

Economic Analysis

Unemployment Rate Drops to 5.6% in December

Kim Fraser Chase

Employment growth continues to surpass expectations, with December's report closing out 2014 as the strongest year of the labor market recovery thus far. Nonfarm payrolls increased 252K following an upwardly revised 353K gain in November (from the initial 321K estimate). The strong +200K job growth seen since February has certainly helped push down the unemployment rate, which ended the year at 5.6%. However, we have also seen simultaneous declines in labor force participation, with the rate falling to 62.7% in December. According to the CPS labor force status flows, the number of those employed who dropped out of the labor force declined more than 8.0% in December, while the number those employed who became unemployed declined 10.7%. This hints at a healthy shift in demographic trends, especially considering the fact that long-term unemployment has declined throughout the past five months. Labor market data has consistently been stronger-than-expected throughout 2014, with more consistent payroll gains and a faster-than-expected decline in the unemployment rate. As such, we are revising our forecasts for the coming years to reflect a more optimistic outlook for domestic activity. Most notably, the unemployment rate could drop below the 5.0% threshold by the end of 2015 or early 2016. Our previous forecasts had been hanging onto the idea that the participation rate would gradually rise as people came back into the labor force, though it appears that it may not increase as much as we had initially expected. Therefore, we will continue to see declines in the unemployment rate partially influenced by low participation but also driven by continued strength in nonfarm payroll growth.

FOMC Meeting Minutes: Committee Stresses Importance of Data Dependency

The details of the December meeting minutes did not shift market expectations regarding the pace of policy normalization. FOMC members' commentary touched upon the important economic factors with expectations of continued strong growth, increasing employment, and slow return of inflation to their target of 2.0%. Inflation concerns were certainly addressed in the meeting, although the statement suggests that the Committee still sees low inflation as only transitory. Members did agree that inflation was likely to fall further (which we have already seen since the meeting occurred) with the idea that it would gradually move towards their target "as the labor market improved further in an environment of well-anchored inflation expectations." FOMC participants acknowledged that declining inflation compensation was a reflection of lower inflation risk premiums instead of a drop in expectations. Still, some members noted the potential severity of this downward trend in inflation compensation as it relates to investor concerns of weaker economic activity. In line with the language change, the FOMC stance on policy normalization remained unchanged. The minutes convey the Committee's positive outlook for further economic growth and acceptance of current low inflation levels. The minutes state that the Fed "might begin normalization at a time when core inflation was near current levels," although with the necessary belief that inflation will move back toward the 2% target "over time." According to the FOMC projected path of the federal funds rate, the dispersion of the appropriate rate for 2015 narrowed. The Fed continues to believe that the highly accommodative monetary policy stance will remain appropriate even after the rate hike as they intend to keep holdings of long-term securities unchanged. The probability of an early rate hike remains positive given the solid improvement in labor market conditions. However, downward pressures on prices may create greater concerns within the FOMC if the low inflationary environment is perceived to be more long-lasting. Therefore, we maintain our baseline scenario for a liftoff in mid-2015 (see our latest [Fed Watch](#)).

Week Ahead

Retail Sales, Ex Auto and Gas (December, Wednesday 8:30 ET)

Forecast: 0.4%, 0.5%

Consensus: -0.1%, 0.5%

Previous: 0.7%, 0.6%

Retail sales are expected to finish 2014 on a strong note, closing out the fourth quarter at a relatively healthy pace. At the headline level, December's sales will be driven by the final push for holiday shopping, though the nominal figure will be weighed down by falling prices. Unit auto sales declined slightly for the month following a big jump in November, but this does not necessarily mean that we'll see a corresponding decline in autos from the retail sales report. Oil prices continued to decline in December and will most likely drag down nominal sales at gasoline stations for the seventh consecutive month.

