

Economic Analysis

Defense Spending Leads 3.5% GDP Growth in 3Q

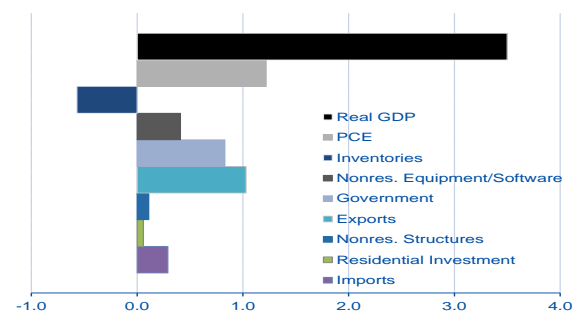
Kim Fraser Chase

The advance report for real GDP growth in 3Q14 came in stronger than expected, up 3.5% QoQ SAAR. However, much of this was driven by an astounding 16.0% jump in national defense spending, the largest gain since 2Q09. Despite the favorable headline figure, this reflects more of a one-off event rather than a steady continuation of the momentum gained in 2Q14. As expected, we did see some adjustment in various GDP components following 2Q14's significant rebound. Not surprisingly, residential investment decelerated significantly but remained positive at 1.8% growth. Nonresidential investment slowed slightly, with a bigger push coming from equipment rather than structures this time around. Imports declined for the first time since 1Q13 but export growth remained strong at 7.8%. Personal consumption did not hold up as much as we had expected, slowing to 1.8% in 3Q14. This initial estimate for 3Q14 GDP puts upward bias on our annual growth forecast for 2014. However, the underlying details support our outlook for gradual yet ongoing improvement in economic activity. Without the big push from defense spending, growth would have been much closer to our projection of 2.5% for the quarter. For 4Q14, we expect that growth will slow down from the rates seen in 2Q and 3Q, though there is more uncertainty given that this will mark the first quarter without any additional stimulus from the Fed.

FOMC Statement: Fed Ends QE3 as Expected, Maintains Reinvestment Policy

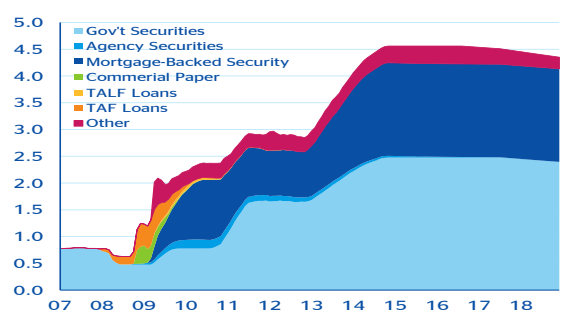
The FOMC moved one step closer towards policy normalization, citing “substantial improvement in the outlook for the labor market” as the main decisive factor behind ending QE3. Forward guidance language remained unchanged, still indicating that the anticipation of the near zero federal funds rate will remain “for a considerable time following the end of its asset purchase program this month.” The data-dependency factor remains vital to future monetary policy action, with the Fed stressing that a faster-than-expected improvement in the economic outlook could result in “increases in the target range for the federal funds rate are likely to occur sooner than currently anticipated.” On the contrary, if the economy progresses slower than the FOMC expects, “increases in the target range are likely to occur later than currently anticipated.” Given the heightened focus on low inflation, we expect that the FOMC will be willing to hold off on the first rate hike until mid-2015, though the probability for an early rate hike will increase if downward pressure on inflation fades by the end of this year, in parallel with sustainable improvements in the labor market (see our recent [FedWatch](#)).

Graph 1
3Q14 Contributions to Real GDP (SAAR pp)



Source: BEA & BBVA Research

Graph 2
Federal Reserve Balance Sheet (\$trillion)



Source: FRB & BBVA Research

Week Ahead

ISM Manufacturing Index (October, Monday 10:00 ET)

Forecast: 57.3

Consensus: 56.5

Previous: 56.6

The ISM Manufacturing Index is expected to increase slightly in October after dipping in September for the first time since January. Still, we do not expect that the index will rise above the three-year high seen in August. In September, the production index was the only component to register even a modest gain. However, new orders dropped nearly 10% for the month and may influence a decline in production for October. Most other components should register at least a minor rebound from September's weakness as we move along in 4Q14.

