BBVA | RESEARCH

United States Economic Outlook

First Quarter 2015
U.S. Unit

- The improvement in world growth will continue in 2015, but there will be significant differentiation across regions
- A balancing act in the U.S.: upward revision to 2015 growth alongside a downward shift in inflation expectations
- On the whole, falling oil prices are a net positive for the U.S., although regional pockets remain vulnerable

Index

Closing Date: February 27, 2015

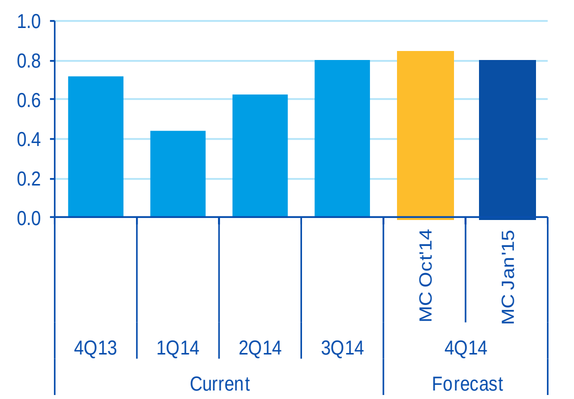
1 Global Outlook

Moderate Global Growth with Increasing Divergence Across Economic Areas

2014 finished better than it began, with the world economy growing by more than 3.0% on the backs of stronger U.S. momentum and the sharp drop in oil prices. According to our estimates, the world economy will close out 2014 with growth near 0.8% QoQ, a similar pace to that in 3Q14[1], and slightly stronger than in the first half of the year. A dynamic economic performance in the U.S. has been offset by a weaker recovery in Japan and the euro area, and the progressive deceleration in China and other emerging economies. The improvement in world growth will continue in 2015 and 2016, exceeding 3.5% on average, but there will also be a significant differentiation between geographies given the asymmetric effects of the fall in commodity prices and the divergence of monetary policies in the developed markets, the two drivers that a priori determine the perspectives for the global economic scenario.

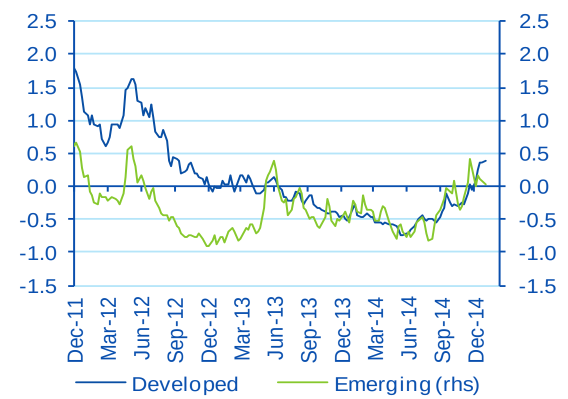
One of the novelties in the global economic scenario in recent months is the very sharp fall in the oil price and its uneven impact on different countries, depending on whether they are net importers or exporters. Overall, we think the global impact of cheaper oil should be positive in terms of growth, inasmuch as the reduced burden on household and corporate income in oil-importing countries (such as the U.S., the euro area, and China) offsets the reduced activity in the principal producer countries. However, lower prices or levels like those at present for Brent, around USD50/bbl, for an extended period could generate geopolitical and/or financial tensions that might compromise global stability.

Figure 1
Global GDP based on BBVA-GAIN, %, QoQ



Source: BBVA Research

Figure 2
BBVA Research Financial Tensions Index



Source: BBVA Research and Bloomberg

In fact, the increased volatility in financial markets, which has now reached the same level as in mid-2013 according to the BBVA Financial Tensions Index, is another of the highlights of the quarter, and one the emerging and developed markets have in common as a consequence of two factors. First, the combination of

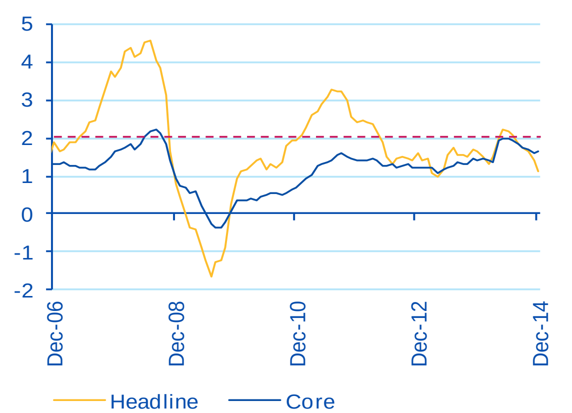
[1] Estimate based on the BBVA Research GAIN indicator; for details of the methodology, see: http://bit.ly/1nl5RIn

the geopolitical crisis between Russia and Ukraine along with the fall in commodity prices has raised doubts on the economic development of many emerging markets. Second, the uncertainty around the Fed's rate-hiking cycle, especially when the ECB is introducing QE measures and there is an increasing political debate on the most appropriate balance of policies to strengthen the region's recovery.

