Durables	14.3	3.2	5.9
Nondurables	1.9	0.0	2.5
Services	0.8	1.3	2.4
Investment	2.6	-1.1	1.3
Structures	9.4	2.9	5.0
Equipment	**10.7**	**-1.0**	**6.3**
Int. property	4.4	4.6	2.7
Residential	**7.2**	**-5.3**	**7.4**
Inventories	**1.4**	**-1.2**	**0.5**
Net exports	-0.4	-1.7	0.3
Exports	**10.1**	**-9.2**	**5.2**
Imports	11.0	2.2	2.5
Federal Gov't	-0.9	-0.1	-6.3
State & local	**2.9**	**-1.3**	**1.2**

GDP Growth

QoQ SAAR, %



Source: BBVA Research & Haver Analytics

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Economic Activity

	Last	3m ago	6m ago	12 m ago
National activity index (% chg, 3mma)	0.4	0.1	-0.9	-0.5
ISM	59.0	55.4	53.2	56.3
ISM nonmanufacturing	59.6	56.3	51.6	57.9
Small business optimism Index	104.8	104.2	103.1	103.0
Capacity utilization (%)	79.2	79.0	78.1	77.5
Industrial production (yoy % chg)	5.0	3.9	2.9	1.8
Capital goods new orders (yoy % chg)	8.0	4.0	-3.4	6.3
Unemployment rate (%)	6.1	6.3	6.7	7.2
Nonfarm payroll (Thou)	142	229	222	202
Auto sales (Million)	17.5	16.7	15.3	16.0
Real disposable income (yoy % chg)	2.6	2.5	2.3	0.6
Real personal spending (yoy % chg)	2.0	2.4	1.9	2.2
Retail sales ex autos & gas (yoy % chg)	3.8	3.8	1.4	4.0
Consumer confidence (Index)	92.4	82.2	78.3	81.8
Bank credit (C&I+RE+C; yoy % chg)	4.5	3.2	1.7	2.8
Housing starts (yoy % chg)	21.7	25.4	0.1	21.4
Home prices (CS/SP, yoy % chg)	8.1	12.4	13.4	12.0
New home sales (yoy % change)	12.3	-8.6	0.9	-0.5

Ongoing gains in business expectations and industrial production

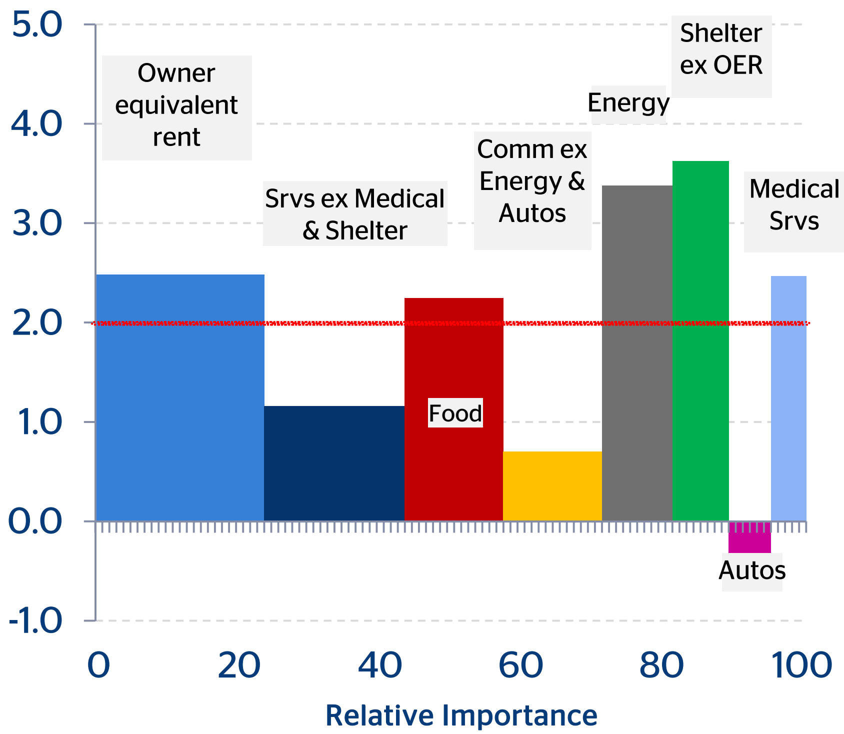
Stronger consumer confidence, auto sales and housing market indicators