Consumer Price Index (December, Friday 8:30 ET)

Forecast: -0.4%, 0.0%

Consensus: -0.4%, 0.1%

Previous: -0.3%, 0.1%

Inflation in December will once again be dragged down by the energy index, with crude oil prices down approximately 20% since November. Natural gas prices have also dropped significantly for the month. As such, we expect that the headline CPI will decline more in December than in November, possibly marking the largest monthly drop in the index seen since the recession. This will be the sixth consecutive month for declining energy prices, and the end does not appear to be anywhere in sight. While we have not seen significant pass through to core prices just yet, we expect that the underlying inflationary pressures will remain subdued throughout the coming months.

Industrial Production (December, Friday 9:15 ET)

Forecast: 0.2%

Consensus: 0.0%

Previous: 1.3%

Industrial production jumped significantly in November, marking the strongest monthly increase since May 2010. In December, we expect to see somewhat of an adjustment from this massive gain. Total output will likely increase at a very modest pace for the month, driven by another positive push from manufacturing and utilities. Mining output has declined throughout the past few months and is unlikely to post a significant rebound in December. Overall, industrial production should finish off the year on solid ground, carrying much of that momentum over into 2015 as well.

Consumer Sentiment (January, Friday 9:55 ET)

Forecast: 94.1

Consensus: 94.2

Previous: 93.6

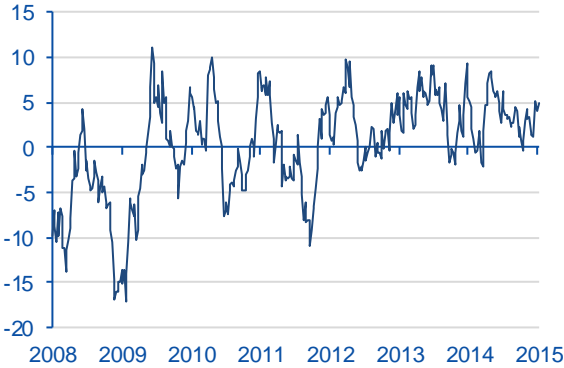
Consumer sentiment is expected to increase in January for the sixth consecutive month as falling gas prices continue to boost purchasing power. The index has been on the rise since August, right when the price of oil began to trend downward. This has certainly helped to lift consumer spirits, particularly during the year-end surge in holiday spending. Short-term expectations improved significantly throughout the second half of 2014 as the job market continued to improve. Given that the index is so sensitive to oil prices, we expect to see positive consumer sentiment throughout the year, in line with our expectations for minimal inflationary pressures.

Market Impact

Market activity is back in the swing of things for the New Year, with the reactions to FOMC minutes and December's employment report under our belts. This week will most likely see a focus on the CPI release to get a better idea of how much oil price declines are impacting inflation and the possible influence this may have over future Fed rate hikes.