The correction in the oil price also accentuates the risks of a global scenario of too low inflation, at least until the second half of 2015. In addition to the recent general decrease in inflation, common to all the principal geographies (the average for the U.S., the euro area, Japan, and China was 1.0% in 2014), there has been a steep fall in industrial production and import prices. Although the translation of the fall in energy prices to core inflation and salaries appears to be contained thus far, the sharp adjustment in medium-term inflation expectations and the all-time lows in long-term interest rates reveal the degree of uncertainty that exists about the rate of recovery of the global cycle and the capacity of the central banks to restore inflation to levels compatible with their objectives.

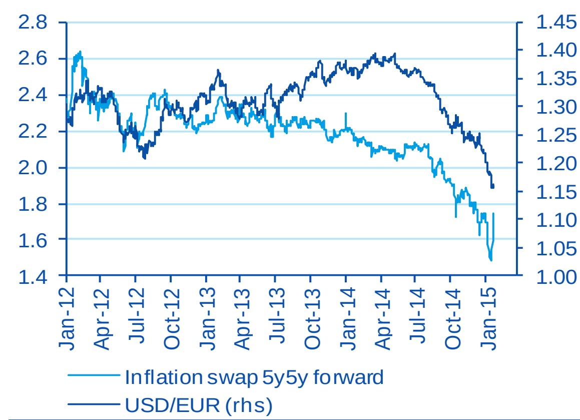
In this context of low inflation and moderate economic growth, monetary policies remain accommodative in tone, although the biases differ (with the Fed and the Bank of England on one side, and the ECB and the PBoC on the other).

Figure 3
Global inflation*, %



* Calculated as the simple average of inflation in the US, the euro area, Japan and China
Source: BBVA Research and Haver Analytics

Figure 4
EURUSD and medium-term eurozone inflation expectations (5Y/5Y fwd inflation swap, %)



Source: BBVA Research and Bloomberg

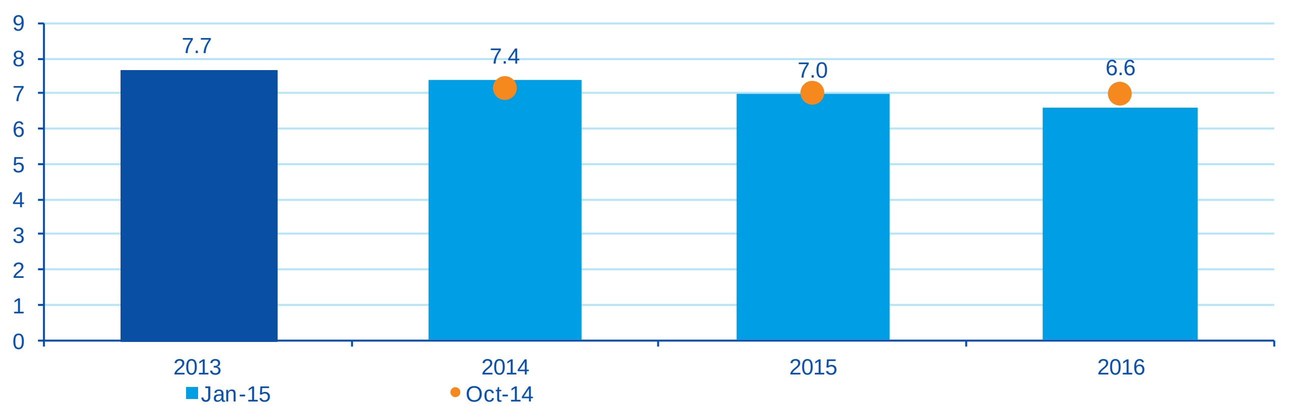
Of the large economic areas, the eurozone is the one which is most likely to have to deal with a scenario of inflation that is too low for too long. In addition to the negative surprises on consumer prices, the area has only a moderate economic growth profile, in line with expectations. Assuming GDP growth reaches around +0.2% in 4Q14, supported by a similar increase in activity in Germany and France and a better relative performance for Spain, our estimate for the eurozone is +0.8% YoY. Altogether, we maintain our forecast for Eurozone growth of 1.3% for 2015, supported by the fall in the price of oil, the accumulated depreciation of the euro in recent months, and the relaxation of monetary conditions thanks to ECB actions. The less restrictive nature of fiscal policy in the peripheral countries is also an element to take into account, as well as the so-called "Juncker Plan", designed to favor investment, and the first fruits of which are expected in the second half of this year.

Some threats arise, including the potential impact of increased tensions in Russia's sphere of influence, both in commercial and (more importantly) financial terms, given the heavy exposure of European banks to those countries. A second risk factor is the uncertainty generated by the divergences between some national authorities and the EU institutions as to the most appropriate supply-side reform, the pace of fiscal consolidation and the support of the ECB to foster growth. Finally, another risk is that medium-term inflation expectations continue to fall, discouraging consumption, and leading to a negative feedback loop.