International Trade (September, Tuesday 8:30 ET)

Forecast: -\$40.9B

Consensus: -\$40.0B

Previous: -\$40.1B

International trade has fared relatively well throughout the past few months, particularly given the increasing concerns regarding slower global growth, geopolitical conflicts, and the ebola outbreak. Net exports marked a positive contribution to GDP growth in 3Q14 for the first time this year, yet we expect that this could reverse again as global demand remains weak and the U.S. dollar continues to appreciate. At the same time, the stronger dollar helps promote domestic demand, and with the start of the fourth quarter holiday shopping season, we could see an increase in imported goods for the month. Overall, we expect to see a slight deterioration of the trade balance in September as domestic activity overshadows external demand.

Nonfarm Payrolls and Unemployment Rate (October, Friday 8:30 ET)

Forecast: 224K, 5.9%

Consensus: 230K, 5.9%

Previous: 248K, 5.9%

The employment situation continues to improve in line with expectations, with nonfarm payrolls exceeding the 200K-per-month mark in seven of the last eight months. For October, we expect to see a similar report, with payrolls slightly above 200K and the unemployment rate holding at 5.9%. However, the declining participation rate allows for further declines in the unemployment rate, particularly if payroll growth continues along at a steady pace. October is usually a big month for retail hiring given the start of the heavy shopping season, so we expect to see a large push from this component.

Consumer Credit (September, Friday 8:30 ET)

Forecast: \$15.1B

Consensus: \$16.0B

Previous: \$13.5B

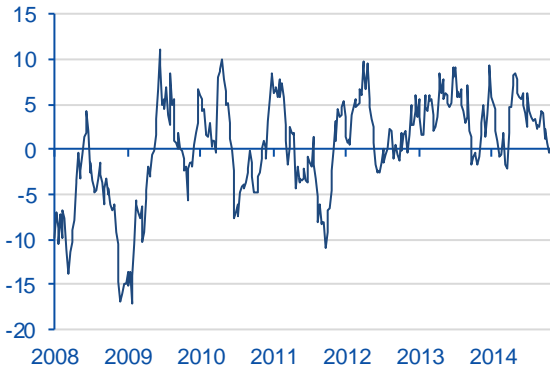
Consumer credit is expected to increase in September at a slightly faster pace than in August. Growth decelerated slightly in August to the slowest pace since November 2013, yet the month-to-month change remains in double-digits. Low inflation has boosted consumers' purchasing power, giving them the added confidence they need to take on additional debt. Therefore, we expect to see a rebound in revolving credit for the month, mostly in the form of credit card debt. Nonrevolving consumer credit is likely to continue along at a steady pace, particularly given the ongoing strength in demand for auto loans.

Market Impact

The end to QE3 passed without a major glitch in financial markets, and 3Q14's better-than-expected advance estimate for GDP growth left markets a bit more relaxed about economic activity in the U.S. This week, markets will focus all attention on Friday's employment report as well as the variety of FOMC member speeches that may divulge further details on the Fed's next steps post-QE3.

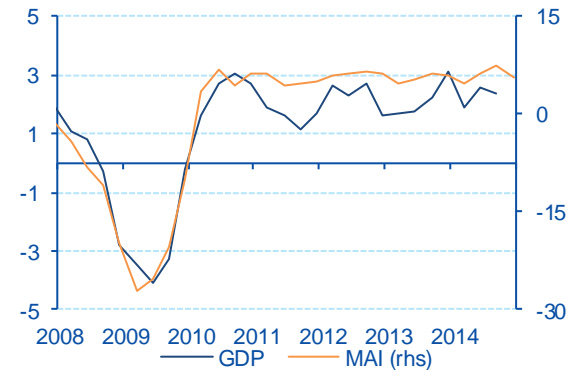
Economic Trends

Graph 3
BBVA US Weekly Activity Index (3 month % change)



Source: BBVA Research

Graph 4
BBVA US Monthly Activity Index & Real GDP (4Q % change)