Inflation

We expect inflation to slowly edge up, but significant inflationary pressures remain contained

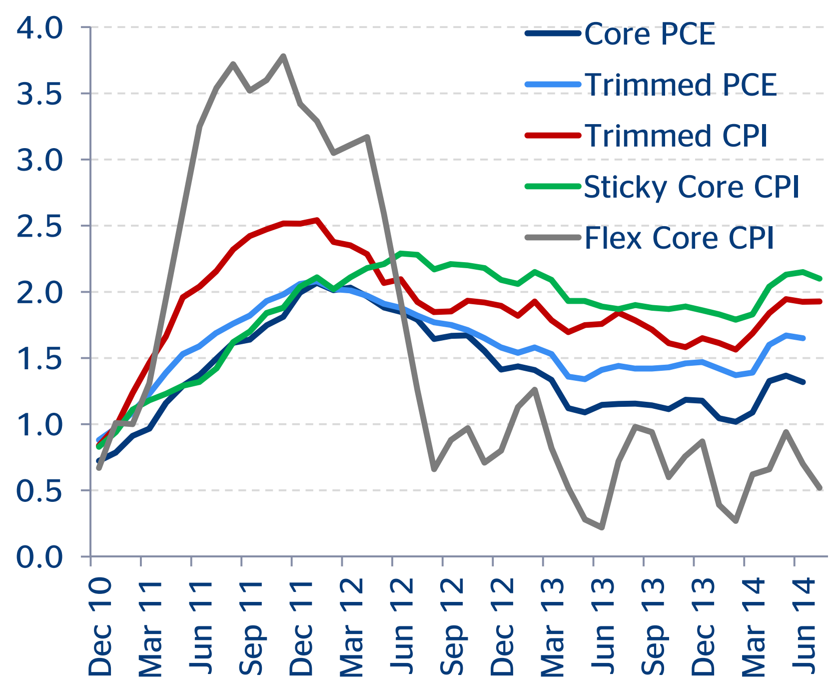
Contributions to CPI

Relative Importance & 12m% change



Inflation

12m % change



Source: BBVA Research / Haver Analytics

Monetary Policy

Fed

FOMC Minutes: July 29-30, 2014

- Most participants agreed on a tentative plan for policy normalization
- The FOMC views improvement in the labor market outlook as sufficient enough; upgrade of forward guidance characterization of "labor market underutilization" on the horizon
- Assessment of medium-term economic projections revealed many participants' worries over possibility of quicker-than-anticipated convergence of economic outlook toward the FOMC goals
- "Many participants noted that if convergence toward the Committee's objectives occurred more quickly than expected, it might become appropriate to begin removing monetary policy accommodation sooner than they currently anticipated."

What do we expect?

- Measured steps of $10bn reduction of QE3 with $15bn. final reduction in October
- Timing of the rate hike and the path of policy rate remains data dependent
- Reinvestments policy to end at or after the zero-bound lift off, with gradual wind-down to smooth the decline in the balance sheet
- The FOMC to communicate its exit strategy later this year, before the first steps of policy normalization are appropriate