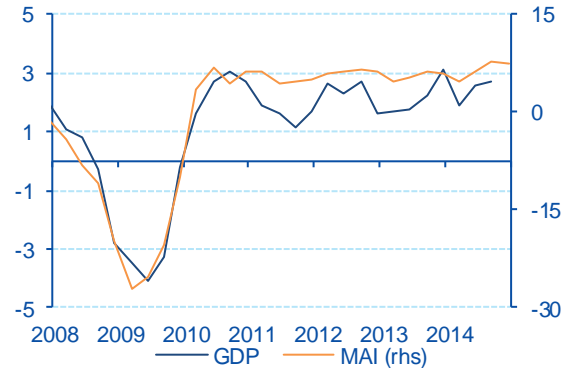
Economic Trends

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



Source: BBVA Research

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



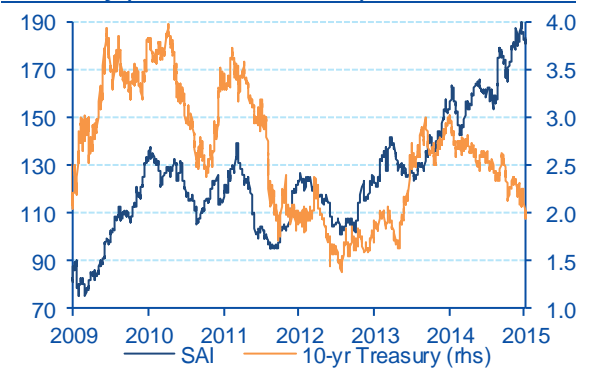
Source: BBVA Research & BEA

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



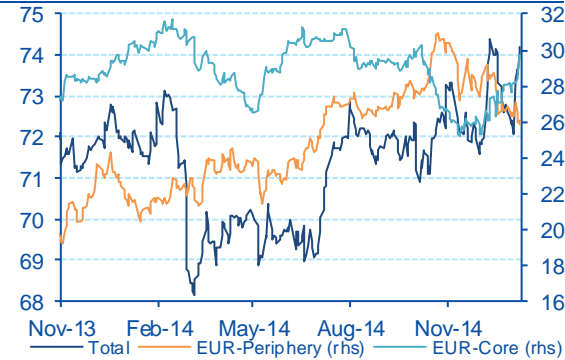
Source: BBVA Research

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



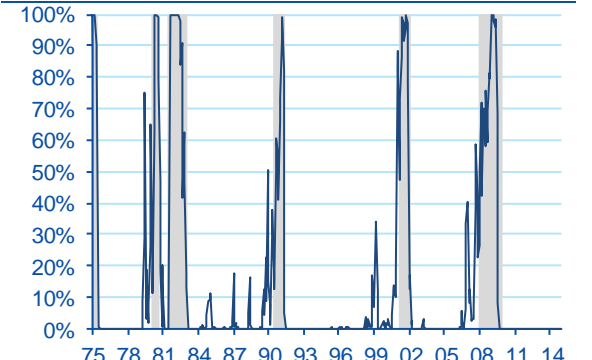
Source: Bloomberg & BBVA Research

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



Source: BBVA Research

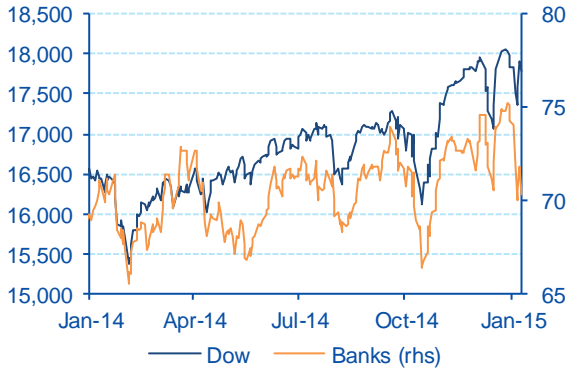
Graph 8
BBVA US Recession Probability Model (Recession episodes in shaded areas, %)



Source: BBVA Research

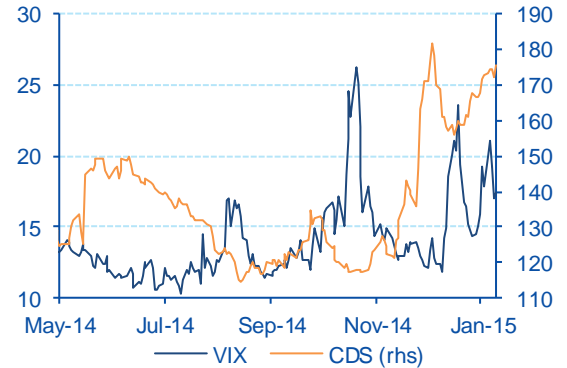
Financial Markets

Graph 9
Stocks
(Index, KBW)