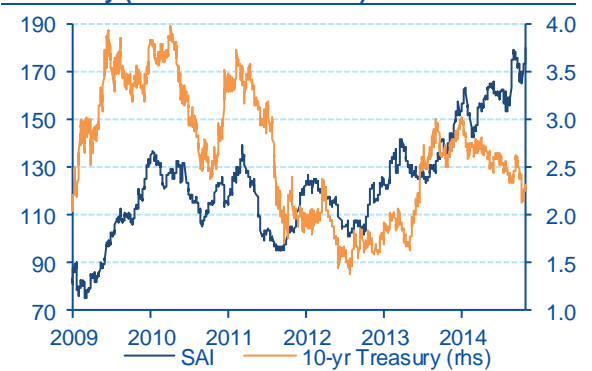
Source: BBVA Research & BEA

Graph 5
BBVA US Surprise Inflation Index (Index 2009=100)



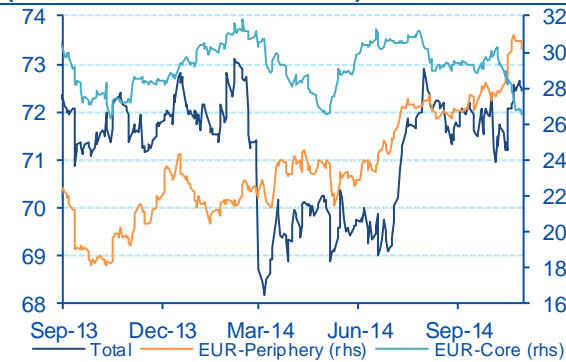
Source: BBVA Research

Graph 6
BBVA US Surprise Activity Index & 10-yr Treasury (Index 2009=100 & %)



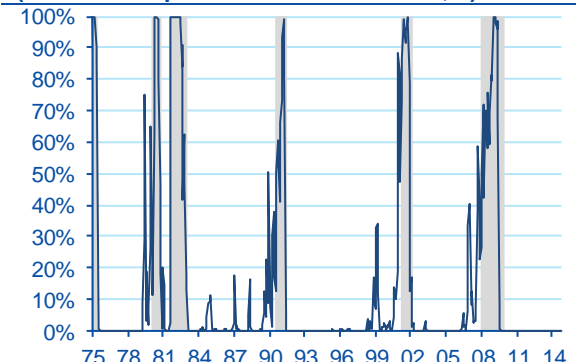
Source: Bloomberg & BBVA Research

Graph 7
Equity Spillover Impact on US (% Real Return Co-Movements)



Source: BBVA Research

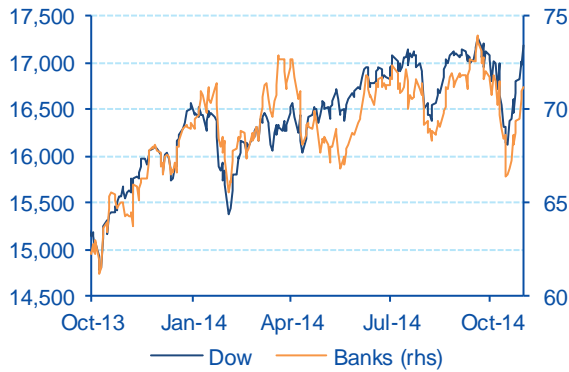
Graph 8
BBVA US Recession Probability Model (Recession episodes in shaded areas, %)



Source: BBVA Research

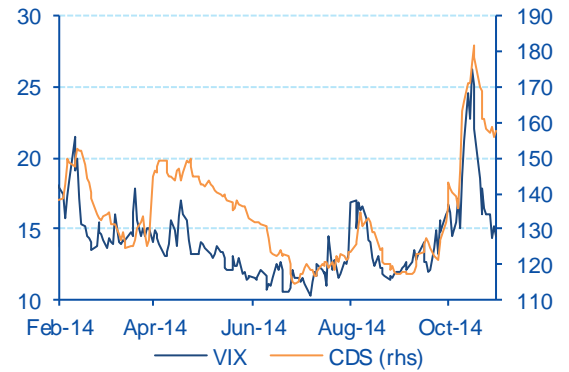
Financial Markets

Graph 9
Stocks
(Index, KBW)