1st Rate increase

Mid – 2015

Maintaining the 3Q15 baseline with a light bias towards an earlier rate hike

Timeline Exit Strategy

4Q14
Expected End QE3

3Q15
First FFR Hike

1H16
Policy Normalization
Let securities mature/sales

FOMC Minutes, July 29-30

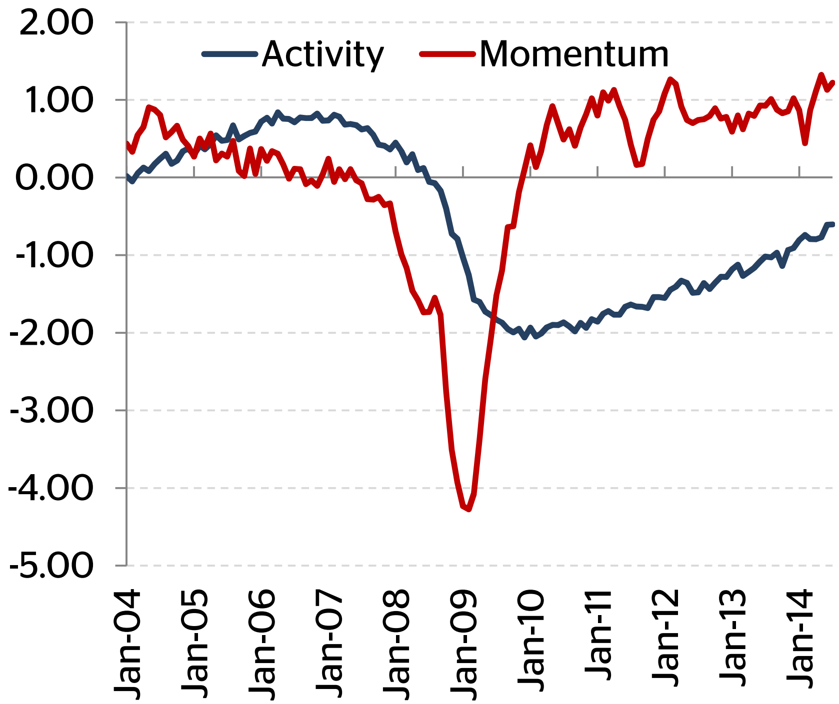
- Retain the federal funds rate as the key policy rate
- Continuing to target a range of 25 basis points for the fed funds at the time of liftoff and for some time thereafter
- Use adjustments in the interest on excess reserves (IOER) rate as the primary tool to move the federal funds rate into its target range and influence other money market rates
- Temporary use of a limited-scale overnight reverse repurchase agreement (ON RRP) facility to help set a firmer floor under money market interest rates during normalization
    - The ON RRP facility should be only as large as needed for effective monetary policy implementation and should be phased out when it is no longer needed for that purpose
    - Desire to limit the Fed's role in financial intermediation and mitigate the risk that the facility might magnify strains in short-term funding markets during periods of financial stress
- Set (at least initially) the IOER rate at the top of the target range for the federal funds rate, and the ON RRP rate at the bottom of the federal funds target range
- In the long run, reduce the balance sheet to the smallest level consistent with efficient implementation of monetary policy and should consist primarily of Treasuries to minimize the effect of the SOMA portfolio on the allocation of credit across sectors of the economy
    - Reduce or end reinvestment sometime after the first increase in the target range for the federal funds rate

Fed Jackson Hole Symposium

"Our assessments of the degree of slack must be based on a wide range of variables and will require difficult judgments about the cyclical and structural influences in the labor market" Janet Yellen, Aug 22, 2014

Labor Market Conditions Indicators

Change; >0 = above long-run average, <0 = below long-run average



"If downward nominal wage rigidities created a stock of pent-up wage deflation during the economic downturn, observed wage and price pressures associated with a given amount of slack or pace of reduction in slack might be unusually low for a time"

"Conversely, profound dislocations in the labor market in recent years--such as depressed participation associated with worker discouragement and a still-substantial level of long-term unemployment--may cause inflation pressures to arise earlier than usual as the degree of slack in the labor market declines."