In the emerging market block, the divergence between industrial activity and services continues. The gradual improvement in private consumption, on the back of the stabilization or increase in employment, has continued to feed through into the figures for retail sales and the confidence indices in the services sector. Meanwhile, the relative improvement in world trade in the first two months of 4Q14 has not yet translated into a substantial increase in industrial production. In general, the emerging markets are seeing the fall in commodity prices in a scenario where there is already a trend towards more moderate growth in China. Altogether, we estimate that global GDP will have grown 3.3% in 2014, 10bp more than in 2013, with a slight increase in the developed markets' contribution vs. the three previous years, and the emerging markets continuing to decelerate.

The slow deceleration in China's activity continued throughout 2014. The flash GDP estimate for 2014 as a whole puts it at 7.4%, which would imply the YoY rate for the fourth quarter at around 7.2%, the slowest since 2009. The macroeconomic dynamics in China are explained by the loss of momentum in fixed capital investment and the deterioration in external competitiveness which was driving the yuan appreciation, together with the correction in the real estate sector.

Figure 5
China, economic growth (% YoY)



Source: BBVA Research

Although we have left our forecast for China's growth in 2015 unchanged at 7.0%, the risks are clearly biased to the downside as a reflection of the magnitude of accumulated financial imbalances, the uncertainty over the evolution of the real estate market, and the uncertainties regarding the capacity for policies to achieve a correction in the present imbalances with economic liberalization underway. The authorities have started to show more tolerance towards economic deceleration, as long as job creation is consistent with the behavior of the active population, while simultaneously betting on a redirection of the growth model towards less dependence on investment. This will allow them to combine an increase in monetary policy laxity with the adoption of fiscal control measures that contain debt, both at the private-sector and public administration levels (in the last decade, non-financial private-sector debt in China increased by 67bp of GDP).

Altogether, the global growth scenario is moderately positive. The world is growing at more than 3.0% but the improvement is slow in the developed markets and the emerging markets have to deal with lower commodity prices and the change in China's growth model. At the same time, the risks are still skewed to the downside. Not only is there uncertainty as to whether the policies introduced will be as effective as expected (for example, in Europe the ECB's asset purchase program and the so-called Juncker Plan to foster investment), but there are also uncertainties regarding the capacity in emerging markets to implement effective counter-cyclical policies. There are also geopolitical risks, particularly if there is a negative feedback loop with oil prices. However, the risks are not only in the conflicts. In the euro area there is growing debate as to which is the most appropriate combination of supply-side reforms, pace of fiscal consolidation and ECB support to favor growth. If we also add to the discussion the payments on already restructured public debt mainly in the hands of other member states (as in the case of Greece), the divergences of opinion turn into disagreements that have to be resolved sooner rather than later. The debate is evidence of the vulnerabilities of a monetary union with neither a political nor a fiscal union, neither of which are going to happen in the short term. In the most probable scenario we expect a negotiated settlement which does not lead to a systemic crisis in the euro area, but if the period of uncertainty is prolonged it could weigh on the pace of recovery in Europe.

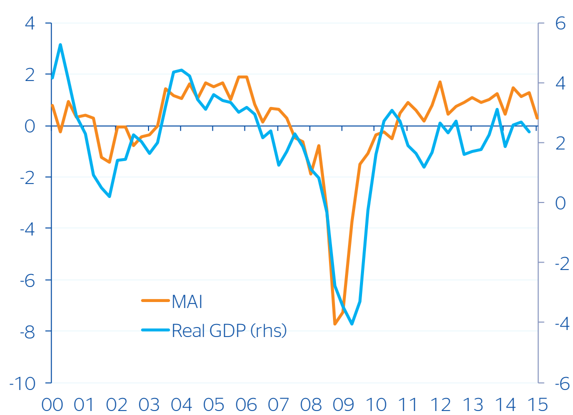
(Note: for a more in-depth analysis of Europe and the emerging markets, see our latest Global Outlook).

2 U.S. Outlook

A Slow Trek Back to "Normal" for the U.S. Economy

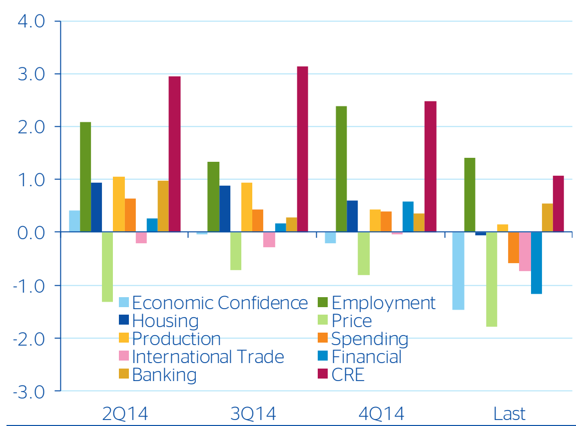
The U.S. economy has kept us all on our toes throughout the past few months. The drastic fall in oil prices remains at the forefront of economic activity, with the potential for a significant boost to growth (via consumption) from lower energy prices. Although there are regional vulnerabilities in oil/gas dependent states like Texas, we expect the net impact to be positive. Real GDP growth in 2015 is expected to accelerate to its strongest rate in a decade, with more evidence of a solid and sustainable expansion. However, strong U.S. growth and lower unemployment conflicts with lower inflation and weaker global prospects, and there is an ongoing balancing act as the Fed tries to determine the appropriate time for the first federal funds rate hike. The recent decline in long term yields has been driven primarily by a rebalancing of global expectations, though various financial market indicators (long-term treasury yields, fed funds futures, commodity prices, etc.) have recovered substantially since hitting low points in January.