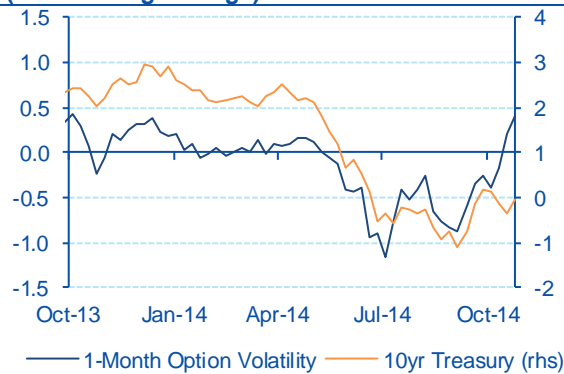
Source: Bloomberg & BBVA Research

Graph 10
Volatility & High-Volatility CDS
(Indices)



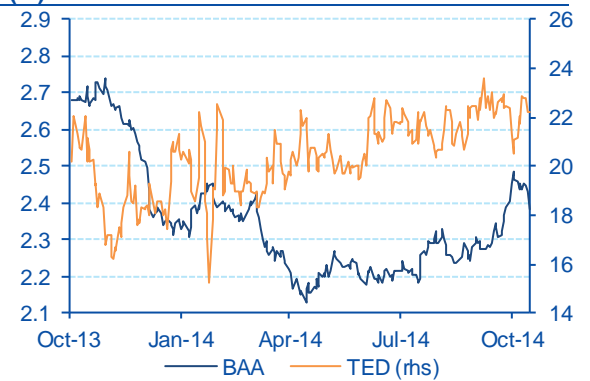
Source: Bloomberg & BBVA Research

Graph 11
Option Volatility & Real Treasury
(52-week avg. change)



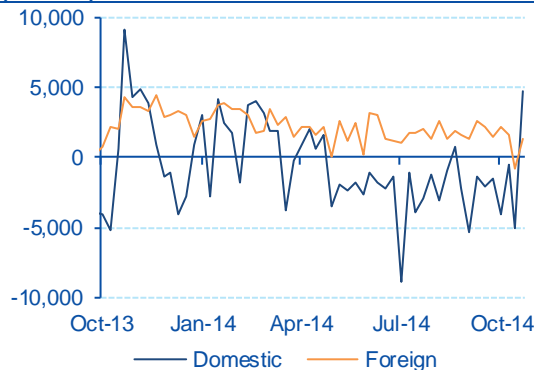
Source: Haver Analytics & BBVA Research

Graph 12
TED & BAA Spreads
(%)



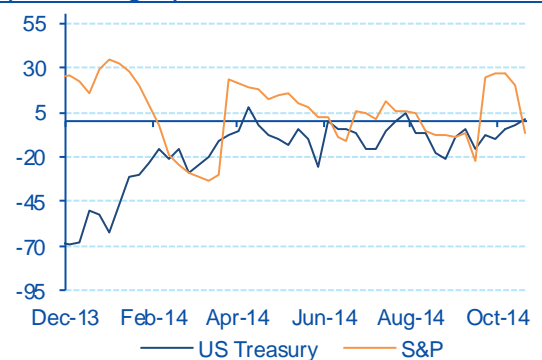
Source: Bloomberg & BBVA Research

Graph 13
Long-Term Mutual Fund Flows
(US\$Mn)



Source: Haver Analytics & BBVA Research

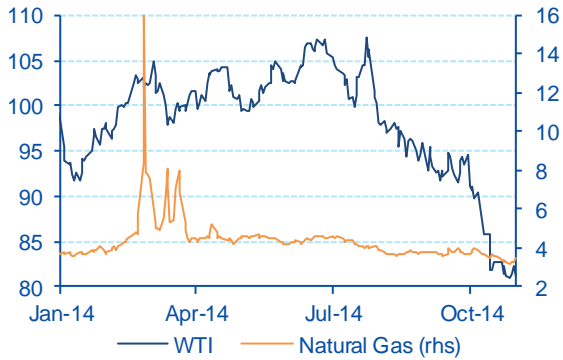
Graph 14
Total Reportable Short & Long Positions
(Short-Long, K)



Source: Haver Analytics & BBVA Research

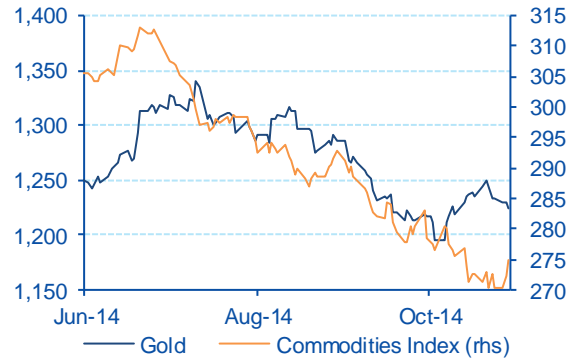
Financial Markets

Graph 15
Commodities
(Dpb & DpMMBtu)