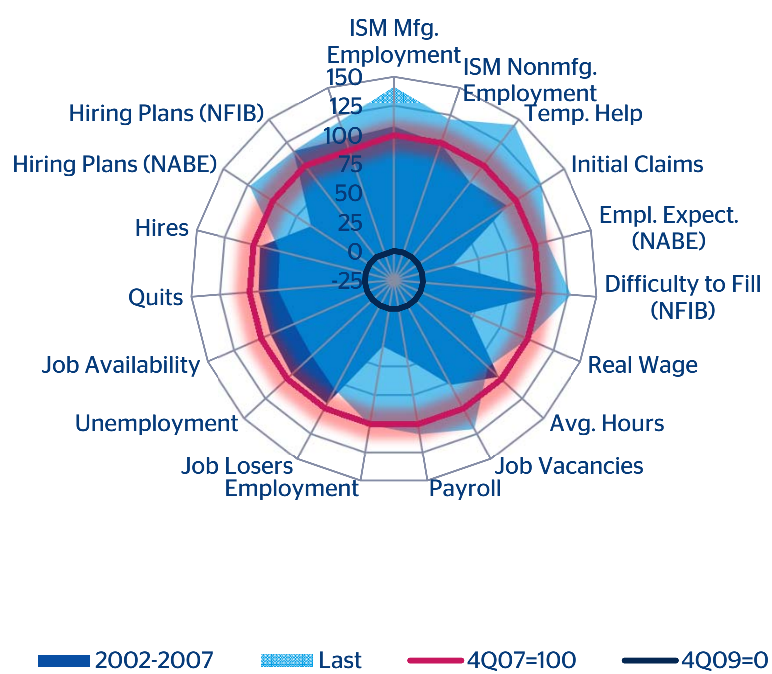
Source: BBVA Research & KC Fed

Fed Jackson Hole Symposium

The improvement in labor market conditions could force dovish FOMC members to reassess their timing of policy normalization

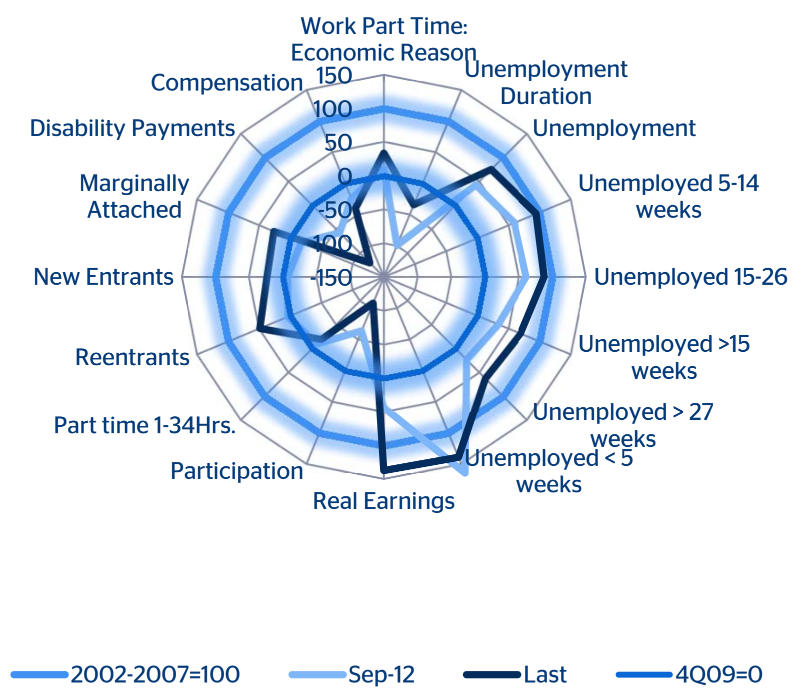
Labor Market Outlook

%



Labor Market Utilization

%



Source: BBVA Research & Haver Analytics

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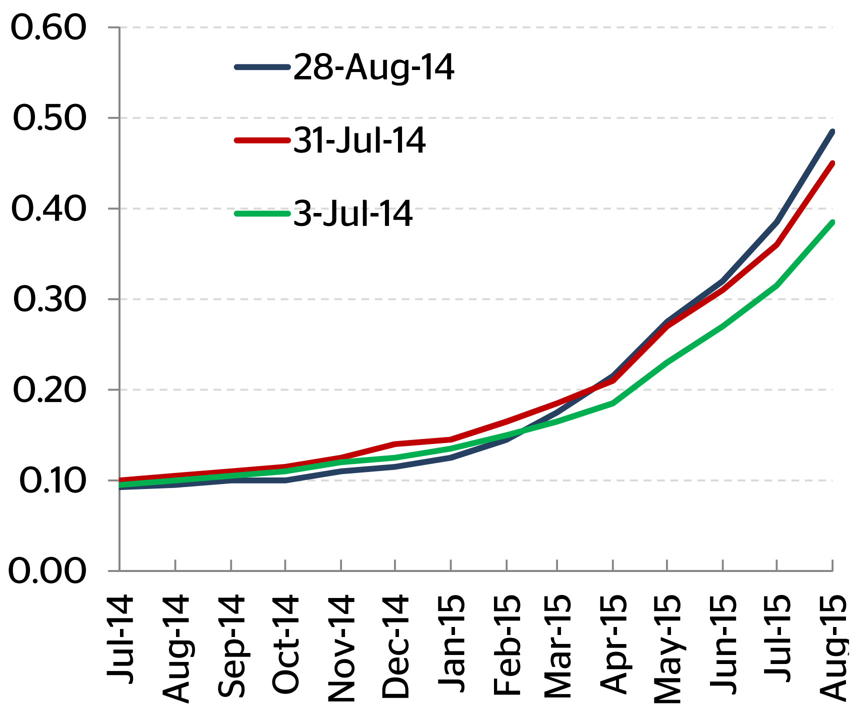
Federal Funds Rate