Figure 6
BBVA Research USA Monthly Activity Index & Real GDP Growth (4Q % Change)



Source: BEA & BBVA Research

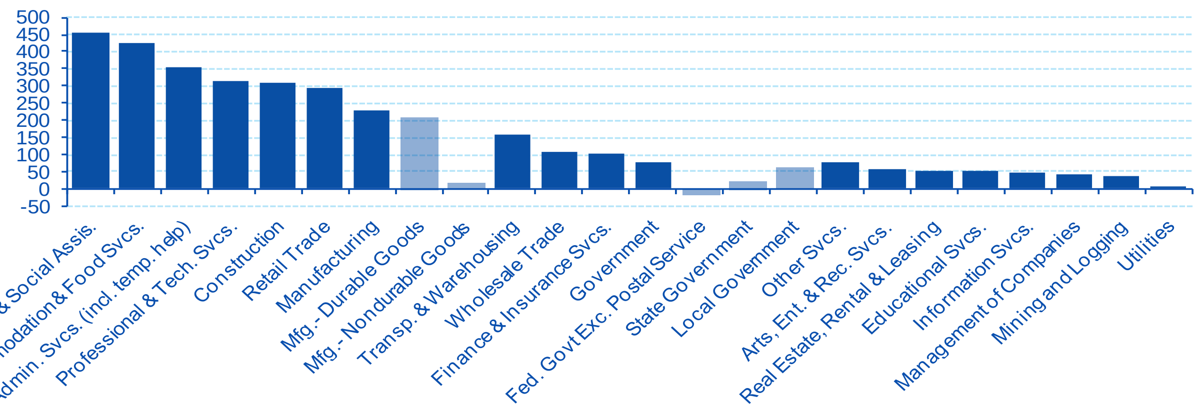
Figure 7
BBVA Research USA Monthly Activity Index Components



Source: BBVA Research

Passing the halfway point in 1Q15, we are seeing the beginning of a slow trek back to "normal" as day-to-day economic data fall more in line with expectations. Despite some hiccups throughout the past few months, we remain optimistic that 2015 will be a standout year for the recovery. Growth has slowed from 3Q14's significant gain, but the underlying trends remain healthy. Employment has been the shining star, with strong job growth across important sectors and faster-than-expected declines in the unemployment rate. In 2014, there were approximately 3.2 million jobs (not seasonally adjusted) created in the U.S., the most since 1999. With monthly payroll growth well-above 200K, we could see the unemployment rate drop below the 5.0% threshold by the end of 2015 or early 2016, especially if labor force participation remains low as expected. Labor market improvements have boosted confidence, and consumption has held up in terms of the contribution to GDP, although the monthly indicators for real retail sales and personal spending have been weaker than expected throughout December and January. Private investment has also picked up, and we have seen a healthy gain for core capital goods orders to start 2015 following a very weak fourth quarter. However, residential investment has been lagging and will likely struggle for some time as scars from the financial crisis and changing demographics continue to influence the housing market.

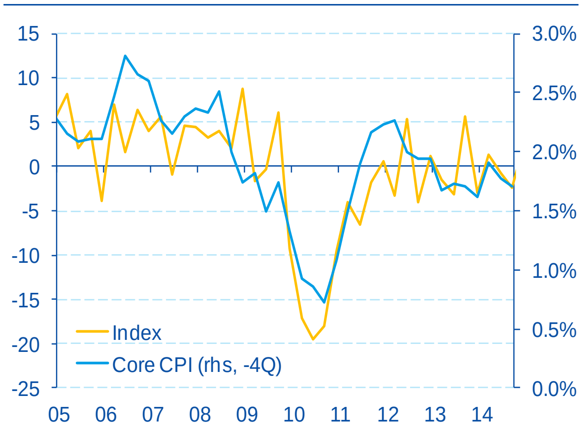
Figure 8
12-Month Nonfarm Payroll Growth (SA, Thousands)



Source: BLS & BBVA Research

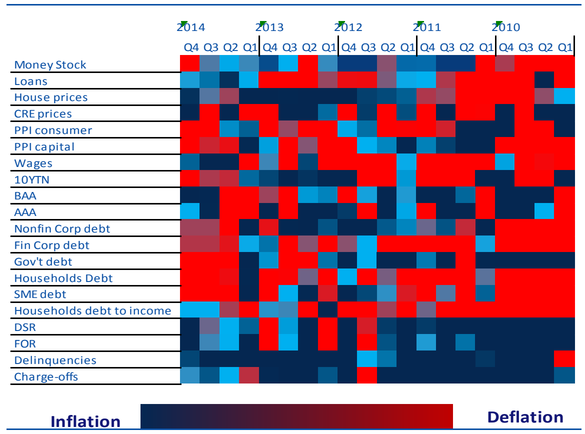
Another important factor impacting growth is international trade, where petroleum prices have influenced the overall balance as of late. Domestic demand is strong, and the favorable price of gasoline lifted petroleum imports nearly 18% at the end of 2014. However, global demand has been slow as economic and geopolitical risks linger. The USD is at its strongest point in 11 years, with the appreciation weighing on exports but boosting imports. Not surprisingly, the nonpetroleum deficit has soared to the largest level of the recovery, right back to where we were before the crisis in 2007. The situation is similar when we consider the nonpetroleum balance as a share of GDP. This highlights the fact that the pre-crisis global imbalances have not disappeared and continue to be a concern. Overall, we expect that demand in the U.S. for imported goods will remain strong throughout 2015, more than offsetting weakness in exports and resulting in limited improvements for the trade deficit.