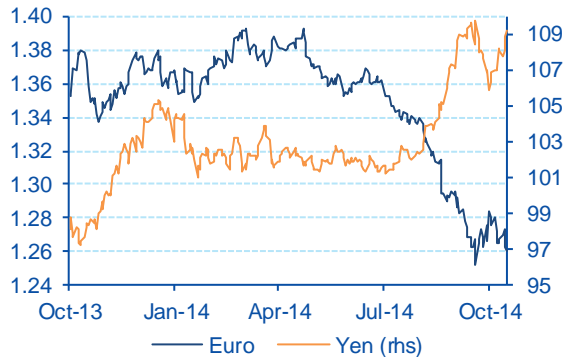
Source: Bloomberg & BBVA Research

Graph 16
Gold & Commodities
(US\$ & Index)



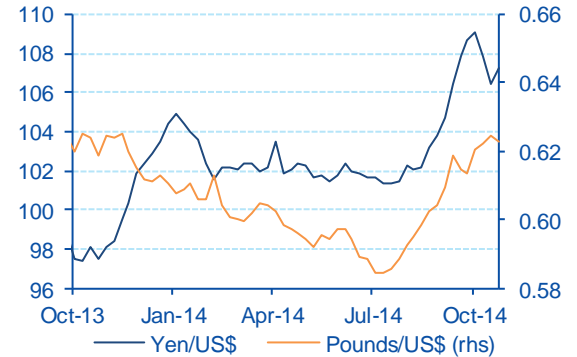
Source: Haver Analytics & BBVA Research

Graph 17
Currencies
(Dpe & Ypd)



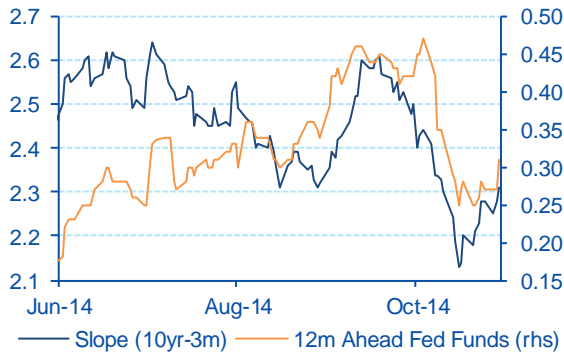
Source: Bloomberg & BBVA Research

Graph 18
6-Month Forward Exchange Rates
(Yen & Pound / US\$)



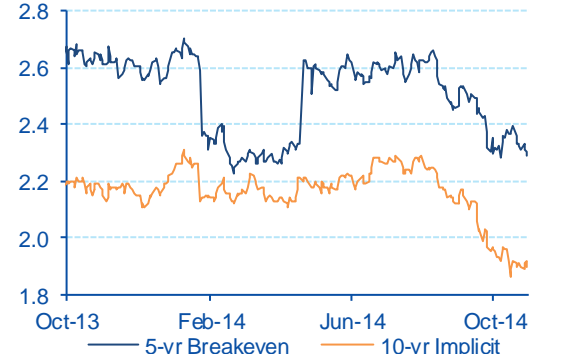
Source: Haver Analytics & BBVA Research

Graph 19
Fed Futures & Yield Curve Slope
(% & 10year-3month)



Source: Haver Analytics & BBVA Research

Graph 20
Inflation Expectations
(%)



Source: Bloomberg & BBVA Research

Interest Rates

Table 1

Key Interest Rates (%)

	Last	Week ago	4-Weeks ago	Year ago
Prime Rate	3.25	3.25	3.25	3.25
Credit Card (variable)	14.86	14.86	14.86	14.10
New Auto (36-months)	2.95	2.94	2.94	2.64
Heloc Loan 30K	4.85	4.84	4.81	5.26
5/1 ARM *	2.94	2.91	3.06	2.90
15-year Fixed Mortgage *	3.13	3.08	3.36	3.23
30-year Fixed Mortgage *	3.98	3.92	4.19	3.99
Money Market	0.42	0.42	0.42	0.42
2-year CD	0.90	0.89	0.89	0.81