Markets expectations are adjusting to an earlier rate hike

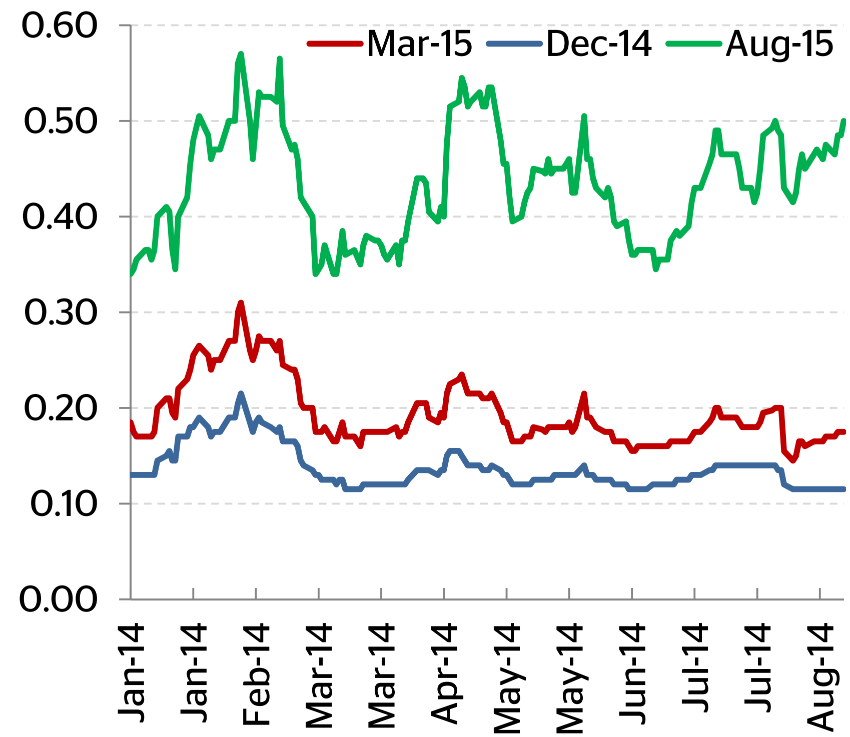
Fed funds futures

%,



Fed funds futures

%



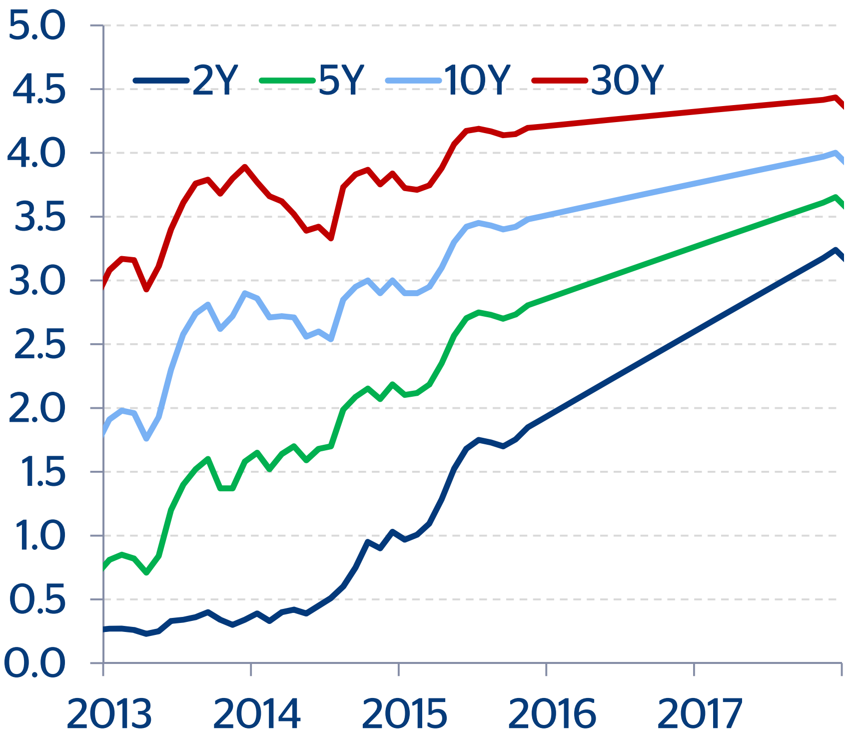
Source: BBVA Research & Haver Analytics

Yield Curve

Official U.S. Yield Curve Scenario