Figure 9
BBVA Research USA Inflation Risk Index



Source: BBVA Research

Figure 10
BBVA Research USA Inflation Heat Map

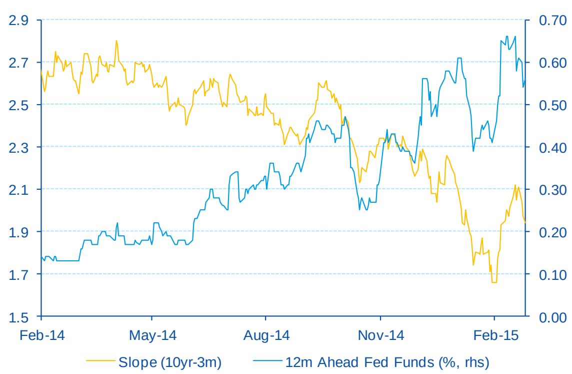


Source: BBVA Research

Inflation is obviously playing a key role as global deflationary concerns continue to rise. Wage growth has been sluggish for far too long, yet recent indicators suggest a stronger push forward for the coming year. While we have seen significant downward pressures from energy prices, the trend is beginning to reverse. January's massive drop in headline inflation is likely to be the last for a while. We have already seen a measurable increase in energy prices throughout February thus far, with Brent crude oil prices up nearly 25% since January 30th. WTI prices have increased a more modest 6% since the end of last month. Natural gas prices have also ticked up more than 11% throughout the past few weeks. All of this suggests a positive adjustment for headline CPI in the coming months, with core inflation expected to remain slow but steady as the pass-through remains limited. Despite our expectations for stronger upward pressures in the coming months, our forecast for average inflation in 2015 remains low. January's YoY inflation rate was much lower than expected, at -0.2% compared to 12 months ago, so we would need to see a significant pickup in 2H15 in order to achieve an annual average near 1.5%. Core inflation is falling right in line with our expectations at 1.6% YoY in January, setting up nicely for an annual average near 1.9% for 2015.

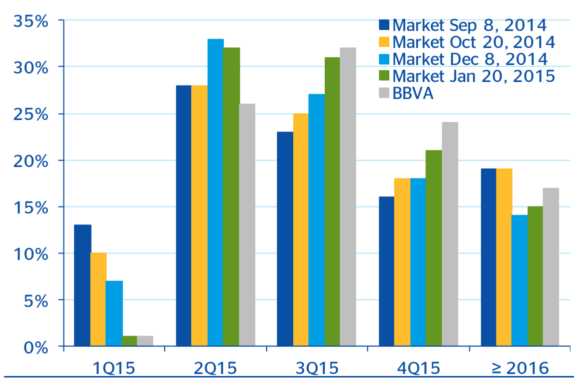
Falling inflation has made it difficult for the Fed to set a clear plan for the first interest rate hike, especially when the counterpart of their dual mandate (employment) has improved significantly over the past year. The Fed continues to stress the importance of data dependent policy, with the hopes that they will be able to implement an effective strategy to communicate the data-dependent path for the federal funds rate in the near future. This process continues to highlight the diverging views within the FOMC, and we expect that discussions will remain intense up until the first rate hike and then dealing with normalization as we move into 2016. Our expectations for a mid-2015 liftoff have not changed, and we will likely see a very gradual pace of interest rate hikes thereafter. See our latest FedWatches for more details (FOMC Minutes and Yellen's Testimony).

Figure 11
Fed Futures & Yield Curve Slope (% and 10YTN-3MTN)



Source: Bloomberg & BBVA Research

Figure 12
Fed Funds Probability of First Rate Increase (%)



Source: FRB & BBVA Research

Overall, we remain mostly optimistic on the U.S. economy in the coming years. The balancing act continues, with an upward revision to 2015 growth alongside a downward shift in inflation expectations. We expect that real GDP growth will reach decade highs over the next few years, reaching 2.9% in 2015 and 2.8% in 2016. Upside surprises like we saw in 3Q14 would allow the Fed to accelerate the pace of rate hikes. On the downside, risks mostly reflect slower global activity and further downward pressure on inflation.