*Freddie Mac National Mortgage Homeowner Commitment US
Source: Bloomberg & BBVA Research

Table 2

Key Interest Rates (%)

	Last	Week ago	4-Weeks ago	Year ago
1M Fed	0.09	0.09	0.09	0.07
3M Libor	0.23	0.23	0.23	0.24
6M Libor	0.32	0.32	0.32	0.35
12M Libor	0.54	0.55	0.55	0.60
2yr Sw ap	0.69	0.65	0.80	0.42
5yr Sw ap	1.73	1.67	1.87	1.49
10Yr Sw ap	2.45	2.42	2.58	2.75
30yr Sw ap	3.03	3.03	3.14	3.67
30day CP	0.10	0.12	0.11	0.12
60day CP	0.13	0.11	0.11	0.15
90day CP	0.16	0.13	0.13	0.13

Source: Bloomberg & BBVA Research

Quote of the Week

Alan Greenspan, Former Federal Reserve Chairman

Former Fed Chief Greenspan Worried about Future of Monetary Policy

29 October 2014

“Recent episodes in which Fed officials hinted at a shift toward higher interest rates have unleashed significant volatility in markets, so there is no reason to suspect that the actual process of boosting rates would be any different.”

Economic Calendar

Date	Event	Period	Forecast	Survey	Previous
3-Nov	ISM Manufacturing PMI SA	OCT	57.30	56.50	56.60
3-Nov	Census Bureau US Construction Spending MoM SA	SEP	0.50	0.70	-0.80
4-Nov	US Trade Balance of Goods and Services SA	SEP	-40.90	-40.00	-40.11
4-Nov	NEW YORK PURCHASING MANAGER Current Business Conditions SA	OCT	64.00	-	63.70
4-Nov	US Manufacturers New Orders Total MoM SA	SEP	-0.70	-0.45	-10.10
5-Nov	ADP National Employment Report SA Private Nonfarm Level Change	OCT	205.00	213.50	212.70
5-Nov	ISM Non-Manufacturing NMI NSA	OCT	59.00	58.00	58.60
6-Nov	US Initial Jobless Claims SA	1-Nov	290.00	285.00	287.00
6-Nov	US Continuing Jobless Claims SA	25-Oct	2385.00	2352.00	2384.00
6-Nov	US Output Per Hour Nonfarm Business Sector QoQ SA	3Q P	1.90	0.90	2.30
6-Nov	US Unit Labor Costs Nonfarm Business Sector QoQ % SAAR	3Q P	-0.50	0.90	-0.10
7-Nov	US Employees on Nonfarm Payrolls Total MoM Net Change SA	OCT	224.00	230.00	248.00
7-Nov	US Employees on Nonfarm Payrolls Total Private MoM Net Change SA	OCT	217.00	225.00	236.00
7-Nov	US Employees on Nonfarm Payrolls Manufacturing Industry Monthly Net Change SA	OCT	5.00	10.00	4.00
7-Nov	US Average Hourly Earnings All Employees Total Private Monthly Percentage Change	OCT	0.20	0.20	0.00
7-Nov	US Average Weekly Hours All Employees Total Private SA	OCT	34.50	34.60	34.60
7-Nov	US Unemployment Rate (%)	OCT	5.90	5.90	5.90
7-Nov	Federal Reserve Consumer Credit Total Net Change SA	SEP	15.10	16.00	13.53

Forecasts

	2011	2012	2013	2014	2015	2016	2017
Real GDP (% SAAR)	1.8	2.8	1.9	2.0	2.5	2.8	2.8
CPI (YoY %)	3.1	2.1	1.5	1.9	2.2	2.3	2.4
CPI Core (YoY %)	1.7	2.1	1.8	1.9	2.1	2.3	2.4
Unemployment Rate (%)	8.9	8.1	7.4	6.2	5.8	5.5	5.0
Fed Target Rate (eop, %)	0.25	0.25	0.25	0.25	0.50	1.50	2.50
10Yr Treasury (eop, % Yield)	1.98	1.72	2.90	2.65	3.36	3.75	3.98
US Dollar/ Euro (eop)	1.31	1.31	1.37	1.23	1.20	1.24	1.26

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