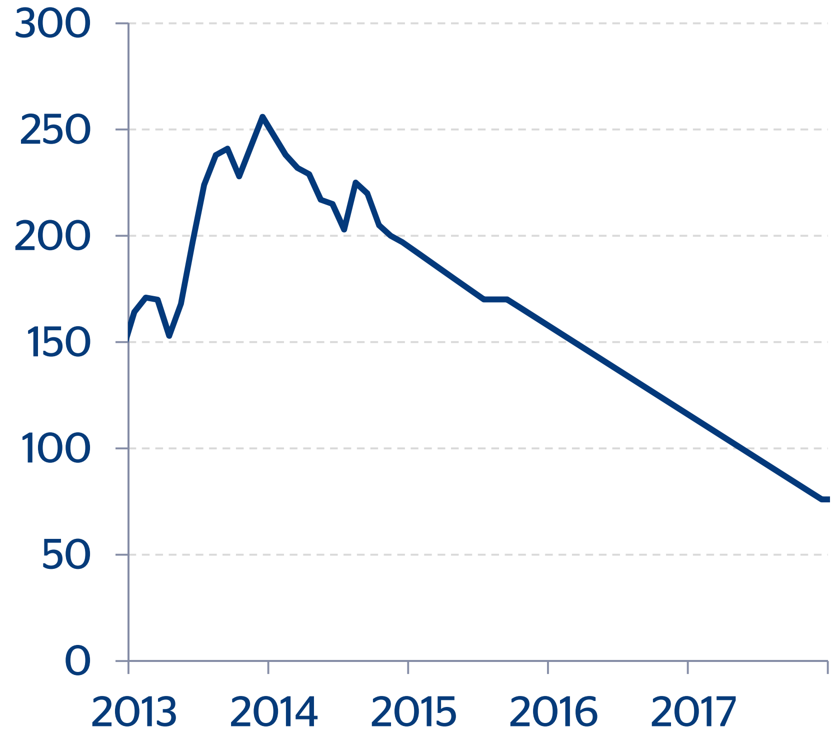
US Yield Curve

%,



Yield Curve Slope 10YTN-2YTN

%



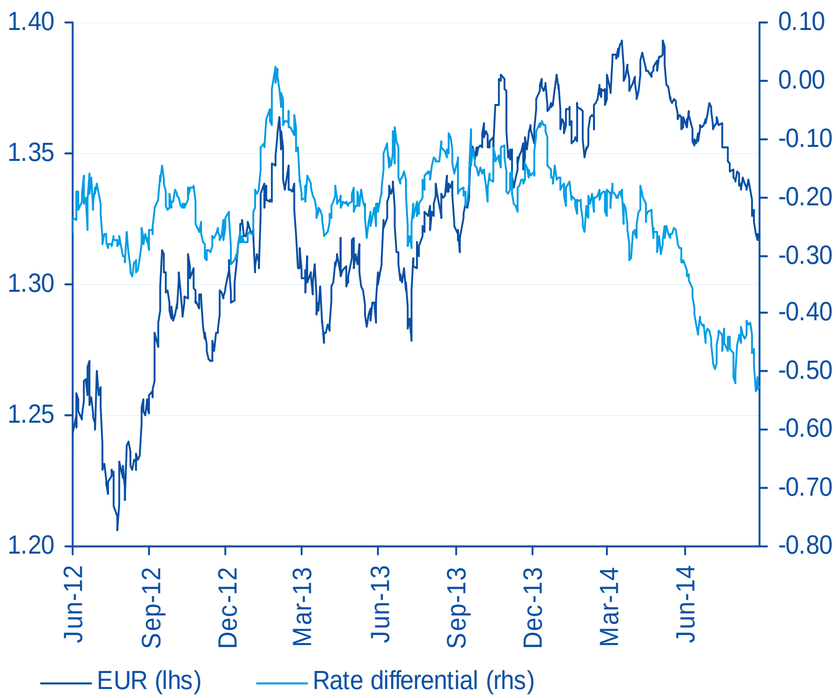
Source: BBVA Research

Euro/Dollar

As expected, Euro depreciation has intensified

EURUSD vs. 2year bond yield differential (GER-US)