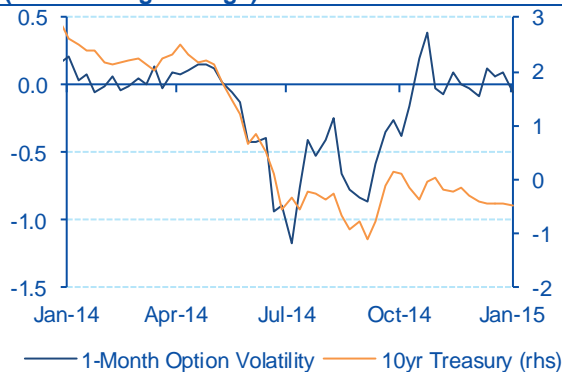
Source: Bloomberg & BBVA Research

Graph 10
Volatility & High-Volatility CDS
(Indices)



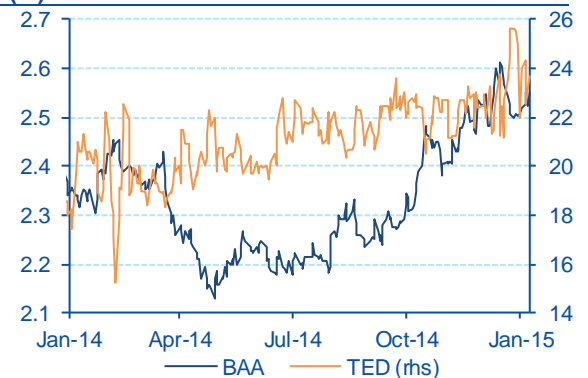
Source: Bloomberg & BBVA Research

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



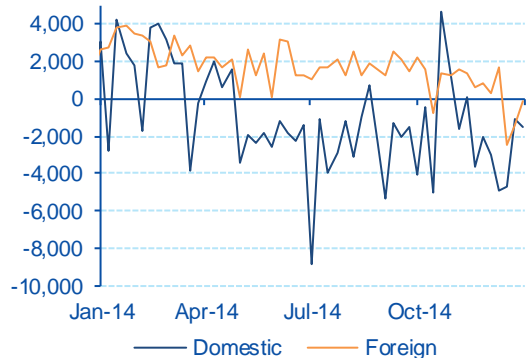
Source: Haver Analytics & BBVA Research

Graph 12
TED & BAA Spreads
(%)



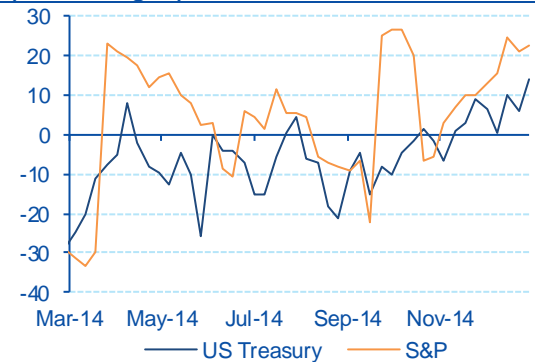
Source: Bloomberg & BBVA Research

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



Source: Haver Analytics & BBVA Research

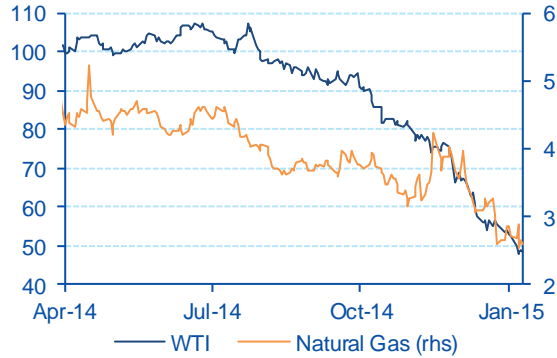
Graph 14
Total Reportable Short & Long Positions
(Short-Long, K)



Source: Haver Analytics & BBVA Research

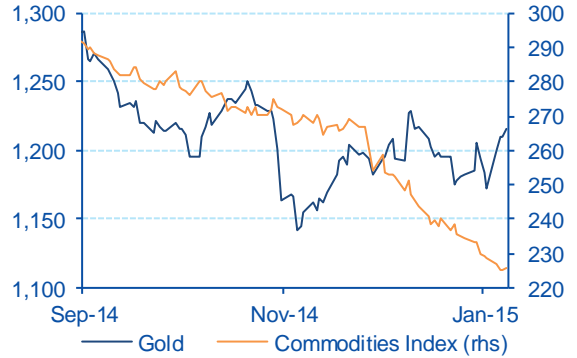
Financial Markets

Graph 15
Commodities
(Dpb & DpMMBtu)