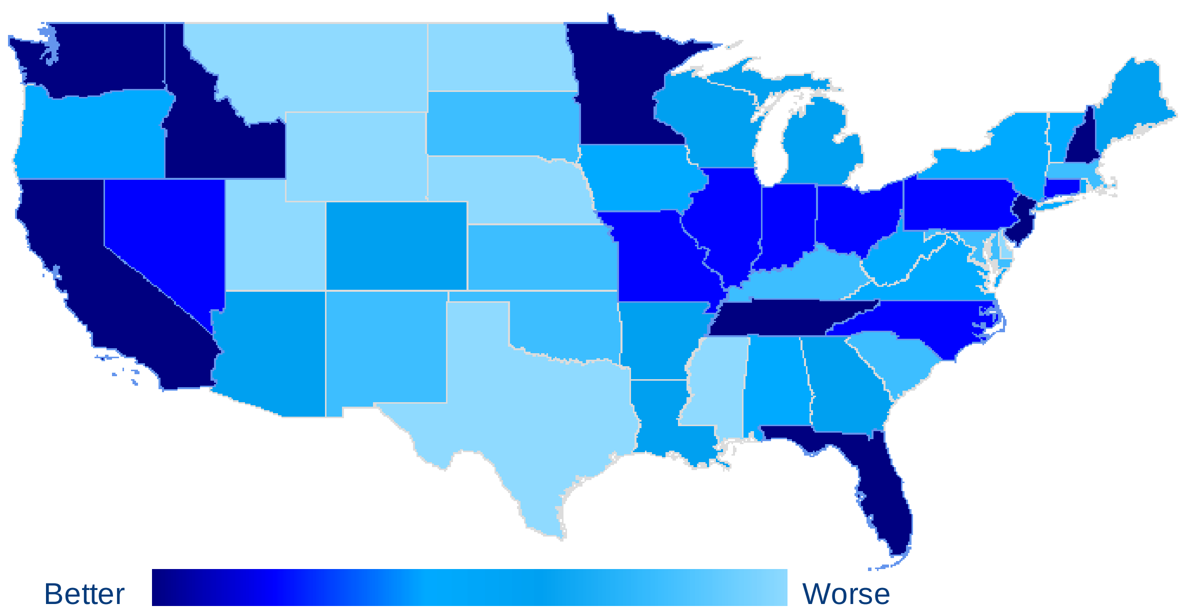
3 Regional Oil Impact

Regional Rebalancing and the Response to Declining Energy Prices

Despite the downside to oil producing states, one of the most likely outcomes of the drop in crude oil prices is a rebalancing among states and regions. The oil-driven recovery in the U.S. left many commodity-poor states lagging behind. Now, these states stand to benefit the most and will likely lead to stronger and more broad-based growth in 2015 and 2016. This creates a unique upside risk for the U.S. economy. In particular, California and Florida, which both experienced a severe downturn and slow recovery from the crisis, are poised to be two of the largest beneficiaries from the price declines. Upside potential for growth could mean an additional 2.0pp of growth in 2015 and 2016–growth for California and Florida throughout the recovery has averaged 1.5% and 0.8%, respectively.

Major oil producing states such as North Dakota, Wyoming, New Mexico, Oklahoma, and Alaska will be negatively impacted by the drop in oil prices as the transfer from the oil & gas industry to consumers will not be large enough to offset the pullback in investment. Downside risks range from a major recession in Wyoming to positive growth in New Mexico, albeit at a below average pace.