Source: Bloomberg and BBVA Research



Monetary policy divergence: ECB's easing vs. Fed's tightening expectations is finally playing its role

Macroeconomic data increasingly supports the USD vs. the EUR

We maintain our projection of 1.31 by year-end. Our bias calls for a stronger dollar considering given our economic outlook and monetary policy expectations for the Eurozone

Baseline Forecasts

	1Q13	2Q13	3Q13	4Q13	1Q14	2Q14	2011	2012	2013	**2014**	**2015**	**2016**	**2017**
Real GDP (% SAAR)	2.7	1.8	4.5	3.5	-2.1	4.2	1.6	2.3	2.2	**2.0**	**2.5**	**2.8**	**2.8**
Real GDP (Contribution, pp)													
PCE	2.5	1.2	1.4	2.5	0.8	1.7	1.6	1.3	1.6	**1.4**	**1.1**	**1.3**	**1.3**
Gross Investment	1.1	1.0	2.5	0.6	-1.1	2.6	0.7	1.3	0.8	**0.8**	**0.8**	**1.0**	**1.2**
Non Residential	0.2	0.2	0.7	1.2	0.2	1.0	0.9	0.8	0.4	**0.7**	**0.8**	**0.8**	**0.9**
Residential	0.2	0.5	0.3	-0.3	-0.2	0.2	0.0	0.3	0.3	**0.1**	**0.2**	**0.2**	**0.3**
Exports	-0.1	0.8	0.7	1.3	-1.3	1.3	0.9	0.4	0.4	**0.4**	**1.0**	**0.9**	**0.8**
Imports	0.0	-1.4	-0.1	-0.2	-0.4	-1.7	-0.9	-0.4	-0.2	**0.6**	**0.5**	**0.4**	**0.4**
Government	-0.8	0.0	0.0	-0.7	-0.2	0.3	-0.7	-0.3	-0.4	**-0.1**	**0.0**	**0.0**	**0.0**
Unemployment Rate (%, average)	7.7	7.5	7.2	7.0	6.7	6.2	8.9	8.1	7.4	**6.3**	**5.9**	**5.8**	**5.5**
Average Monthly Nonfarm Payroll (K)	206	201	172	198	190	267	174	186	194	**208**	**210**	**231**	**250**
CPI (YoY %)	1.7	1.4	1.5	1.2	1.4	2.1	3.1	2.1	1.5	**1.9**	**2.2**	**2.3**	**2.4**
Core CPI (YoY %)	1.9	1.7	1.7	1.7	1.6	1.9	1.7	2.1	1.8	**2.0**	**2.1**	**2.3**	**2.4**
Fiscal Balance (% GDP)	-	-	-	-	-	-	-8.7	-6.8	-4.1	**-3.0**	**-2.7**	**-3.0**	**-3.0**
Current Account (bop, % GDP)	-2.6	-2.6	-2.4	-2.0	-2.6	-	-3.0	-2.8	-2.4	**-2.8**	**-2.7**	**-2.5**	**-2.0**
Fed Target Rate (%, eop)	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	**0.25**	**0.50**	**1.50**	**2.50**
Core Logic National HPI (YoY %)	10.01	11.20	11.51	11.67	11.43	8.24	-3.92	3.89	11.11	**11.27**	**10.92**	**8.16**	**7.22**
10-Yr Treasury (% Yield, eop)	1.96	2.30	2.81	2.90	2.72	2.60	1.98	1.72	2.90	**3.00**	**3.50**	**3.75**	**4.00**
U.S. Dollar / Euro (eop)	1.30	1.32	1.34	1.37	1.38	1.36	1.32	1.31	1.37	**1.31**	**1.29**	**1.36**	**1.36**
Brent Oil Prices (dpb, average)	112.6	102.7	110.3	109.3	108.2	109.7	111.3	111.7	108.7	**110.8**	**118.6**	**122.1**	**127.6**

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