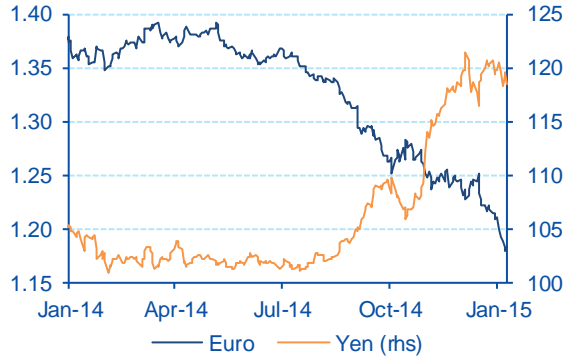
Source: Bloomberg & BBVA Research

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



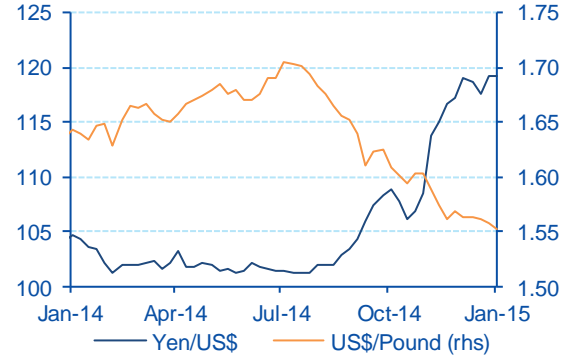
Source: Haver Analytics & BBVA Research

Graph 17
Currencies
(Dpe & Ypd)



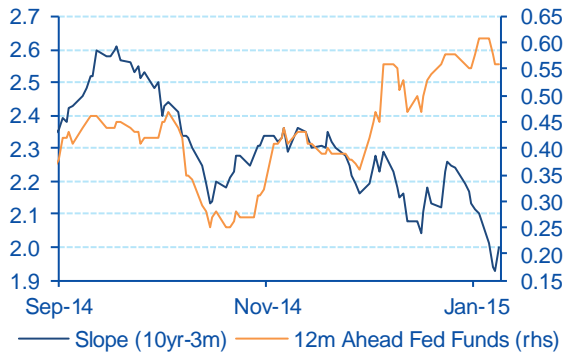
Source: Bloomberg & BBVA Research

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



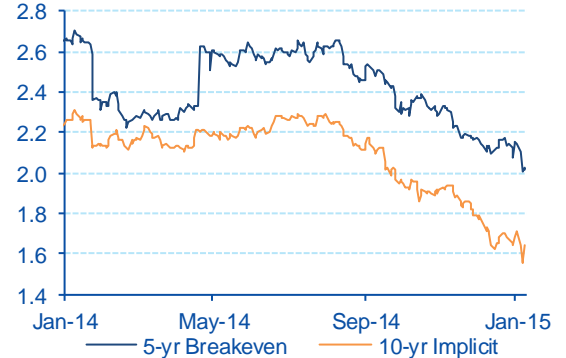
Source: Haver Analytics & BBVA Research

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)	2.61	2.66	2.84	2.45
Heloc Loan 30K	4.95	4.93	4.91	5.30
5/1 ARM *	2.98	3.01	2.98	2.90
15-year Fixed Mortgage *	3.05	3.15	3.20	3.23
30-year Fixed Mortgage *	3.73	3.87	3.93	3.99
Money Market	0.43	0.44	0.43	0.42
2-year CD	0.86	0.88	0.87	0.83