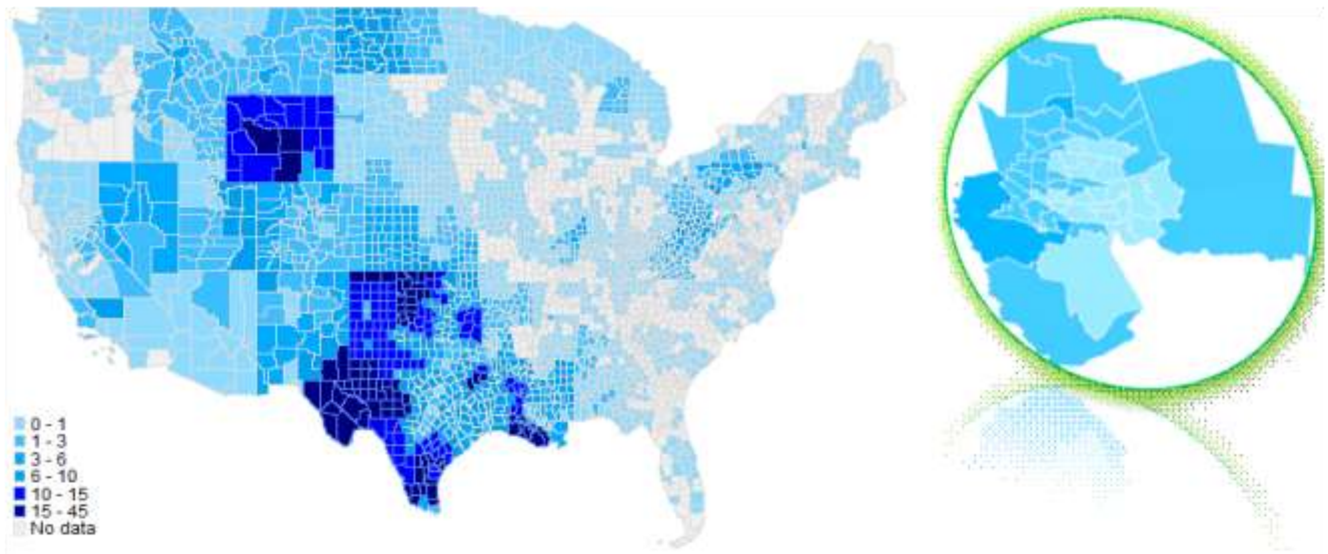
Map 1
Rebalancing Across States- GDP



Source: BBVA Research, Haver Analytics & BLS

The recent memory of the oil price collapse of the 1980's and stagnant prices throughout the following decade left a lasting scar on the Texas economy. These memories, and the growing importance of a non-trivial share of highly productive industries, which benefit from lower prices, underpins our outlook for slower, but nevertheless positive growth in 2015 and 2016. Despite growing economic diversity, Texas and large MSAs such as Houston maintain high concentrations of energy-sector workers. Furthermore, based on a two-stage, activity-based model, we found that a 10% decline in oil prices produces an average decline in mining sector employment of 3.8%, all else equal. As it stands today, with oil prices trending close to $50/barrel and Texas rig counts trending towards crisis lows (from 902 units in November 2014 to 576 units February 2015), our new baseline is for Texas GDP to slow to 1.9% in 2015 and then rise to 3.6% in 2016.

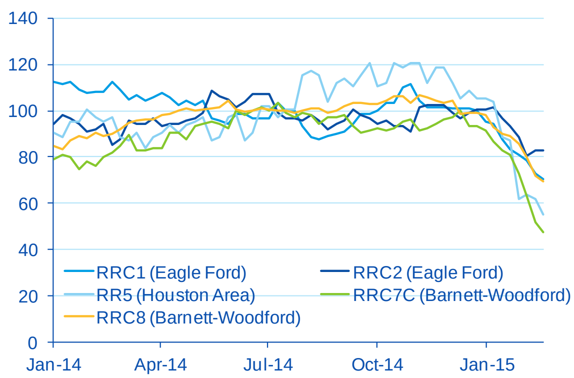
Map 2
Oil & Gas Extraction and Mining Support Services Employment Concentration (location quotient)



*Houston MSA, concentrations shown by Public Use MicoArea (PUMA) in window
Source: BBVA Research & IPUMS

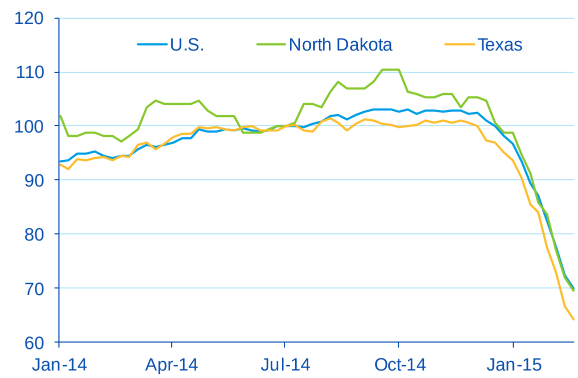
Thus far, indications of slowing activity have been mixed. Rig activity, which is a widely used as a proxy for exploration and production activity, has shown a strong historical relationship - possibly a causal link - to the real economy. The count has started to trend downwards after remaining relatively stable through the price declines in 2014. This drop is in line with historical trends which show activity moving hand-in-hand with oil prices. As a result, as lower oil price expectations were factored into capital plans and exploration and production strategies, rig activity has decline sharply and is now 36% below July's highs. Despite the dramatic drop in drilling or rig activity, production has continued accelerating and Texas is now producing 3.8M barrels/day (1.3M barrels/day in January 2009). The unresponsiveness of production to the drop in rig activity will persist as long firms continue to shut down the least productive rigs and maintain operations in more prolific drilling areas that are already cash-flow positive on a project-basis. The delayed response in activity has also insulated the Texas labor market for the time being, as the pace of job growth unexpectedly picked up for oil & gas extraction and support services in December.

Figure 13
Active Rig Count Texas Rail Road Districts (Index: July 2014=100)



Source: BBVA Research, Baker Hughes & Haver Analytics

Figure 14
Active Rig Count (Index: July 2014=100)



Source: BBVA Research, Baker Hughes & Haver Analytics

Although global demand conditions are improving from 4Q14, the unabating increase in global crude oil supply will likely continue to outweigh more upbeat global economic conditions and keep prices lower in the short-run. Similar to consumers in the U.S., Texas residents will benefit from lower gasoline and energy costs. The boost to the consumer balance sheet acts as a de-facto tax break, boosting household disposable income, particularly for low-income individuals who devote a large share of their income to consumption. However, despite the upside to the consumer, offsets from weaker investment, slower income growth, job losses in the mining sector, uncertainty regarding employment and future income, and the fact that employment in the sector tends to be at the higher end of the high-wage distribution will neutralize this effect and likely lead to higher levels of unemployment and slower housing price appreciation. Specifically, we expect unemployment to trend towards 5.5% in 2015 and 2016, but remain well below recessionary peaks over the stressed period. For housing prices, our baseline was for housing prices to slow in 2015 due to inventory rebuilds, lower affordability, upward pressure on interest rates and difficulties for first-time home-buyers to qualify for mortgages. The added pressures from higher unemployment rates and weaker growth will only add downward pressure to prices in 2015 and 2016, yet in our baseline scenario prices remain positive in the this period.