*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	0.12	0.06	0.12	0.07
3M Libor	0.25	0.26	0.23	0.24
6M Libor	0.36	0.36	0.32	0.34
12M Libor	0.63	0.63	0.55	0.57
2yr Sw ap	0.80	0.89	0.78	0.50
5yr Sw ap	1.59	1.73	1.66	1.74
10Yr Sw ap	2.08	2.22	2.21	2.96
30yr Sw ap	2.49	2.64	2.70	3.79
30day CP	0.11	0.12	0.11	0.12
60day CP	0.13	0.11	0.11	0.15
90day CP	0.15	0.13	0.13	0.13

Source: Bloomberg & BBVA Research

Quote of the Week

Jeffrey Lacker, President of the Federal Reserve Bank of Richmond
Economic Outlook, January 2015
9 January 2015

“Granted, we’ve seen short-run growth spurts before during the course of this expansion, only to see the pace of growth subside. But some recent developments that were largely absent during previous spurts have improved the likelihood that the recent pickup in growth will be sustained.”

Economic Calendar

Date	Event	Period	Forecast	Survey	Previous
13-Jan	NFIB Small Business Optimism Index	DEC	98.70	98.50	98.10
13-Jan	US Job Openings By Industry Total SA	NOV	4875.00	4850.00	4834.00
14-Jan	Adjusted Retail & Food Services Sales SA Total Monthly % Change	DEC	0.40	-0.10	0.70
14-Jan	Adjusted Retail Sales Less Autos and Gas Stations SA MoM Percent Change	DEC	0.50	0.50	0.60
14-Jan	US Import Price Index by End Use All MoM NSA	DEC	-2.00	-2.90	-1.50
14-Jan	US Manufacturing & Trade Inventories Total MoM SA	NOV	0.30	0.20	0.20
15-Jan	US Initial Jobless Claims SA	JAN 10	290.00	291.50	294.00
15-Jan	US Continuing Jobless Claims SA	JAN 3	2400.00	2402.00	2452.00
15-Jan	US Empire State Manufacturing Survey General Business Conditions SA	JAN	5.50	5.00	-3.58
15-Jan	US PPI Final Demand MoM SA	DEC	-0.30	-0.40	-0.20
15-Jan	US PPI Final Demand Less Foods and Energy MoM SA	DEC	-0.10	0.10	0.00
15-Jan	Philadelphia Fed Business Outlook Survey Diffusion Index General Conditions	JAN	17.30	19.50	24.30
16-Jan	US CPI Urban Consumers MoM SA	DEC	-0.40	-0.40	-0.26
16-Jan	US CPI Urban Consumers Less Food & Energy MoM SA	DEC	0.00	0.10	0.07
16-Jan	US Industrial Production MoM 2007=100 SA	DEC	0.20	0.00	1.26
16-Jan	US Capacity Utilization % of Total Capacity SA	DEC	80.20	80.00	80.10
16-Jan	US Industrial Production Industry Groups Manufacturing MoM SA	DEC	0.10	0.20	1.10
16-Jan	University of Michigan Consumer Sentiment Index	JAN P	94.10	94.15	93.60

Forecasts (Revisions Pending)

	2011	2012	2013	2014	2015	2016	2017	2018
Real GDP (% SAAR)	1.8	2.8	1.9	2.0	2.5	2.8	2.8	2.9
CPI (YoY %)	3.1	2.1	1.5	1.9	2.0	2.3	2.4	2.4
CPI Core (YoY %)	1.7	2.1	1.8	1.9	2.1	2.3	2.4	2.4
Unemployment Rate (%)	8.9	8.1	7.4	6.2	5.8	5.5	5.0	5.0
Fed Target Rate (eop, %)	0.25	0.25	0.25	0.25	0.50	1.50	2.50	3.25
10Yr Treasury (eop, % Yield)	1.98	1.72	2.90	2.21	3.12	3.67	3.90	3.98
US Dollar/ Euro (eop)	1.31	1.31	1.37	1.23	1.20	1.24	1.28	1.32

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