All said, it is important to note that these forecasts incorporate a more positive global growth environment and do not consider other idiosyncratic shocks from geopolitical uncertainty or lower-than-anticipated growth in Latin America, or a more dramatic slowing in economic activity in China. In addition, market uncertainty over future global production or weaker-than-anticipated growth in Europe and Japan could drive prices lower, as stakeholders vie for market share in an oversupplied and shrinking market. Taken together, these factors would likely destabilize the delicate balance for Texas and point towards recession in 2H15 and 2016.

There are downside risks for energy-dependent industries and states, yet the decline in oil prices is a net positive to the U.S. economy, benefiting consumers and energy-intensive industries. In fact, lower energy prices will lead to a healthy rebalancing process, supporting regions that have lagged during the expansion cycle. This will also benefit consumers who have struggled to mend balance sheets and shed debt amidst tepid labor markets and low wage growth.

4 Economic Forecasts

Table 1

	3Q13	4Q13	1Q14	2Q14	3Q14	4Q14	2011	2012	2013	2014	**2015**	**2016**	**2017**	**2018**
Real GDP (% SAAR)	4.5	3.5	-2.1	4.6	5.0	2.2	1.6	2.3	2.2	2.4	**2.9**	**2.8**	**2.8**	**2.9**
Real GDP (Contribution, pp)														
PCE	1.4	2.5	0.8	1.8	2.2	2.8	1.6	1.3	1.6	1.7	**1.9**	**1.8**	**1.7**	**1.6**
Gross Investment	2.5	0.6	-1.1	2.9	1.2	0.8	0.7	1.3	0.8	1.0	**0.6**	**0.8**	**1.0**	**1.0**
Non Residential	0.7	1.2	0.2	1.2	1.1	0.6	0.9	0.8	0.4	0.8	**0.7**	**0.7**	**0.7**	**0.8**
Residential	0.3	-0.3	-0.2	0.3	0.1	0.1	0.0	0.3	0.3	0.1	**0.2**	**0.3**	**0.2**	**0.2**
Exports	0.7	1.3	-1.3	1.4	0.6	0.4	0.9	0.4	0.4	0.4	**0.5**	**0.5**	**0.6**	**0.6**
Imports	-0.1	-0.2	-0.4	-1.8	0.2	-1.6	-0.9	-0.4	-0.2	-0.6	**0.3**	**-0.1**	**-0.2**	**-0.3**
Government	0.0	-0.7	-0.2	0.3	0.8	-0.3	-0.7	-0.3	-0.4	0.0	**0.1**	**0.0**	**-0.1**	**0.0**
Unemployment Rate (%, average)	7.2	7.0	6.6	6.2	6.1	5.7	8.9	8.1	7.4	6.2	**5.3**	**4.9**	**4.6**	**4.5**
Average Monthly Nonfarm Payroll (K)	190	217	193	284	237	324	173	188	199	260	**229**	**234**	**252**	**256**
CPI (YoY %)	1.5	1.2	1.4	2.1	1.8	1.2	3.1	2.1	1.5	1.6	**1.5**	**2.1**	**2.2**	**2.3**
Core CPI (YoY %)	1.7	1.7	1.6	1.9	1.8	1.7	1.7	2.1	1.8	1.7	**1.9**	**2.1**	**2.2**	**2.3**
Fiscal Balance (% GDP)	-	-	-	-	-	-	-8.7	-6.8	-4.1	**-2.9**	**-2.7**	**-2.6**	**-2.6**	**-2.7**
Current Account (bop, % GDP)	-2.4	-2.0	-2.6	-	-	-	-3.0	-2.8	-2.4	**-2.5**	**-2.9**	**-2.9**	**-2.5**	**-2.3**
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**	**3.25**
S&P Case-Shiller Index (YoY %)	11.50	11.73	11.24	7.92	5.63	5.05	-3.83	3.90	11.09	7.40	**6.10**	**5.70**	**4.38**	**3.25**
10-Yr Treasury (% Yield, eop)	2.81	2.90	2.72	2.60	2.53	2.21	1.98	1.72	2.90	2.21	**2.60**	**3.11**	**3.54**	**3.90**
U.S. Dollar / Euro (eop)	1.34	1.37	1.38	1.36	1.29	1.23	1.32	1.31	1.37	1.23	**1.15**	**1.20**	**1.28**	**1.32**
Brent Oil Prices (dpb, average)	110.3	109.3	108.2	109.7	102.0	76.3	111.3	111.7	108.7	99.0	**60.0**	**90.8**	**99.5**	**100.5**

Source: BBVA Research & Haver Analytics

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